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Sent via email: regcomments@ncua.gov

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

Re: Marvin Umholtz Comments on Notice of Proposed Rulemaking for Part 741, Maintaining Access to Emergency Liquidity

Dear Ms. Rupp:

I appreciate having the opportunity to present these comments to the members of the National Credit Union Administration (NCUA) Board about the NPR concerning mandatory emergency liquidity access by certain federally insured credit unions (FICUs). The opinions in this comment letter represent my point of view and are not necessarily the views held by any of my clients or by any organization with which I may be affiliated. I oppose the public policy objectives represented by the emergency federal liquidity mandate and many elements of the proposed solutions, especially the retention of the NCUA Board-managed Central Liquidity Facility (CLF) and its *de facto* forced recapitalization. The NCUA Board also asks for comments concerning the potential application of the Basel III liquidity and capital requirements on certain credit unions. I would encourage the NCUA Board to not apply Basel III to credit unions of any size.

Do Not Apply Basel III Capital Expectations on Credit Unions
In its July 24th request for comments about federally insured credit union access to emergency federal liquidity the NCUA Board stated, "While it is beyond the scope of this proposed rule, the Board is exploring whether certain Basel III liquidity measures and monitoring tools should be incorporated into NCUA's supervisory expectations for the very largest credit unions, those over $500 million. Basel III's proposed standards include, for example, the potential use of such measures as a liquidity coverage ratio and a net stable funding ratio. The standards also include liquidity monitoring tools to track maturity mismatches on the balance sheet, funding concentrations, and the amount of unencumbered assets available for secured borrowing. These measures and monitoring tools are designed to enhance the liquidity risk management framework and improve the banking sector's ability to absorb shocks arising from financial and economic stress. NCUA must similarly consider the impact that its very largest FICUs could have on the liquidity of the credit union system and the NCUSIF by virtue of their size, complexity, and potential interconnectedness. The Board requests comment on the costs and benefits of applying Basel III liquidity measures and monitoring tools to FICUs with assets over $500 million." At mid-year according to NCUA financial performance report data there were 401 federally insured credit unions with assets above $500 million representing 5.76% of credit unions and holding 65.00% of the total assets.

Back on June 12, 2012 the Federal Reserve System Board of Governors, the Federal Deposit Insurance Corporation (FDIC) Board, and the Office of the Comptroller of the Currency (OCC) proposed applying Basel III capital standards to U.S. banks and portions of those proposals apply to all sized banks. The Basel III standards were developed for very large European banks and similar institutions around the world. Applying Basel III to local community banks and credit unions might inappropriately damage the economy at the worst possible time. Setting capital requirements higher than necessary will contract lending and other economic activity. For that matter, if Basel III were imposed on the aforementioned

large European banks effective today, very few of them would be considered solvent. Several paragraphs in an obscure section of the Federal Credit Union Act [12 U.S.C. §1790d(2)(A),(B), and (C)] that deal with Prompt Corrective Action (PCA) could pressure the NCUA Board to adopt higher capital requirements for federally insured credit unions should federal banking regulators impose Basel III as it now appears that they will.

Although it is not currently known how the NCUA Board would choose to apply Basel III to federally insured credit unions, I would assume that it would be patterned after the requirements for U.S. banks. Basel III establishes higher capital ratios for all banks and imposes a new capital buffer of 250 basis points added on top of all of the minimum capital requirements. Basel III also applies higher revised risk weighted assets requirements on banks, including such assets as residential mortgages, construction loans, short term loan commitments, and past due loans, among others. According to one analysis targeted at bankers, the majority of the Basel III requirements would be implemented on January 1, 2015 and the capital buffer would need to be fully funded by January 1, 2019. It would not appear prudent for either the banking regulators or the NCUA Board to impose these potentially counterproductive restrictions without first thoroughly analyzing the impact on the respective industries and the national economy.

Extended Due Diligence Advised on Basel III Application to Credit Unions

The input to the federal banking agencies on their joint Basel III proposals is now due October 22, 2012 following an extension of the comment period announced August 8, 2012. It would be a wise move for the NCUA Board to allow those bank regulators to sort through the comment letters received on the topic prior to the NCUA Board involving itself in the rulemaking process as it might apply to credit unions. With the work put in by the federal bank regulators in hand, the NCUA Board could then move forward with better informed proposals for applying Basel III on federally insured credit unions. In addition to the initial issues relating to liquidity identified by the NCUA Board in the background to its proposed rule, the NCUA Board should engage in an extended full-fledged proposal and comment process should it have specific plans to apply Basel III in whole or in part.

If the NCUA Board feels compelled to apply Basel III on larger credit unions, the application should only be to the very largest, most-sophisticated, and complex credit unions over $10 billion in assets and/or perhaps the corporate credit unions. That would be consistent with the mission of the NCUA Board's newly established Office of National Examinations and Supervision (ONES). In its request for comments about Basel III included in the emergency federal liquidity proposal the NCUA Board was starting an appropriate discussion about the potential application of the requirements on credit unions. That Basel III discussion should be a thoughtful and protracted one that contemplates credit union-specific issues like how to count the 1% deposit in the National Credit Union Share Insurance Fund (NCUSIF), the at-risk capital investments in corporate credit unions, and the subscriptions to CLF capital stock, if any. The costs of applying Basel III to federally insured credit unions of any size could far exceed its alleged benefits.

NCUA Pressure on Credit Unions to Purchase CLF Capital Stock

The NCUA Board's proposed regulation requires federally insured credit unions with assets of $10 million or more to have a contingency funding plan that clearly sets out strategies for addressing liquidity shortfalls in emergency situations. Credit unions with $100 million or more in assets must also have a backup federal liquidity source for emergency situations – either the Federal Reserve Discount Window or membership in the NCUA-managed CLF that has borrowing authority from the U.S. Treasury's Federal Financing Bank. To use the CLF as this backup source of liquidity a credit union would need to purchase CLF capital stock costing one-half of one percent of the credit union's paid-in and unimpaired capital and surplus. Since most credit unions offer checking (share draft) accounts they are eligible to borrow from the Fed Discount Window already.

As of June 30, 2012 there were 1,434 federally insured credit unions $100 million in assets or larger. 3,088 credit unions were between $10 million and $100 million in assets. There were 2,438 credit unions below $10 million. Although it is clear in the proposed rule that the 1,434 largest credit unions would have to use the Discount Window or recapitalize the CLF, it is less clear whether the next 3,088 credit unions

that must have an extended emergency liquidity plan must also implement one of these two options. It would seem likely that just having a plan without the actual access would not qualify as adequately addressing an emergency liquidity situation where time might be of the essence. For all practical purposes any credit union over $10 million in assets will be under examiner pressure to have actual access to emergency federal liquidity. According to a comment made by CLF President J. Owen Cole during the August 14th NCUA webinar concerning the proposed rule, credit unions would be encouraged to establish a relationship with the Federal Reserve and to purchase CLF capital stock.

Cost vs. Benefit of CLF Capital Stock to a Credit Union

To date the NCUA Board and senior staff have not talked much about the costs of participating in the CLF. In order to join the CLF each retail credit union would have to invest one-half of one percent of that credit union's "paid-in and unimpaired capital and surplus" of which one-half must be transferred to the CLF and the other one-half held by the credit union on call of the NCUA Board. For the purposes of CLF capital stock, the Federal Credit Union Act [12 U.S.C. §1795a] defines "paid in and unimpaired capital and surplus" to mean the balance of the paid-in share accounts and deposits as of a given date slightly modified by several other factors. The actual cost of the CLF capital stock is like adding another 0.5% to the National Credit Union Share Insurance Fund (NCUSIF) annual 1% of insured shares deposit. Similarly to the NCUSIF deposit, as the credit union grows its CLF capital stock commitment increases and is updated annually.

A credit union's CLF capital stock investment is illiquid and not tradable; however, it can be redeemed with required notice. It also carries with it an opportunity cost. The CLF capital stock investment can earn a dividend but since it is reinvested in U.S. Treasury deposits there can't be much of a spread for the CLF to pass back to its stock holders. The lost opportunity would be for the credit union to make that same dollar amount investment in something other than the CLF capital stock and earn more. The other opportunity cost is associated with keeping the "callable" half of the dollar amount of the CLF capital stock in a highly liquid low-yielding instrument like short-term Treasury securities. A CLF member credit union would be giving up some basis points it would earn if it could invest longer somewhere else.

NCUA Board Too Reliant on CLF Borrowing for Deposit Insurance and Stabilization Backup

The proposed emergency federal liquidity access rule is most flawed by its continued reliance on the CLF as a backup to the NCUSIF and the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). Under the Federal Credit Union Act the NCUSIF also has the ability to borrow from the CLF up to the CLF's unused borrowing authority with the U.S. Treasury's Federal Financing Bank. That borrowing authority is calculated based upon the amount of CLF capital stock and other assets times twelve.

The mixed-ownership government-managed CLF was originally authorized by the enactment of the comprehensive *Financial Institutions Regulatory and Interest Rate Control Act of 1978* and included as Title III of the Federal Credit Union Act. During its decades of existence the CLF was rarely tapped for liquidity by individual credit unions. Its primary use turned out to be to bailout the corporate credit unions and to keep that debacle from cascading down to retail credit unions. Despite the fact that the NCUA Board had publicly sworn that there will never be another corporate credit union bailout, that statement is undermined by the agency's apparent decision to keep the CLF around when it should instead be humanely euthanized. Through this forced recapitalization of the CLF the credit union industry essentially would be required to prepay for the next largely theoretical emergency occurrence. The purpose of the CLF and its structural elements are not well understood by mainstream credit union officials. The bottom line is that to keep the CLF running it will cost retail credit unions a pretty penny and there is no end to the financial, reputational, and political exposure that the CLF represents.

As far back as its 1997 credit union study, the U.S. Treasury recommended that Congress discontinue the CLF. The Treasury said, "The CLF's current borrowing authority raises serious policy and budget concerns. It has legal authority to advance several billion dollars to the Share Insurance Fund without regard to its ability to repay. In a systemic crisis, taxpayers could be put at risk if such funds were advanced to shore-up troubled credit unions or a troubled insurance fund." Seemingly prescient the U.S. Treasury report also stated, "We are also concerned that the CLF creates a concentration of credit risk for itself by holding all of its investments at U.S. Central. If U.S. Central were ever to become impaired, the

CLF's elaborate redeposit-based capital structure could collapse and its share accounts could suffer losses; the combined effect could largely eliminate the CLF's net worth. If the CLF continues to operate, credit unions should capitalize it directly and the concentration of credit risk should be eliminated, perhaps by depositing funds at the Treasury as the Share Insurance Fund does." Back in March 2009 the NCUA had conserved U.S. Central and taken over its operation. In August 2009 the CLF transferred its funds, including the CLF stock proceeds, from U.S. Central to the U.S. Treasury and invested them in U.S. Treasury securities. When U.S. Central Bridge is wound down October 25th the approximately $1.8 billion CLF capital stock proceeds will be used to satisfy other obligations dramatically reducing the CLF's borrowing leverage net worth. Ironically, as long as the NCUA Board keeps the CLF around as a systemic source of liquidity it is also keeping around a potential systemic liability.

Large Credit Unions Will Choose the Fed Discount Window

There are fewer than 100 retail credit unions that are currently direct CLF members. The soon-to-be-closed-down U.S. Central Bridge Corporate Federal Credit Union (and its non-conserved predecessor) had made the investment in the CLF capital stock on behalf of everyone else involved in the corporate credit union system. A couple of years after the CLF was established, credit unions were authorized to use the Fed Discount Window. Although not that many credit unions currently have established access to the Discount Window, given the mandated choice between that and purchasing CLF stock many more, especially the larger ones, will select the Federal Reserve.

Recapitalizing the CLF from scratch is problematic since the corporate credit unions are not well positioned to make the agent investment on behalf of all of their member retail credit unions since the corporate credit unions are themselves capital-challenged. The only true source of potential funding to purchase the CLF capital stock is the retail credit union. Based upon all of the recent NCUA communications about the CLF and from the webinar, it was abundantly clear to me that the NCUA had every intention of keeping the CLF around as long as it can in whatever size it ends up being. The CLF's long-term prognosis is not good. At best, the liquidity access mandate will buy time for the NCUA Board to rethink its systemic risk bailout strategy.

This proposed rule should not be adopted. The CLF should be phased out. Basel III should not be applied to credit unions or to community banks. Thank you for the opportunity to provide these comments. I would welcome the opportunity to provide additional information or respond to questions.

Marvin U. 09/21/12

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Marvin Umholtz is President & CEO of Umholtz Strategic Planning & Consulting Services based in Olympia, Washington south of Seattle. He is a 36-year credit union industry veteran who has held many leadership positions with credit union organizations and financial services industry vendors during those years. A former association executive and lobbyist, he candidly shares his credit union industry knowledge and analysis with public policymakers, financial industry executives, and vendor companies. Umholtz also writes and distributes *CU Strategic Hot Topics*, a "clients and colleagues" newsletter that analyzes the actions of the National Credit Union Administration (NCUA), the Congress, the Consumer Financial Protection Bureau (CFPB), the Federal Reserve, the corporate credit union crisis, the mortgage finance mess, the sagging economy, uncertainties in financial markets, divisive partisan politics, and the growing conflict about the future role of credit unions in the financial services industry.