

Suggested points for credit unions to address in their comment letter regarding proposed part 704.

Overview of cause of corporate credit union network issues:

- Lack of appropriate sector concentration limits in the existing regulation: The current version of part 704 did not include concentration limits on particular sectors; it only required that the corporate put in place some type of limit. A few corporates assumed unduly large concentrations of private mortgage backed securities, impacting the entire network.

- Overlapping fields of membership: The expansion of corporate fields of membership led to certain corporates either attempting to gain additional deposits or attempting to retain deposits by increasing rates. This in turn led to an increased risk profile – either directly or indirectly – across the corporate network. Ultimately, term certificates at corporate credit unions exceeded comparably structured securities issued by government sponsored entities by as much as 10 to 15 basis points. Although this benefitted natural person credit unions in the short run, it eventually resulted in substantial losses to the movement.

Issues:

1. Part 704.3: Capital

- The regulation details in its Definitions section that contributed capital is available to cover losses that exceed retained earnings and that corporates “may not restore or replenish the affected capital accounts under any circumstance”. This is inconsistent with GAAP and the practice of other industries which are able to carry negative retained earnings.

Suggested recommendation: Credit union member capital should only be depleted after the losses have been incurred, or alternatively, the NCUA should allow depleted capital to be restored if projected losses ultimately overstate actual losses.

- The capital requirements required in the regulation are overly aggressive especially in light of the ALM, credit and investment restrictions that are included. The combination of the capital level and the brief time line for corporates to achieve these levels will potentially result in substantially lower rates and higher fees to credit unions. It will also shift risk and excessive costs to credit unions in terms of the systems, processes, resources, and compliance issues that credit unions will be required to manage.

Suggested recommendation: NCUA should allow the transition period required to meet the proposed rule's minimum capital requirements as either: a) one year after the implementation of a legacy asset solution; or b) one year after the effective date of the finalized Part 704 - whichever is later. This will allow time for credit unions to evaluate new corporate business models and recapitalization plans.

2. Part 704.4: Prompt Corrective Action

- Although it is acceptable that corporates be subject to PCA, just as natural person credit unions, Section 704.4 (c) (2) establishes that the NCUA can arbitrarily and subjectively reclassify a corporate's capital classification (well, adequately or undercapitalized) based on supervisory review, regardless of a corporate's actual capital ratio. The preamble suggests several subjective items which allow the NCUA to lower a corporate's capital classification including whether the agency believes that callable certificates are being offered solely to reduce a corporate's NEV volatility.

Suggested recommendation: NCUA should apply a consistent methodology in determining a component rating instead of relying on the subjective determination of an individual examiner and allow for an appropriate time frame for a corporate to resolve any deficiencies.

3. Part 704.6: Credit Risk Management

- A. Part 704.6 (c): Issuer Concentration Limits. This portion of the credit risk management section of the proposed revisions requires an obligor limit of 25 percent of capital. This limit is overly restrictive for certain types of obligors such as bank counterparties for Fed Funds transactions and high quality ABS trusts in that there are an inadequate number of highly rated counterparties to maintain compliance with this restriction.

Suggested recommendation: NCUA should amend the 25% single obligor investment limitation and allow a larger limit of 200% of capital on money market transactions with a term of 90 days or less.

- B. Part 704.6 (d): Sector Concentration Limits: Although several investments are excluded from these limits, including deposits in other depository institutions, Fed Funds are not specifically excluded.

Suggested recommendation: For better clarity, we recommend that Fed Funds be specifically excluded from the single obligor limit because the proposed rule has already provided for obligor limits and also, given the weighted average asset life restrictions placed in Part 704.8 (h), corporates will likely be heavy users of the overnight Fed Funds market.

4. Section 704.8: Asset and Liability Management

A. Part 704.8 (c): Penalty for early withdrawals.

- The proposed revision would prohibit a corporate from paying a gain on a certificate that is redeemed prior to maturity if rates have declined. However, losses would be incurred by the member credit union if rates rise resulting in uncompetitive terms products for credit unions.
- This will reduce term funding for corporates from credit unions and negatively effect system liquidity and the ability for credit unions to obtain lines of credit from corporates. It will also lower the investment earnings credit unions receive on term products.

Suggested recommendation: Retain the current rule for certificate redemptions which incorporate market-based penalties and gains.

B. Part 704.8 (e): Cash Flow Mismatch Sensitivity Analysis.

- The proposal requires that a corporate apply a credit shock on both its assets and liabilities by 300 basis points at least quarterly and defines certain limits that a corporate must stay within in terms of NEV changes.
- This credit spread widening may be appropriate for certain sectors, but would not be appropriate for others (for example government sponsored enterprises).

Suggested recommendation: This NEV credit spread widening test may be appropriate for certain sectors, but it is not appropriate for others, such as government sponsored enterprises. Therefore, the credit spread widening test should be sector specific. Additionally, the proposed rule should account for the fact that instruments from similar issuers with shorter maturities will have less spread widening than those of longer maturities.

NCUA should also integrate core deposit assumptions on overnight accounts into the credit spread test. Overnight deposits related to credit unions' settlement activity and liquidity needs are relatively stable and measurable over time and should be incorporated as core deposits in the NEV tests.

C. Part 704.8 (f): Cash Flow Mismatch Sensitivity Analysis with 50 percent slowdown in prepayment speeds.

- This portion of the revised rule requires a corporate to incorporate a 50 percent reduction in prepayment speeds across all sectors in

conjunction with the 300 basis point credit spread shock described above.

Suggested recommendation: This test should be sector specific for both the credit spread shock as well as the prepayment speed slowdown test and the maturity of the instrument. Additionally, although it is widely recognized that mortgage related product demonstrates volatile prepayment rates which is highly correlated to the level of interest rates, other asset classes permissible by the proposed regulation do not.

D. Part 704.8 (h): Weighted Average Asset Life.

- The proposed revisions require that the weighted average life (WAL) of the assets of a corporate must be no more than 2 years. This would severely restrict the corporate's earnings capabilities, negatively impact investment rates earned by credit unions, and impact the ability for credit unions to obtain lines of credit from corporates.

Suggested recommendation: Remove the weighted average life requirement. The proposed rule uses the two-year weighted average life limit as a means to control credit spread risk in asset portfolios, but the new credit shock test as noted above already incorporates a mechanism to manage credit spread risk by limiting NEV sensitivity in a credit spread widening environment.

5. Part 704.11: Corporate CUSOs

- The proposed revisions limit the permissibility of corporate CUSOs to brokerage service and investment advisory services. All other CUSO functions are required to be approved by the NCUA.
- By restricting CUSO functionality in the manner suggested by the proposed revision, corporates may incur a significant delay in the approval process and therefore may impact the services that credit unions rely on from these CUSOs.

Suggested recommendation: The proposed rule should a) identify CUSOs that have sufficient performance records and reflect those activities and services as permissible, or b) provide for a "fast track" approval process for existing CUSOs.

6. Part 704.14: Representation

- The proposed regulation requires that no individual may serve on the board of a corporate credit union for more than six consecutive years.
- Serving on a corporate credit union board exposes an individual to substantial complexities and requires a certain amount of time to become acclimated to the institution.

Suggested recommendation: Expand the proposed six year term limit to ten or twelve years.

7. Part 704.19: Disclosure of executive and director compensation

- The proposed rule stipulates that a corporate credit union distribute and make available upon request the dollar compensation of all “senior executive officers” – defined as all employees at a vice president level and above.

Suggested recommendation: NCUA should use the guidelines employed by the Securities and Exchange Commission that the compensation of the top five employees be disclosed.