Community Plus Federal Credit Union

P.O. Box 255 ● 526 E Champaign Avenue ● Rantoul, IL 61866-0255 ● (217) 893-8201

March 9, 2010

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3424

Dear Ms. Rupp:

Thank you for the opportunity to provide comment on the Proposed Regulation Part 704. We appreciate that the National Credit Union Administration has attempted to listen to the concerns of Natural Person Credit Unions (NPCU) throughout the past 15 months.

Our credit union has $13 million in assets. It is a low income community charter with two branches. I speak for the Board of Directors and our membership.

Our response addresses grave concerns that we have regarding these proposed rules. We also will discuss an issue that these regulations do not address, but is absolutely essential to the future of the credit union movement.

There is no dispute that there is a need for change in the regulation of the Corporate Credit Unions (CCU). That change will, and indeed it must, forever change the structure of the Corporate Credit Unions. Our common goal should be that what follows strengthens the credit union movement.

Our comments follow this introduction. Again, thank you for this opportunity to comment.

Very truly yours,

Michael Daugherty

Michael Daugherty, CPA
President/Manager

Response to the Proposed Corporate Regulations

Small Credit Union Issues

The CCU network was setup to address basics needs of all NPCU. While credit unions of all sizes utilize the corporate network, small credit unions have a heavy dependency on it. The services that NPCU require are:

- Settlements
- Payment processing
- Overnight account management
- Access to borrowing (short and long term)
- Investments

All of those services are heavily influenced by economies of scale. As credit unions we are competing against banks where the size threshold for a “small” bank holding company is $150 million to $500 million. Obviously, small credit unions and even larger ones lack negotiating power on the services listed above when they operate in the banking arena. Therefore, the CCU network developed to aggregate credit unions to build economies of scale.

The CCUs in many cases also lacked the economies of scale and volume to effectively compete. Many of them used U.S. Central to aggregate their volume in order to compete. U.S. Central has lost all of its member capital. There will need to be a structure to replace this. A possible replacement would be just one or a few large CCUs with regional sales and service offices.

Larger NPCU may already have relationships with the Federal Reserve to provide some of those services. However, even larger NPCUs may find it advantageous to outsource settlement and payment processing to a CCU rather than do it in-house. For small credit unions the only alternative may be a local bank. In doing that the credit union is subsidizing its competition. Instead of profits flowing back to the NPCU and ultimately its members, profits then will flow to bank shareholders. There is also always the risk that a competitor may determine the best business decision to deny services to its competition. Then the small credit union may be unable to continue offering services to its members.

Our credit union had an experience with a local bank that taught us this lesson. Recall the environment in late 1999 when both regulator and credit union alike were concerned about possible liquidity problems if the public were to panic over the Y2K fears and pull their cash out. In that situation we were notified by the local bank who had been providing currency and item processing that it was going to impose a very large increase in the fee for those services. By that point we had done our Y2K due diligence on all vendors and had imposed a moratorium on any vendor changes. We were forced to solicit proposals from alternative vendors and conduct due diligence in an uncertain environment. Of course, the Y2K liquidity crush did not materialize. If it had, how much support would we have received from our bank?

In the latest financial crisis liquidity was an issue for banks and the CCUs, but largely did not affect the NPCU. If that had been different, could credit unions have been able to go to banks for liquidity? It is not likely. Therefore, the CCU network is needed for both short-term and long-term borrowings by NPCU.

In all of the comments that follow, please keep in mind that for every argument made here the impact on small credit unions of the failure of the CCU network is much greater than the larger NPCUs. If NPCUs are faced with much higher operating costs, the inability to offer services to their members, and a loss of liquidity options, then the outcome could be the failure of many small credit unions that are currently serving their members. This will not only affect our members, but will also further strain the Share Insurance Fund. We could be creating a cycle that feeds upon itself.

NPCU Capital at CCU, Legacy Assets, and Recapitalization of the CCUs

It has been widely reported in the trade journals that the NCUA is working on a plan for the treatment of the so-called “legacy assets”. We believe this should have been dealt with simultaneously with the proposed Regulation Part 704. The proposed regulation makes assumptions regarding their recapitalization of CCUs by NPCUs that are not realistic unless the issue of legacy assets is clarified.

At the beginning of November certain credit unions (including our own) wrote to the NCUA Board regarding the extinguishment of our credit union’s membership capital at CCUs. A number of those letters made the following points regarding extinguishment of our capital:

- There was no disagreement that the NCUAS had the authority to require the CCUs to offset their negative Reserve and Undivided Earnings against membership capital. However, this extinguishment is not required by GAPP. Analysis was provided to NCUA by Certified Public Accountants in support of this position.
- Extinguishment would be based upon estimated losses. These losses are not based upon credit losses, but in the market value of the investments at a time when no reasonable market exists.
- Extinguishment of member capital would preclude NPCUs from recouping any investment losses that do not occur.

It appears that our concerns have been ignored. The extinguishment of capital has been moving forward.

During recent town hall meetings the NCUA has stated that NPCU participation is crucial to recapitalization of CCUs. This raises the question as to why a NPCU would be willing to invest additional capital that would be a risk of further write-downs from these legacy assets. Unless there is a “firewall” wrapped around those legacy assets our credit union will certainly not invest any new money in a CCU.

The proposed regulation makes the assumption that NPCU will contribute capital without a risk premium. That is an unreasonable assumption. It is even more unreasonable if the existing capital has been extinguished and there is no chance of recovery.

CCU Capitalization Requirements

The Regulation proposes a capital structure that follows Basel I standards. These were anticipated, and are essentially similar to those of banks. However, other restrictions are more onerous and will prevent the CCUs from being able to obtain the capital levels in the required time frame.

The investment standards are much tighter than those of banks. The regulation prohibits most "most derivatives" without specifying which derivatives. CCUs have not used derivatives for speculative purposes, but to manage their interest rate risk.

A truism in this industry is that we do not eliminate risk, we manage it. The restrictions on risk are so stringent that CCUs will be unable to generate the earnings necessary to reach required capital levels.

If the CCUs cannot build capital through the management of risk in investing, then they must build it through fees charged on the payment and settlement services. Those higher fees will then eat into the margins of NPCU further weakening them. CCUs must also remain competitive or the larger NPCUs that have remained with them will take their business elsewhere. This further weakens the entire credit union system.

As stated earlier, NPCU will not assist in building capital unless they are protected from legacy assets.

Given the points just made, the proposed timetable for meeting these requirements is unrealistic.

NEV Test

The proposal imposes two Net Economic value (NEV) tests on the CCUs. The first shocks assets with credit spread risk by 100, 200, and 300 bp. The second test adds a 50 bp slowdown.

For floating rate instruments, the shock test will be applied to the entire life of the instrument. These instruments will be tested as a fixed rate, thereby eliminating the very feature that makes them desirable from an NEV perspective.

A 300 bp shock test is an effective tool to measure risk in a portfolio, but it is not an accurate measure of likely events. It is a very useful modeling tool, but is an extreme measure when combined with other provisions in the regulation. For example, credit is not allowed for core deposits. Core deposits from overnight liquidity and settlement accounts are relatively stable and should be credited. This combined with the weighted-average-life rule to be discussed in the next section make this test very difficult.

The consequences of failure of the NEV test are so severe that CCUs will be required to structure their balance sheets in a way that cannot succeed. Possible changes to this regulation include:

- Lowering the standard of a regulatory violation from the 300 bp shock level
- Drop the average-life rule
- Increase NEV volatility from the 25%

Weighted-Average-Life

The proposed regulation uses a two year WAL limit as a means to control credit-spread risk. The unintended consequences of this rule may include:

- A lack of diversification in the investments
- Lower investment yield for the CCU
- NPCUs will have difficulty obtaining term loans beyond two years from their CCU
- Higher fees to NPCU as a result of lower investment income to CCUs
- Lower rates on certificates offered by CCUs

CCUs currently have less than 30% of the investment market from NPCUs. This rule will make them uncompetitive and cost them that market. It will also remove a source of long-term liquidity to NPCUs.

Redemption of Certificates

This also relates to the ability of NPCU to borrow term from the CCU. CCU need to be able to offer early redemption on their term certificates to be competitive. Those term certificates then fund term loans to NPCUs. While some NPCU have an alternative source at the FHLB, many small credit unions are unable to do that.

This feature of CCU certificates allowed them to mimic Agency offerings. Taking it away will make Agencies more attractive as investments to NPCUs.

This rule was intended to protect the CCU liquidity, but in fact it may be detrimental to it. It will certainly be detrimental to NPCU borrowing needs.

Board Governance

The regulation seeks to improve the CCU system through changes in Board rules. It imposes a six year term limit of CCU directors. We are skeptical of term limits as an effective tool. However, if the NCUA feels term limits are necessary then a six year limit is too short. CCUs are quite different from NPCUs that the directors are required to come from. It takes several years for a director to become truly effective. Under this rule the average director will only have three years experience. When the next economic crisis hits (and it will) there will be no institutional memory. We suggest a limit of twelve years. This will give a range on experience among the directors.

There is also a proposed restriction on indemnification in some cases. Here the language should be more narrowly written. It will be difficult enough to recruit volunteers. Quality leadership may not appear if their personal assets are too much at risk.

Every effort should be made to recruit strong volunteers and provide them training.

Due Process

We are especially troubled by limits placed on due process. The new regulations appear to give the NCUA staff the ability to subjectively change minimum capital requirements and to change the rules and regulations with due process.

We strongly feel that the NCUA Board should not delegate their responsibility to staff to make regulatory changes. The current regulatory approval process may take time, but history has shown that over-reaction during crisis can pose as great a risk as inaction.

NCUA Board approval should also be required for a reassessment of capital level requirements. Such change should be based upon an appropriate documentation of the risk. CCUs must be given a chance to defend themselves and present their own evidence.

In all cases there must be an appeals process available to both CCUs and NPCUs when they are faced with regulatory action. The current crisis cannot take this fundamental right away from credit unions.

NCUA's Mission and Strategic Plan

Good governance demands that we assess all of our actions against our mission statement and strategic plan. We have looked at the NCUA's.

The NCUA web site states their mission to be:

> to foster the safety and soundness of federally insured credit unions and better enable the credit union community to extend financial services for provident and productive purposes to all who seek such service while recognizing and encouraging credit unions' historical emphasis on extension of financial services to those of modest means.

In our analysis of these rules we have concluded that they will:

- Jeopardize the soundness of NPCUs by changes in the regulation of CCUs that will result in higher fees, lower investments returns, and loss of liquidity sources
- NPCUs rely upon CCUs to extend financial services, and will likely be forced to curtail them or raise fees
- Members of modest means are those most likely to be negatively impacted by this.

The NCUA 2006-2011 Strategic Plan states:

Goal 1: A safe, sound and healthy credit union system.
Goal 2: Access to financial services offered by federally insured credit unions for all eligible consumers throughout the United States.
Goal 3: A prudent, flexible and efficient regulatory environment for all federally insured credit unions.
Mission: Facilitate the availability of credit union services to all eligible consumers, especially those of modest means, through a regulatory environment that fosters a safe and sound credit union system.
Vision: A dynamic, self-sustaining, cooperative credit union system that offers financial services to all eligible consumers.

Goals 1 and 2 were addressed in comments on the mission statement. We do not see this regulation enhancing the goals in #3 of "prudent, flexible and efficient regulatory environment". With all due respect, we also fail to see how these proposed rules will accomplish the visions set forth.

Summary

In summary, we find there are serious flaws in the proposed Regulation Part 704. The proposed Regulation presented a "model corporate" to demonstrate how a CCU might be structured after these rules. This model corporate is unworkable. We do not believe that there is any way to structure a CCU under these regulations that can succeed.

It is our opinion that the CCU network will cease to exist within the next few years if these regulations are enacted. The higher costs that will be borne by credit union as a result of this will likely accelerate the demise of NPCUs. The failures of the CCUs and NPCUs will force the Share Insurance Fund to drastically increase premiums, forcing even more NPCUs under. Given the tremendous pressure the credit union system is currently under, this has the potential of pulling down the last cooperative financial system left in this nation.

We urge the NCUA Board to listen to the comments made by NPCU, CCU, Leagues, and other trade associations. You will not hear from every small credit union, or even every large one. Many have given up, thinking what they say will not matter. Many have heard that the NCUA will not consider any type of "form letter", and are intimidated by the intricacies of this discussion. We suggest you remember the adage that elected officials live by: for every person that writes or calls there are 400 of like mind that don't speak up.

Please consider these comments, and bring us a new set of proposed rules to consider.