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NAFCU

March 8, 2010

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

RE: NCUA Proposed Rule on Part 704, Corporate Credit Unions

Dear Ms. Rupp:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I am providing you comments on the National Credit Union Administration's (NCUA) proposed revisions to its rules on corporate credit unions.

The future of the corporate credit union system is at a critical juncture. Accordingly, the path that the agency chooses to take will have long-term impact not only for corporate credit unions, but our industry as a whole. While fully recognizing that under the parameters set forth in the rule, natural person credit union member owners will ultimately determine the nature and extent of corporate credit unions, our comments are based on the premise that the corporate system should continue to provide, at a minimum, a central depository for payment systems functions.

Of particular note, since the rule's promulgation, the agency has publicly intimated that it is its intention to segregate the "legacy" assets within the corporate credit unions' balance sheets. However, NCUA's proposed rule does not address what mechanism will be implemented to accomplish this objective. Credit unions clearly have concerns regarding their potential reinvestment in corporate credit unions if there is a chance that their capital will be further depleted by legacy assets. Other credit unions that are not planning to invest in the corporate system in the future are concerned that losses from legacy assets would be transferred to the share insurance fund. Regardless of one's perspective, the issue as to how future losses will ultimately be paid has not been addressed by the agency. Further, when NCUA's new rule regarding corporate credit unions goes into effect, the resulting structure must pose the least risk to the share insurance fund and credit unions must see clear evidence of this loss mitigation. As NCUA moves forward to implement a plan to segregate legacy assets, and implements its rule, we would welcome the opportunity to comment on how these plans dovetail to create a comprehensive solution to move our industry into the future. The eventual exit strategy for the deposit and borrowing guarantees is also a vital issue and accordingly, NAFCU respectfully suggests that the corporate rulemaking be considered in the broader context of the multitude of critical issues and consequent alternative courses of actions that the agency may need to take as its actions with respect to the corporates continues to unfold.

Capital Requirements

NAFCU commends the NCUA for tackling the important issues surrounding capital requirements. We agree with the proposed prompt corrective action (PCA) like approach. Moreover, we believe that providing corporates adequate time to meet these requirements is important.

There are two aspects of the proposed rules on capital, however, that we would like NCUA to re-consider: the proposed changes regarding minimum term of certificates and the proposed elimination of requiring membership for obtaining services.

In regard to requiring a minimum term of five years on term certificates relative to the non-perpetual contributed capital accounts (NCA), or five-year notice of withdrawal for those instruments with no maturity, NAFCU understands that the proposed five-year term would conform the capital rules on corporates to Tier 2 capital requirements under the Basel Accords and the regulations adopted by other federal regulators. While our members are split regarding the term limit and withdrawal notice requirement, NAFCU recommends that NCUA clarify in the proposed definition of NCA that it is the original term that is determinative in the maturity of the certificate. This can be done by simply adding “original” before “minimum term of certificates” in the proposed definition of NCA. On the withdrawal notice of five years for instruments with no maturity, we recommend that the withdrawal notice be reduced to three years if the funds contributed have been in the NCA accounts of the member credit union for at least two years.

Second, NAFCU asks the NCUA to carefully consider whether the proposed elimination of the prohibition of requiring membership achieves a fair corporate system. The prohibition serves to protect natural person credit unions (NPCUs) in all degrees of sophistication from having more capital at risk. While other parts of the proposed rule should serve to prevent a recurrence of the events leading up to the present crisis in the corporates, this requirement will not prevent a future crisis that is caused by products, securities, investment techniques and technology, or an event that the NCUA or the industry cannot foresee. Given that the payment services function will remain with the corporates in one capacity or another, corporates will remain an important partner for NPCUs, especially smaller credit unions. However, granting corporates the ability to condition payment services or other services on membership could force only those

NPCUs who have no other alternative to seek those services from other sources to place more capital at risk and out of their control.

In addition, the proposed rule would allow the agency to change a corporate's "PCA" rating for reasons other than the corporate's capital ratio. NAFCU requests that the agency provide clear examiner guidance as to how examiners will use this discretionary tool.

Investment Authority

Under the proposed rule, corporates' investment authority would change significantly. Corporates would be prohibited from making investments in collateralized debt obligations (CDO) and net interest margin securities (NIMS). The proposed rule would also retain major portions of corporates' current expanded investment authorities; and additional controls would also be instituted. One example is that for authority to invest in lower Nationally Recognized Statistical Rating Organization **(**NRSRO) ratings (as low as A-), a leverage ratio of 6 percent and total minimum capital ratio of 6 percent would be required. One category of expanded investment authorities, which currently allows investments in securities rated BBB or the equivalent, would be eliminated. Also, authority relative to derivatives would be limited so that it would be allowed only to mitigate interest rate and credit risk or to create structure products equivalent to what a corporate could purchase directly.

NAFCU generally believes that NCUA's proposed limitation on corporates' investment authority is appropriate and balanced. We offer the specific comments below.

Prohibition from Investing in CDOs and NIMS

First, we agree with the proposed prohibition of investing in CDOs and NIMS, as these instruments have proven to spread risk and uncertainty. CDOs, probably more than any other asset backed securities, pass credit risk from the asset originators to the investor, and often the investor either has inadequate information to measure and understand the risk or is simply unqualified or under-qualified to make the investment decisions. In the credit union industry, corporates have often been relied upon by their member credit unions to make difficult investment decisions. These decisions have been shown to have significant potential implications on the NCUSIF and the credit union movement altogether. NAFCU agrees that the credit risks involved with CDOs and NIMS should be curtailed.

Expanded Authorities

NAFCU also generally agrees with the NCUA's approach to continue to allow qualifying corporates to obtain expanded investment authorities while also instituting controls on the authorities. Under the proposed rule, corporates must have more capital than currently required to pursue certain investments and the aggregate amount purchased under expanded authority would be limited. We agree with both of these proposed measures.

However, we do not believe the agency should continue to allow corporates, as part of their comprehensive due diligence, to rely on any and all NRSRO ratings to determine the risk associated with particular securities, whether under expanded authority or otherwise. As NCUA is aware, some NRSROs use the "issuer-based model," under which the credit rating agency (CRA) is compensated by firms who are selling the particular securities being rated. We believe, whether in the near or distant future, the inherent conflict of interest caused by the compensation arrangement between securities issuers and these NRSROs can easily lead to unwarranted risk exposure to the corporate that relies on the ratings and consequently to the member credit unions and even the NCUSIF.

Accordingly, we recommend that the agency require that corporates use only those NRSROs that use the subscription models and have been given the NRSRO designation by the Securities & Exchange Commission (SEC), when they are available. Unlike the issuer-based model NRSROs, the inherent conflict of interest does not exist for these NRSROs. While we recognize that those NRSROs that use the subscription models have not historically been as reputable, we emphasize that the NRSRO designation by the SEC should provide adequate quality and regulatory controls on the subscription-based NRSROs.

Concentration Limits

The rule would establish explicit concentration limits by investment sector. A number of sectors would be subject to more stringent concentration limits of the lower of 500% of capital or 25% of assets because of the risk associated with them. These include: residential mortgage-backed securities; commercial mortgage-backed securities; private student loan asset-backed securities; auto loan/lease asset-backed securities; credit card asset-backed securities; and other asset-backed securities. Others would be subject to less stringent concentration limits of 1000% of capital or 50% of assets. These include: Federal Family Education Loan Program (FFELP) student loan asset-backed securities; corporate debt obligations; municipal securities; and registered investment companies.

NAFCU generally supports limiting concentration of risk as a part of the overall regulatory scheme to impose more controls on corporates while at the same time maintaining a dynamic corporate system that has parameters on investment authorities. As is widely acknowledged, a major reason for the demise of many corporates' financial condition was a concentration of investments in one or few kinds of securities, in particular, mortgage and asset backed securities. Thus, it is appropriate that the agency addresses this issue in its revised regulations, and NAFCU agrees with the general approach of limiting concentration by sector.

We do, however, urge the agency to make two changes to this aspect of the proposed rule: impose sub-limits on corporate debt obligations; and re-categorize investment in registered investment companies to the more stringent category.

In regard to corporate debt obligations, NAFCU recognizes that it is important to provide corporates with investment flexibility. Still, we believe the category "corporate debt obligations" is too broad in that it appears to encompass high-yielding and more risky debt obligations (i.e., lower-rated investments). Additionally, as proposed, it appears that a corporate would technically be able to concentrate a significant portion of its investments in one or a few industries.

To address these concerns, we recommend that the agency incorporate concentration limits according to corporate debt obligations held in a particular industry. Thus, for example, only a percentage (i.e., 20%) of the corporate debt obligations held by a corporate would be in the real estate industry. Further, we believe that the final rule should address the quality of the debt obligations, e.g., investment ratings. Absent this clarification, we are concerned that unnecessarily risky investments could take place.

NAFCU also believes that investment in registered investment companies should be more limited than as proposed. NAFCU understands that the legal and regulatory requirements on registered investment companies, including those requirements imposed by the Investment Company Act of 1940 and the implementing regulations, plausibly provide safeguards. However, we are not convinced that investment in such companies can be stated to be comparably as safe as government-backed securities, with which investment companies are grouped in the proposal.

Asset and Liability Management

The proposed rule would maintain the current requirement that a corporate have a written asset and liability management policy and that the corporate have an ALM committee that submits ALM reports on at least a monthly basis. In addition, it would limit the weighted life average of assets to two years, require testing of the assets at least once a month and report noncompliance to the NCUA immediately. The calculation must assume that issuer options will not be exercised. It would also limit investments from a single member or other entity to 10 percent of the corporate's daily average net assets. Further, it would impose a number of modeling and stress testing requirements, including required average life (AL) mismatch NEV modeling in addition to the existing IRR NEV modeling.

NAFCU generally supports periodic modeling and stress-testing requirements. Further, we support the limitation on investments from a single member or other entity.

However, the proposed broad two-year average life of assets limitation should be removed. On the one hand, it poses potentially unrealistic limitations on corporates; on the other hand, it could potentially have the unintended consequence of allowing an investment portfolio made up of predominately high-risk and low-risk securities with limited representation of those securities with moderate risk rating. To address these extreme scenarios, we recommend that average life of assets be restricted according to asset types.

Also, in conjunction with the proposed change to instituting a weighted average life of assets limitation according to assets, or as an alternative to the proposed imposition of weighted average life of assets, we recommend the NCUA consider instituting a management tool that focuses on price sensitivity. An option adjusted duration measure will assist corporates in managing interest rate risk and will identify when corporates amass significant option risk.

Corporate Governance

NCUA's proposed rule imposes changes to the governance of corporate credit unions. NAFCU believes that corporate governance issues are best left to be decided by the member-owners of corporate credit unions. However, as a baseline, NAFCU does believe that corporate boards should be made up of member credit unions. The requirement would reinforce the fact that corporates, like natural person credit unions, are owned by their members.

Should NCUA move forward to regulate corporate governance, we oppose the proposed limitation that boards be made up of CEOs, CFOs or COOs. NAFCU agrees with the agency's presupposition that such individuals in general are qualified and able to be effective directors. However, we believe there are others who can also be effective and should not be excluded. One such group is directors of natural person credit unions. As NCUA is aware, credit union boards are composed of individuals with expertise in finance, law, management or other fields that can easily translate to and be useful for a corporate.

With regard to the prohibition that the chair of a corporate board should not serve as an officer, director or employee on a credit union trade association, we request that this prohibition be extended to serving in any capacity on the corporate board. While we recognize that this would exclude talented individuals, we believe consideration of the potential conflict of interest outweighs any concerns of excluding such individuals.

The proposed rule would also require corporates to prepare and maintain annual disclosures of the compensation paid to senior executive officers and directors. Compensation would encompass all benefits and the disclosure must ascribe a dollar value to each component of compensation. Members may make a written request for any of the disclosures for the prior three years and the requested disclosures must be provided within 5 days at no cost to the member. In cases of mergers, material increases (15% or $10,000, whichever is greater) in compensation would have to be disclosed. Merger plans submitted to NCUA must describe the compensation arrangement.

The issue of disclosure of executive compensation is sensitive for those whose salary is disclosed. In that light, NAFCU urges the agency to require that the member receiving the information agree not to disclose the information outside of the credit union. While we support member credit unions' ability to access the compensation information for proper purpose, we believe that this interest should be balanced with the privacy concerns of individual senior managers and directors.

In addition, the proposed rule creates limitations on golden parachutes and indemnification. With limited exceptions, golden parachute payments would be prohibited at troubled, undercapitalized or insolvent corporates. All corporates would be prohibited from paying or reimbursing institution-affiliated parties' legal and other professional expenses incurred in administrative or civil proceedings instituted by NCUA or the appropriate state regulatory authority. NAFCU supports the proposed limitations.

Access to Financial Records

In the preamble of the proposed rule, the agency indicates that it intends to revise corporate credit union reporting requirements on the 5310 so that there is a more clear and comprehensive view of the corporates' financial condition. NCUA anticipates that the changes will include: (1) credit ratings and sector concentrations by book and market value; (2) average lives and durations, spread and effective, of a corporate credit union's assets and liabilities; and (3) additional disclosure on pricing sources and pricing level.

NAFCU would support the changes described above to the 5310 Call Reports. We also support these reports being promptly posted to the NCUA website.

NAFCU also believes the NCUA should make additional changes relative to transparency of corporate financial records. Specifically, we strongly urge the NCUA to make changes to its current regulations on access to corporate records by member credit unions as well as others that hold investments with the corporate credit union. We believe that any one member or investor should be able to have access to financially related records. The current requirement that a group of member credit unions request such records unnecessarily serves to hinder the ability of credit unions with a financial stake to conduct adequate research and investigation as they see fit.

Conclusion

Inevitably, should NCUA promulgate a final rule that is substantially similar to the proposed rule, some corporate credit unions will not survive. At that point, decisions as to whether to conserve more corporate credit unions, liquidate corporate credit unions or merge corporate credit unions will affect how the credit union industry further pays for losses from unprofitable investments. We believe that these decisions are just as important as or more important than the current rulemaking in stabilizing the industry. We look forward to working with NCUA in the months and years to come as credit unions move forward to continue to provide sound financial services to their members.

Should you have any questions or would like to discuss these issues further, please contact Carrie Hunt, NAFCU's Director of Regulatory Affairs, by telephone at (703) 842-2234 or by e-mail at chunt@nafcu.org or me by telephone at (703) 842-2215 or my e-mail at fbecker@nafcu.org.

Sincerely,

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President and CEO