From: Evan Clark [eclark@docfcu.org]
Sent: Friday, March 27, 2009 5:25 AM
To: _Regulatory Comments
Subject: Evan Clark - Comments on Advanced Notice of Proposed Rulemaking for Part 704
Attachments: Evan Clark's comments on ANPR 704.doc

To Whom It May Concern:
Attached is a read only copy of my comments on the ANPR 704. Below is a complete copy of my comments as well. Thanks, Evan

March 27, 2009

To the Board of Directors of the National Credit Union Administration,

Thank you for the opportunity to comment on the proposed rule making regarding the corporate credit unions. Also, thank you for your leadership on this issue. I believe that in the past NCUA should have been much more proactive in this issue and the lack of proper oversight by NCUA contributed to the issues we are now discussing. However in the past two months I believe NCUA has been proactive on this issue and I have full confidence that you will continue to have a proactive stance.

Over the past few days there have been many in the credit union movement who have accused NCUA of not being fully transparent on the issue of the losses at the corporate credit unions (corporates). I have a feeling their comments are based in the frustration and anger, (feelings I share), that come from having to face up to a very difficult, painful reality. The corporates were making investments that they most probably did not fully understand and now a significant portion of the credit union industry is in jeopardy because of their actions.

This is not a conspiracy by PIMCO as some have suggested. This is a group of investments with enormous credit losses that the credit union movement will have to acknowledge and absorb. Ultimately many credit unions may not survive because of the actions at the corporates unless they are allowed access to more capital in some form. The number of credit unions with this issue may grow as the full extent of the credit losses at the corporates are realized. In my opinion this is the single biggest issue and capital formation and retention should be the biggest concern of the credit union industry right now. I believe credit unions should have a mechanism other than just net income with which to accumulate capital and it may be worth taxation to have this mechanism.

Below are 19 bullet points that reflect my opinions. Once again thank you for this opportunity to comment and thanks again for your leadership.

Sincerely,

Evan Clark
President/CEO
Department of Commerce Federal Credit Union

NCUA is culpable in the issues at the corporates. They should have had sufficient knowledge of investments to do proper oversight prior to giving the corporates expanded investment authority.

NCUA should use $16 billion (the worst case scenario) when calculating the loss at Wescorp and US Central. Economic conditions will probably continue to deteriorate for an extended period of time and the credit losses on the investments will, in all likelihood, continue to increase.

It is disingenuous of anyone in the credit union industry to say that they didn't see this coming. The blogger at UnrealizedLosses has been warning of this problem for over a year and a half. I warned the credit union movement about this problem in a September 15th letter to the editor of Credit Union Journal, a copy of which I have attached.

Forty percent of the average credit union's balance sheet is in investments. Giving the money to the corporates to invest is akin to indirect borrowing and as has been shown over the past few months it can have the same disastrous consequences. The onus is on all credit unions to learn much more about investments. Most credit unions have developed an evaluation system to determine the credit worthiness of a member.
The ability to effectively make loans is a learned skill. The ability to invest effectively is also a learned skill, a skill that all credit unions should have. Credit unions should not be doing indirect investing via the corporate credit unions.

When the Corporate credit union network was created many of the credit unions in existence were too small to effectively buy investments on their own. Now most large credit unions can, if they have the knowledge and expertise, purchase investments themselves. How much investment capacity at the corporates is really necessary? I would answer, very little.

Corporate credit unions should not have expanded investment authority.
In fact, all investment authority beyond the investing of settlement funds should be stripped from the corporate credit unions. The danger from the concentration of so many assets in a few large credit unions is too great for the credit union movement to bear as the events of the past few months have shown.

Smaller credit unions with excess liquidity could invest in larger and medium size credit unions in $100,000 or $250,000 blocks. This would spread the concentration of asset risk among many credit unions.

Although the economy exacerbated the deterioration of the investments bought by US Central and Wescorp it was not the economy that caused the problem. It was poor management decisions when the investments were purchased. If the investments would have been reviewed at a collateral level where actual loan files were reviewed the toxicity of the investments purchased would have been clearly revealed and these investments would not have been made.

Corporates should never rely on the credit ratings provided by the ratings agencies. Every bond should be evaluated at on a collateral based level to understand the risk and potential credit loss inherent in the investment. If this had been done at the corporates they wouldn't have invested in the AAA bonds they did

Net Interest Income (NII) testing is a critical part of evaluating a financial institution's balance sheet. However, NII would not have revealed the problems at the corporates. These are credit issues. The underlying collateral on the investments purchased have substantial credit losses in them. If the corporates had been reviewing changes in the credit enhancements of the investments on a regular basis they have they would have immediately seen the deterioration as I described in the Credit Union Journal letter to the editor.

All brokers and brokerage firms that were involved with selling the suspect investments to the corporates should be banned from ever doing business in the credit union movement.

There should be an investigation of the relationship between the rating agencies and the investment firms that created the investments the corporates purchased. The goal of this investigation is to ensure the propriety of that relationship.

The interest rates on certificates held by credit unions and corporates at Wescorp and US Central respectively should be reviewed for reduction.
The rates currently being received on these certificates may be based on the assumed earning power of the nonperforming investment portfolio.
Reducing these rates will increase the net income of the Wescorp and US Central and may decrease the burden on all natural person credit unions.

A definition of a complex investment portfolio should be developed for natural person credit unions. Any credit union with a complex investment portfolio should, on an annual basis, have their investment portfolio evaluated by an independent investment firm. Any investments that pose a potential credit loss to the NCUSIF should be identified.
The credit union should be forced to either dispose of the investment or provide sufficient reserves to ensure protection of the NCUSIF.

It is important when NCUA is evaluating an investment portfolio that they recognize the difference between a credit loss and a market loss.
A credit loss is a permanent loss and poses a real threat to the NCUSIF.
A market loss, if a credit union can show that they have the ability and intent to hold the investments to maturity, poses no threat to the NCUSIF. There have been instances where NCUA and its examiners have caused enormous losses and threats to the NCUSIF by forcing credit unions to sell investments that would have been better held by the credit unions. CapCorp is the most famous example but look at the comments of Ray Ewin of CBC Federal Credit Union. CBC was forced to sell investments that resulted in a multi-million dollar loss to the credit union. The examiners who forced CBC to sell these investments acted in a reckless fashion that caused a real threat to the NCUSIF and their actions should be reviewed at the highest levels of the Agency.
More importantly the NCUA and its examiners should be much more judicious in their forcing of credit unions to sell investments. As these two examples clearly illustrate, the NCUA and its examiners can pose a much greater threat to the NCUSIF than a well managed credit union investment portfolio.

I don't believe the corporates should provide liquidity to the credit union system because I don't think they can do it competitively and the only way they could be a liquidity conduit is by the accumulation of credit union assets. As the events of the past few months have shown large amounts of credit union assets should not be concentrated in one entity. A better approach would be the continued use of the FHLB and expansion of the lending authority of the CLF.

NCUA and the credit union movement should press Congress to dramatically expand the CLF. Increase the authority to $100 billion and then allow corporates and natural person credit unions to borrow against the fund and also use the fund for capital. Something akin to subordinated debt on a bank's balance sheet that is included in its capital.

Expanding use of the CLF could force credit unions to be taxed. I believe the time has come to revisit the issue of taxation. As the losses at the corporates and at natural person credit unions mount, capital retention and formation will become increasingly important issues, perhaps more important than taxation.

I believe no corporate credit union should have a national field of membership. The competition amongst the corporates was part of the reason some corporates stretched for yield.

Corporates Need To Answer These Six Safety & Soundness Questions Credit Union Journal | Monday, September 15, 2008 As I've read the various articles and opinions on the financial state of the corporate credit unions I'm struck by the lack of questions about the quality of the corporates' investment portfolio. As I read the comments of the corporate officials and representatives I get the feeling that there isn't complete transparency in their comments. I hope I'm wrong, but I offer up the following questions that I believe if they were answered fully and completely by the corporate credit unions they would clear the air on what is in the corporates' investment portfolios that could cause risk to the corporates and more importantly to their member credit unions in the future.

Question No. 1

Are there any CDOs or SIVs in the corporates' investment portfolio?

The following definitions of CDOs and SIVs come from Wikipedia and give a basic understanding that will be important in the questions to follow:

Collateralized debt obligations are a type of asset-backed security and structured credit product. CDOs are constructed from a portfolio of fixed-income assets. These assets are divided into different tranches:

senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). Losses are applied in reverse order of seniority and so junior tranches offer higher coupons (interest rates) to compensate for the added default risk. CDOs serve as an important funding vehicle for fixed-income assets.

A structured investment vehicle is a fund that borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. SIVs are a type of structured credit product; they are usually from $1 billion to $30 billion in size and invest in a range of asset-backed securities, as well as some financial corporate bonds. A SIV has an open-ended (or evergreen) structure; it plans to stay in business indefinitely by buying new assets as the old ones mature, and the SIV manager is allowed to exchange investments without providing investors transparency/the ability to look through to the structure.

Question No. 2

If the corporates have CDOs or SIVs or any other asset- backed investments on their books, does the underlying structure of the security contain any mezzanine or support tranches from private label mortgage pools? The reason this question is so important is that as mortgages go bad in these pools the losses are absorbed by the mezzanine or support tranches of the private label mortgage pools.

If the corporates have these type of investments in their portfolio and they've seen the price drop on the investments there's a reason. The mezzanine or support tranches are getting eaten up and therefore will be close to worthless. These tranches may still be getting scheduled interest payments but it's only a matter of time before the tranches are eaten up by the losses. Interest payments will cease and the bonds will be totally worthless.

Question No. 3

This is related to question No. 2. If the corporates have investments on their books that are backed by private label mortgages, namely CDOs or CMOs have the credit supports on the investments increased or decreased since the time of purchase? Credit supports are the tranches below your tranche in the mortgage pool. In a well-designed pool the credit supports for the A or AA classes should be increasing throughout the life of the investment because the principal pay down to the A or AA tranches will be greater as a percentage than the loan losses are as a percent of the supporting tranches. If the credit supports are decreasing it could spell trouble for even the A or the AA classes of the structure because the support tranches may be totally eaten away by losses exposing the A or AA classes to potential loss.

Question No. 4

Have any of your investments been downgraded by any of the three major rating agencies in the past year. Note that I said any of the three rating agencies. A common trick by companies trying to hide a problem is to show that their investments haven't been downgraded by one of the rating agencies but they may have been downgraded by one or two of the other agencies.
Question No. 5
Related to question No. 4. When was the effective date of the last rating of all of your private label investments by the three rating agencies? There's so much of this garbage out there that the rating agencies are playing a catch up game trying to get all of the pools rated. If the last rating was sometime in late 2007 that could indicate a problem that hasn't been identified as of yet. Plus the rating agencies are under pressure because they contributed to this mess in a big way by their rating of some of the sub-prime pools.
Question No. 6
What pricing source are you using to value your holdings? If the assets are not being priced by an independent pricing source, then it throws into question the investment valuations presented by the corporates.
The answers to questions two, three and four above are critical. If the corporates have investments that are permanently impaired then they should write them down or off immediately. And don't fool yourself if there are mezzanine tranches or falling credit supports involved then chances are that there's also permanent impairment involved.
Why do I ask these questions? Because I get this feeling that we're not being told all that there is to know about this story. If the corporates have a problem and we're going to be asked to help them recapitalize or even worse if the NCUSIF needs to be recapitalized I'd rather know about it sooner rather than later. And there are a number of credit unions that have such severe problems of their own that they may not survive never mind assisting in a recapitalization of a corporate. These are my reasons for asking these six questions.
Evan Clark, CEO
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