



Discussion Framework
Critical Concern Issues Related to Proposed Rule 704
January 11, 2010

While the proposed NCUA Regulation Part 704 contains some beneficial changes that will reduce risk and augment the value of corporate credit unions going forward (i.e. stronger capital standards, limits on investment concentrations, prohibitions on certain securities, and enhanced liquidity processes), the proposed rule contains several changes which, left unchanged in the final rule, will significantly limit the value that corporates will be able to provide and therefore are not in the best interests of the credit union system.

The critical areas outlined below include: 1) NCUA's model for retained earnings growth under proposed investment and ALM limitations including new NEV credit shock and 50% prepayment speed slowdown tests - 704.8(e), (f), (h); 2) Prohibition against redeeming certificates at a premium - 704.8(c); 3) Time period for capital ratio attainment; 4) Prohibition on replenishing capital - 704.2; 5) Prohibited indemnification payments - 704.20(c); 6) 10% deposit concentration limit - 704.8(k).

1. NCUA's model for retained earnings growth, credit risk shock, and prepayment speed slowdown test

Commentary on NCUA's model for retained earnings growth under proposed investment and ALM limitations

Pages 99-101 of the NCUA proposed rule preamble contains an example of the ability to grow earnings under the proposed investment and ALM limitations. We believe this example does not represent an attainable or realistic outcome. The NCUA's example does not include any cost for new capital that must be attained and assumptions on spreads and other factors are not reasonable or achievable.

For instance, in the NCUA example, the model works because it allocates 10% of the investment portfolio to a fairly high risk, extremely illiquid sector - private label student loans. This is on top of a 20% allocation in government guaranteed student loans. Allocating 30% of the portfolio to the student loan sector represents a significant exposure in student loans versus the overall ABS market insofar as a corporate could even find enough of these risk assets to make the model work. This single sector of the NCUA example balance sheet accounts for an astounding 75% of the interest income and 59% of net interest income (20 of 34 basis points) comes from 10% of the portfolio with that 10% of the portfolio yielding LIBOR+200. This represents way too much exposure and is simply not representative of a long run average for sector yield.

Current market intelligence indicates that there is now only one active originator of private label student loans. And, unlike the L+200 spread that NCUA's example portends to achieve on a 0.5 year AAA senior security, a more realistic spread on student loan ABS based on a historical perspective would be more like L+30 or L+50. Based on our review, the only time AAA ABS has ever traded in a LIBOR plus 200 range was during the massive once-in-a-lifetime market disruption in 2008/09. Swapping out 10% of the portfolio at L+200 for a more reasonable long run average of L+30 would make the net interest margin fall from 34 basis points to 17 bps, leaving net income of 4 bps - barely profitable and no way to achieve the capital targets.

There are also issues with the funding mix suggested by NCUA's example. Using 66% of funding in the form of certificates when the proposal seeks to abolish the payment of premiums on early withdrawals (see concern # 2) will dramatically change the funding mix. Adoption of that proposed rule change will surely reduce the amount and term of certificates that will be issued. Any change in the funding mix with lower volume and/or shorter average lives, will cause the volatility limits to be exceeded by greater amounts. It is interesting that the examples of the balance sheet for risk measures (illustrated on pages 90 & 92) have 75% of the funding in overnight balances.

Recommendation

The new NEV tests, two-year weighted average life limitation, and cash flow mismatch constraints in the proposed rule need to be amended in order to allow for a viable business model for corporate credit unions.

Since the examples provided in the preamble do not represent achievable long run averages or a realistic reflection of the constraints contained in the proposed rule, we created a revised model to illustrate a more reasonable and realistic outcome. This revised model is based on a \$10 billion dollar balance sheet for example purposes and assumes no growth in assets or asset mix. Spreads are adjusted downward by 2 or 3 bps over the 7-year time horizon to reflect expectations. Funding has been modified to include a capital note of \$400 million (4% capital assuming a \$10 billion balance sheet) issued on day one, priced as floating at a spread of 200 bps to LIBOR. The adjusted model also assumes that fees and operating expense will increase in line with inflation at an assumed rate of 2% per annum. As the NCUA example did not provide sufficient detail to perform the shock tests, no meaningful results could be produced.

As the table below shows, after adding the 4% capital note and adjusting fees and expenses for inflation but keeping other parameters consistent with NCUA's example, net income drops to 12 bps from 21 bps. An assumed cost of capital of 200 bps may be viewed as excessive. However, as capital is needed on day one, before a corporate is in a position to demonstrate its ability to generate revenue with very little risk, this assumption could be seen as somewhat optimistic. With a capital cost of 200 bps and the spread on private label student loans adjusted to a more reasonable level of an aggregate 50 bps, the model shows a *negative* net income spread of -3 bps.

Fundamentally, the examples below confirm that a corporate cannot make enough net interest margin, starting from zero RUDE, with the credit shock and pay down shock risk limits as proposed. As these are purported to limit the average life gap to 3 months, it is equally clear that no sustained yield curve could generate anything but a very thin net interest margin. As the example in the preamble did not provide details of fixed and floating instruments, no NEV shock analyses could be performed.

	NCUA EXAMPLE		ADJUSTED FOR CAPITAL		ADJUSTED FOR SPREAD	
	PERCENT OF BALANCE SHEET	SPREAD TO LIBOR	PERCENT OF BALANCE SHEET	SPREAD TO LIBOR	PERCENT OF BALANCE SHEET	SPREAD TO LIBOR
ASSETS						
FFELP Student Loans	20%	25	20%	25	20%	25
Private Student Loans	10%	200	10%	200	10%	50
Auto ABS	20%	25	20%	25	20%	25
Credit Card ABS	10%	30	10%	30	10%	30
Other ABS	10%	10	10%	10	10%	10
Overnight	30%	0	30%	0	30%	0
TOTAL	100%	34	100%	34	100%	19
SHARES AND EQUITY						
Overnight Shares	30%	0	30%	0	30%	0
Certificates	70%	0	66%	0	66%	0
Capital Note	0%	0	4%	200	4%	200
TOTAL	100%	0	100%	8	100%	8
NET INTEREST MARGIN		34		26		11
OTHER INCOME		17		18		18
OPERATING EXPENSES		30		32		32
NET INCOME		21		12		-3

The following revised model illustrates an investment portfolio projected over a 6-year period using realistic and prudent sector mixes and spreads.

LONGER-TERM ANALYSIS

	BASE EXAMPLE			REQUIRED VOLATILITY	
	PERCENT OF BALANCE SHEET	SPREAD TO LIBOR		PERCENT OF BALANCE SHEET	SPREAD TO LIBOR
ASSETS					
Loans	10%	50		10%	50
ABS - Autos	20%	37		20%	37
ABS - Credit Cards	15%	42		15%	42
FFELP Student Loans	5%	45		5%	45
Structured Agency	15%	34		15%	34
Bank Floaters	5%	29		5%	29
Other Short-term	8%	12		8%	12
MBS - CMBS	7%	100		7%	100
Overnight	15%	4		15%	4
TOTAL	100%	36		100%	36
SHARES AND EQUITY					
Overnight Shares	50%	0		50%	0
Certificates	46%	0		46%	0
Capital Note	4%	200		4%	200
RUDE	0%	0		0%	0
TOTAL	100%	8		100%	8
NET INTEREST MARGIN		28			28
OTHER INCOME		18			18
OPERATING EXPENSES		32			32
NET INCOME		14			14

MAXIMUM CHANGES YEARS 1,3 AND 6

RETAINED EARNINGS	PROJECTED	TARGET	RETAINED EARNINGS	PROJECTED	TARGET
YEAR 3	\$44.4mm	\$45mm	YEAR 3	\$44.4mm	\$45mm
YEAR 6	\$97.3mm	\$100mm	YEAR 6	\$97.3mm	\$100mm
NEV SHOCKS	MAXIMUM	LIMIT	NEV SHOCKS	MAXIMUM	LIMIT
RATES +300bps	-14.0%	15%	RATES +300bps	-14.0%	-15%
CREDIT +300bps	-84.3%	15%	CREDIT +100bps	-30.3%	-35%
+PAYDOWNS -50%	-92.6%	25%	+PAYDOWNS -50%	-32.7%	-40%

Commentary on credit risk shock

The NCUA proposed rule introduces two new NEV tests, a credit widening NEV test, and a credit widening plus 50% slowdown test. The draft regulation calls for a 300 bps *credit* shock to base case pricing for all balance sheet items but *excludes off-balance sheet transactions*, such as derivatives. The proposed rule also indicates that limits would be set at the same level that is applied to the +300bps interest rate shock test (i.e., 15% maximum decline for NEV changes, and a 2% floor on the NEV ratio).

For fixed rate instruments, this will slightly increase the amount of risk assigned, as the same 300 bps decline will be discounted at a lower rate in the credit shock environment. However, for floating rate instruments, the impact will be much larger. The credit spread shock will apply to the entire life of the floating rate instrument, effectively converting it to a fixed rate for measurement purposes. Floating rate instruments are normally attractive investments for a corporate as they react quickly to changes in interest rates giving relatively stable price profiles, but their attractiveness would be eliminated under this test.

Our analyses indicate that there is no combination of assets, with a 2-year average life and limited extension risk, which can generate sufficient margin to attract funding *and* pass a 300 bps credit shock test.

Historic analysis indicates that 100 bps would be an unusual and rare event in the market sectors which would be allowed under the new regulation. Over the last 15 years, excluding recent events, Credit Card and Auto ABS credit spreads to LIBOR widened to a maximum of around 50 bps, and generated a standard deviation of spread volatility of around 10 bps.

Recommendation

The Proposed Rule should be amended to a 100 bps credit spread widening and a 35% NEV volatility tolerance limit and there should be a limited shock for GSE debt. Consideration should also be given to scaling the credit shock to the weighted average life of the instrument.

Setting the credit shock test at 100 bps widening – double the historical average – is a more reasonable and realistic requirement. Even at 100 bps credit shock, a NEV volatility limit of 35% decline is needed to accommodate the impact of floating rate investments carrying the loss to maturity.

Further, there is a significant difference between Agency issued instruments and other securities. Debt of Government Sponsored Entities would not carry concentration limits in the proposed rules. These securities trade in very large and liquid markets. Therefore, we recommend using a lower credit spread shock, for example 50% of the regular spread shock, for securities issued by GSEs.

Commentary on prepayment speed slowdown test

While ABS prepayment speeds do change modestly from time to time, they appear to be more driven by economic events rather than interest rate or credit events. There is no factual or historic basis for halving ABS speeds in the context of a credit risk shock test. However, MBS pay downs are subject to interest rates and economic events, and an arbitrary factor of a 50% slowdown may be warranted,

and in some cases, may not be enough. The proposed rule recognizes that slowing pay down speeds on MBS by 50%, on top of the credit shock test, requires the NEV volatility limit to be expanded by 10%.

The portfolio/asset limit of 2 years in weighted average life along with the credit shock and prepayment speed slowdown tests will effectively make holdings in MBS (the single largest asset backed sector) virtually impossible. However, there is clearly a significant difference between private label MBS and Agency issued MBS – GSEs do not carry any concentration limitations.

Recommendation

To gain access to this market and earn a spread for taking prepayment risk without taking credit risk, consideration should be given to having separate rules for Agency MBS. Clearly prepayment speed slowing needs to be assessed, but it would be more reasonable if it were applied to a smaller credit shock, for example 50% of the credit shock used for other security types. Further, it is recommended that the proposed regulation apply the prepayment speed slowdown test to MBS holdings only and drop the prepay slowdown test for non-residential mortgage ABS and to set the NEV volatility limit to 40%.

2. Prohibition against redeeming certificates at a premium

Commentary

Currently, a corporate may adopt a policy to redeem an outstanding certificate at a market rate, even if it is at a premium dollar price. The proposed regulation eliminates this ability.

This will place corporate credit unions at a significant funding disadvantage and will likely destroy or make non-economical, the institutional funding market for term certificates. This change will also have negative implications on system liquidity, corporates ability to achieve a sound funding strategy, and may impact the ability of corporates to provide lines of credit to credit unions.

Corporate term certificates are in direct competition with Agency issued debt. Corporates have been able to compete effectively based on yield (paying competitive interest rates), flexibility (structuring terms that meet credit union needs rather than credit unions having to take whatever the Agency market happens to be offering), collateral value (assigning 100 cents on the dollar on corporate certificates regardless of market value whereas Agency debt is assigned a percentage of the prevailing market value), and liquidity (redeeming certificates at prevailing market prices). By removing the comparable liquidity option, all corporate certificates will be at a distinct disadvantage and brokers will be very quick to point that out to credit unions.

While the intent of this proposed change may be to encourage stability in corporate funding, the resulting impact will be the opposite as term funding will move off of corporate balance sheets. This will significantly reduce overall liquidity in the corporate system and lead to heavier dependence on volatile daily and very short term shares funding corporate balance sheets. Corporates will have to maintain higher levels of short term assets for prudent liquidity and volatility limit conformity, but this will reduce the ability for corporates to generate net interest income to build retained earnings and it could negatively impact corporates' ability to fund credit union lines of credit since corporates will have fewer longer term assets to pledge as collateral with other funding participants.

Recommendation

Leave the current rule as is for certificate redemption and if necessary, possibly define a mechanism for how a gain should be paid.

3. Time period for capital ratio attainment

Commentary

The one year window to attain the risk-based capital ratios is a significant concern since this will require corporates to bring in new capital or at a minimum convert existing MCA to the new PCC during a time when significant issues still remain with regards to legacy assets for some corporates. Further, we believe that the proposed rule actually indicates that corporates need to not only attain the risk-based capital ratios after the first 12 months of the rule becoming final, but that the leverage ratio also needs to be achieved within 12 months as opposed to the 36 months that was discussed during town hall meetings (see below for sections from the proposed rule that addresses this).

Most corporate credit unions are currently undercapitalized with little or no retained earnings and total capital that consists exclusively of 3-year notice MCAs. In order to comply with the 4% Leverage Ratio requirement that we believe starts 12 months following the publication of the final rule, corporate credit unions may only utilize NCC in an amount equal to PCC plus retained earnings. Since most corporates do not have 5-year MCAs, a conversion of 3-year MCAs to PCC within 12 months of the final rule is the only logical action to achieve a 4% Leverage Ratio. Most corporate credit unions will also have to ask their member credit unions to contribute substantial additional capital dollars as current MCA balances do not add up to a 4% capital to assets ratio.

Due to a lack of sufficient retained earnings at most corporates, credit unions will be asked to contribute roughly 4% of their corporate credit union deposits as perpetual capital within 12 months of the final rules' publication. Many credit unions will likely balk at contributing additional capital in such a short time frame as corporate credit unions will be managing legacy assets as well as adapting to the new business models that flow from the revised regulation 704. This rush to achieve a 4% Leverage Ratio via PCC may lead natural person credit unions to pull deposits from the corporate system and result in severe liquidity concerns for corporate credit unions.

The language contained in the proposed rule is copied below in the order that it appears within the proposed rule with sections cut out that don't pertain to the specific language that requires corporate credit unions to achieve a 4% Leverage Ratio after 12 months. Additionally, language in the proposed rule is included that specifies NCC in excess of PCC + RE will be excluded from the calculation of the Leverage Ratio during the months 12-36 following publication of the final rule.

Proposed rule language - after 12 months certain definitions change including the definition of Adjusted Total Capital as well as the definition of the Leverage Ratio.

3. Effective [DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise §704.2 to read as follows:

§ 704.2 Definitions.

Adjusted total capital means total capital modified as follows: to the extent that nonperpetual contributed capital accounts are included in total capital, and the sum of those NCAs exceeds the aggregate of the corporate's PCC and retained earnings, the corporate will exclude the excess from adjusted total capital.

Leverage ratio means, before [DATE 36 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], the ratio of adjusted total capital to moving daily average net assets.

Nonperpetual capital means funds contributed by members or nonmembers that: are term certificates with a minimum term of five years or that have an indefinite term (i.e., no maturity) with a minimum withdrawal notice of five years; are available to cover losses that exceed retained earnings and perpetual contributed capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, the holders of nonperpetual capital accounts (NCAs) will claim equally. These claims will be subordinate to all other claims (including NCUSIF claims), except that any claims by the holders of perpetual contributed capital (PCC) will be subordinate to the claims of holders of NCAs.

4. Effective [DATE 12 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], revise §704.3 to read as follows:

§704.3 Corporate credit union capital.

(a) *Capital requirements.* (1) A corporate credit union must maintain at all times:

(i) A leverage ratio of 4.0 percent or greater;

(ii) A Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) A total risk-based capital ratio of 8.0 percent or greater.

Recommendation

Extend the time period for attaining the risk-based capital ratios to three years and clarify language in the proposed rule that discusses attainment of the Leverage Ratio to coincide with a time period of three years.

4. Prohibition on replenishing capital

Commentary

The ACCU, CUNA, credit unions, and others have continued to express concerns with the regulatory mandate to permanently deplete capital based on estimated losses created by OTTI models with no ability for corporates to replenish capital back to existing capital holders if actual losses are less than projected. GAAP does not require the treatment being applied by the NCUA, which is covered in the Letter to Credit Unions 09-CU-10 and now included in the revised definitions in the proposed rule. Further, as part of its Accounting for Financial Instruments project, it is likely that the FASB will change the credit impairment model standards in 2010 to allow OTTI reversals as loss projections improve. Therefore, corporates who have taken prior OTTI charges may be able to reverse those

charges as loss projections improve. NCUA regulatory accounting treatment should allow for the same accounting treatment as national standards and not permanently deplete credit union capital based on projections which will continually change.

Recommendation

NCUA should not require permanent depletion of capital based on estimated OTTI model predictions and should allow for a mechanism to exist where corporates would be able to replenish capital back to existing capital holders if actual losses are less than projected.

In separate communications and discussions with the NCUA, the ACCU developed a model and mechanism that would facilitate the ability of member credit unions to recapture depleted capital by having corporates segregate and measure the performance of previously impaired legacy assets from all other assets. Future recoveries in value could be available to return to the original member contributed capital holders in the form of a “paid in kind” PIC dividend and once a corporate met all regulatory hurdles, the Corporate’s board could determine that any portion of the paid in kind PIC balance could be redeemed in cash. The corporate credit union would thus possess the right, but not the obligation, to pay recovery dividends.

This, or some other mechanism to replenish the capital of credit unions should be allowed in order to lessen the strain on the industry.

In addition, in these communications and discussions, the ACCU has also advocated for the NCUA to utilize the Stabilization Fund to absorb any future impairment on legacy assets, acting as a buffer to protect the value of newly contributed capital. Any recoveries to legacy assets would first have to be applied to the Stabilization Fund to restore previous depletions before it could become available to restore previously depleted capital.

5. Prohibited indemnification payments

Commentary

This proposed change imposes what appears to be unlimited personal and professional liability risk for corporate directors and management with respect to the decisions that are made in carrying out their official responsibilities. As a result, it will be difficult if not impossible to maintain volunteers or management without indemnification for actions taken while performing their professional responsibilities. Qualified and knowledgeable directors and management are crucial for a corporate or any entity to succeed. The proposed change seems to inflict consequences that other financial regulators do not impose on the organizations that they regulate.

Recommendation

Continue to allow corporates to provide, at their discretion, indemnification coverage for directors and management incurred while performing duties that are not provided by insurance.

6. 10% deposit concentration limit

Commentary

This proposed change will drain liquidity from the system by forcing credit unions to place funds outside of the corporate system resulting in less efficient deposit processes and possibly larger risks for credit unions. This proposed limitation places further regulatory constraints on corporates that no other regulated financial institutions are required to follow. New regulatory restrictions, coupled with the bank capital standards that corporates will be required to achieve, will make it very difficult for corporates to compete in the financial services marketplace. Credit unions can choose to invest an unlimited amount of funds in banks as long as proper due diligence is conducted. They should not be precluded from investing those funds in another credit union (corporate) as long as they conduct the same due diligence.

Recommendation

Credit unions should be able to make their own assessments of the value and risk they want to assume and an arbitrary limit placed on corporates should not be put into effect. An alternative solution to achieve NCUA's objectives with this proposed change could be that deposits from one source should be limited to the greater of 10% of a corporate's assets or 100% of a corporate's assets that carry a risk weighting of 20% or less.