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Corporate One ANPR Response

Corporate One
FEDERAL CREDIT UNION

March 23, 2009

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Advanced Notice of Proposed Rulemaking to 12 CFR Parts 704

Dear Ms. Rupp:

On behalf of the management and Board of Corporate One Federal Credit Union, I would like to take this opportunity to comment on the recently issued Advance Notice of Proposed Rulemaking (ANPR) to 12 CFR Part 704.

The NCUA has requested comment on a variety of issues regarding the corporate credit union network and is considering amending current regulations governing corporates.
The following comments are being submitted in response to the ANPR.

The need exists to reflect deeply on the root causes of the current situation and the issues being faced. By doing so, we create a basis for the development of new principles that can address these risks and subsequently build these principles into a new regulatory framework.

The following is a list of key areas we feel were factors in creating the current situation that hinders the future success of the credit union movement. An accompanying recommended solution follows:

1. **Concentration of Asset Classes**

   Issue: The corporate credit union system has extreme examples of too much concentration in specific asset classes, namely mortgages. Diversification within the mortgage asset class was attempted by using different issuers, servicers, and trusts, etc. as per the regulation. However, in the macro portfolio analysis, the basic tenant of diversification was not accomplished. As an example, being well diversified within a class of assets, such as mortgages, yet investing a majority of one's assets in the same general class, is not appropriate.

   Recommended Solution: The new regulation needs to reinforce a "portfolio level view" of investment diversification and not just an issuer-based definition, as is presently the case. Regulation should focus less on dollar diversification, as it assumes that all asset classes produce the same amount of risk. Instead, the regulation should focus more on capital at risk and mandate a diversification of that risk.

2. **Leverage**

   Issue: Leverage is taking borrowed funds and reinvesting those funds in assets. In some instances, some corporate credit unions inappropriately used leverage solely as a means to generate income or enhance profits. At times, corporates used leverage that was too great in terms of the total balance sheet, for the purpose of enhancing the corporate's earnings. The borrowing of funds on a short-term basis and investing the proceeds in significantly longer-term assets was, and is, a major issue for many financial institutions (including corporates) during this financial crisis. Instead, an appropriate use of leverage is to use it as a tool to smooth out seasonal demands or cash flows.

   Recommended Solution: The current corporate regulations need to be enhanced to (a) avoid borrowing solely for profit or arbitrage; (b) permit only borrowings for short-term seasonal needs, and only then as a short-term match; or (c) with a firm plan for repayment. With appropriate risk-based capital allocation, leverage can be a tool for enhancing return on capital.

3. **Inadequate Liquidity and "Cash Reserves"**

   Issue: Adequate liquidity and sufficient cash reserves were not maintained by all corporates to assure the payment of daily settlement from a pool of cash reserves.

   Recommended Solution: We need a guiding principle added to our regulation that requires adequate ready cash reserves to assure that a corporate does not need to borrow regularly to fund daily settlement activity. Requiring the establishment of a "cash reserve" is recommended. Efforts to preserve and strengthen the ability of corporates to provide adequate liquidity to natural person credit unions is warranted, but it would be short sighted to attempt to achieve this objective by restricting the ability of a corporate to offer other types of products and services. The ability of a corporate to meet the liquidity needs of its member credit unions is directly related to its ability to have a balance sheet with high quality assets, as these two functions are interdependent. Therefore, we urge the agency to preserve the ability of corporate credit unions to safely offer multiple product and service offerings to their member credit unions, and focus on the creation of a ready "cash reserve." The regulation should require a segregation of cash between that generated through the payment system and that related to term deposits.

   Further, we believe all corporates should be required to give up their banker's bank status and gain full access to the Federal Reserve Bank (FRB). In doing so, the risk to the entire credit union network will be reduced. This requirement would also provide a safety valve in times of extreme stress in the financial markets. The FRB is the ultimate lender of last resort, and establishing this access should be required.

   We also recommend that corporates be free to establish "cross liquidity guarantees" among themselves to ensure that if any one of the corporates need liquidity, others have the ability and means to support them. We envision this to be a contractual guarantee primarily related to guaranteeing daily settlement and should be voluntary.

4. Subsidized Product Costs

Issue: With the majority of a corporate's earnings and capital being generated by investment activities, product/service offerings are often being subsidized with the earnings from the investment's Net Interest Margin (NIM). We believe that product costs, the income they generate, and the capital needed to support that product or service should stand on their own and not be subsidized by the NIM.

Recommended Solution: This subsidy can be segregated by requiring that cost accounting be implemented at the line of business level to capture the costs, including a capital charge, and revenues of individual products and services. In addition, the agency should impose a structure similar to a holding company in which all subsidiary activity in a Credit Union Service Organization (CUSO), or other legal entities are segregated and all transactions between subsidiaries are conducted at arm's length.

5. Risk-Based Measures

Issue: Risk-based measures are currently not in place. Accordingly, the total risk of various investment instruments is not being taken into consideration.

For example, a corporate with 100% of its assets on deposit with the FRB is required to have the same capital ratio as a corporate with 100% of its assets invested in privately issued mortgage-backed securities. The current regulation does not appropriately reward a corporate for taking less risk or provide an appropriate charge for the corporate taking more risk.

Recommended Solution: Regulation should mandate that all corporates develop capital allocation models to demonstrate risk based capital adequacy.

6. Market-Based Penalties for Early Withdrawals

Issue: The formulas used by many corporates to calculate the market-based penalties for early withdrawals were based on the estimated replacement cost of the shares that were early redeemed. In other words, it was a cost-of-funds-based calculation. The current regulation states that the estimated replacement cost should be the minimum penalty. As cooperatives, most corporates manage their portfolios such that the shares are priced based on the return of the assets the corporates are able to buy. As market dislocations developed, many early withdrawals were allowed with little, or no penalty, even though the corporate could not dispose of the assets the shares were matched against.

Recommended Solution: We recommend that the regulation regarding the penalty for early withdrawals be re-writt ›n to explicitly state that early withdrawals be based on market pricing. Although the current regulation allows for market pricing, the practice was not consistently used by all corporates. The market pricing should be set by the corporate and should be commensurate with the risk of the assets matched against the shares. During extreme market dislocations, this type of pricing for early withdrawals creates severe penalties that either helps offset the cost of selling assets at distressed prices or discourages the early withdrawal so the corporate does not have the liquidity drain. True market pricing of early withdrawals can still result in a gain to the credit unions instead of a penalty. For example, when markets are not severely distressed and spreads are tight, the market price would be primarily driven by changes in the interest rate environment. So, in periods where interest rates are low, the early redemption of higher paying shares may result in a gain to the credit union.

7. **Risk Management**

   Issue: We believe an enterprise view of risk management would have been able to see a growing concentration in assets, foreseen the potential for a liquidity event, and made recommendations for corrective action.

   Recommended Solution: All corporates should be required to establish appropriate risk management infrastructures to manage the overall level of risk at the organization. That is, the risk management function needs to be formalized in regulation, and we also recommend the Risk Management Department be required to report to the Board and/or Supervisory Committee, independent of management. A Risk Management Department must also demonstrate the ability to measure specific internal risks, such as strategic, credit, operational, interest rate, and market risk. The Department should also be able to assess external risks, such as regulatory and reputation risk, and be capable of, and have authority to, enforce the management of these risks.

   Focus must be developed on an organization's overall risk posture. While the department must have the ability to assess specific risks associated with a particular bond or activity, it must also be capable of providing guidance on the entire enterprise's risk posture and be empowered to affect change.

8. **Corporate Capital**

   Issue: Corporate capital needs to be revisited, as the current definitions and structure do not support an "equity" instrument – the regulation only identifies PIC and MCS. A more current approach is required to allow corporates to mirror the equity tools found in the financial markets so that rating agencies and others performing outside comparisons easily recognize our capital tools. As recent events once again demonstrate, the risks associated with PIC and MCS are real; however, when reviewed by outside rating agencies, appropriate credit is not given, if at all, to these instruments.

   We have also been supportive of the agency's efforts in recent years to seek statutory changes that would allow the NCUA to implement a risk-based capital system to bring capital standards for credit unions more in line with other federally insured financial institutions. In our view, the current capital system for corporates is insensitive to the underlying risks and fails to properly align capital retention at the corporate, with the risk being assumed by each individual corporate credit union. Because of this, there is less incentive for corporate credit unions to engage in risk-reducing activities. Clearly, if never more evident than today, changes in the current capital structure for corporates are absolutely necessary.

Recommended Solution: Corporate capital requirements should be based upon appropriately weighted risk. Allowing corporates to create new equity capital instruments that are recognized in the marketplace as Tier I capital should be addressed in regulation. Further, it is imperative that those using the services of a corporate place appropriate levels of capital into the corporate. The FHLB model is an excellent example of this requirement.

We strongly believe that the stated principles and objectives of Basel create uniformity and a set of best practices in risk management. Thus, we believe Basel provides an excellent framework for the NCUA to consider as it evaluates the potentiality of a risk-based capital system for the corporate credit union network.

9. **Expanded Investment Authority**

Issue: We feel "expanded authority," in and of itself is not a direct contributing factor to the current situation. However, we believe the use of expanded authority must be done prudently and within a safe and sound environment. Although additional modifications to the process may indeed be warranted, it is important to recognize that the authorization of expanded investment authority has enabled many corporate credit unions to meet the needs of their natural person credit union members for a number of years.

Recommended Solution: We strongly urge the agency to also consider risk-based capital standards for corporate credit unions as part of the expanded authorities process. A properly weighted risk-based capital structure would enable the NCUA to equate capital charges with the investments being purchased under expanded authorities.

The ANPR also asks whether corporate credit unions should be required to re-qualify for expanded authorities on a periodic basis. In light of recent events, we believe that, in addition to regular oversight, it would be a sound regulatory practice for the agency to require corporate credit unions to sufficiently demonstrate their ongoing ability to manage the expanded investment authorities they have been granted. We further recommend the NCUA establish a periodic review requirement to maintain the expanded investment authority going forward.

We believe that the expanded authority did not significantly contribute to the current issues facing corporate credit unions. We believe a principle-based regulation that uses the supervisory examination process to determine the adequacy of risk controls in a corporate credit union will lead to greater safety and soundness.

Further comments regarding the need for enforced portfolio level diversification standards are set forth in our comment #1 above.

10. **Structure: Two-Tiered System**

Issue: The current two-tiered corporate system is not a root cause of the current situation. It is not practical or efficient to have a third wholesale institution offering redundant products and services, as it must be capitalized to the same level as any other institution. In recent history, it is evident that risks were upstreamed to U.S. Central, but adequate capital was not in place to support those risks.

Retail corporates have traditionally played an important and vital role in the success of their member credit unions by providing products, services, and economies of scale. As the credit union movement represents almost 8,000 endpoints of service for corporates, concentrating services into one entity is not practical and may in fact introduce even higher concentrations of risk.

Recommended Solution: While structural changes may be warranted that could potentially result in fewer corporates, or corporates operating significantly different than what exists today, we urge the agency to carefully evaluate any proposed structural changes from a member service perspective. The vast majority of credit unions, particularly those with small to moderate assets, rely heavily, and in most cases exclusively, on their corporate credit unions for key services. Therefore, any changes to the current structure must preserve the ability of retail corporate credit unions to meet the needs of their credit union members.

11. **Field of Membership Issues**

Issue: The ANPR suggests the current situation facing the corporate credit union system is, in part, a result of NCUA's longstanding policy of allowing corporate credit unions to have national fields of membership. Current national field of membership policies and regulations are not the root cause of the problems affecting the corporate credit union system and we disagree with the premise that national fields of membership have caused undue competition amongst corporates. We are unaware of any analysis that would support the notion that the existence of a national field of membership and competition caused the corporate credit unions to violate sound operating principles and/or to engage in significant or undue risk taking.

Our credit union network is faced with severe competition every day, and to suggest that the very existence of competition drove unwise decision making is simply untrue. Conversely, we believe that national fields of membership have fostered healthy innovation and competition among corporates. We feel this healthy competition resulted in a valuable diversification choice for natural person credit unions and helped them avoid undue concentration of risk. Eliminating national fields of membership and returning to a defined or regional field of membership simply results in the restriction of competition and the removal of choice from the credit union network. The present crisis clearly shows the disadvantage a natural person credit union possesses when having only a single corporate choice. Concentration risk is enhanced for credit unions if they do not have the option of more than one corporate.

Recommended Solution: While consolidation of the corporate industry is expected and likely necessary in the current financial marketplace, we believe it is far more important to ensure that all corporates ultimately emerge from the consolidation process being financially strong, healthy and competitive.

The comments above provide a basis for regulatory response that is based upon key guiding principles, such as portfolio diversification and liquidity. Our comments also address potential points of failure by establishing guiding principles. If followed, stated guiding principles will help avoid future situations. Thus, we will be able to more effectively address the root causes and focus efforts to avoid a future crisis.

Respectfully submitted,

Lee Butke

Lee C. Butke
President and CEO

CC: Chairman Fryzel
Vice Chairman Hood
Board Member Hyland