



January 21, 2010

Draft Response to National Credit Union Administration Proposed Regulation of 12 CFR Parts 702, 703, 704, 709 and 747.

Overview

On November 19, 2009, the National Credit Union Administration (NCUA) issued a Proposed Regulation for 12 CFR Parts 702, 703, 704, 709 and 747. The rulings for part 704 aim to alter “significantly”¹ the regulations governing the operation of nation’s Corporate credit unions.

The full NCUA ruling can be found at the link found below. Please note that the file is over 250 pages long. It outlines sweeping changes, many of which are very smart. Others cause concern to those in the Corporate credit union system, particularly among executives who are best placed to comment on how the newly promulgated rules will affect their businesses. (A cause-and-effect analysis.)

[\[http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/FINALPart704_12-8-2009WebVersion.pdf\]](http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/FINALPart704_12-8-2009WebVersion.pdf)

Given the state of the Corporate system and the benefits that its continued existence affords to the credit union system as a whole, it is imperative that all credit unions initiate a strong response, constructively highlighting the areas believed to be excessive, ill-advised or still-needed regulation. This need is even more important given that the two conserved Corporates, U.S. Central and WesCorp, are now unable to comment on the proposed changes.

This regulatory overhaul aims to reduce the risk in the Corporate system “not only to avert a repeat of the recent problems encountered in the Corporate system but also to anticipate new problems that *might* occur” as stated in the preamble to the regulation. NCUA is attempting to achieve this goal by imposing new “risk-based capital requirements; [imposing] new prompt corrective action requirements; [placing] various new limits on corporate investments; [imposing] new asset-liability management controls; [amending] some corporate governance provisions; and [limiting] a corporate CUSO to categories of services preapproved by NCUA.”²

NCUA’s objectives are laudable and may make some sense in the wake of the economic turmoil; however, the extent of these restrictions—both individually and in

¹ NCUA Proposed Regulation 12 CFR Parts 702, 703, 704, 709, and 747.

<http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/FINALPart704_12-8-2009WebVersion.pdf>

² *Ibid.*

their totality—raises serious questions about the ability of the Corporate system to operate profitably going forward. As such, it is imperative that the NCUA hear a strong, reasoned response from the credit union system as to how these changes can be improved to guarantee stability within the Corporate system, while ensuring that they remain viable institutions that serve natural person credit unions (NPCUs.)

Be in no doubt: these rules do not just affect the Corporates—they affect most credit unions. Should the rules go through in their current state, there is a serious risk that NPCUs will face lower yields on Corporate deposits, very limited loan products, increased costs from fees associated with payment systems, potential changes in other product offerings and fewer competitive investing options, in both short and longer term deposits options.

Some estimate that enacting these rules in the current form would cost NPCUs \$18 – \$23 million in lost income annually, at a minimum.³ Most of the increased costs would be borne by the small and medium-sized credit unions since the larger ones may have better options and better negotiation leverage. As the larger credit unions seek alternatives to these cooperative models of co-ownership, the costs will go even higher for the small and medium credit unions. Given that over 95 percent of NPCUs use the Corporates, there is little doubt that such an outcome would weaken not only NPCUs, but the cooperative credit union system as a whole.⁴ These regulations could force NPCUs to go back to seeking investment, liquidity and payment system options from banks, brokers, Wall Street firms, and other profit-seeking intermediaries.

Call to Action

The deadline for comment is March 9, 2010. All credit unions should review the proposed changes summary provided, review the NCUA's proposed changes (link below) and conduct additional research to establish and respond during the open comment period.

Proposed Changes

III.D. Pro Forma Income Analysis – p. 98 – 105

Are these regulations based on flawed economic assumptions?

The new regulation dedicates a lot of time to well reasoned capital standards and PCA regulation. Further, in section III.3.D (p. 96), the NCUA modeled for these assumptions—a move that always accompanies good rulemaking. The Agency's board encouraged respondents to review this section, including the viability of its financial assumptions.

³ See "Proposed Regulations for Corporate Credit Unions: Summary of Key Issues," *Members United Corporate FCU*. Based on 2009 year-end balances.

⁴ *Ibid.*

Through this example, the NCUA seeks to show future Corporates would be profitable under the proposed regulatory structure. Critics have a contrarian view, claiming the business model proffered is flawed. Accordingly, they worry that all suggested regulatory changes may be equally flawed if they are based on unsustainable economic assumptions.

The example provided does not represent achievable long-run averages or a realistic reflection of the potential profitability of a model Corporate in the future. This is largely because the results overlook the costs of raising additional capital, adjustments for inflation, and historic spread yields for student loan portfolios. If these factors are taken into account, the model reflects significantly different results, and would not be able to earn 21 basis points in ROA. Instead, it would actually lose money—around negative 3 bps of ROA—and would create an operating loss. Further, it would not permit any capital growth to meet the new standards, and, a Corporate would not be able to shrink its balance sheet, as is suggested throughout the regulation, far enough to make this a profitable operation.

This analysis must be justified. It is fundamentally important that Corporate credit unions have a viable business model after these new rules are implemented.

704.2. Definitions – p. 140 – 151

Do respondents have all the necessary facts and should the ruling be put out for comment again with clarification? What is the timeline for clean Corporate balance sheets?

At the time that these proposed rule changes were put out for comment on November 19, 2009, NPCUs were being assessed for billions of dollars in actual and unrealized losses, while losses to mortgage-backed security (MBS) holdings had caused two Corporates to be placed into conservatorship and most other Corporates to be classified as “problematic.”

The proposed rule was initially issued in an environment where NPCU executives were told that the Corporates would probably hold all MBS to maturity in order to minimize systemic loss. However, on a teleconference with credit union leaders during the week of January 11, 2010, NCUA Director of the Office of Corporate Credit Unions Scott Hunt indicated that by the time proposed changes were implemented all Corporate balance sheets will be cleaned of OTTI and legacy assets. This represents a material change in the credit union system, and significantly alters the context under which these proposed rules should be considered.

Since removal of MBS—and their treatment under GAAP—would have profound effect, this act itself is worthy of review by the industry because of the associated financial obligation and impact on all NPCUs. Furthermore, it might be reasonable to ask that the

comment period on the Corporates be suspended until after the NCUA fully discloses such plans for the Corporate system.

To protect the insurance fund, the NCUA has required the extinguishment of NPCU capital based on projected losses, in many cases, because of the modeled estimates of a single vendor. At least one Corporate credit union has proven to the NCUA that GAAP does not require the extinguishment, only the recording of the loss. Furthermore, in some cases, the Corporates have recorded OTTI, extinguished NPCU capital based on that vendor's calculations, and in less than 12 months, the valuation of some securities has improved. However, since the NCUA has required extinguishment, the Corporate cannot recognize the increased value or return the capital back to NPCUs.

Accordingly, the proposed regulation is framed in such a way that it seems to justify the NCUA's established extinguishment position going forward.

These provisions should be removed; and there should be no forced extinguishment of capital until actual cash-flow losses are realized. Further clarification by the Agency should be provided regarding the planned separation of "legacy assets" from the Corporates.

704.8 (d), (e), (f), (h) Net Economic Value Tests – p. 179 – 181

Are new tests so strict that Corporates cannot build sufficient capital or provide NPCUs with attractive yields? Can the use of derivatives and hedge instruments for safety and soundness be maintained under proposed new rules? Do US government agency and GSE instruments require the same new stress testing and/or limitations as private-label securities?

The ruling would impose two Net Economic Value (NEV) tests on the Corporates: The first takes each asset⁵ and shocks it by 100, 200, and 300 basis points; the second test adds an across-the-board 50 percent slowdown. In these tests, Corporates would be prohibited from a decline in NEV of more than 15 percent and must keep any NEV ratio above 2 percent.

Credit spreads should be utilized in NEV analysis; however they should be used for the entire balance sheet, not just with assets. FAS 157 defines "fair value" as: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." As accounting standards move closer to fair value measurement, it would be improper to apply risk measurements inconsistently across the balance sheet. Only a Credit spread risk applied consistently across the entire balance sheet can correctly measure NEV risk.

Furthermore, the interest rate NEV test accounts for prepayment slowdown so this would effectively be exaggerated in the second test.

⁵ Only those assets that have credit spread risk.

The NCUA has mandated the utilization of third party provider prepayment models in NEV analysis for certain Corporate credit unions. These providers continue to calibrate their models based on expected impacts such as changes in underwriting standards, interest rates, and overall economic conditions. Corporate credit unions have in the past adjusted these models based on their outlook and forecasts, but have been criticized by the regulators. An across the board 50 percent slowdown and extension of any prepay sensitive instruments would provide results that are inconsistent with Prepayment model providers' intended results and Corporate credit unions competitor/comparable entities governed by the FDIC.

The proposed changes also include a provision that, “[s]pecifically prohibits certain types of investments, including most derivatives,” without indicating which derivatives would be prohibited. Corporate credit unions do not use derivative transactions for speculative trading, and are yet to experience a financial loss as a result of counterparty default on a derivative instrument; instead, derivatives are used in the effective management of interest rate risk on both the asset and liability side of the balance sheet. Not only are counterparty limits and credit requirements appropriate, but eliminating the use of derivative instruments would actually increase risk in the credit union system.

There is concern that these tests are so stringent that they could stop Corporates from doing business altogether. They do not allow the Corporates to generate sufficient interest margin to build retained earnings to meet the proposed capital requirements. The effect is particularly evident in floating rate instruments, where the shock test will be applied to the entire life of the instrument. Since there is no effective means of determining where the rate will be in the future, it will be tested as a fixed rate, thereby eliminating the NEV attractiveness of floating rate investments altogether. Furthermore, as many in the industry note, there is no combination of assets with a two-year average life (see below) and limited extension risk that can generate sufficient margin to attract funding and pass a 300 bps shock.

These tests are seen as being extremely harsh, while ignoring ways that Corporates can shelter themselves from risk, particularly through derivatives. Another point is that a 300 bps shock is not representative of historical norms, where even 100 bps is double the historical average. Finally, these tests do not appreciate the difference across asset classes, particularly those issued by government sponsored entities (GSEs), which are highly liquid, instead treating all assets as if they are the same.

Such strenuous testing is not the issue. There is nothing wrong with stressing these securities to 200 or 300 bps for information; however, putting restrictions and limitations based on these tests is inappropriate, because it would not allow for any investment other than cash and equivalents to be held. A more realistic test would be to limit the credit shock to 100 bps and raise the NEV volatility to 35 percent.

A further differentiation should be made between GSE and non-GSE instruments by exposing the former, which have little credit risk and no redemption problems, to only 50 percent of the normal credit shock.

704.8 (c) Penalty for Early Withdrawals on Corporate Certificates – p. 179
Will credit unions keep money in the Corporate system for assurances of business stability?

This clause stops a Corporate from redeeming an outstanding certificate at the market rate for a NPCU, even if it is at a premium dollar price.

The apparent intent of this section is to remove NPCUs' motivation to withdraw funds prior to maturity—as many did during the current crisis. Currently, a credit union can redeem one of its Corporate certificates, even if the redemption price, due to falling rates, is above par. This proposed rule would penalize early withdrawals and eliminate the Corporates' ability to pay a premium on early withdrawals. NPCUs would have little choice but to look outside the Corporate system for longer-term liquid instruments, which would not punish them for early redemptions.

NPCUs benefit from the redemptions of premiums on certificates via recognition of income. Corporate credit unions historically hedge certificates issued with longer term durations. The corresponding interest rate swaps can be unwound resulting in no negative earnings impact to the Corporate credit union. The current practice results in slightly positive earnings for Corporate credit unions along with premium income as appropriate for the NPCU.

This ruling would certainly eliminate the Corporate certificate market for all but the shortest maturities and the smallest credit unions, and would likely portend the end of the Corporate certificate market altogether—a market that NPCUs rely upon because it offers ease of use, higher yields compared to U.S. agency-issued debt, and because these instruments can be structure to meet the investors' specific needs. Ultimately, this ruling will virtually eliminate Corporates' ability to fund NPCUs' lines of credit and would reduced overall liquidity in the credit union system, which in turn may trigger Corporates to sell their securities early and cause the loss recognition.

This proposal should be removed in its entirety.

704.8 (h) Weighted Average Asset Life – p. 181

If Corporates only make short-term investments, can they be profitable themselves and provide a yield that is attractive to a credit union depositor? Would three- or five-year WAL limitation be more consistent with a Corporate's business purpose? Is this possibly an overreaction?

Under this provision, the weighted average life (WAL) of the Corporates' investment portfolio, excluding derivatives and equity investments, may not exceed two years.

This rule will force the Corporates to issue short-term loans almost exclusively to ensure that they not only meet the two-year WAL ceiling, but are sufficiently beneath it. In the event that a longer term loan was issued, the Corporate would have to charge significantly more in interest and fees to compensate for the negative WAL impact. 704.8 (h) would also reduce the asset mix and hinder efforts to diversify the balance sheet mix—something that would be helpful if there was, for instance, a hit to short-term assets—thereby further weakening the Corporate system.

For NPCUs, this would be a pernicious ruling since its outcomes run counter to one of the Corporates primary purposes: an issuer of cheap liquidity for the credit union system from the credit union system. NPCUs would have little alternative but to turn to the Federal Home Loan Banks (FHLBs), which are themselves suffering in the current economic climate and increasing rates and fees, or a bank, which would be more expensive and would place a credit union's liquidity in the hand of a competitor.

The FHLBs have also been further restricting credit. This provision directly impacts the competitive nature of Corporate credit unions and FHLBs. As written, it will likely raise borrowing costs for credit unions and impact their access to term funding as a method of managing interest rate risk.

This provision should be removed in its entirety, especially if there are stress tests and other new limitations on Corporate investments.

704.6 (c) & (d) Concentration Limits – p. 176

Is it possible to Corporates to operate with such a small limit on their operations?

These two provisions would limit the Corporates to holding instruments from a single obligor to only 25 percent or \$5 million, whichever is greater; and limits aggregate holdings in selected investments to the lower of 100 percent of capital or 5 percent of assets.

This limit is too small and restrictive, and may serve to drive up costs in the search for alternatives. If imposed, a Corporate will be severely challenged to invest short-term liquidity at reasonable rates, in part because Federal Fund transactions would be restricted. Since their own investment opportunities are limited in other sections, there will be an inevitable impact on the overnight rates NPCUs receive.

One partial remedy would be to include Federal Funds or Federal Funds transactions in the exemption from sector concentration limits listed in 704.6 (d). Another amelioration would be to change 704.6 (c) to allow a larger single obligor limit (e.g., 200 percent of capital) on money market transactions with a term of 90 days or less or to specifically allow a single obligor limit (e.g., 200 percent of capital) Federal Funds transactions sold to other depository institutions.

This provision should be amended.

704.8 (k) Limit on Business Generated from Individual Credit Unions – p. 182
Is the limit on deposits in the Corporates too harsh and imprudent?

Under 704.8 (k), a Corporate would be prohibited from having a single member or entity make up more than 10 percent of its moving daily average net assets.

While well intended, this restriction could negatively affect the Corporates' short-term borrowing ability as well as the options the NPCUs can choose. Corporate balance sheets can fluctuate by as much as 25 percent of assets within a month and, as such, short-term borrowing is extremely important. The current limit of 10 percent may force a Corporate to accept less favorable terms regarding price, maturity, and collateral, which could increase cash balances, thus negatively impacting both earnings and their service to NPCUs.

A simple fix would be to give an exemption from this provision for the Federal Reserve Bank, a Federal Home Loan Bank, a Repurchase Agreement counterpart or a Federal Funds counterpart by eliminating the clause "or other entities." Alternatively, a higher borrowing limit (e.g., 20 percent of the Corporate's moving daily average net assets) would also alleviate these concerns.

An additional revision to the proposed change should include offsets for credit unions. Credit union deposits should be offset against borrowings. Any limits on business generated should be netted and not analyzed on a gross basis.

704.11 Corporate Credit Union Service Organizations – p. 183 – 185
Will Corporates be able to establish and operate any CUSO or subsidiary operations at all given the uncertainty in this provision?

Credit Union collaboration is a hallmark of the system. Using the Corporate for settlement of collaboration endeavor has been a natural extension of our philosophy. Under the proposed regulation, a Corporate CUSO must limit brokerage service, investment advisory services, and "other categories of services as approved in writing by NCUA."

On the surface, like many parts of this new regulation, this new provision seems innocuous. It is the latter part of the provision that causes the most concern. Without a clear definition of what CUSO activities are allowed, how can CUSOs and their NPCU partners possibly continue working together? Further, third-party providers (or even another NPCU who is insured by ASI and state chartered) are likely to be reluctant to allow the NCUA free access to balance books, records, software and operations; this could result in Corporate partnerships being dissolved as well as NPCU's CUSOs in the future. It does not take much to imagine the NCUA imposing this same provision in NPCUs and therefore restrict what kinds of efficiencies they can gain by partnering and to which partners.

This rule could also reduce the sophistication of the credit union system as a whole. Many CUSOs arise through joint partnerships between NPCUs and Corporates, which bring expertise that is not available to all credit unions. Such partnerships could no longer be effective if a Corporate partner were constantly at risk of pulling out at the behest of the NCUA.

A clearer definition of what will be permissible in the final rule must be set out; no restrictions should be placed on CUSOs where the Corporate credit union does not have a controlling interest; and a restriction on examination rights to other third party enterprises is also needed.

704.19 – Disclosure of Executive and Director Compensation – p. 187
How will Corporates hire and maintain talent who are wary of public salary disclosure?

Under this clause, the Corporate would be required to disclose “the compensation, in dollar terms, of each senior executive officer and director.”

Again, this provision is too strict. By requiring disclosures for senior executive officers, even those that do not work directly with the CEO, it risks publicizing the compensation of mid-level employees, which could cause problems with hiring and holding talent.

One solution might be to exclude vice presidents who do not report to the CEO; another would be to disclose the compensation for just the three to five top earners at the Corporate; while another would be to disclose these amounts in aggregate, rather than individually.

Concerning salaries, the mood of the country and of Washington, DC, more specifically, is towards transparency, largely because institutions have received public funds and are thereby held to different standards. However, only two Corporates have been conserved and one has received a Prior negative Undivided Earnings guarantee; the rest are still operating under their own business plans without public funds. What justification can there be for holding these remaining institutions to the standards of public institutions when it comes to salary disclosure?

Moreover, the question arises of how this requirement would reduce the risk at a Corporate credit union? How does it further the NCUA's self-declared primary mission "to ensure the safety and soundness of federally-insured credit unions"?⁶ Indeed, it could conceivably do just the opposite as higher qualified and better candidates choose jobs where their salaries and benefits are not in the public domain.

Finally, if this rule is imposed on the Corporates, how long until NPCUs' management are required to disclose their compensation? Similar staffing problems would be anticipated. How long before volunteer travel, education and reimbursement expenses would also have to be published?

This provision should be reconsidered as noted above.

709 & 747 – p. 244 – 252

Does the NCUA need more new powers to complete an enforcement action or to lift the legacy assets?

These rules outline various powers that the NCUA feels would improve their ability to handle the oversight and liquidation of any Corporate. These include: payout priorities in involuntary liquidation; reclassification of a corporate credit union on safety and soundness criteria; dismissal of a director or senior executive officer; and enforcement of agency directives.

The section concludes: "Notwithstanding any other provision of this title, the NCUA may, without any administrative due process, immediately place into conservatorship or liquidation any corporate credit union that has been categorized as critically undercapitalized."

However, given the ongoing uncertainty about the legacy assets, how can credit unions comment on the necessity of these powers? Does the NCUA need the powers to clear the balance sheets of the Corporates as their officials have indicated they may do? Or are these new authorities seen as important in efforts beyond the legacy assets issue?

Conclusion

There are a number of good proposals in these regulations in its current state, including: raising the capital requirements for entities with higher investment risks; reducing the use of short-term funding to finance longer term assets; and improving portfolio diversification. These provisions should remain.

However, there are also serious issues that must be addressed, as listed above. Any one of these new rules on its own would cause a major change to the operations of the

⁶ *Ibid.*

Corporate credit unions; together they may threaten their very existence. And yet, a question lingers about whether this proposal effectively addresses the fundamental problem that has weighed down the Corporates for the past 18 months: the OTTI in legacy assets. This problem remains unsolved by these rules. Any effort that fails to address this issue cannot be truly effective.

It is fundamentally important that credit unions respond to the NCUA's proposal and outline their concerns, as well as their own prescriptions. Please review these findings and use them when drafting your response as applicable.

To Respond

The deadline for comment is March 9, 2010. To submit a comment, use one of the following:

- Federal eRulemaking Portal: <http://www.regulations.gov>
- NCUA website:
http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include —[Your name] Comments on Part 704 Corporate Credit Unions|| in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

For further information contact:

- Richard Mayfield, Capital Markets Specialist, Office of Corporate Credit Unions, at the address above or telephone: (703) 518-6642;
- Ross Kendall, Staff Attorney, Office of General Counsel (OGC), at the at the address above or telephone (703) 518-6540;
- Paul Peterson, Director, Applications Section, OGC, at the address above or telephone (703) 518-6540; or
- Todd Miller, Regional Capital Market Specialist, Region V, at telephone (703) 409-4317.

Full Proposed Regulation from NCUA:

http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/FINALPart704_12-8-2009WebVersion.pdf