Constitution® CORPORATE

March 8, 2010

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Proposed Corporate Rule Comments

Dear Ms. Rupp:

Thank you for the opportunity to respond to the proposed rule for corporate credit unions. Constitution Corporate Federal Credit Union (Constitution) agrees that revisions to Part 704 of NCUA's Rules and Regulations are necessary. The credit union industry was built on a cooperative framework; in good times and in bad, we are all in this together. The regulator, corporate credit unions, and natural person credit unions (NPCUs) need to continue to work together to strengthen credit unions. Constitution Corporate and industry participants are striving to create solutions and innovate in order to build a better credit union system.

As we are all keenly aware, the United States has experienced the worst economic downturn since the Great Depression. The country's economy is still hampered by continuing high unemployment, limited business and consumer spending, and continued weakness in the housing markets. Market participants will take what they have learned over the last two years and apply that knowledge in future decision making. Sweeping changes to corporate regulation are being proposed as the credit union industry struggles with billions of dollars of economic losses arising from corporate credit union investments that met regulatory and individual corporate credit union policies and requirements.

The NCUA is commended for its efforts to draft amendments to part 704 that are intended to strengthen individual corporates and the corporate credit union system as a whole. Agency forbearance and uninterrupted support for corporate operations and services to the credit union industry during these unprecedented times is greatly appreciated. We are concerned, however, that the proposed rule may have a number of unintended consequences that add up to less flexibility and income for NPCUs and their members precisely at the time when they struggle with significant earnings pressures from the economic downturn unrelated to corporate credit union difficulties. If the proposed rule is adopted unchanged, the challenge of recapitalization in light of a diminished value proposition should not be underestimated.

Each corporate is, to an extent, unique; their investment, product, and service offerings have evolved to meet the needs of their members. Corporate credit unions exist solely based on their member-owner credit unions' support. The newly proposed tests and limits will not impact each corporate in the same way. In this context, Constitution Corporate asks that NCUA take the requisite time to fully assess all feedback and work cooperatively with corporates and credit unions to craft an effective new corporate rule that will treat all stakeholders equitably while providing corporate credit unions a viable and sufficiently flexible operating model so that corporate credit unions can continue to effectively serve the varied needs of their member-owner credit unions.

Constitution's response to the proposed corporate regulation makes the following key points:

- As proposed in the rule, the risk-based capital ratios must be met within 12 months of the final published rule. Other capital requirements are phased in over three-year and longer periods. We respectfully submit that these timeframes are too aggressive, especially in light of current distressed conditions, and propose a five- to seven-year timeframe with appropriate milestone requirements similar to those proposed in terms of retained earnings accumulation.
- The Agency has rightly acknowledged that shielding new capital investments from immediate loss from "legacy assets" on corporates' books is required before recapitalization under virtually any set of circumstances. Constitution commends the Agency for prioritizing development of a proposed solution to this issue. Given its importance, it is recommended that proposed changes to the rule be resubmitted for review and public comment once an approach to this critical issue has been developed.
- In the interest of fairness, providing credit unions with the right to recovery of contributed capital should be permitted if the impaired losses taken for accounting purposes are not fully realized. This could also assist in recapitalization issues.
- Constitution is concerned that the additional investment and ALM restrictions in the proposed rule are such that the earnings from the resulting operating model would be insufficient to meet the revised capital and earnings retention provisions proposed. The proposal includes in its discussion and analysis section a sample balance sheet and other analysis intended to illustrate how a corporate credit union could structure itself to meet all the proposed rules. Constitution details its concerns as to several important shortcomings in the analysis.
- The proposed regulation's 10% limit on the amount that a corporate credit union can receive or borrow from any one entity would unnecessarily restrict Constitution from having full access to all available investment opportunities as well as external liquidity sources. The provision appears to discriminate against smaller corporates with strong, well-managed relationships with large key members or partners. It does not appear to have extensive support and is considered arbitrary. Reconsideration of this limitation or a higher limit is recommended.
- Constitution Corporate has been blessed with diligent and supportive volunteers who have faithfully served its membership. A six-year hard limitation on length of service would mandate that each current volunteer serving on the board be deemed ineligible to stand for reelection at the expiration of their current terms. We suggest changing the term limit to a longer period of nine years or simply including in regulation the requirement that the corporate adopt an appropriate term limitation standard with some form of grandfathering in recognition of possible transition concerns.
- It is also suggested the Agency revisit proposed limitations on corporate CUSOs and consider grandfathering those currently serving NPCUs.

Further detailed comments and recommendations are included in the attachment to this letter as to rule assumptions, capital requirements and timing of recapitalization, credit risk/investment limits, and asset liability management measures. Based on proposed investment, ALM, and capital requirements, it appears that a viable corporate credit union operating model may not be available to support recapitalization by NPCUs. Corporate credit unions are long-term valued and trusted partners with their member-owner NPCUs, and the regulatory changes need to be tempered in terms of aggressive timing and scope of changes proposed.

Sincerely,

Robert T. Nealon
President/CEO

William F. White
Executive Vice President

Attachment

cc: Board of Directors, Constitution Corporate Federal Credit Union
Supervisory Committee, Constitution Corporate Federal Credit Union
Mr. Scott Hunt, Director, OCCU, NCUA
Mr. Daniel J. Buckley, Corporate Field Supervisor, OCCU, NCUA
Mr. Charles S. Whorton, Jr., Capital Markets Specialist, OCCU, NCUA

Section 704.3 Capital Requirements

Using the Basel I format to set the new capital requirements is reasonable and will put financial institutions on an even playing field with respect to the level and calculation of capital. The NCUA's phase-in of the new capital requirements appear to be too optimistic given the current investment environment and corporates' balance sheets. In addition, the proposed rule allows corporates to decide whether natural person credit unions (NPCUs) must capitalize a corporate to become a member and receive services.

The proposed rule states clearly that perpetual contributed capital and non-perpetual contributed capital be available to cover losses beyond retained earnings, and in addition, once capital is depleted, it may not be restored or replenished. This issue is central to corporate network support from NPCUs. NPCUs must be allowed to share in any recovery of estimated losses recorded that do not materialize as projected. If depletion of capital accounts remains in the final version of the rule, the rule should provide for the replenishment of member capital accounts if losses do not materialize. This provision would be within the spirit of being cooperatively owned.

Alternatively, the rule should allow corporates to carry an undivided earnings deficit as a component of equity until the actual losses incurred exceed retained earnings. Constitution believes the requirement to deplete capital if an undivided earnings deficit occurs, without being able to recover the depleted amount when undivided earnings return to a positive balance, will be a disincentive for NPCUs to invest in corporate capital instruments.

The proposal emphasizes the retained earnings portion of capital. Specifically, the proposed rule requires that a certain percentage of capital come from retained earnings. However, throughout the proposed rule, the NCUA discourages a corporate from growing its balance sheet to earn its way to capital compliance. The proposal encourages corporate credit unions to shrink their balance sheets while not recognizing that off balance sheet alternatives to increasing retained earnings are much more limited than the alternative.

For some corporates, a strategy to reduce their balance sheets will be tied to the proposed limit on the amount of deposits that can be taken from any one entity. Under the proposed regulation, a corporate has 30 months to comply with the limit on business generated from individual credit unions. Since the amount of capital required for the corporate is tied to the size of the balance sheet in the proposal, corporates should be allowed time to shrink the balance sheet before being required to meet the proposed capital ratios.

A corporate that intends to reduce its balance sheet over the next 30 months to meet the limit on business from individual credit unions will require less capital in the future than it would today. Therefore, a more reasonable time frame for capital implementation would be five years rather than three years to allow corporates to shrink their balance sheets to a sustainable level. Once a smaller balance sheet is achieved, the corporate can calculate the capital needed to support the organization. Should a corporate successfully solicit capital prior to reducing its balance sheet, it could result in more capital than is needed for well capitalized status once the balance sheet reduction is complete. Under the proposed regulation, a corporate cannot return this capital without permission from NCUA.

Appendix C explains how a corporate credit union must compute its risk-weighted assets for purposes of determining its capital ratios. In discussions with NCUA staff involved with drafting the proposed regulation, it was noted that not all the information necessary to compute the risk-weighted asset figure was provided in the proposed rule. During the same discussions, it was conveyed that corporates could use their discretion in choosing the risk-weighting or ratings-based approach on an investment basis in calculating the risk-weighted asset figure. Constitution requests that all information required to calculate newly proposed standards, including the capital ratios, be made available prior to publishing the final rule and that discretion permitted as to calculation methodology also be clearly stated in the final rule.

Results: Projected Capital Positions

Under four recapitalization scenarios, NCUA projects how many corporates will meet the proposed capital requirements. Three of the four scenarios outlined in the proposed regulation on pages 102-103 assume NPCUs will voluntarily recapitalize the corporate system at historical rates, while one scenario assumes NPCUs would limit capital investments in the corporate system to 50% of historical rates. Based on these optimistic assumptions, just five to seven corporates would achieve adequate capitalization by year three when the capital requirements take effect. However, by year five, at least two-thirds of the corporates would be considered adequately capitalized under three of the scenarios. Based on these calculations, a more reasonable time frame for capital requirement implementation would be five years rather than three years. These results also justify the NCUA requiring capital for membership in a corporate.

Assuming corporate recapitalization at historical rates is optimistic for several reasons. First, the legacy asset issue (i.e., non-agency mortgage related securities) must be addressed so that new capital investments by NPCUs are not at risk of depletion from losses experienced from these securities going forward. Even if the legacy asset issue is resolved, trust and confidence in the corporate network has been negatively impacted by the depletion of capital.

Second, retail corporate credit unions are not likely to recapitalize U.S. Central at the historical level due to the new requirement stipulating that 100% of investments in another corporates' capital instruments must be deducted from its own core capital when calculating its capital ratios. In fact, the comment accompanying the rule on page 36 states that the proposed deduction from corporate capital discourages capital investment between corporates. The proposed regulation also paves the way for the elimination of the wholesale corporate tier in the corporate credit union structure, which implies that U.S. Central will be competing with retail corporates. As a result, retail corporates competing with U.S. Central provides a disincentive to recapitalize.

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

(c) Issuer Concentration limits

(1) General rule: the aggregate of all investments in any single obligor is limited to 25% of capital or $5 million, whichever is greater.

The proposed changes to the capital section of regulation put forth several different definitions of capital. It is not clear in the proposal which capital definition is to be used in calculating the issuer concentration limit. Constitution believes the term Total Capital as defined in section 704.2 should be used to calculate the issuer concentration limits.

Section 704.2 defines obligor as the primary party obligated to repay an investment. The structured finance obligations typically purchased by corporates are bankruptcy remote trusts; each trust is unique. Based on the rule's definition of obligor, each trust would be considered a separate obligor. Constitution believes the single obligor limitation may not go far enough to avoid concentration risk. Accordingly, it is suggested the Agency consider modifying the rule to adopt an issuer shelf concentration limit within each sector to promote further diversification.

Many debt issuers take advantage of universal shelf registrations which include a base prospectus and information from periodic SEC reports. Once the shelf registration is approved, these issuers may offer securities at any time by filing a prospectus supplement for each individual security offering. The issuer shelf is frequently the deal name without the series. An example of an RMBS issuer shelf is Wells Fargo Mortgage Backed Securities (WFMBS). Even though each securitized trust is separate, issuers tend to utilize the same underwriting standards and servicing practices over a period of time. An overweight in any one issuer shelf could expose an investor to undue risk should the practices or performance of a given issuer change. Based on the information currently available to investors of structured finance deals, it is difficult to recognize a negative change in an issuer's underwriting until poor performance emerges.

The issuer shelf limit is calculated by dividing the sum of the book value of every bond issued under a single issuer shelf by Total Capital. Constitution suggests Agency consideration for limiting investment in the largest issuer shelf and largest five issuer shelves in the various sectors listed in the sector concentration limits section of the proposed rule. Within each sector, market participants rank the performance of each issuer and label them based on tiers. Tier 1 issuers have the best performance among their peers, while Tier 3 issuers have some of the worst performance. The number of Tier 1 issuers in each sector varies depending on the number of issuers in the asset class. For example, there are far more RMBS issuers than credit card issuers. Due to the small number of Tier 1 issuers in the auto and credit card sectors, it is not practical to employ a limit on the five largest issuer shelves in those sectors. Using a uniform limit for all sectors would be counterproductive if a corporate were forced to invest in Tier 2 and Tier 3 issuers just for the sake of diversification.

(d) Sector Concentration Limits

The proposed rule includes sector concentration limits; these are calculated using the lower of capital or assets. For clarification purposes, Constitution suggests using Total Capital as defined in Section 704.2 for the calculation of sector concentration limits. It is also not clear which definition of assets should be used in this calculation. Constitution suggests using moving Daily

Average Net Assets (DANA) as defined in Section 704.2 in the calculation of the sector concentration limits. This is consistent with the rationale provided in the proposal for the leverage ratio denominator.

The proposal requires corporates to calculate and comply with the sector concentration limits upon publication of the final rule. In the proposal, the term Total Capital is scheduled to change 12 months after the final rule is published. By order of the NCUA board, effective April 21, 2009, corporate credit unions may use their capital levels as reported on their November 30, 2008 call reports for purposes of determining compliance with capital ratios. Constitution suggests continuing this order until the new Total Capital definition is in effect.

The sector concentration limits are based on the lower of a percentage of assets or capital. If Constitution's November 30, 2008 capital figure is used in the calculations, the lower of the two values for all sectors is the percentage of assets. Assets tend to fluctuate on a short-term basis and are cyclical in nature. This seasonality is recognized by the NCUA and was taken into consideration when developing the leverage ratio. In addition, an organization is able to manage asset balances much more easily than the capital figure. Constitution proposes the rule be modified so that the sector concentration limits be based solely on a percentage of capital rather than the lower of a percentage of assets or capital to promote stability in the limits.

The selection of sector limits should include an evaluation of risk in the various sectors based on investment attributes and historical performance. Those sectors that are deemed less risky and match the asset-liability management needs of the corporate should represent a larger portion of the portfolio, while those assets that are deemed more risky should have lower concentration limits. This statement coincides with the intent of the proposed regulation, yet a number of the proposed sector limitations are not consistent with fulfilling this objective. The higher limits assigned to the following sectors in the proposed rule should be reassessed: corporate debt obligations, municipal securities, FFELP student loan ABS, and registered investment companies. Several of these sectors do not meet the yield, weighted average life, or asset-liability management needs of corporates.

Corporate debt obligations are unsecured debt obligations of corporations. The repayment of this debt is dependent on the willingness and ability of the borrower to repay the debt. With the exception of commercial paper, the maturities of newly issued corporate debt generally exceed one year. Since the proposed regulation also places a limit on the weighted average life of a corporate's assets, it is unlikely corporate debt would be an appropriate ALM fit. The higher concentration limit for this sector implies a greater role in a corporate's investment portfolio, yet the risk and weighted average life characteristics are not suited for a corporate credit union investment portfolio.

Within the corporate obligations sector, a comprehensive review of a corporate's exposures should be contemplated. For example, asset-backed commercial paper (ABCP) conduits would fall in the corporate obligations sector. Similar to regulation pertaining to the investment company sector, a corporate should be prohibited from investing in an ABCP program that can invest in securities the corporate is not authorized to purchase. In addition, the various holdings within an ABCP program should be broken out into the various sectors identified in the proposed regulation and included in those exposure calculations to ensure the corporate identifies its true exposure to these sectors.

The sector limitations should be further reviewed to address concentrations of risk and promote diversification. The NCUA should consider an industry limit for higher risk investments such as corporate obligations. Constitution suggests limiting industry exposure using the North American Industry Classification System (NAICS) developed by the Office of Management and Budget and used by federal statistical agencies.

Municipal bonds have also been given the higher concentration limit of 1000% of capital or 50% of assets in the proposed regulation. Interest payments from municipal bonds are federally tax-exempt and may also be exempt from state taxes depending on the investor's legal residence. The primary benefit of municipal bonds is the tax benefit, yet this benefit is worthless to corporate credit unions since they are already afforded tax-exempt status.

Occasional market disruptions may make municipal securities attractive to corporates, but generally these securities do not earn as much yield as taxable fixed income asset classes. While an established secondary municipal bond market exists, new issue municipal bonds typically have long maturities, which if purchased would raise the weighted average life of the portfolio beyond the proposed two-year limitation. As a result, municipal securities are not a practical investment for corporate credit unions.

The proposal includes a concentration limit of 1000% of capital or 50% of assets for FFELP student loan ABS. Student Loan ABS (SLABS) have been negatively impacted by the recessionary economic environment and the dysfunction of the auction rate security (ARS) and variable rate demand bond (VRDB) markets. In 2009, there was very little FFELP issuance available and average lives on existing bonds extended significantly as a result of slowing prepayments. Student loan ABS typically pay principal and interest on a quarterly basis. Since corporate credit union liabilities are paid monthly, investing in SLABS creates basis risk. These characteristics do not make student loans a practical asset choice for a corporate credit union's asset-liability management needs.

The student loan market is currently engulfed in uncertainty. The House of Representatives passed the Student Aid and Financial Responsibility Act on September 17, 2009, which abolishes the FFELP program as of September 30, 2010. All future student loan entitlements are planned to be made through The Direct Loan Program. As a result of legislative uncertainty in the future, Constitution suggests the proposed regulation include a more generic term than FFELP student loan ABS to accommodate possible congressional changes in the future. There is also uncertainty in the private student loan segment as congress is determining if there could be more circumstances under which private student loans could be discharged through bankruptcy.

Registered investment companies have also been granted a higher sector limitation in the proposed regulation. These investments are typically perpetual in maturity and are extremely difficult to model. These features are inconsistent with the proposed weighted average life limit and additional ALM scenario proposals. The NCUA may consider adding a limit within the investment company sector to limit investment manager concentration. Similar to the rationale for the issuer shelf limit described above, a limit on manager concentration would help protect a corporate from counterparty failure or mismanagement.

Current and proposed regulation states a corporate may only invest in a registered investment company if the fund's prospectus limits the fund to investments otherwise permissible for direct corporate investment. Based on experience, Constitution has found that virtually all investment companies can purchase derivatives. As a result, this sector is not accessible to most corporates which have not been granted Level IV investment authority. Therefore, for the majority of corporate credit unions, a sector limit for investment companies does not provide the opportunity to diversify.

Despite the lower proposed concentration limits for auto, credit card, private student loans, and other ABS, NCUA recognizes the large role these sectors must play in a corporate's investment portfolio as evidenced by the asset mix given in the sample balance sheet beginning on page 99. In fact, that asset mix includes only one of NCUA's preferred sectors, FFELP student loans. Half of the investment portfolio is made up of the sectors that have a less favorable proposed sector limit of the lower 500% of capital or 25% of assets.

Additional Credit Risk Limitations

NCUA should consider per deal limitations to restrict the percentage of an offering owned. Constitution suggests limiting the amount of an offering that can be purchased as a percentage of the entire size of the investment offering. The concentration would be calculated by dividing the book value of the corporate's entire investment in the offering by the total offering size. The limits would be based on rating; AAA rated securities should have a higher limit because higher rated tranches are typically larger in size.

Another concentration that was noticeably absent from the credit risk limitations is a limit on monoline insurance companies or wrapped securities. Several corporates have significant exposure to wrapped securities which were typically considered extremely safe investments. Since impairment from these investments has already impacted corporates, which may have resulted from an overreliance on the insurance protection provided, a limit on wrapped investments would be a relevant addition to the credit risk limitations. Constitution suggests a limit on overall wrap exposure as well as exposure to any one monoline insurer.

Section 704.8 Asset Liability Management

The proposed regulation assumes additional resources will not be required by corporates to adhere to the new regulations. Based upon a detailed review of modeling capabilities and system limitations, it appears that even with considerable additional resource commitment it will be challenging to complete all the current regulatory tests as well as the newly proposed ALM tests prior to filing the 5310 report based on established submission requirements.

Constitution utilizes data from third parties to complete its modeling requirements. Critical information from one of these third parties is not available until the 11^{th} of the month. As a result, ALM modeling cannot begin at Constitution until the 11^{th} of the month, leaving Constitution with 10 days or 75 business hours to complete the necessary modeling and report preparation to submit accurate data in the 5310 report by the 20^{th} of the month. Constitution now spends 85¾ hours to meet current regulatory requirements. Once interest rates rise and all the interest rate shocks are conducted, Constitution will spend 118 hours conducting the modeling and reporting necessary to complete the 5310 report. Based on the times provided, there is a significant time and resource commitment to complete the monthly reporting required under current regulation.

The proposed regulation includes additional ALM testing. Two of the additional tests are cash flow mismatch and cash flow mismatch with prepayment slowdown. Constitution conducted these tests and determined that they take approximately 10 hours each to compute. Including both tests will add another 20 hours to the monthly modeling production. The proposal also requests weighted average life information assuming no call options are exercised. At the present time, this information can be obtained from the model without additional computing hours. However, under functioning market conditions, the prudent modeling assumption for a number of asset types owned by Constitution would be to run the securities to call. In these conditions, an additional scenario would be required to obtain the WAL assuming call options are not exercised. This additional scenario is estimated to take 10 hours.

The proposed regulation also calls for the measurement of effective and spread durations at least once a quarter. According to the proposal, the assets and liabilities are subjected to interest rate shocks and changes in credit spreads. These calculations require additional inputs and therefore must be run separately from the NII and NEV scenarios. Constitution calculated effective duration which took an estimated 20 hours to compute. Based solely on the additional proposed testing, 40% more time is estimated to be required to conduct the required modeling and reporting.

NCUA has articulated its intention to make changes to the monthly 5310 report to accommodate proposed changes to regulation and obtain pertinent information. To fulfill this request for accurate data, Constitution proposes NCUA adopt a month-end filing date for the 5310 report. In addition, Constitution suggests a phase-in period for the new reporting to allow corporates adequate time to comply with the new requests. The ALM models employed by corporate credit unions vary, but given the sophistication required, all involve significant investment and maintenance efforts. For example, to accommodate the new regulation, Constitution would likely be required to upgrade its modeling with features allowing it to set up multiple scenarios to run consecutively on an automated basis. The cost of the feature alone is $30,000 for a 10-year license and $6,000 a year for maintenance.

(d) Interest Rate sensitivity Analysis

Under the proposal, corporates must measure, at least quarterly, the impact of instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 basis points on its NEV and NEV ratio. If the base case NEV ratio falls below 3.00%, these tests must be calculated monthly. However, expanded authority corporates, including Constitution, are required by regulation to conduct interest rate sensitivity analysis on a monthly basis. In addition, undercapitalized corporates must perform the ALM scenarios on a monthly basis rather than quarterly under the proposed regulation.

The proposal requires a corporate credit union to limit its risk exposures to levels that do not result in a decline in NEV of more than 15%. However, Appendix B to Part 704 Expanded Authorities and Requirements allows corporates with expanded investment authority a decline in

NEV greater than 15%. Constitution proposes that NCUA allow the NEV change requirement in the interest rate sensitivity analysis to match that allowed under Appendix B to Part 704.

(e) Cash Flow Mismatch Sensitivity Analysis

Constitution believes this test is valuable and has been conducting it on a periodic basis for a number of years. As a result of the significant time constraints the proposed rule put on the ALM function, Constitution proposes this test be run after the monthly production is complete, similar to how the periodic tests are currently conducted. The proposal requires a corporate credit union to limit its risk exposures to levels that do not result in a decline in NEV of more than 15%. However, Appendix B to Part 704 Expanded Authorities and Requirements allows corporates with expanded investment authority a decline in NEV greater than 15%. Constitution proposes that NCUA allow the NEV change requirement in the cash flow mismatch sensitivity analysis to match that allowed in the interest rate sensitivity analysis under Appendix B to Part 704.

The proposal does not provide information on how to conduct the test. Constitution allowed its ALM model to calculate a market value for all assets and liabilities based on the Libor curve. The market value was then used to produce an option adjusted spread (OAS) that was then widened by 300 basis points. To obtain consistent results from all corporates, it may be necessary for NCUA to provide guidance in the calculation of the cash flow mismatch sensitivity analysis.

(f) Cash Flow Mismatch Sensitivity Analysis With 50% Slowdown in Prepayment Speeds

Constitution does not believe this additional analysis is needed or warranted. Constitution agrees it is valuable to perform a modeling scenario that assumes a significant change in prepayment rates and has been conducting this test on a periodic basis for a number of years. Under current and proposed corporate regulation, the periodic additional tests already include a test to consider the impact of significantly faster/slower prepayment speeds; the additional testing does not add meaningful additional analysis.

In addition, there is a high correlation between interest rates and prepayment speeds for a majority of the asset classes permitted under the proposed regulation. As a result, the interest rate shock tests and periodic prepayment test are sufficient to identify risks from a change in prepayment rates. If multiple stresses are applied to the portfolio, the corporate cannot determine the reason behind the change in results without performing each of the stresses in isolation. When Constitution performed this test, it found the interest rate shock tests had a greater negative impact on the portfolio than the cash flow mismatch sensitivity analysis with 50% slowdown in prepayment speed scenario.

(h) Weighted Average Asset Life

Constitution believes this information should be calculated from the base case scenario only. Constitution’s membership has consistently indicated that competitively priced investment products, both overnight and term, rank as one of their highest priorities. Constitution’s members have historically placed 60% of their investments in term certificates and 40% in overnight and liquidity funds. Constitution’s term book has at times had an average life beyond two years in order to support the corporate’s liabilities.

More recently, low interest rates and the Temporary Corporate Credit Union Share Guarantee Program have pushed Constitution's members into investments inside a two-year maturity; however, this is not consistent with its members' long-term behavior. If the two-year weighted average asset life requirement remains in the final corporate rule, corporate credit unions will be restricted from effectively competing for NPCUs' term investment business.

In order to meet NPCUs' investment and liquidity needs, Constitution proposes that corporate credit unions offering longer term deposits or loans to NPCUs be allowed to manage the associated risk through ALM regulation and not through a fixed average asset life restriction. If the Agency believes a set weighted average asset life limit is required, raising such limit to three years from two years will mitigate difficulties with implementation.

(i) Effective and Spread Durations

Constitution requests that NCUA better define both effective duration and spread duration and provide additional guidance for the proposed requirement to measure at least once a quarter the effective duration and spread duration of each of its assets and liabilities. Constitution's ALM model includes an effective duration function but not a function for spread duration.

In discussions with Agency staff involved in drafting the regulation, it was indicated certain assets or liabilities could be exempted from calculation of effective and spread durations. Clarification of possible exemptions under this section of the proposed rule should be clearly articulated. Analysis on sub-sections of the balance sheet can be exceedingly time consuming and is not easily accommodated by Constitution's ALM model. Due to the time commitment of this test, it is suggested that the duration calculations be performed after the current month production, similar to how the periodic tests are performed now.

Ability to Grow Retained Earnings Under Proposed Investment and ALM Limitations

The proposal includes a sample balance sheet on pages 99-101 intended to illustrate how a corporate credit union could structure itself to meet all the proposed rules. NCUA analyzed the ability of corporates to meet the retained earnings portion of the capital requirements and determined a corporate would need to earn 17 basis points of net income a year to reach the proposed requirements. There are several shortcomings in the sample portfolio that have been overlooked.

The sample portfolio includes a 30% concentration in government-backed and private label student loans, an overconcentration in one isolated asset sector. These student loan investments account for roughly 75% of the sample corporate's income, with roughly 60% of that coming from private student loans. Constitution suggests it may be questionable to rely on one sector for so much of the corporate's income; the 30% allocation to student loans appears inappropriate.

Dealer offerings obtained by Constitution in mid-February 2010 indicate the spread for private student loans in the example is exaggerated. Market information indicates this sector trades in the area of Libor +45, although no offerings were available when the information was requested. Using this spread for private student loans in the sample portfolio results in a portfolio return of just 18.5 basis points. Finding an eligible investment that earns 200 basis points over Libor would be difficult if not impossible. In addition, the wide spread when compared to other investment offerings indicates the risk of the investment may not be appropriate for a corporate credit union.

Based on asset data in the 5310 reports for expanded authority corporates as of November 2009, the amount of student loan ABS the corporate network would need to purchase to match the asset mix provided in the sample balance sheet is roughly $23 billion. This volume would overwhelm the student loan market; corporates would be competing with one another to purchase the available securities and in the process drive up prices. Total issuance of public and 144A term ABS student loans in 2009 was $21.7 billion, with $11.3 billion coming from FFELP issuance. Even based on peak student loan issuance of $82.4 billion in 2006, corporates would need to purchase 30% of issuance to mirror the proposed investment mix provided in the proposed rule. The allocation to student loans is unrealistic given the size of the student loan market, even when assuming a reduction in corporate balance sheets.

The credit card and auto sectors have been helped by the Term Asset-Backed Securities Loan Facility (TALF) which is set to expire March 31, 2010 for ABS. Strong issuers in prime auto and credit card origination have moved away from the program, but subsectors such as dealer floorplan loans, private student loans, and retail credit cards still rely on the program to issue. As a result, many analysts believe issuers in these sectors have the incentive to issue deals before TALF expires. This is likely to draw potential future issuance forward causing issuance to dry up in these sectors at least for the rest of the year.

Spreads and weighted average lives in the proposed regulation were based on dealer offerings in mid-October 2009. Spreads widened considerably during the credit crisis and have yet to fully recover for non-government issued securities. The assumptions used to justify the proposed rule changes must consider the currently low interest rate environment and wide spreads that are not expected to continue indefinitely. As a result, the spreads given in the sample are not sustainable in the long term. These spreads show how it is possible for corporates to make 17 basis points in the next 6 to12 months, but not beyond.

The liabilities in the sample portfolio break down to 70% in term certificates and 30% in overnight shares. Historically, most corporates have relied heavily on the overnight book of business. Despite the emphasis on term liabilities in the sample portfolio, other areas of the proposed regulation such as the cash flow mismatch requirement discourage the management of assets on a term basis. The NCUA's emphasis on corporates being liquidity providers is contrary to the Agency's significant portion of term liabilities. The sample's rate for liabilities does not accurately represent funding costs for term certificates. Based on the current yield curve and long-term interest rate changes, it is not reasonable to assume, as the sample does, that the same spread is appropriate for overnight and term investments. The sample also assumes no cost of capital, which is unrealistic given the arguments presented above in the capital section.

Rates currently paid on liabilities are historically low, with the Federal Funds target set at a range of 0 to 25 basis points. Given the low starting point and eventual economic recovery, the rates paid on liabilities have nowhere to go but up. Based on future expectations for rates on assets and liabilities, the margin at corporate credit unions is expected to decline. Corporate credit unions would have a very short window of opportunity to put together a portfolio that mirrors the sample portfolio before spreads change. These factors will have a negative impact on a corporate's ability to earn 17 basis points a year.

The pro-forma income statement on page 101 illustrates how corporates can build 100 basis points of retained earnings over six years. Several of the inputs used in the calculation of net income are not realistic. As pointed out above, net interest income is overstated by the exaggerated spread for private student loans. In addition, the net interest margin earned at this corporate in 2009 is roughly 20 to 25 basis points wider than historical performance due to the market dislocation and income earned on impaired bonds. Once active trading resumes in the structured finance market, spreads will tighten and net interest income will decline. The sample reflects net interest income improving as investment average lives shorten. This statement is based on the assumption that the yield curve maintains its slope over the life of the investment. Since the sample assets are expected to mature in one to two years, this assumption is unrealistic.

NCUA personnel have indicated the belief that corporates have discretion to raise pricing to member credit unions using item processing products and services. Based on detailed knowledge of competitive alternatives available to its NPCU members, Constitution has been severely limited in its ability to increase pricing as a result of market and cost factors. Constitution is in fact actively pursuing restructuring and alliance opportunities to leverage economies of scale so as to remain competitive in this marketplace.

In the retained earnings portion of the capital requirements, NCUA has proposed a minimum corporate requirement of 200 basis points of retained earnings at the end of ten years. This can be accomplished only through lower investment rates and higher fees on products and services to the NPCUs. Member-owner credit unions, which have lost their capital investment and been assessed for the corporate stabilization plan, will be asked to give even more financial support to corporates to meet the new capital requirements. This situation does not present a strong value proposition to NPCUs to continue doing business with corporates. Consequently, assumptions as to recapitalization may be undercut by these requirements.

Based on the above concerns, it is respectfully submitted that the Agency commit to a thorough reassessment of the corporate business model using more realistic assumptions before promulgation of the extensive proposed changes in regulation.

Section 704.8(k) Overall Limit on Business Generated from Individual Credit Unions
The proposed rule notes concerns "about risks to both individual corporates and individual NPCUs that arise from placing undue reliance on a single entity," and that a larger member "might decide to remove its funds which could cause severe liquidity problems at the corporate."

The proposal adds a new provision to regulation that would prohibit a corporate credit union, after a 30-month phase-in period, from accepting "any investment" from a NPCU or any other entity if, following that investment, the aggregate of all investments from that member or entity would exceed 10% of the corporate's moving daily average net assets. "Any investment" is indicated as "including shares, loans, PCC or NCA's" so that even short-term overnight loans and capital contributions with withdrawal restrictions are subject to the above restriction. A deposit from a large NPCU may be 10% of the corporate's moving daily average net assets while being a small percentage of that credit union's investment portfolio. The provision would appear to discriminate against smaller corporates with strong, well managed relationships with key larger members.

The 10% limit was represented by Agency staff in one of the town hall meetings as being based upon "professional judgment." Constitution's largest member-owners have recognized the risk noted and have managed their liquidity and investment activity in a prudent, cooperative manner with Constitution, which has benefitted the entire industry, particularly when concern for industry liquidity was high. Contrary to what has been reported elsewhere in the county, the largest credit unions in Connecticut have remained the most critical, consistent, steadfast and reliable sources of liquidity to Constitution during the recent challenging period. Constitution Corporate is honored to have the support of its member credit unions.

The traditional success of corporates relies heavily on the cooperative nature of the credit unions that use its services, including the support of larger credit unions. The 10% limit on the amount that a corporate credit union can receive or borrow from any one entity (e.g., from long-term strategic partner credit union(s), national banking partners such as Bank of America, or lenders such as the Federal Home Loan Bank) would also unnecessarily restrict the corporate from having full access to all available investments as well as external liquidity sources.

The appropriate manner to address deposit or liquidity source concentration risk is in the oversight and examination process; i.e., require that corporate credit unions document their assessment and management of perceived or actual concentration risk. Examination guides can incorporate the 10% guide to require more vetting of the issue.

Section 704.14 Representation
Term Limits and Other Board Restrictions
The proposed regulation limits directors to six consecutive years of service and prohibits putting forward a new candidate for directorship after one or more of its prior representatives has served on the board for six consecutive years.

Constitution currently does not have term limits for Directors, and the average years of service for its Board of Directors is 7.7 years. Constitution suggests the proposed regulation include a term limit of nine consecutive years, as this allows time for appropriate acclimation and follow-through on company initiatives.

Section 704.11(e) Corporate Credit Union Service Organizations
(Corporate CUSOs) – Permissible Activities
The proposed rule would require a corporate CUSO to limit its activities to a limited set of services not fully encompassing those currently provided by corporate CUSOs to NPCUs. Constitution proposes a "grandfather" provision allowing all services that corporate credit unions currently provide to credit unions through corporate CUSOs to continue, especially in light of the extensive changes proposed elsewhere in the rule and the potential disruption and higher costs to NPCUs that could be incurred by the change proposed.

Section 704.19 Disclosure of Executive and Director Compensation
The proposed regulation requires the annual disclosure of the compensation, in dollar terms, of each senior executive officer and director. Senior officer is defined as "a chief executive officer,

any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller)." The term also includes employees of any entity hired to perform the functions described. Constitution supports transparency efforts and would recommend the disclosure be allowed in aggregate for the identified senior officials.