Magnus Enterprises

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

Dear Ms. Rupp:

I am grateful for the opportunity to comment on the NCUA's Proposed Rule on Corporate Credit Unions. Even though I write anonymously, I know that my views will be given a fair hearing by the NCUA board and staff.

The stated goal of the agency's proposed rule on corporate credit unions was to establish capital levels and proper restrictions on balance sheet risk that would ensure that the corporates' roles as providers of (in order of importance) settlement, liquidity and investment services would never be interrupted.

I believe that the proposed rule meets this standard, but that does not mean it is perfect. There are areas in the revised capital and interest rate risk (IRR) rules that seem arbitrarily determined. The proposed investment rules are simultaneously too permissive in some areas and too restrictive in others and offer an unhealthy incentive for corporates to take credit risk over interest rate risk.

These points, as well as a few comments on the proposed corporate governance rules, will be covered later in the letter, but I first wanted to offer my own version of NCUA's preamble.

The history—especially the critical events of the second half of the decade—was accurately chronicled. The national field of membership and increased rivalry between the corporates led to aggressive risk-taking behavior, all in the name of booking a few extra basis points of yield that could be passed on to members.

I know that a lot of folks are demanding accountability before moving on, but the problem with any sort of public bloodletting is that everyone is complicit.

- The NCUA clearly dropped the ball by letting corporates become overly concentrated in privately-issued mortgage securities and either overlooking or failing to detect the degree to which WesCorp was invested in subordinated tranches of these deals.

- The corporates were guilty of selecting securities on the basis of credit ratings and monoline insurance coverage and not completing an honest assessment of the underlying collateral. Would you believe that WesCorp published an article in their Summer 2005 Inside Risk magazine that included the phrase "housing bubble" and discussed the perils of pay option, negative amortizing mortgages? It's true, and yet they still happily bought tranches of privately-issued CMO's with leveraged credit risk and securities backed by option ARM's. They surely understood the risks of the trade, but they enjoyed a false sense of security provided by high credit ratings and bond insurance.

- Finally, natural person credit unions and those who advise them also bear some responsibility. Didn't it seem odd to anyone that corporates could pay 15 basis points above agencies on their certificates while still paying expenses and recording profits? Finance professionals know that there's no such thing as a free lunch, yet as long as the yields were good and consistent, it was easier to book the income than ask difficult questions.

While I feel that any dredging up of the past would be unsatisfying, I have long believed that any persons involved in the risk-taking that led to the losses lack the moral standing to lead us out of the crisis. The decision makers at today's NCUA are not the same people who were in charge when the mistakes happened, and I think this is an important fact. The corporates that can demonstrate that meaningful management and governance changes have been implemented will, in my opinion, have more success in asking their members for fresh capital.

Let me address two other things before getting to the heart of the proposed regulation. First, NCUA should not insinuate that Wall Street Journal played any role in the corporate saga. The unrealized losses were huge relative to corporate capital, regardless of whether the WSJ was reporting on it or not. There would have been no fear of a run on the corporates had the institutions or the regulator led a proactive discussion of the issue instead of hoping it would go away. The fact that the WSJ article was news to anyone in the industry shows what a poor job NCUA and the corporates were doing in explaining the situation.

Secondly, I have generally been quite supportive of NCUA's actions beginning with the steps taken in January 2009, to the point where I have been labeled an apologist for the agency. Yes, lax oversight contributed to the current situation, but NCUA's actions to support liquidity within the corporate network and to lead an NPCU-funded bailout but spread the costs of the inescapable investment losses over seven years have benefited the entire industry. The recent momentum that NPCU's have seen through programs like "Move your Money" would not have been possible had we taken TARP money like some of our leaders demanded.

Finally, I would like to reiterate my support for a more activist approach by the agency. In the original Advanced Notice of Proposed Rulemaking, I suggested that NCUA intervene in the corporate market by chartering a new national corporate that would enjoy monopoly powers but be subject to unprecedented oversight and extremely limited investment authorities. I still believe consolidation is the only salvation for the corporates and I remain skeptical that the free market will reduce the number of competitors in the industry to a sustainable level. I am pleased that other notable industry figures have recently joined my call for the "public utility model" when it comes to the corporate network. Nonetheless, the agency has called for comments on the proposed rule and I will restrict the rest of my comments to the specifics of the proposal.

Capital Rules

The designation of Tier 1 and Tier 2 capital accounts will encourage corporates to add permanent capital to their balance sheets. The proposed capital requirements, when taken in concert with the proposal's investment limitations, should provide a sufficient buffer to ensure that the industry will not suffer through a repeat performance of the past few years.

If anything, the revised capital requirements are arguably too restrictive, but I think the proposed rules are consistent with NCUA's overarching approach to put in place a set of regulations where the corporate network's ability to provide critical services will not be interrupted.

The one area in the revised capital rules that I disagree with concerns the retained earnings accumulation plan (REAP) and the fact that the proposal says that under prompt corrective action (PCA), the NCUA board can strictly penalize corporates for not meeting the REAP milestones. I understand the motivation here, since retained earnings provide a buffer to absorb losses prior to any capital depletion. However, the decision concerning how quickly a corporate must build retained earnings is better left to the corporate's members. In an extreme case, one could imagine a corporate being generously recapitalized by its members only under the condition that all earnings were returned to members. This hypothetical corporate would have adequate Tier 1 capital under international standards, but would lack sufficient adjusted core capital under the proposed regulations.

Incidentally, the opposite side of this argument is made by some commenters who argue that by not including a cost of capital in its pro forma income calculations later in the proposal that NCUA is overstating the profitability of corporates. I am not troubled by the lack of cost of capital in this margin analysis. Any new capital that comes into the corporates is going to come from NPCU's and they all understand that their capital investment isn't really a traditional investment that pays a high annual yield. Instead, it's an investment to rebuild the corporate network that may not pay dividends for 10 years or more. Whether net income is returned as dividends or used to build retained earnings is immaterial in the long run, it's simply a question of how the pie is being divided. Applying a traditional corporate finance treatment to cooperative capital isn't the right approach--members aren't evaluating an investment in their corporate relative to, say, the common equity of Bank of America. Moreover, the return on equity is the same whether the return takes the form of a dividend or retained earnings. Members who value the cooperative nature of their relationship with their corporate should be willing to forsake the dividend on PCC and NCA in the short run in order for the corporate to rebuild retained earnings.

I think more flexibility needs to be included in the proposed rule when it comes to retained earnings. The critical issue is this: corporates must be able to present business plans to their members that are compelling enough to get those members to contribute significant permanent capital. If we don't get over that hurdle everything else is irrelevant. If a corporate must pay a dividend on PCC in order to attract that PCC, the agency should be happy with this, even if it results in a slower accumulation of retained earnings. At the same time, NPCU's must recognize that they shouldn't expect the traditional dividend on PCC during this transition phase because it is important that corporates build sufficient Tier 1 capital. NPCU's should also recognize the risks implicit in their demands. If they want a bigger dividend on PCC, their corporate will build earnings more slowly and that increases the risk of a PCC impairment. However, this is a decision best left to corporates and their members, and as long as the corporates have sufficient Tier 1 capital NCUA should be less concerned with the composition of that capital.

Prompt Corrective Action

I have no significant comments on the new PCA section of the corporate regulations. Others have noted that the proposed rules give NCUA significant power to downgrade a corporate's capital classification, but I think as long as the possibility for reckless behavior exists—and even with the strict proposed investment and ALM rules this possibility exists—then the agency needs to have the ability to intervene.

Investment Limitations and ALM

These two topics should be addressed simultaneously, since the ALM restrictions predominantly affect the assets of the corporates, and the assets are largely composed of investments.

Overall, I find the proposed rules on ALM for corporates to be overly conservative. The proposal handcuffs the corporates' ability to take interest rate risk so much that the only way for them to earn sufficient margins to meet the retained earnings requirements is to take unacceptable levels of credit risk. The agency's approach is surprising given that the recent problems in the corporate network were primarily the product of credit risk and not of interest rate risk.

NCUA should prohibit all investments in subordinated tranches of privately-issued mortgage securities. If the corporates took advantage of the proposed rule and held these securities at a level equal to 100 percent of their capital, they would still be exposing their capital to too much risk of catastrophic loss. The numbers presented in the proposed regulation tell the story: both WesCorp and U.S. Central had about the same amount of privately-issued mortgage securities relative to capital, but WesCorp's losses of over $6.5 billion are more than twice the $3 billion lost by U.S. Central. The fact that WesCorp was four times as concentrated in subordinated tranches of these securities almost completely explains the vast difference between the two institutions' losses. Granted, these securities are unlikely to lose more than fifty percent of their value again any time in the near future, but if there was one poster child security for the corporates' recent plight it was the subordinated tranche of private-label MBS (not CDO's or NIM's, the two securities prohibited by the proposed regulation), and these securities deserve to be prohibited too.

Subordinated tranches of other ABS are also allowed under the regulation to a maximum of 20 percent of assets or 400 percent of capital, whichever is lower. Again, this rule appears to be courting trouble, especially with the corporates' inability to take meaningful interest rate risk under the proposed regulation. If the rules require them to earn hefty margins from day one and if they cannot take interest rate risk, they have little choice but to take credit risk. Credit risk losses can add up a lot faster than interest rate risk losses. Corporates could face a complete prohibition on investing in subordinated tranches of all ABS/MBS and still earn required returns if they were allowed to assume more interest rate risk.

However, the general framework that divides non-agency investments into 10 categories and limits investments in each of those categories is sound. The rule achieves its goal of ensuring diversification and the minimizing the unique risks associated with excessive investment concentrations.

The proposed rule limits the weighted-average life of assets to two years (and potentially less than that given the proposed AL NEV tests) and this is too restrictive. Yes, it helps ensure that corporates will not take on excessive interest rate risk, but the rule incentivizes corporates to take on undue credit risk to meet earnings requirements. I would change the proposed regulation to have the two-year average life rule apply only to non-GSE investments, the 10 categories in the proposed section 704.6(d). I say this because securities like floating rate agency CMO's with average lives in the 3 to 5 year range are exactly what corporates should be buying. They could earn Libor plus 60 on these investments with little interest rate risk and practically zero credit risk. However, the proposed regulation would allow only a tiny allocation to these securities since they would increase the overall WAL of assets too much. Loans to members should also be excluded from the WAL calculation. If a corporate has to ration credit to members because of the WAL rule, then the rule is impairing the corporate's liquidity function and needs to be amended.

The AL NEV tests themselves are flawed. The across-the-board 300 basis point spread widening test is overly simplistic, and the regulation offers no basis for choosing this number. A better approach would be to apply spread widening tests to each investment category in accordance with their historical volatility. If this spread widening test was done at the three standard deviation level, for example, it would better capture the interest rate risk the corporates face while still offering a rigorous test. Note that this three-sigma framework would be in many ways similar to the value-at-risk (VAR) model, which has become the standard day-to-day risk metric for financial institutions with complex balance sheets. The other shortcoming of the plain vanilla spread widening test is that it doesn't account for the benefits to the corporate that happen with wider spreads. Spreads typically widen when there is concern about a particular asset class or risky assets in general. These events are invariably accompanied by an increase in Libor as financial institutions worry about lending to each other. When Libor increases relative to the Fed funds rate, corporates benefit as demonstrated by their record operating earnings in 2008. While wider spreads may cause mark-to-market losses on securities, they also tend to increase corporate earnings, thereby mitigating some of the risk. Attempting to model these correlations between wider spreads and other items on the balance sheet isn't easy, but this correlation analysis is another hallmark of modern VAR testing.

The second AL NEV test that gauges the WAL risk for slower prepayments is equally arbitrary. Where did the notion of a fifty percent decline in prepayment speeds come from? The biggest driver of slower prepayment speeds is higher interest rates, and the regular IRR NEV calculation already measures this risk. The AL NEV test on prepayment speeds apparently endeavors to assess the reasons not related to interest rates that could cause slower prepayments. This is an attempt to quantify something that is inherently unquantifiable. It seems like an unnecessary burden and is unlikely to provide any helpful risk management beyond what the IRR NEV test already reveals.

NCUA invited comment on the pro forma balance sheets used to perform the AL NEV calculations, but like other commenters I would like to focus on the pro forma interest margin and net income calculations offered on pages 99-101 of the proposed rule. These numbers show that a corporate can earn 34 basis points of net income margin and 21 basis points of net income while maintaining a portfolio that passes the stringent

WAL and AL NEV tests. I agree with the common complaint that these numbers only work because of a 10 percent allocation to private student loan ABS at Libor + 200 bps. Any investment that yields Libor + 200 with little interest rate risk ***must*** have substantial credit risk and these pro forma calculations show what happens because of the decision to give preference to credit risk over interest rate risk. Imagine if the corporates instead invested half of their term portfolio in floating rate agency mortgage securities at Libor + 60. The balance would go to the less risky ABS sectors and the 30 percent cash allocation would remain unchanged (although I've adjusted the spread on overnight investments and deposits to Libor – 5 bps, which is more representative of current market conditions. Now, the corporate earns Libor + 28.75 on its assets and has a net interest margin of 33.75 bps, virtually unchanged from NCUA's pro forma numbers. More importantly, this is a balance sheet with significantly less credit risk and no greater interest rate risk, especially given that all of the agency investments are assumed to be floating rate securities.

Investments			
Sector	Portfolio Percentage	Total WAL (years)	LIBOR/ EDSF Spread
Agency Mortgages*	35%	4	60
FFELP Student Loan ABS	15%	0.5	25
Auto ABS	10%	0.6	25
Credit Card ABS	10%	1	30
Overnight Investments	30%	0.003	-5
Total	100%	1.6359	28.75

*The interest rate risk of these investments is much less, as they reprice frequently and have little spread risk.

Liabilities			
Type	Total Percentage	Total WAL (years)	LIBOR/ EDSF Spread
Overnight Shares	30%	0.0003	-5
Term Certificated	70%	0.5	-5
Total	100%	0.351	-5

The net income figure of 21 basis points is also plausible. It will likely take some time for operating costs to decline to 30 basis points across the network unless significant consolidation occurs. In fact, as more corporates are faced with the prospect of investing in-house and not through a wholesale corporate, operating costs will likely rise in the short term. Let me reiterate one key point: if a particular corporate wanted to reduce its retained earnings and offer a dividend to its PCC/NCA holders, the agency should not care as long as that corporate had sufficient Tier 1 capital.

Therefore, I am in overall agreement that the numbers could work if greater interest rate risk and WAL flexibility for agency investments are included in the regulation. Unfortunately, as currently written, the regulation requires excessive credit risk to make the numbers work and NPCU's should be highly concerned about their corporate taking on this credit risk when it was credit risk that caused our current problems.

Prohibition on above-par CD redemptions

Much has been made about the proposed regulation's prohibition on redeeming member certificates above par. The opinion that capping the value of certificates at par puts them at a severe disadvantage relative to agency bullet securities is theoretically defensible, but I think that actual practice will show that these concerns are unfounded.

First, natural person credit unions generally have a hold-to-maturity mindset. This is a sound practice that minimizes transaction costs. Second, corporate certificates are typically just one part of a diverse portfolio, and it is commonly agreed that corporate CD's have inferior secondary liquidity characteristics since a CD seller is captive to the corporate's bid, while a credit union selling a security can get bids from multiple buyers. An NPCU looking to raise liquidity through selling investments would likely have marketable securities that it would sell before liquidating CD's.

Finally, the series of events that would lead an NPCU to sell premium corporate CD's are pretty far-fetched. In order for CD's to appreciate to significant premium prices, interest rates would have to fall. Falling rates are generally associated with periods of economic weakness when loan demand is relatively weak and deposits tend to be on the rise. The conditions that generate premium CD prices are the same conditions that result in ample liquidity at NPCU's. CD sales at premium prices would rarely be motivated by liquidity needs, meaning the only reason they would happen would be to harvest profits and reinvest the proceeds into a different investment vehicle. This practice is uncommon at NPCU's and most institutions will simply enjoy their above-market coupon rates on old CD's rather than implement a total return approach.

Governance

I advocated unprecedented transparency of executive compensation at the time I submitted my original ANPR response, and I am pleased to see the agency incorporate a strong compensation disclosure requirement in the proposed rules.

There currently exists favorable treatment for federally chartered corporates, which do not have to file IRS Forms 990 that include information on executive compensation.

Introducing disclosure parity between federal and state charters is a noble goal and one that I strongly support.

I am less convinced that the proposed rule determining which employees are subject to compensation disclosure makes sense. SEC rules call for disclosing the compensation for the CEO and the four highest paid executive officers. I think this framework makes sense for corporates too, and I agree with NCUA’s definition of “senior executive officer.” Rather than disclosing the compensation for all senior executive officers, which could affect close to twenty employees at the larger corporates, limiting it to the four highest paid officers plus the CEO seems like a good compromise.

I agree with NCUA’s proposed rules on director qualification and term limits. It goes without saying that there are competent outside directors who will be excluded under the new rule, but the corporate exists to serve its members and it’s perfectly reasonable to require that only senior representatives of member organizations serve on the board.

The six-year term limit for directors seems to strike a good balance between the competing issues. There is value in having long-tenured board members, as they understand the business better and have served through economic cycles. However, long term limits also increase the likelihood of the board becoming less vigilant and too cozy with management. There can be no absolutely correct answer for the new term limit, but six years seems appropriate to me.

Miscellaneous issues – Legacy Assets

NCUA's announcement at during its February 18, 2010 virtual town hall meeting that it was preparing a separate plan for dealing with the corporate network's "legacy assets" came as welcome news to many in the industry. Many corporate credit union leaders have asserted that their members would not recapitalize the corporates as long as the threat of more OTTI loomed, and I completely agree with this sentiment. The mechanics of segregating legacy assets is best left to accountants and regulators, and I will offer just a few high-level observations.

1. The highest priority must be to avoid the recognition of any unrealized losses. Transferring assets between entities generally involves a marking-to-market of assets and should be avoided, although if the losses accrued to a non-depository institution whose funding was orchestrated by NCUA, then it matters less. However, this practically would mean turning WesCorp and U.S. Central into "bad corporates" that no longer function as depository institutions, and the industry may not be ready for that.

2. A more practical approach might be a "ring fencing" of assets on the balance sheets of corporates where NCUA guarantees losses beyond a certain level. However, I believe that corporates should be required to bear losses on existing investments at least to the

level of existing capital. To guarantee losses at a level higher than "legacy capital" is tantamount to a capital infusion from NCUA to the affected corporates and would mean that members of affected corporates received disparate treatment than members of U.S. Central, WesCorp and Constitution Corporate, where all contributed capital was impaired.

3. A precise definition of "legacy assets" must be established. The investments producing large unrealized losses include privately issued mortgage-backed securities and traditional asset-backed securities (especially student loan ABS). However, only the mortgage-backed securities have significantly contributed to OTTI. Limiting the ring fencing to mortgage securities may unfairly disadvantage those corporates who favored investments in ABS. They would have to report large unrealized losses to members without being able to offer the same guarantee against future OTTI. Instead, the more equitable approach would be to say that every security purchased before 1-1-2008, for example, is a legacy asset and that each institution is ring fenced against losses in those positions.

4. It is also worth noting that as of 11-30-2009, 19 of the 26 retail corporate credit unions had total unrealized losses less than their capital positions. This means that new capital contributions at these corporates, if granted seniority over existing capital, face almost no risk of impairment due to legacy assets. If NPCU's choose to recapitalize only those institutions with healthy balance sheets, the legacy asset issue is effectively solved. The corporate stabilization program already backs any future OTTI beyond capital at the other seven corporates. Similarly, any newly-chartered corporate would be free of legacy assets, and the industry consolidating behind a new, single national corporate would be the most elegant way of dealing with the legacy assets.

Again, thank you the opportunity to comment. Feel free to contact me at unrealizedlosses at gmail dot com if I can be of assistance.

Regards,

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