Members United
CORPORATE FEDERAL CREDIT UNION

Members United Corporate FCU

Response to NCUA Advance Notice of Proposed Rulemaking

Developed by the members, Board of Directors, Committee members, and staff.

As of March 29, 2009

Table of Contents

1. The Role of the Corporates in the System ……………………………………………….. 2
ANPR Issue Description and Questions
Members United's Position(s)

2. Corporate Capital ……………………………………………………………………………… 10
ANPR Issue Description and Questions
Members United's Position(s)

3. Permissible Investments ………………………………………………………………….. 12
ANPR Issue Description and Questions
Members United's Position(s)

4. Credit Risk Management ………………………………………………………..…… 14
ANPR Issue Description and Questions
Members United's Position(s)

5. Asset Liability Management…………………………………………….…………..…… 16
ANPR Issue Description and Questions
Members United's Position(s)

6. Corporate Governance ……………………………………………………………..…… 17
ANPR Issue Description and Questions
Members United's Position(s)

Other Issues ……………………………………………………………………………….… 19
Members United's Position(s) in response to the NCUA Board invitation for comment on the six issues above and any other relevant issues pertaining to corporate credit unions.

Members United Corporate FCU

Response to NCUA Advance Notice of Proposed Rulemaking

Many observers of the credit union movement have long believed that the Corporate Network and its key business models must undergo significant change for corporate credit unions to be relevant contributors in the future.

The past year's market events and their impact upon corporate credit unions have led to unprecedented cooperation among corporates and extraordinary actions by the NCUA to address liquidity, confidence, and capital needs. They have also prompted corporates and other stakeholders to examine longer-term systemic solutions to address risks exposed by the current market crisis. More recently, the NCUA formalized its own examination by issuing an Advanced Notice of Proposed Rulemaking and Request for Comment (ANPR).

NOTE: Throughout this document, italicized text indicates passages from NCUA 12 CFR Part 704.

1. THE ROLE OF CORPORATES IN THE CU SYSTEM

ANPR Issue Description and Questions

Recent events have highlighted structural vulnerabilities in the corporate credit union system. NCUA is considering whether comprehensive changes to the structure of the corporate system are warranted. Possible approaches the agency is considering include eliminating the second or wholesale tier from the corporate system, modifying the level of required capital, isolating payment services from the risks associated with other lines of business, determining which product and service offerings are appropriate for corporates, requiring a restructure of corporate boards, and tightening or eliminating the expanded investment authority that is currently available to corporates.

<u>Payment system</u>. *Some of the questions and issues arising in this context, on which the Board is seeking comment, include matters such as whether payment system services should be isolated from other services to separate the risks. If so, what is the best structure for isolating these services from other business risks? Specific comment is solicited concerning whether, for example, it would be better to establish a charter for corporate credit unions whereby a corporate's authority is strictly limited to operating a payment system, with no authority to engage in other services, such as term or structured investments. Additionally, a separate charter may be available for corporate credit unions that want to engage in providing investment services. Another alternative would be for NCUA to establish distinct capital requirements for payment systems risk and the risks of other corporate services. NCUA could also require that a legal and operational firewall be established between payment system services and other services. In connection with this topic, comment is also sought on the question of whether there is sufficient earnings potential in offering payment systems to support a limited business model that is restricted to payment systems services only.*

Liquidity and liquidity management. Historically, the primary role of corporate credit unions has been to provide and ensure liquidity. Corporate investments were made with an eye towards ensuring funds would be available (or used as collateral for borrowings) to meet members' short-term liquidity needs. Recent events underscore the need to assure a corporate properly considers its investment position relative to its cash flow needs. The Board recognizes and understands that providing liquidity for the credit union system is one of the principal purposes of the corporate credit union network. One question for consideration and comment is whether liquidity ought to be considered a core service of the corporate system, and if so, what steps should be taken, and by whom, to preserve and strengthen corporates' ability to offer that service? For example, should NCUA consider limiting a corporate's ability to offer other specific types of products and services in order to preserve and defend the liquidity function? What specific types of products and services should corporates be authorized to provide?

NCUA is considering additional cash flow measuring requirements to assist corporates in achieving and maintaining proper liquidity management. In this respect, comment is specifically solicited on the question of whether NCUA should add aggregate cash flow duration limitations to Part 704. If so, commenters are invited to describe how this requirement should be structured, and also to identify how such limitations would benefit liquidity management. Finally, comment is solicited on the question of what cash flow duration limits would be appropriate for corporate credit unions, particularly in an evolving interest rate market with previously unseen credit risk spreads.

Field of Membership Issues. NCUA also seeks comment on whether and how to restructure the corporate credit union system. For example, despite its intention of fostering competition, NCUA's decision to allow corporates to have national fields of membership (FOMs) may have resulted in significant, and unforeseen, risk taking. For example, corporates have competed with each other to offer higher rates, and have done so through the accretion of credit and marketability risks. To address this development, should the agency return to defined FOMs, for example, state or regional FOMs?

Expanded Investment Authority. At present, Part 704 provides for an option by which corporates meeting certain criteria can qualify for expanded investment authority. For example, a corporate meeting the criteria set out under Part One of the expanded authority is allowed to purchase investments with relatively lower credit ratings than otherwise permissible under the rule. NCUA seeks comment, first, as to whether the need for expanded authorities continues to exist. If so, should NCUA modify the procedures and qualifications, such as higher capital standards, by which corporates currently qualify for expanded authorities? If so, what should the new standards be? Should NCUA reduce the expanded authorities available? If so, which ones? Alternatively, should any of the limits in existing expanded authorities be reduced or increased? If so, which ones? Once granted, should NCUA require periodic requalification for expanded authorities? If so, what should be the timeframe?

Structure; two-tiered system. Over time, the corporate system has evolved into two tiers: a retail network of corporates that provide products and services to natural person credit unions, and a single, wholesale corporate that exclusively services the retail corporates. NCUA solicits comment about whether the two-tier corporate system in its current form meets the needs of credit unions. Specifically, NCUA seeks input from commenters about whether there is a

continuing need for a wholesale corporate credit union. If so, what should be its primary role? Should there be a differentiation in powers and authorities between retail and wholesale corporates? In considering these issues, commenters are specifically asked to consider whether the current configuration results in the inappropriate transfer of risk from the retail corporates to the wholesale corporate. Commenters should also address whether, assuming the two-tiered system is retained, capital requirements and risk measurement criteria (e.g., NEV volatility), as well as the range of permissible investments, for the wholesale corporate credit union should be different from those requirements that apply to a retail corporate credit union.

Members United's Position(s)

Payment System

It is really a liquidity management issue – The pressing issue related to payments is a corporate's ability to fund settlement associated with the payments services it provides. This is effectively a subset of the overnight and intra-day settlement and liquidity risks that corporates incur by being in the settlement services business. A corporate settles many classes of transactions including the payments it operates, payments others (e.g. Federal Reserve, banks, League Service Corporations, independent processors) operate, deposits and associated dividends, loans and associated payments, etc. The ANPR asks whether the payment services should be isolated from other services to separate the risks. Members United believes that settlement of payments cannot be effectively separated and should be addressed in a broader context than just payments. This issue is addressed further under "Liquidity and Liquidity Management" below.

Corporates have managed other payment risks well – Corporates have offered payment services and managed the associated risks quite well for decades. In fact, part of the value corporates offer is mitigating some of their members' payment risks through corporates' payment offerings and associated settlement services. Assuming the primary issue of liquidity risk is addressed, there is little reason to believe that corporates cannot continue to operate their own, and distribute others', payment services successfully.

Corporates must offer payment and settlement services – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Allocating capital for payment operations is appropriate – Corporates must fully understand all material risks to capital and should allocate an appropriate portion of their capital to all business lines (e.g. deposits, lending, settlement services, and payment services).

Corporates do not need to operate many of the payment services – Corporates need to offer and settle the products but do not necessarily need to operate many of the products in-house. Today, nearly all corporates distribute products operated by U.S. Central, Leagues, League

Service Corporations, CUSOs, and non-credit union third parties. In many cases, they augment distributed products with value-added education, implementation services, support, and/or consulting. Most corporate in-house payment operations are for member and third party domestic wires, share drafts, check collection deposits (and related image services), and corporate share draft. Though corporates have significant expertise and are offering some unique solutions to their members, there is little reason why these operations cannot be removed from the corporates' operations and processed by others.

Corporate payment operations should be consolidated – The redundant corporate payment operations limit corporate profitability, slow capital accumulation, and inflate fees to members. The fragmented nature also limits incremental and radical innovation, while the limited (regional) markets often make new products infeasible because required scale cannot be achieved. The industry should consider consolidating corporate payments, and potentially those of some other credit union-owned payment operations, to better serve credit unions. Though this consolidation would require several years and considerable expense to complete, the long-term strategic and financial benefits to the industry would be significant.

Suggested changes to regulation, rules, and other guidance – Members United believes the NCUA should consider the following when revising related regulation, rules, and other guidance:

- Require corporates to isolate certain payment operations from the core corporate and require that the business model be self-sustaining (have sufficient capital and profitability). This will likely encourage consolidation and/or out-sourcing to third parties.
- Eliminate the "excess capacity" provision for payment CUSOs that do not have a single majority owner. This would allow these separate entities to serve credit union business clients and non-credit union markets to amass greater scale, higher profitability, and accelerated capital accumulation.

Liquidity and Liquidity Management

Liquidity must continue to be a core service of the corporate system – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Corporates have historically managed liquidity risks well – Corporates have successfully managed their own liquidity while providing liquidity solutions for members through many difficult economic cycles.

Unprecedented economic crisis severely tested even the best liquidity plans – The current unprecedented and catastrophic economic downturn has created a credit and liquidity crisis few imagined possible. The corporates have successfully accommodated dramatic decreases in deposits even without the ability to sell investment securities.

Require cash flow measurement and reporting – To effectively manage liquidity, corporates must have adequate measurement and reporting processes. To the extent corporates' processes are inadequate to properly assess their cash flows, regulators should require improvement under best practices and other guidance. Applicable methods include:

- Cash flow GAP modeling across prepayment ranges
- Limits on illiquid asset classes
- Limits on readily liquid assets and cash (minimums)
- Review of deposit concentration risk
- Development of requirements for diversified funding sources
- In-depth contingency funding plans

Improve liquidity strategies, plans, and modeling – Corporates' liquidity plans have been effective during many difficult economic cycles. The recent crisis has underscored several best practices that should be employed (e.g. multiple borrowing sources, adequate cash reserves to cover unexpected short-term liquidity swings). Require modeling of liquidity plans for typical fluctuations in economic cycles.

Establish best practice of set-aside funding for settlement – Require corporates to set aside a portion of liquidity to specifically fund daily settlement. The set-aside must accommodate the timing of settlement of debits and credits as well as the daily, monthly, and annual cyclical activity levels. The allocation must be clearly identifiable from other activity and reserved for settlement only. The investment restrictions on these funds should be greater than overall investment guidelines.

Enhance liquidity contingency plans to accommodate more dramatic scenarios – Stress liquidity plans by modeling performance under more dramatic scenarios and adjust liquidity requirements/sources accordingly. Require provisions to increase existing or add new sources of liquidity if limits are hit. One such tool may be to secure member balances as the primary source of liquidity for settlement services and allow the required level of deposit to be adjusted under extraordinary circumstances (such as what the market is currently experiencing). For example, require members to maintain a settlement account balance equal to 1 to 1.5 times a credit union's average or peak historical settlement activity. This is a common practice by some corporates today. The contingency plan may include triggers that increase this requirement to 1.5 or 2 times the average or peak activity in order to ensure adequate liquidity to continue settlement.

Improve the Central Liquidity Facility (CLF) – The CLF has proven to be an invaluable tool for the NCUA throughout the credit and liquidity crisis. However, the agency has encountered legislative barriers that prohibited or hampered their efforts to effectively address the crisis. Conduct a comprehensive evaluation of the CLF and advocate for changes (e.g. higher borrowing authority, ability to lend directly to corporates, ability to invest capital in credit unions or corporates) that improve it as a tool for use by the NCUA and the industry.

Build corporate capital – Corporate capital has historically been adequate to weather economic cycles. However, this market crisis will redefine capital adequacy for all sectors of the financial services industry. Higher capital levels would provide corporates greater ability to either sell securities at a loss when liquidity is needed, or to hold securities that cannot be sold for a fair value (accommodate "Other Than Temporary Impairment (OTTI)"). Higher capital levels would

also help the corporates retain higher ratings, preserving member balances and external sources of liquidity.

Field of Membership Issues

Impact of national fields of membership – Granting of national fields of membership did foster competition as well as increased risk-taking, as cited in the ANPR. It also contributed to:

- Margin compression, lower return on assets, and slower capital accumulation
- Better rates for member credit unions
- Fragmented innovation and product operations as corporates sought ways to gain advantages over other corporates
- Reduction in cooperation, trust, and utilization of shared resources such as U.S. Central

The Corporate Network must cooperate to succeed – With such low capital and low margins, corporates must find every way possible to leverage precious resources to meet member needs, widen margins, and accumulate capital. The primary areas where corporates should cooperate include payment operations, shared back office services, and innovation.

Eliminate or greatly reduce competition between corporates – Competition is nearly always a productive force. However, Members United strongly believes that the value of mass cooperation among corporates will produce much greater value to credit unions than mass competition. The level of competition from numerous non-corporate providers is enough competition to ensure innovation, service, and competitive price levels.

The "Preferred Corporate" alternative – A more practical approach is to allow each credit union to pick their primary corporate, regardless of location. This approach would involve the following:

- Require perpetual membership capital for a credit union to obtain services from a corporate
- Standardize capital requirements so that corporates do not compete over credit unions by lowering required capital levels
- Allow corporates to vary rates on perpetual membership capital to help build capital, then reward owners for financial performance of the corporate once minimum capital targets are met
- Allow very limited portability of membership by permitting a credit union to sell their perpetual capital in one corporate (to another willing buyer) and join another corporate (contributing perpetual capital to the new corporate). Include restrictions required for the perpetual capital to qualify as GAAP Tier 1 capital. Require Board of Director approval so that a corporate does not experience a catastrophic loss of capital if a group of credit unions changed during the same period. Govern unforeseen occurrences by requiring NCUA approval of such migrations
- Enable corporates to distribute other corporates' investment and lending products, for a fee. This would allow credit unions to diversify investments and liquidity sources across multiple corporates without fostering the fierce competition that currently exists
- Allow credit unions to directly diversify their investments and liquidity sources by establishing one or more relationships with "secondary" corporates. The credit union would be allowed to obtain select services (term investments, term loans) by depositing

three-year term membership capital shares in proportion with the level of services utilized. Pricing of these products would be no better than what a “primary” member could obtain (to reduce competition for diversification services)

Expanded Investment Authority

Corporates are restricted to highly rated investments – Corporates are only allowed to purchase highly rated securities and have well-defined guidance for risk exposure. Regulation and guidance have evolved with the financial markets and have proven adequate prior to the current extreme credit and liquidity crisis.

Expanded investment authorities are appropriate tools – These expanded authorities should not be universally prohibited by regulation. Corporates use expanded authorities to increase investment options (for both diversification and yield), create product offerings, mitigate risks (using derivatives), and facilitate member liquidity by participating in member loans. The tools have valid applications, and the competition outside the Corporate Network has these tools available to them. The question should be whether the corporate has appropriate expertise, systems, processes, and controls to utilize the tools effectively and safely.

The NCUA currently correlates eligibility and limits with capabilities – The agency currently grants specific authorities and sets limits based upon a corporate’s capital, risk profile, and ability to utilize the tools effectively and safely. Access to expanded authorities requires significant investment in staff, systems, and process development. The bar is already set very high; adjust it as needed.

Setting more definitive guidance for required capital levels is appropriate – The agency currently considers many factors in granting authorities and setting limits. Agency staff members need latitude in this area. However capital levels should be a foundation requirement for additional authorities, so it seems reasonable that more definitive guidance be provided.

The NCUA currently conducts at least annual reviews of corporate authorities – Corporates with expanded authorities are subject to extensive and ongoing reviews by the NCUA that may result in changes to limits, moratoria on new use of authorities, suspension, or termination of authorities. If these processes are inadequate to determine whether the corporate can effectively and safely exercise the authorities, then the agency should consider enhancing these processes rather than layering on additional redundant processes.

Structure: Two-Tiered System

The Corporate System should be collapsed into a single tier – Many functions are replicated at the two tiers creating significant inefficiencies. Capital accumulation at both tiers is not feasible given current low margins and ROAs, prospective losses, and anticipated increases in capital requirements across the entire financial services industry. To gain efficiencies, improve margins, and accelerate accumulation of capital, one tier should be eliminated.

Single corporate and multiple corporate models are both viable – 1) A single national corporate would provide the greatest operating efficiency and can be more responsive to industry opportunities and challenges. However, all risk would be concentrated into a single

organization. It is likely the percentage of credit union investable funds and borrowing currently held in corporates would drop as members would not have the option of diversifying across multiple corporates. 2) The multi-corporate options would spread risk but would also be less efficient. Under the current models, the fewer the corporates, the more efficient the network would become. These inefficiencies may be tempered somewhat if the level of competition was dramatically reduced and cooperation (e.g. consolidation of common functions such as payments, core technology, and innovation) was dramatically increased. Solutions for enabling credit union diversification of investments and borrowing across multiple corporates must be implemented to ensure that the network retains credit union business, increasing earnings and capital accumulation. The members of Members United unanimously see the need for corporates and the services that they provide. Many members expressed they could not survive without their corporate relationship and would have to turn to banks for services if they lose the corporate's services. There is consensus among the members that there should be four to six corporate credit unions. One national corporate represents too much concentration risk while the current system has too many corporates. It was frequently suggested that the credit unions be the ones that determine how many corporates there should be and which ones should survive.

Elimination of a tier will spur consolidation of corporates and common corporate functions – Elimination of one tier will require all corporates to have the capability to effectively manage its investments, liquidity, risk and other functions. The more the corporates cooperate to create efficiencies (e.g. consolidate payments, share technology, cooperatively innovate), the greater the viability of the existing corporates. Ultimately, the marketplace, the level of cooperation, and the expenses to operate in a safe and sound manner will determine the number of corporate credit unions.

There is need for one or more central CUSOs – Whatever the number of corporates, certain functions should be consolidated for efficiency and to enable opportunity. At a minimum, this entails centralized payments, technology (core account processing, common electronic delivery channel), and innovation functions. Other opportunities to centralize functions for scale include risk modeling, member call centers, business lending, health banking and brokerage services. This action would require strong regulation and supervision of CUSOs by NCUA.

2. CORPORATE CAPITAL

ANPR Issue Description and Questions

NCUA is considering revising various definitions and standards for determining appropriate capital requirements for corporate credit unions. For example, the agency could establish a new required capital ratio consisting only of core capital excluding membership capital accounts as a component of regulatory capital; the agency could also determine to increase the required capital ratio to more than four percent. The agency could also establish a new ratio based on risk-weighted asset classifications, which could include some form of membership capital. These changes would bring the corporate capital requirements more into line with standards applied by other federal financial regulators, such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation (recognizing, however, that there are other accounting differences that apply with respect to the calculation of regulatory capital for banks). Another issue under consideration is whether to require a certain level of contributed capital from any natural person credit union seeking either membership or services from a corporate.

Core capital. The Board is considering several issues relating to the agency's approach to core capital (i.e., the traditional "tier one capital" definition as used by the several federal financial institution regulators). Under the current rule, core capital is defined as retained earnings plus paid-in capital. 12 CFR 704.2. Comment is invited concerning whether NCUA should establish a new capital ratio that corporates must meet consisting only of core capital, and if so, what would be the appropriate level to require. Commenters should offer their view concerning what actions are necessary to enable corporates to attain a sufficient core capital ratio as described above, as well as their thought about what would be an appropriate time frame for corporates to attain sufficient capital. The Board invites comment also on the question of what is the appropriate method to measure core capital given the significant fluctuation in corporate assets that occur. Commenters are invited to offer their view on the correct degree of emphasis that ought to be placed on generating core capital through undivided earnings. Finally, NCUA is considering whether to require that a corporate limit its services only to members maintaining contributed core capital with the corporate. Commenters are invited to react to that idea, and to offer any other suggestions or comments relative to the issue of core capital for corporates.

Membership capital. The Board is also considering several issues involving membership capital. 12 CFR 704.3(b). Issues under consideration and for which comment is sought include whether NCUA should continue to allow membership capital in its current configuration, or should the agency eliminate or modify certain features, such as the adjustment feature, so that membership capital meets the traditionally accepted definition of tier two capital. Other questions include whether to tie adjusted balance requirements, as set out currently in §704.3(b)(8), only to assets, as well as whether to impose limits on the frequency of adjustments. The agency is considering whether to require that any attempted reduction in membership capital based on downward adjustment automatically result in the account being placed on notice, within the meaning of current §704.3(b)(3), so that only a delayed payout after the three-year notice expires is permissible. Comment is also sought on whether to require that any withdrawal of membership capital be conditioned on the corporate's ability to meet all applicable capital requirements

following withdrawal. Comment is invited on all these issues and on any revisions NCUA should consider for the definition and operation of membership capital.

Risk-based capital and contributed capital requirements*. Comment is solicited with respect to the following issues pertaining to risk-based capital and contributed capital requirements. Should NCUA consider risk-based capital for corporates consistent with that currently required of other federally regulated financial institutions? What regulatory and statutory changes, if any, would be required to effectuate such a change? Should a natural person credit union be required to maintain a contributed capital account with its corporate as a prerequisite to obtaining services from the corporate? Should contributed capital be calculated as a function of share balances maintained with the corporate? What about using asset size?*

Members United's Position(s)

Core capital definition should be GAAP Tier 1 capital – Under this definition, the corporates' retained and undivided earnings (RUDE) and perpetual paid-in capital (PIC) would qualify. Corporates' term PIC (representing the vast majority of all PIC outstanding) would not qualify.

Core capital requirement of 4% – To build sufficient capital, the Corporate Network must be consolidated for efficiency. This will require several years. A 4% core capital target is achievable if corporates deleverage balance sheets, shrink member deposits, and obtain perpetual member-contributed capital.

Future core capital requirement of 6% – Higher core capital is needed to accommodate changing views of risk and meet expectations of industry stakeholders. The ability for the Corporate Network to build to 6% core capital will depend upon efficiencies gained through consolidation, and its ability to demonstrate enough value to members so they will contribute perpetual capital. Setting a clear vision will serve as a catalyst for consolidation. Without a higher expectation for core capital, fewer hard decisions will be made.

RUDE must be sufficient to accommodate growth – Member-contributed Tier 1 capital must be considered core capital in all respects. Discounting the value in corporate regulation is inconsistent with the GAAP definition of Tier 1 capital. However, RUDE must be sufficient to accommodate balance sheet growth, whether caused by economic cycles or increases in market share. Each corporate should be required to maintain a capital plan that models growth scenarios and maintains RUDE sufficient to accommodate such growth.

Actual capital divided by 12-month DANA is appropriate – The current requirement, actual capital divided by 12-month daily average net assets (DANA), accommodates fluctuations in assets due to seasonality. This will continue to be an appropriate method for measuring capital.

Retain existing membership capital shares (MCS) until core capital is 6% – The existing membership capital shares are needed given the corporates' current capital levels. Once a corporate reaches this capital level, membership capital shares may no longer be needed and might be returned to members (without a notice period). Allow the corporate the option of maintaining this structure to augment core capital in order to fund additional products and services. Govern unforeseen circumstances by requiring NCUA approval of MCS distributions.

Require capital for access to corporate products and services – Limit access to the corporate's core services to those members that have contributed membership capital shares, term PIC, and perpetual PIC. As the Corporate Network is able to retire membership capital share and term PIC structures, users of services will all be perpetual PIC holders.

Index required MCS to usage of applicable services – MCS deposits have historically been indexed to assets with a cap on MCS over a specified asset size. A better approach may be to index MCS to the products that benefit from the capital deposits in excess of required PIC. This may vary across corporates. Allow adjustment between one and four times per year, in a manner that is reflective of the cyclical nature of the underlying products that MCS supports.

Create provision allowing credit unions to diversify investments and borrowing across multiple corporates – Credit unions need to diversify their portfolios. Enabling diversification across corporates meets this need, adds to the aggregate liquidity of the corporate network, and accelerates capital accumulation within the network. Two structures would accomplish this:

- Allow corporates to distribute other corporates' term certificates and term lending as brokered transactions. Limits would govern how much a corporate could distribute through other corporates in order to limit dilution of that corporate's capital and temper competition among corporates. Corporates should not be able to set rates for certificates and loans distributed by other corporates higher than what the issuing corporate's own members can obtain. This, plus a brokerage fee paid to the selling corporate, will temper competition
- Allow credit unions to directly diversify their investments and liquidity sources by establishing one or more relationships with "secondary" corporates. The credit union would be allowed to obtain select services (term investments, term loans) by depositing three-year term membership capital shares in proportion with the level of services utilized. Pricing of these products would be no better than what a "primary" member could obtain (to reduce competition for diversification services)

Establish risk-based capital requirements – Implement risk-based capital regulation in a manner consistent with other federally regulated financial institutions.

3. PERMISSIBLE INVESTMENTS

ANPR Issue Description and Questions

NCUA is considering whether the corporate investment authorities should be constrained or restricted. Presently, corporates have the authority to purchase and hold investments that would not be permissible for natural person FCU members under Part 703 (or, in some cases, outside of what is authorized for a state chartered credit union). This increases a corporate member's exposure to these risks commensurate with their level of investment in the corporate. Questions on which comment is solicited in this context include whether NCUA should limit corporate credit union investment authorities to those allowed for natural person credit unions. NCUA is

also considering whether to prohibit certain categories of, or specific, investments, for example: collateralized debt obligations (CDOs), net interest margin securities (NIMs), and subprime and Alt-A asset-backed securities. Comment is solicited on that issue, as well as on whether NCUA should modify existing permissibility or prohibitions for investments.

Members United's Position(s)

Corporate mission requires different investment authorities than credit unions – There is a natural dichotomy between the investment needs of corporates and natural person credit unions. Credit unions often use investments as an alternative to loans in periods of economic weakness or to more efficiently utilize excess liquidity (usually a small percentage of their total balance sheet). Corporates, in their role as liquidity providers, should be solely focused on the liquid and shorter-term investment products. Credit union balance sheets carry investments primarily for cash/liquidity management, based on much smaller positions. Therefore credit union needs for a wide range of permissible investments, level of investment expertise, and extent of investment and risk infrastructure differs substantially from that of corporates. Credit union infrastructure and expertise is understandably more extensive and appropriately allocated to member lending activities. Whereas corporate balance sheets, which represent primarily investment of credit unions' liquid assets, need a wider range of short-term investment alternatives along with more extensive investment and risk management infrastructure and expertise. Our members overwhelmingly support additional investment authorities for corporates.

Some currently authorized investment types should not be permissible or, if permissible, be subject to conditions – Some currently authorized investment types should be subject to strict conditions, and in some cases, should not be permissible. Examples of such investment types include long-term interest-only strips, long-term principal-only strips, and some types of leveraged floaters and inverse floaters.

New investment types should be made available only after review – Historically, there has been rapid development of investment types. Corporates were typically able to enter these investments on their own. There needs to be some process to effectively evaluate these new investment types in a timely manner before they are brought onto corporate balance sheets. Ideally, this review should be validated by a qualified third party and/or the NCUA staff. This is particularly important if diversification/sector standards are initiated, as new asset classes will be seen as an attractive way to meet such diversification/sector requirements.

4. CREDIT RISK MANAGEMENT

ANPR Issue Description and Questions

The reliability of credit ratings for investments has become more questionable in light of events in the financial industry and the current absence of regulatory oversight for rating organizations. Consequently, NCUA is considering curbing the extent to which a corporate may rely on credit ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs). Comment is requested on whether NCUA should require more than one rating for an investment, or require that the lowest rating meet the minimum rating requirements of Part 704. NCUA also solicits comment on whether to require additional stress modeling tools in the regulation to enhance credit risk management.

Several specific aspects of this issue are under consideration, for which comment is solicited, including whether Part 704 should be revised to lessen the reliance on NRSRO ratings. Commenters are invited to identify any other changes they believe may be prudent to help assure adequate management of credit risk. In this respect, commenters should consider whether Part 704 should be revised to provide specific concentration limits, including sector and obligor limits. If so, what specific limits would be appropriate for corporate credit unions? Comments are also solicited on the question of whether corporates should be required to obtain independent evaluations of credit risk in their investment portfolios. If so, what would be appropriate standards for these contractors? Another issue under consideration is whether corporates should be required to test sensitivities to credit spread widening, and if so, what standards should apply to that effort.

Members United's Position(s)

Existing practices proved too reliant on ratings – Corporate regulation and credit risk practices used rating agencies as the predominant metric for evaluation of credit risk associated with investment securities. While this has been historically reliable, it proved inadequate throughout the current credit crisis, providing a false sense of confidence as ratings volatility and downward migrations have reached historic levels. Ratings, while predominant, were not the only metrics used to evaluate investment securities. Additional input included rating agency comments, analysis from other providers (brokers, analysts, and industry sources), internal modeling, historical performance of asset types, and forward-looking reviews by industry experts.

Fix the rating agencies – The financial services industry must require significant improvement in the rating agencies' performance. The agencies must maintain their independence and minimize conflicts of interest between agencies and issuers.

Require ratings from multiple agencies – Improve practices by obtaining ratings from multiple agencies utilizing, or assigning greater weight to, the lowest rating. However, the industry should be cautious that obtaining multiple ratings can also provide a false sense of security as

current credit market dislocations were not accurately assessed by any of the rating agencies. We can hope that the use of multiple rating agencies in the future will prove more effective as the rating agencies revise their modeling, internal governance, and accountability to both investors and regulatory bodies.

Establish an external review process for new security types – Obtain an external review, by a qualified third party, of the appropriateness of new security types as well as existing types as the industry evolves. An alternative is to obtain a regulatory review of any new asset class.

Limit duration or cash flow structures – Establish rules to limit cash flows and duration of investment securities with the intent to minimize the potential impact of deterioration of credit spreads (as we have witnessed over the past 24 months).

Better-defined and controlled concentration limits – New limits and controls are essential. However, there are prerequisites to implementing effective limits and controls. While "Obligor" is a well-defined term, "sector" is not. Each investor has its own definition of sectors. A standard definition of sectors must be created and applied consistently across all corporates. Governance of this definition must be nimble enough to accommodate the pace of change in the industry (e.g. new asset classes). It is not feasible for this to be coded in regulation but should be governed by other agency guidance.

Target optimum, not maximum, diversification – Diversification needs to be the hallmark of new guidance for corporates going forward. However, care must be taken to avoid unintended consequences of increasing risk. While diversification can provide definitive benefits, too-stringent diversification requirements can perversely increase risk as sub-standard asset classes could be added only as a diversification requirement.

Establish independent evaluations of credit risk portfolios – These reviews would be conducted by qualified third parties at a frequency appropriate for the risks of the portfolio. The costs of such reviews must be appropriately balanced with the risks and costs.

Test sensitivities to credit spread widening – Credit spread widening should be included as one of the risk parameters in the review of credit risk, and should be included in the reviews of interest rate and liquidity risk.

Change third-party reviewers every few years or conduct cross-validation with another party – Encourage corporates to change providers of external reviews periodically or conduct periodic cross-validation to ensure that the corporates' view of these risk categories are appropriate with current risk methodologies, new developments, and consistent with industry best practices.

5. ASSET LIABILITY MANAGEMENT

ANPR Issue Description and Questions

In a previous version of its corporate rule, NCUA required corporate credit unions to perform net interest income modeling and stress testing. Because one of the problems leading to the current market dislocation is a widening of credit spreads, the agency is considering re-instating this requirement. Alternatively, the agency may consider some form of mandatory modeling and testing of credit spread increases. Comment is solicited on whether NCUA should require corporates to use monitoring tools to identify these types of trends, including specifically comments about tangible benefits, if any, that would flow from these types of modeling requirements.

Members United's Position(s)

Reinstate requirement for modeling and stress testing net interest income – All corporates should model projected net interest income.

Establish requirement to model net income and NEV – All corporates should model net income and net economic value (NEV) as part of their monthly risk modeling and monitoring processes.

Encourage corporates to explore and utilize alternative methodologies – In addition to the standard required processes, corporates should explore the appropriateness and utility of employing concepts such as value at risk (VAR) and NEV utilizing total capital. As new tools and methodologies become available, corporates should always be examining new methods (without this being required by regulation).

Require modeling and testing of credit spread increases – The impact of recent market events exposes weaknesses that can be addressed by this important risk management process.

Require external reviews of all key risk processes – Corporates should obtain external validation of interest rate risk, credit risk, and liquidity risk processes and results (similar to the external validations that credit unions are required to obtain on their interest rate risk modeling). This will ensure that the corporates' view of these risk categories are appropriate with current risk methodologies and new developments, and are consistent with industry best practices.

Anticipate and accommodate significant change over the next two years – The current crisis will prompt significant change in how the financial services industry views, measures, and manages risk. This will cause numerous changes to related best practices, tools, and technologies. Corporates and the NCUA must be able to understand and accommodate the coming change.

6. CORPORATE GOVERNANCE

ANPR Issue Description and Questions

The sophistication and far-reaching impact of corporate activities requires a governing board with appropriate knowledge and expertise. NCUA is considering minimum standards for directors that would require a director possess an appropriate level of experience and independence. The agency is also considering term limits, allowing compensation for corporate directors, and requiring greater transparency for executive compensation. Comment is sought on all these issues.

In addition, commenters are invited to respond to the question of whether or not the current structure of retail and wholesale corporate credit union boards is appropriate given the corporate business model. Should NCUA establish more stringent minimum qualifications and training requirements for individuals serving as corporate credit union directors? If so, what should the minimum qualifications be? NCUA is also considering whether to establish a category of "outside director," i.e., persons who are not officers of that corporate, officers of member natural person credit unions, and/or individuals from entirely outside the credit union industry. Commenters should offer their view on whether that approach is wise, and, if so whether NCUA should require that corporates select some minimum number of outside directors for their boards. Should a wholesale corporate credit union be required to have some directors from natural person credit unions? Comment is sought on whether NCUA should impose term limits on corporate directors, and, if so, what the maximum term should be. Comment is also sought on whether corporate directors should be compensated, and, if so, whether such compensation should be limited to outside directors only. Another issue under consideration, for which reaction from commenters is sought, is whether NCUA should allow members of corporate credit unions greater access to salary and benefit information for senior management.

Members United's Position(s)

Ensure minimum qualifications are commensurate with activities – Each corporate currently maintains minimum qualifications for Board and Committee members. Ensure that each corporate's minimum qualifications are commensurate with the activities of the corporate.

Require ongoing Board and Committee training – Require each corporate to maintain a training program commensurate with the activities of the corporate. Require documentation of attendance or documentation of qualification through testing.

Require Board and Committee peer reviews – Require each corporate to conduct annual peer reviews of their Board and Committee members. Require the Board to address deficiencies through training and/or prohibition of re-election.

Allow corporate Boards the option of outside directors – There are many arguments for and against outside directors. Allow each corporate to determine whether to have outside directors

and what number is appropriate. Prohibit outside directors from outnumbering directors from credit unions.

Allow corporate's Board or members to determine term limits – There are many arguments for and against term limits. Allow each corporate Board or their members to determine whether to have term limits and what limit is appropriate.

Allow corporate's Board or members to determine compensation – There are many arguments for and against director compensation. Allow each corporate Board or their members to determine whether to compensate directors and what the compensation structure should be.

Apply credit union guidance to disclosure of corporate compensation information – Corporates should be subject to the same guidance as credit unions.

OTHER ISSUES

ANPR Issue Description and Questions

The NCUA Board invites comment on any of the issues discussed above including specifically if NCUA's regulations should be amended to address the issues discussed in this ANPR. NCUA also welcomes comment on any other relevant issues pertaining to corporate credit unions that have not been addressed in this ANPR.

Members United's Position(s)

Retain Office of Corporate Credit Unions (OCCU) or equivalent function – The NCUA has indicated that it is considering elimination of the Office of Corporate Credit Unions (OCCU). Members United believes that the agency should retain OCCU or an equivalent function. Corporate credit unions are unique in their purpose, balance sheet composition, product offerings, risk profile, etc. This requires regulation, guidance, and examination processes that are tailored to corporates.

Greater transparency: annual report of investment and risk functions – Improve transparency for member credit unions by requiring corporates to publish an annual report on the corporate's investment and risk management functions. At a minimum, it should include/address:

- A summary description of policies and procedures
- An overview of human and system infrastructure supporting investment and risk management functions
- A description of investment strategies
- Market outlook/perspective
- Risk metrics and positions
- Recap of that annual cycle's third-party reviews
- Summary of pertinent accounting policies

Greater transparency: monthly publication of financial, portfolio, and risk positions – Improve transparency for member credit unions by requiring corporates to publish monthly reports: financials and a summary of investment and risk positions.