Magnus Enterprises

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

Dear Ms. Rupp:

I had no plans to comment further on the ongoing corporate credit union situation. I have been largely supportive of NCUA efforts to find a least-cost solution to the unavoidable corporate losses, and I appreciate NCUA policymakers incorporating some parts of my comment letter on the proposed Part 704 revisions into the final rule.

However, the ill-conceived "Voluntary Prepaid Assessments Program" has spurred me back into action. This proposal is so economically inefficient and such a bad deal for the credit union system that NCUA should withdraw the proposal. The fact that Chairman Matz has received "many requests" for a voluntary prepaid assessment program does not automatically make it a viable policy.

My complaints with the proposal are summarized below.

1. The overall credit losses derived from the conserved corporates' investments in privately issued mortgage securities and other troubled assets are unaffected by this program. The NCUA executives on the webinar made this point very clear, and it makes perfect sense: the ultimate credit losses are completely removed from the mechanism to pay for those losses.

2. The prepaid assessment program doesn't reduce how much we'll be asked to pay (in cash terms) over the next two years. NCUA made it clear that it expects to assess 38 basis points over the next two years for corporate stabilization. If the total prepaid assessment comes in at 10 basis points of insured shares, the regular assessment over that two year horizon might be reduced from 38 to 28 bps, but the total cost is still precisely 38 bps (28 in regular assessments, 10 bps in prepaids). If all credit unions contribute 36 bps—the maximum allowed—there will still be regular assessments in the next two years and the cash outlays would actually be larger than if we did nothing. Overall, the cash flow implications are, at best, a wash.

3. I fear a number of credit unions don't appreciate the disconnect between establishment of the prepaid expense asset and the actual expensing of the stabilization costs. In fact, Melinda Love, the director of the office of examination and insurance, noted in the webinar on this topic that a "rip the Band-Aid off" approach, where the entire cost of corporate stabilization is expensed today is favored by many credit unions. However, the prepaid assessment program, which at first glance seems similar to ripping off the Band-Aid, actually serves to defer expenses farther into the future by reducing the magnitude of the regular assessments over the next two years. If NCUA proceeds with this program, I would encourage the agency to include a more detailed discussion of the standard accounting treatment as part of the final announcement.

   This is the appropriate place to mention one benefit of the proposal. By reducing the regular assessments over the next two years—expenses which would be made up in years 3 to 11 of the stabilization program—it might actually keep some credit unions from falling below PCA Net Worth limits in the short run and give them time to earn their way out of current difficulties. If this is a material effect, I would appreciate NCUA's opinion on how much benefit to the NCUSIF the reduced regular assessments in 2011-2012 would provide.

4. The proposal would save NCUA money, but cost natural person credit unions even more money. NCUA would effectively replace borrowing from the Treasury with a zero percent loan from credit unions. NCUA borrows from Treasury at the average 1-year Treasury rate, currently around 18 basis points (bps), and being able to borrow, say, $1 billion from credit unions at zero would save the NCUA $1.8 million a year. The interest rate on this borrowing resets annually and would be expected to rise in future years.

   Meanwhile, credit unions would transfer the same $1 billion from their investment portfolios to the NCUA and earn nothing. **The opportunity costs here are much more than what NCUA would save.** Credit unions could take this same money and invest in 1-year investments. The yield on these investments would also be expected to rise in the future as the positions matured and were rolled over. The yield on 1-year agency securities has averaged about +9 bps to Treasuries over the past year. Investments in insured CDs earn even more relative to Treasuries, somewhere on the order of +25 bps. If we assume that instead of giving this $1 billion to NCUA, credit unions invest in a mix of 1-year agencies and insured CDs, they could earn 15-20 bps more than what the NCUA would save by not borrowing from the Treasury. This is a better outcome for the credit union system.

   (I should also add that if a credit union chose to invest in a 0% yielding, fixed-rate, amortizing investment with a stated final maturity of 2021, an examiner would definitely question the wisdom of that decision. That's exactly what these prepaid assessments represent.)

5. It is important to think about the financial condition of the entire credit union system, not just NCUA's bottom line. After all, the capital that supports the share insurance fund, the money that will pay for the failure of the corporates and the annual operating revenue for NCUA all come from credit unions. NCUA is the regulator of federally insured credit unions, but it is also part of an interconnected system and it should promote policies that improve the financial condition and safety and soundness of the entire industry.

   The word "arbitrage" gets thrown around a lot in this industry, often incorrectly, but in this case there truly is an arbitrage opportunity. If NCUA borrows from the Treasury instead of asking for prepaid assessments, and if it encourages credit unions to take the money they would have used for the prepaid assessments and instead invest in one-year agency bonds and insured CDs, then the industry comes out ahead to the tune of 15-20 basis points and has the exact same interest rate risk.

   The only scenario where the prepaid assessment program makes any sense is one in which NCUA believes it may fully exhaust its $6 billion credit line from the Treasury and would be unable to convince Congress to expand the borrowing limit. If this is the case, the few million dollars that the prepaid assessment program potentially "costs" is money well spent, but it would also be helpful if Chairman Matz expended her political capital with Congress in shoring up the agency's contingent funding sources and not on other topics better left to our trade organizations.

   In the absence of this risk, the voluntary prepaid assessment proposal weakens the strength of the credit union industry and does nothing to reduce the system's interest rate risk.

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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