

Proposed Regulations for Corporate Credit Unions
SUMMARY of KEY ISSUES

Introduction

With its release of **12 C.F.R. Part 704** (Proposed Regulation), NCUA has begun the process of enacting the most far reaching regulation of the credit union industry in recent memory. While the changes contemplated apply directly to only corporate credit unions (corporates), the effects of the regulations will be felt by most natural person credit unions (credit unions) because it will alter the way that corporates operate, the services provided, and the costs associated with providing those services.

We agree that change is necessary, and NCUA has dedicated tremendous time and effort into formulating a good start. They solicited the input of credit unions, corporates and other stakeholders, and then used that input in preparing the Proposed Regulation. But the job is not done. NCUA is holding two town hall meetings to discuss the Proposed Regulation with stakeholders, and is soliciting public comment.

The regulation is currently out for comment through March 9, 2010. And besides simple disagreements and differing opinions, there are *substantive unintended consequences to credit unions if the regulation is enacted as it is today*. This is hardly surprising— With a regulation of this complexity and length, it would be virtually impossible to avoid issues. However, the very size and complexity of the document makes it untenable for credit unions to take the time to thoroughly analyze the document and project how the various provisions in it would affect them.

In our opinion, there are several areas that, if changed, would make for a better regulation. But *in a few key areas, changes are absolutely necessary to avoid the unintended consequences that will affect your credit union*. Now more than ever, your input is vital. We need your help, and your voice is critical! Without a high volume of credit union input, the Proposed Regulation may be adopted as originally drafted.

The rest of this document is organized into four sections. They are:

1. The *critical items* that must be changed to allow uninterrupted service to your credit union and by extension, to your members
2. A vital item that is missing from the Proposed Regulation that must be addressed— A cooperative solution to the legacy assets that have created the instability in the corporate system
3. Important *additional suggestions* that would make for a better regulation and a stronger corporate system
4. How you can get involved

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Section 1- Critical Items

The most important unintended consequences of the Proposed Regulation involve two main areas: the average life requirement and the credit shock test. ***Without changes to both of these areas, credit unions will see:***

- Significantly ***higher fees*** for products and services. So high, in fact, that the services would not be competitive, forcing credit unions to turn to non-cooperative solutions (i.e. banks)
- ***Lower rates*** on investments, (20-25 basis points based on our estimates), costing member credit unions between \$18 and \$23 million in lost income annually based on 2009 year-end balances. Coupled with other restrictions in the Proposed Regulation, these offerings would generally be uncompetitive and unacceptable to credit unions
- It is likely that ***term lending*** would need to be significantly ***curtailed*** or abandoned

Much of the Proposed Regulation is based upon the implementation of new, tighter standards. After careful review and detailed modeling of both our existing balance sheet and a new start-up corporate balance sheet (i.e., no legacy assets), we were unable to develop an actionable business model that meets the requirements of the Proposed Regulation for capital accumulation, while at the same time meeting the proposed risk limits. We agree tighter regulations must exist; however, specific sections of the Proposed Regulation should be changed, so corporates can generate sufficient income to build critically-needed capital. The Proposed Regulation is predicated on several key assumptions (please see pages 99-101 of the Proposed Regulation) regarding the business model that we believe are unrealistic. Specifically:

- No cost of capital – Members will not contribute additional capital with no credit premium
- Extremely high-yielding, single asset class concentration (private student loans ABS) – The proposed levels of investment in this asset class are beyond levels we believe are prudent.
- Private student loan sector is not deep enough to support aggregate corporate demand– Given the lack of depth of this segment, it is likely that corporates would bid up for these assets, substantially reducing the yield. It should be noted that this relatively small segment of investments is projected to produce almost 60% of projected corporate income.
- Ignores impact of legacy assets– Corporates that have OTTI on their own books still have adjustments to net interest income going forward that equals about 10 basis points, making it impossible to meet the new capital requirements. Further, members are unlikely to re-capitalize the corporate if they continue to be exposed to losses from these assets.

Based on numerous analyses by our staff, as well as several other corporates, corporate credit unions cannot meet both the proposed capital and risk metrics, even with no legacy assets on their books.

Members United strongly recommends that NCUA, at a minimum, make the following key changes:

- Drop the average-life requirement while maintaining the 300 basis point credit shock test ensuring strong risk management

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- Provide credit for core deposits in the credit shock test. This is an important change to accurately assess risk in this stressed scenario

Both changes are needed. Doing any less jeopardizes the viability of the corporate system and ultimately the operating environment of many in the credit union system. Additional information follows below.

Recommendation– Drop the Average-Life Requirement

One key area is the proposed limitation on the average life of assets (investments and loans) to two years. The proposed regulation uses the two-year limit as a means to control credit-spread risk in asset portfolios. This objective is important because even though corporates did not take interest-rate risk, as we purchased floating-rate assets, these assets were sensitive to changes in credit spreads. However, the proposed regulation already features a mechanism to manage credit-spread risk. Credit-spread risk is managed by limiting NEV sensitivity in a credit-spread-widening environment. This approach also involves a shock to prepayments, effectively preventing corporates from taking excessive credit-spread risk. Therefore, we recommend that the new regulation drop the average-life limit. Additionally, the limit would also be sensitive to the level of cash balances a corporate may be carrying. As seasonal trends change, the cash balances may temporarily fall. This effect could cause a temporary violation of the average-life limit. Unchanged, what this means to credit unions, is that corporate portfolios will become shorter in duration. In turn, corporates will be much less likely to make term loans and spreads will decline, which in turn will force corporates to reduce rates substantially. Our analysis indicates that the impact will be to make most of our investment offerings uncompetitive.

Recommendation– Provide Credit for Core Deposits in the Credit Spread Shock Test

We strongly encourage NCUA to integrate core deposit assumptions on overnight accounts into the credit spread test. While overnight deposit accounts generally respond to interest rate changes immediately, certain balances, related to core correspondent settlement activity and credit union liquidity needs, are relatively stable.

Taken together, these two important changes would still maintain the integrity of stronger risk controls, but allow for Members United to take measured levels of credit risk to be able to pay reasonable rates and earn the required levels of income to meet the capital requirements.

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Section 2- Vital Missing Item: The Legacy Assets

The Proposed Regulation in its current form does not address the issue of the legacy assets that are creating the instability in the network as a whole, but it should.

The corporate network and NCUA need to cooperatively address the business and regulatory issues associated with investment securities remaining on corporates' books today. Impact from OTTI assessments and depletions has had far reaching effects. For example, corporates must book the non-credit portion of OTTI in subsequent years. This is estimated to be 10 basis points each year for the next five years for Members United. Since we cannot earn this back under the new regulation, the alternative is to lower deposit rates to make up the 10 basis points (another \$8 million in lost revenue for our members.) Under the Proposed Regulation, due to this issue alone, Members United could not meet the ongoing capital requirements, nor could it pay market rates to members on virtually any of its deposits if it were to attempt to meet the capital requirement without relief on this issue.

Section 3- Suggestions for an Improved Regulation

Certificate Redemption– The Proposed Regulation prevents redeeming certificates at a premium. While we understand the intent to protect liquidity, we feel this will have a significant negative effect in the marketplace. Corporate certificates will *de facto* be less liquid than other providers. Unless yield is adjusted (i.e. corporates pay more), members will take their business elsewhere. What this means to credit unions is that corporate certificates will be inferior to other certificate offerings, unless there is a substantial price differential, which corporates are unlikely to be able to afford. A conservative estimate of the required yield differential because of this feature could cost Members United an additional 10 basis points or \$2.5-\$3 million a year on term deposits. This would essentially weaken certificates offered to members, increase our costs, and hamper our liquidity.

Regulatory Authority– It is critical that the regulator has sufficient authority to manage, supervise and control corporate credit unions. However, the Proposed Regulation vests an untenable level of regulatory control with little oversight, no required documentation, and no objective appeal process.

Our observations include:

- NCUA has the ability to subjectively change minimum capital requirements for virtually any reason
- NCUA has the ability to subjectively change the application of rules and regulations without appropriate due process. Should changes to regulations be necessary, due to new financial instruments or strategies, the NCUA Board should make amendments to the regulation through the current regulatory approval process

At a minimum, NCUA board approval should be required to reassess capital level requirements or regulatory rating changes at corporate credit unions. Both the reduction of the capital rating and the basis for the reduction (declines in a single CRIS-rating category) are subjective decisions made by

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NCUA. The NCUA already has sufficient regulatory tools to enforce compliance with safe and sound operating practices, without this complex and, what could conceivably become, arbitrary process. We strongly recommend that an appeal mechanism be developed to support an objective process. Further, we propose that the authority to exercise these regulatory prerogatives be tightened significantly. We also recommend that the NCUA Board approve any such change in capital requirement only with: a) appropriate documentation of risk, and b) the opportunity for the corporate to offer explanatory evidence.

Governance and Board Limits– We agree that it is critical to maintain qualified representation from member credit unions on our board. We further agree that there is a rationale for term limits; however, term limits do not ensure a well-qualified and diverse board – only a new board.

We believe that it is more important to charge a corporate’s nominating committee with the responsibility of establishing detailed criteria for the expertise of board members. Under the proposal, it is possible for a corporate board to be made up of credit unions with the same asset size or of like mind and similar talents. An ideal board would be composed of diverse individuals possessing complementary talents.

To allow for better representation, nominating committees should be required to define the qualifications of ideal or targeted candidates. For example, board qualifications could include:

- A specialization in finance, accounting, marketing or operations, and
- Leadership from an array of credit union asset sizes, and
- A representative distribution across geographic regions, and
- A desire to promote the good and welfare of the organization

Corporates should also require that boards and board members adopt best practices related to attendance, training, self assessment and review.

We are concerned that the current 6-year term limit, as proposed, will require the entire board to turn over every 6 years. While term limits are appropriate, a rapid turnover of volunteers who direct and oversee the operations of financial institutions like corporates would be detrimental. Term limits this short will only guarantee the loss of institutional intelligence. Having a 6-year term limit would produce an average service of three years or even less, if unanticipated turnover takes place. This would occur if a director lost his or her qualifications to sit on the board, or circumstances otherwise necessitated an unplanned resignation. A new board member would not be able to gain the wider breadth of experience that another board member, who has been through several business cycles at the corporate, would possess.

Additionally, a knowledge “ramp-up” for most board and committee members occurs as they develop a more detailed understanding of the business processes and strategies applied by the corporate. This knowledge base and experience is fundamentally different than those developed by credit union management that works with the boards of natural person credit unions. We believe that term limits should be expanded to 9-12 years, from the proposed 6-year timeframe. Board membership would still

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benefit from “new blood” while maintaining the organizational history of the corporate. An unstable or inexperienced board should pose a safety-and-soundness concern for the regulator.

Indemnity. The Proposed Regulation prevents indemnity in some cases. While we understand the intent is to prevent indemnification against regulatory actions, the language is fairly broad and exposes volunteer directors and management to unlimited personal risk. What this means to credit unions is that it may be difficult to find and retain volunteers and management. Quality leadership will be critical in the future and this may cause many capable leaders not to participate.

Section 4- How Credit Unions can get Involved

Comments on **12 C.F.R. Part 704** are due by March 9, 2010. Your comments do not have to be long and involved. They simply need to state what you believe, and how you would like to see the proposed regulation changed.

Take ownership of the regulation and speak up for your credit union’s future success by submitting your comments in one of the following ways:

- **Federal eRulemaking Portal** - www.regulations.gov
- **NCUA Website** - www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html
- **Email** - regcomments@ncua.gov with “[Your name] Comments on Part 704 Corporate Credit Unions” in the subject line
- **Fax** - (703) 518-6319 with “[Your name] Comments on Part 704 Corporate Credit Unions” in the subject line
- **Mail or Hand-Deliver:** Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.