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Via email to regcomments@ncua.gov

April 3, 2009

The Honorable Michael E. Fryzel
Chairman, National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

The Honorable Rodney E. Hood
Vice Chairman, National Credit Union Administration

The Honorable Gigi Hyland
Board Member, National Credit Union Administration

Re: Comments on the Advanced Notice of Proposed Rulemaking for Part 704

To Chairman Fryzel, Vice Chairman Hood, and Board Member Hyland:

Southwest Corporate Federal Credit Union (Southwest Corporate) appreciates the opportunity to make this response (hereinafter referred to as our "Response") to the NCUA's Advanced Notice of Proposed Rulemaking (ANPR) for Corporate Credit Unions. 74 Fed. Reg. 6004 (2009).

Southwest Corporate was chartered in 1975, and has always served credit unions in multiple states. Headquartered in Plano, Texas, with an office in Portland, Oregon, Southwest Corporate serves nearly 1,500 credit unions located in 44 states. Credit unions in seven core states including Arkansas, Louisiana, New Mexico, Oklahoma, Oregon, Texas and Washington, comprise the bulk of the corporate's membership. Products and services include investments, liquidity solutions, advisory services, settlement, imaged item processing, remote deposit services and a variety of funds transfer and payment services. These products and services provide reduced expenses and increased earnings for member credit unions.

Southwest Corporate acknowledges the multiple factors that contributed to the current credit market dislocation and the resulting issues facing all financial institutions, including corporate credit unions. There is clearly a need to apply the lessons learned and to take a fresh look at corporate credit union operations. Regulatory changes must be done in a thoughtful and prudent manner to ensure corporate credit unions can continue to provide valuable products and services to their member credit unions. Corporate credit union operational changes should be achieved through both regulation and examination, combined with an expectation of broader financial market reforms. Changes to the structure of the corporate credit union network should be decided by the credit unions that are member-owners of the nation's corporate credit unions as a basic tenet of the cooperative model.

This Response sets forth Southwest Corporate's recommendations regarding the questions raised in the ANPR.

1. THE ROLE OF CORPORATES IN THE CREDIT UNION SYSTEM

Payment Systems

The operation and settlement of payment systems is core to the relationship between Southwest Corporate and its member credit unions. One of Southwest Corporate's core competencies is the operation of item processing systems, and it is one that member credit unions heavily rely on for its efficiencies. More than 600 member credit unions use Southwest Corporate as the processor for member share drafts. More than 400 member credit unions use the corporate's Check 21 solutions for remote deposit services including branch, teller, ATM, business and member capture. The economies of scale of these operations are significant at Southwest Corporate. Savings are passed on to member credit unions in the form of lower fees, faster collection times, and more secure delivery systems. The national movement to exchange check images instead of paper checks has created additional ways to maximize efficiencies in item processing operations. As national check volume has declined, Southwest Corporate has taken advantage of that trend by expanding its activities in direct image presentment and settlement with exchanges and other financial institutions.

The settlement of payment systems transactions at a corporate credit union is a liquidity function, since the funding for all types of payment system transactions is done through member credit unions' share balances and available lines of credit (LOC).

The primary risk associated with payment systems is that a corporate credit union would not have sufficient liquidity to fund settlements or the ability to process payments due to negative developments experienced in the investment portfolio. Southwest Corporate believes these risks would be mitigated by recommended enhancements to liquidity management practices, capital requirements and investment management described elsewhere in this Response. Also contributing to mitigating payment systems risks would be the impact of broader financial regulatory and operating reforms that are expected to occur over the next few years, including improved practices surrounding rating agency activities.

Southwest Corporate's recommendations:

1. <u>Address payment systems risks through enhanced liquidity management practices, capital requirements and investment management.</u>

As further described in the "Liquidity and Liquidity Management", "Corporate Capital" and "Permissible Investments" sections of this Response, the following enhancements to liquidity, capital and investment management practices are recommended:

- Establish cash flow gap requirements under various base-line and stressed cash flow scenarios.
- Maintain appropriate levels of short-term assets.
- Use external borrowing only in contingency situations.
- Establish diversified sources of external liquidity including the expanded, permanent use of the Central Liquidity Facility (CLF).
- Adopt higher capital limits, including requiring all credit unions to capitalize a corporate credit union in order to utilize its products and services.
- Adopt specific investment concentration limits.

2. Neither segregation of payments processing operations nor establishment of separate corporate credit union charters is necessary in order to mitigate payment systems risks.

Southwest Corporate does not believe it is necessary to isolate the payments processing operations from other corporate credit union operations in order to mitigate payment systems risks. As previously noted, these risks would be mitigated by recommended enhancements to liquidity management practices, capital requirements, and investment management described elsewhere in this Response.

One option suggested in the ANPR is to isolate payment processing and settlement functions in one charter, with a separate charter to be used for investment services. As suggested in the ANPR question, one corporate charter would be for overnight investments, share accounts, settlement activities and other correspondent services. Another charter would be for term certificate operations. Southwest Corporate does not believe such an approach is necessary as the payment systems risks would be mitigated by the combined impact of critical ANPR recommendations regarding liquidity management, capital requirements and investment concentration limits.

Payment processing could also be isolated into a CUSO, but settlements could not be processed in the CUSO (because settlement must be done by a financial institution) and the long-term profitability of a payments-only CUSO would be questionable. Also, as with the separate charter idea, this option is not deemed necessary to mitigate payment systems risks.

Liquidity and Liquidity Management

Providing liquidity to member credit unions is one of the primary roles of Southwest Corporate. For more than 33 years, Southwest Corporate has served credit unions of all asset sizes and balance sheet complexities. Eighty-six percent of member credit unions in Southwest Corporate's seven core states have established LOCs with Southwest Corporate, for an aggregate total of more than $6 billion. Member credit unions consider their LOCs at Southwest Corporate a core service upon which they rely. For example, in 1999, Southwest Corporate assisted more than 600 member credit unions in completing CLF forms and in setting up Y2K contingency LOCs.

Historically, Southwest Corporate has offered competitive interest rates on loans and has secured those loans with a variety of types of collateral. Southwest Corporate does not charge loan origination fees or other premiums for establishing LOCs or term loans, a practice commonly used by other financial institutions. Also, Southwest Corporate provides convenient online account access, automated LOC loan advances (i.e., for automated settlement) and other options for structuring term loans and LOCs.

Southwest Corporate's recommendations:

1. <u>Providing liquidity to member credit unions should remain a core service provided by corporate credit unions.</u>

Southwest Corporate recommends that liquidity (i.e. credit) products should remain a core service of the corporate credit union system. To improve and strengthen the corporate system's ability to offer liquidity products as a core service, best practices and supervisory guidelines should continue to be reviewed and enhanced. Developing analytical tools that provide strong and meaningful decision-making capabilities to the Treasury Management function should be included in liquidity management best practices. For example, Southwest Corporate recommends adopting short-term cash flow gap limits and increased emphasis on liquidity contingency practices.

Corporate credit unions should continue to offer a broad range of liquidity products designed to meet the diverse liquidity needs (both current and future) of their member credit unions. Such liquidity products include LOCs and term loans, both at fixed and variable interest rates, and structured term loan products (callable, amortizing, puttable, etc.). Other credit services including letters of credit, facilitating CLF loans, and committed LOCs also should continue to be offered.

2. <u>Enhanced liquidity management practices should be implemented.</u>

Southwest Corporate recommends improvements to a corporate credit union's internal processes and policies in order to facilitate the proper assessment of cash flow needs, thereby retaining ample liquidity to meet the expected needs of member credit unions. We recommend NCUA amend Part 704 and require corporate credit unions to do the following:

- Establish minimum short-term cash flow gap requirements based on historical seasonally adjusted deposit flows.
- Demonstrate the ability to meet expected short-term and intermediate-term liquidity needs of members through internally generated cash flows.
- Maintain an appropriate amount of short-term liquid assets that in aggregate would represent a multiple of the expected cash flow needs.
- Model members' short-term liquidity needs under various stressed scenarios.
- Obtain external liquidity sources that are diversified, reputable and reliable.

- Limit external borrowing activities by borrowing only to meet unexpected short-term liquidity needs.
- Limit illiquid asset classes (i.e., private placements and funding agreements).
- Maintain a comprehensive contingency funding plan that is reviewed and up-dated frequently.

In its supervisory capacity, NCUA should test the adequacy of a corporate credit union's liquidity policies and procedures.

3. As a risk-limiting constraint, use cash flow gap rather than cash flow duration.

Section 704.8(d)(2)(iii) currently requires a corporate credit union to "assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV". One specific factor identified is adjustments to the market spread assumptions for non-Treasury instruments to consider the impact of widening spreads (cash flow duration). Id., Section 704.8(d)(2)(iii).

Southwest Corporate currently conducts and completes a cash flow duration analysis each month. However, cash flow duration limits do not account for credit or liquidity stress-related risks. For example, overnight member credit union share deposits placed in an overnight repurchase agreement at a broker/dealer would have no duration mismatch and would easily pass any duration limitation. However, this simple risk measure fails to capture a more critical aspect of the transaction, liquidity, because duration is not an adequate measure of available funds.

In this example, despite the short duration of a repurchase transaction, the broker/dealer could become unable to return the funds because of a cataclysmic event such as the failure of Long-term Capital, AIG, or Lehman Brothers. Further, fixed duration limits would be ineffective given corporates' seasonal cash flows. Thus, a duration limit appropriate for November would not be as appropriate in late January. Southwest Corporate believes that diversification of funding sources is much more critical than duration limits and when combined with cash flow stressing should be sufficient to protect member credit union's access to liquidity.

Southwest Corporate recommends cash flow gap as a more appropriate risk limiting constraint. Member credit unions withdraw funds in absolute dollar amounts and not in the time-weighted dollar amounts that duration calculations envision. An appropriate cumulative cash flow gap limit, based on expected cash flow needs for 180 days would be zero ($0). Thus, a corporate credit union must be able to fund internally all expected cash flow needs within 180 days. Effective cash flow gap limits will ensure that funds are available to meet member credit unions' short-term liquidity needs.

An aggregate cash flow duration measure may not be sensitive enough to capture a corporate credit union's short-term liquidity needs. For example, a six-month aggregate cash flow duration limit may be an appropriate limit to mitigate price risk due to an unforeseen widening in credit risk spreads. However, the same six-month limit would be inadequate to meet short-term member credit union liquidity needs if the asset cash flows are heavily weighted in the six-month maturity range.

Due to the weaknesses of an aggregate cash flow duration limit as an effective tool for managing short-term liquidity needs, Southwest Corporate recommends aggregate cash flow duration limits not be added to Part 704. However, if NCUA chooses to implement cash flow duration limits, we believe these should be required only for that portion of the investment portfolio dedicated to the overnight share portfolio.

4. Broaden the CLF's lending capabilities.

NCUA should continue to investigate opportunities to broaden the CLF's lending capabilities to include access for corporate credit unions. Additionally, NCUA should pursue the authority for the CLF to permanently lend up to its statutory limit, which currently is approximately $41 billion.

Field of Membership

Southwest Corporate has nearly 1,500 member credit unions located in 44 states. Credit unions from seven core states comprise the bulk of the membership, including Arkansas, Louisiana, New Mexico, Oklahoma, Oregon, Texas and Washington. These core states comprise Southwest Corporate's original geographic field of membership and the fields of membership of two corporate credit unions with which Southwest Corporate merged.

Corporate credit union restructuring is necessary, but it should be an evolutionary process, not a revolutionary one. Many of the changes recommended in the ANPR will significantly influence changes to corporate operations and system structure. National fields of membership should be maintained as credit unions should have the ability to select from which corporate credit union or corporate credit unions they obtain products and services.

Southwest Corporate's recommendations:

1. Corporate credit union restructuring is necessary, but it should be an evolutionary process driven by ANPR reforms and decided by member credit unions.

Corporate credit unions have been consolidating over the past ten years due to natural market forces. Many of the changes recommended in this Response will serve as a significant catalyst driving further changes to corporate credit union operations and system structure. However, corporate-level restructuring decisions should ultimately be made by the credit unions that are member-owners of the nation's corporate credit unions.

The primary operational changes from the ANPR that will result in structural changes are higher capital requirements at corporate credit unions and the requirement that all member credit unions capitalize a corporate credit union in order to utilize its products and services. These changes would drastically change inter-corporate credit union competition, essentially returning corporate credit union membership back to core geographic territories as most credit unions would likely limit membership to a single corporate. Higher capital requirements would also temper corporate credit union balance sheet growth.

Another contributing factor to restructuring would be the recommended transition of US Central Federal Credit Union (US Central) away from a wholesale corporate structure, thereby requiring all corporate credit unions to make adjustments to their existing business model. Southwest Corporate's recommendations regarding US Central are discussed in another section of this Response.

2. National fields of membership should remain in place.

Southwest Corporate recommends that national fields of membership remain in place. Credit unions should have the ability to diversify their funding sources and choose which and from how many corporate credit unions they access products and services, and which to capitalize. Despite the fact that national fields of membership are recommended to stay in place, many of the changes recommended in the ANPR will significantly influence corporate credit union restructuring and likely limit credit union membership to a single corporate.

Expanded Investment Authority

Under Part 704, Appendix B – Expanded Authorities and Requirements, corporate credit unions may obtain expanded authority to purchase investments that have lower long-term and short-term credit ratings, enter into derivative transactions that are specifically approved by NCUA, purchase investments in certain foreign obligations, and manage higher levels of aggregate interest rate risk. It is important to note that expanded authorities were not required to purchase AAA-rated mortgage-backed securities.

The board and senior management of each corporate credit union should assess the need for expanded investment authority in light of the products and services the corporate credit union offers, or plans to offer, to its member credit unions. Corporate credit unions seeking expanded authorities must have the systems, support and operational capacity to identify, measure, monitor, report and control risk related to current and projected risk activities. Approval of expanded authorities may require extensive revisions to existing policies and procedures relating to, at a minimum, investments and asset and liability management. Other areas of operations will also be impacted and the policies and procedures governing those areas must be updated and managed accordingly.

The request for expanded authorities is a two-part process. A corporate credit union must submit a self-assessment plan to NCUA supporting its request. The self-assessment plan must include draft policies and procedures, and the proposed systems and personnel needed to manage efficiently and effectively the proposed risk activity. NCUA reviews the plan and assesses management's ability to engage in the proposed risk activity given the infrastructure and other resource requirements described in the plan. The second part of the process is implementation of the approved plan. NCUA staff performs on-site reviews of the corporate credit union's financial and operational condition before actual expanded authority transactions take place. The reviews include evaluating the corporate credit union's self-assessment plan, interviewing selected corporate staff and/or officials and reviewing the adequacy of the systems most relevant to the proposed activity. Each corporate credit union must demonstrate its ability to operate safely and soundly under the additional authorities.

Southwest Corporate believes a corporate credit union's ability to diversify its investment portfolio is critical to its member credit unions. One of Southwest Corporate's recommendations includes establishing aggregate concentration limits by investment types and individual obligor/issuer concentration limits. As a result of these lower concentration limits, corporate credit unions would require access to a wide range of permissible investments and high quality obligors/issuers to achieve appropriate portfolio diversification. Member credit unions that have contributed capital to a corporate credit union that has demonstrated in-house expertise, systems and controls should have access to the expanded benefits their corporate credit unions can provide. By using the expanded authorities process, NCUA can act as a control point for natural person credit unions accessing increased value through their corporate credit unions of choice.

Southwest Corporate's recommendations:

1. <u>Expanded investment authorities are needed for diversification.</u>

In reference to expanded authorities, and more specifically to investment powers, Southwest Corporate believes that diversification is more important today than ever before because of the tremendous downward migration of ratings across all sectors of the economy, and because of the near failure of more than one agency issuer. Southwest Corporate's recommendation to maintain expanded authorities under Part 704 is supported by other recommendations in this Response including higher capital requirements and concentration limits on investment types and individual obligors. The diversification of funding sources is another primary objective of expanded authorities.

The requirement that corporate credit unions and natural person credit unions invest only in the highest rated entities at a time when so few of those entities exist, only further concentrates credit union funds in fewer names and fewer sectors. Therefore, eliminating certain investments or specific collateral types that are currently permissible under Part 704 would further reduce the universe of eligible investment options and diminish a corporate credit union's ability to achieve proper portfolio diversification.

Southwest Corporate believes one of the most effective elements of liquidity risk management is borrowing long and lending short. Any financial institution that does not have term certificates as a funding source is basically maximizing liquidity risk, regardless of its maturity matching limits. To maximize a corporate credit union's liquidity position, it must have the capacity to issue term certificates and to invest the funds in shorter-term assets, other than loans to member credit unions. To do this in the typical upward-sloping yield curve environment, a corporate credit union must have the ability to use interest rate swaps or financial futures. Interest rate swaps will allow corporate credit unions to buy assets and to swap the interest cash flows to match the cash flows of their member credit unions' term certificates.

2. Require minimum total capital ratio requirements for expanded investment authorities.

Under Part 704, Appendix B – Expanded Authorities and Requirements, requires a corporate credit union that seeks to engage in expanded authorities, maintain a higher minimum capital ratio based on the percent decline in the net economic value (NEV) stress test, which is higher than the minimum required by Section 704.8(d)(1). Southwest Corporate agrees that a higher minimum capital standard, similar to the current requirements for expanded authorities, should be retained. Southwest Corporate recommends if a corporate credit union operates under expanded authority, the corporate credit union's minimum total capital ratio of 6 percent (as recommended in this Response) should increase to 7 percent or 8 percent, depending on its NEV ratios.

3. Maintain the authority for qualified corporate credit unions to engage in derivative transactions.

Southwest Corporate believes there should be limitations to a corporate credit union's authority to engage in derivative transactions. Such transactions should be limited to transactions that: (i) create structured products, (ii) manage the corporate credit union's own balance sheet, or (iii) hedge the balance sheet risk of its member credit unions. Derivative transactions are necessary for the effective and efficient management of interest rate risk embedded in a corporate credit union's balance sheet. This is accomplished by managing the interest rate risk represented by share certificates issued to member credit unions, managing the interest rate risk of long-term fixed rate loans extended to member credit unions and reducing basis risk between two variable-rate indexes.

In this regard, Southwest Corporate notes that if NCUA determines that certain types of derivative transactions are inappropriate for use by a corporate credit union, NCUA already has the ability to restrict those applications under Part 704, Appendix B, Part IV(a).

Southwest Corporate recommends that ongoing qualification for expanded authorities be assessed through NCUA supervision and examination. In particular, requalification should be required whenever a material change that is relevant to a corporate credit union's expanded authority occurs in the corporate credit union's management infrastructure or in asset liability management practices.

<u>Structure: Two-Tiered System</u>

US Central is the only wholesale corporate credit union serving retail corporate credit unions. Over the years, US Central's corporate credit union membership base has contracted from the original 48 to 26 corporates today.

Southwest Corporate accesses the following services from US Central: overnight and term investments, LOCs, broker/dealer services through ISI, ACH processing for former Northwest Corporate users, automated settlement, cash concentration and automated debit transfer, bill payment through Corporate Network eCom, some international wire transfer transactions and foreign currency collection and securities safekeeping.

Southwest Corporate's recommendations:

1. <u>US Central should not continue in its current form.</u>

A wholesale corporate credit union drawn from a membership of less than 30 corporate credit unions inevitably causes significant concentration risk for each of its member corporates. This concentration risk has historically been deemed acceptable because regulations limited US Central to highly-rated investments. However, despite these regulatory limitations, US Central's conservatorship and likely capital account impairment clearly illustrate the detrimental effect of concentration risk when a worst-case scenario actually occurs.

The current wholesale corporate credit union structure also results in inadequate earnings accumulation, thereby requiring a disproportionate amount of member-contributed capital and magnifying the inherent concentration risk associated with having too few member corporate credit unions. The principal reason why the current wholesale structure provides an insufficient earnings base to build retained earnings is that there are two levels of corporate credit unions that earn a spread on the same products and services. The impact of the two levels, together with the commodity nature of corporate credit union products and marketplace pricing pressures, results in minimal income and retained earnings growth for a wholesale corporate credit union.

2. <u>US Central should evolve into a new role, not as a wholesale corporate credit union but as a CUSO provider of off-balance sheet products and services.</u>

This new role would entail providing products and services that do not require a wholesale corporate credit union charter or the maintenance of a substantial balance sheet and capital. For example, current US Central CUSOs including ISI and Corporate Network eCom, could continue to provide broker/dealer and bill payment services.

It would take several years for US Central to evolve into this new role, because its investment portfolio must pay down and US Central must reduce its dependence on external borrowings. This time will allow NCUA and corporate credit unions to decide what services US Central should offer.

2. CORPORATE CAPITAL

Core Capital

Regulatory capital in the corporate credit union system consists of retained earnings, membership capital shares (MCS) and paid-in-capital (PIC). Core capital is defined as retained earnings plus PIC. PIC, which is perpetual, and MCS are not subject to share insurance coverage by the NCUSIF and cannot be pledged against borrowings. PIC is callable only at the option of the corporate credit union and only if it meets its minimum required capital and NEV ratios after the funds are called.

Southwest Corporate's recommendations regarding capital requirements for corporate credit unions are designed to achieve two primary objectives: (i) strengthening the corporate credit unions' capital structure by increases in minimum capital requirements and improvements in the permanency of total capital, and (ii) creation of consistency with the capital standards that are applicable to other federally regulated financial institutions.

Southwest Corporate's recommendations:

1. Increase capital ratio requirements at all corporate credit unions.

Southwest Corporate supports a minimum core capital ratio of 4 percent based on a corporate credit union's 12-month trailing daily average net assets (DANA). To maintain consistency with other federally regulated financial institutions, core capital should include only retained earnings and PIC. If this requirement was applied to corporate credit unions, most would need to convert a substantial portion of their current MCS to PIC to attain a core capital ratio of 4 percent.

Corporate credit unions should be required to maintain a minimum total capital ratio of 6 percent. If a corporate credit union has expanded investment authorities, a total capital ratio above 6 percent should be required as further described in the Expanded Investment Authority section. The recommended capital requirement of 4 percent core and 6 percent total capital ratios are consistent with other recommendations made in this Response to elevate current requirements including; (i) additional liquidity requirements, (ii) elimination of certain investment types, and (iii) restrictions on concentration limits for most investment types.

One additional impact of a higher minimum core capital requirement is limiting the growth and size of a corporate credit union's balance sheet. The expected decline in the size of a corporate credit union's balance sheet in order to comply with the higher minimum core capital requirement would primarily be driven by a sharp reduction in member credit union share certificates.

2. Establish a minimum operating income target of at least 15 basis points.

It is critical that corporate credit unions manage efficient operations allowing them to deliver competitively priced products and services to their member credit unions while also generating sufficient income from operations to build core capital. Southwest Corporate recommends a minimum operating income target of at least 15 basis points to ensure that appropriate emphasis is placed on generating core capital through growth in retained earnings.

3. All credit unions using products and services offered by corporate credit unions should be required to contribute capital

Southwest Corporate believes each member credit union using the services of a corporate credit union should be required to contribute capital to each corporate credit union it uses. Contributed capital would be comprised of PIC (i.e. part of core capital) and MCS (i.e. part of total capital). Southwest Corporate recommends that Part 704 be amended to exclude the restriction that a corporate credit union may not condition membership, services, or prices for services on a member credit unions' contributed capital. NCUA should also consider amending Part 704 to make it mandatory that member credit unions' contributed capital is required to access products and services and as a condition of membership in a corporate credit union.

4. Grant a reasonable transition period.

Southwest Corporate's recommendations regarding higher minimum capital ratios are based on our long-term view of what appropriate capital standards should be for corporate credit unions. As such, comprehensive changes to the structure of corporate credit union capital requirements should be enacted over a period of time so that the impact of corporate credit union investment losses becomes clearer. At that time, member credit unions will be better positioned to make decisions regarding corporate credit union services and capitalization. Southwest Corporate believes it is currently not possible to specify with any precision what timetable should be assigned for compliance with new, higher capital requirements.

Membership Capital

The capital companion to a corporate credit union's retained earnings is the capital that is contributed by member credit unions. Membership capital combined with retained earnings and PIC, gives a corporate credit union the ability to operate a balance sheet from which it can provide transaction settlement, liquidity, and secure investments, and can generate earnings that build more capital and provide for the offering of fee-based services.

The following recommendations serve to provide a stable and lasting capital base from which a corporate credit union can provide a variety of needed services. The overarching recommendation is that member contributed capital based on a credit union's total assets should be a requirement for any credit union using a corporate credit union for any product or service.

The new membership capital requirement, which would carry a five year withdrawal notice, would be enacted over a reasonable transition period to give credit unions a smooth conversion.

Southwest Corporate's recommendations:

1. <u>All credit unions using products and services offered by corporate credit unions should be required to contribute capital.</u>

Southwest Corporate believes each member credit union using the services of a corporate credit union should be required to contribute capital to each corporate credit union it uses. Contributed capital would be comprised of PIC (i.e. part of core capital) and MCS (i.e. part of total capital). Southwest Corporate recommends that Part 704 be amended to exclude the restriction that a corporate credit union may not condition membership, services, or prices for services on a member credit unions' contributed capital. NCUA should also consider amending Part 704 to make it mandatory that member credit unions' contributed capital is required to access products and services and as a condition of membership in a corporate credit union.

2. <u>Extend the notice period on MCS to five years.</u>

Extending the withdrawal notice period on MCS from three years to five years will provide greater permanency and consistency with the capital requirements applicable to other financial institutions. For example, to meet the requirements of Tier 2 capital, certain capital components are required to have an original minimum maturity of five years. Currently, MCS accounts with a notice period of three years would not qualify as a component of Tier 2 capital since its maturity is less than five years. To align a corporate credit union's capital requirements with other financial institutions and to meet the definition of Tier 2 capital, Southwest Corporate recommends that the MCS withdrawal notice period be increased to five years.

3. <u>Credit union member contributed capital should be based on a percentage of a member credit union's asset size.</u>

Southwest Corporate recommends that adjusted balance requirements be based on the member credit union's total assets, and should be adjusted annually. Adjusted balance accounts that are tied to deposits in a corporate, as currently permitted by Section 704.3(b)(8), effectively reduce the maturity of certain MCS balances to six months. Downward adjustments that are not based on a member credit union's asset size should not be permitted.

4. Grant a reasonable transition period.

As discussed under "Core Capital", Southwest Corporate's recommendation regarding extending the withdrawal notice period on MCS to five years is based on our long-term view of what appropriate capital standards should be for corporate credit unions. As such, changes to the MCS account structure should be enacted over a period of time so that the impact of corporate credit union investment losses becomes clearer. At that time, member credit unions will be better positioned to make decisions regarding corporate credit union services and capitalization. Southwest Corporate believes it is currently not possible to specify with any precision what timetable should be assigned for compliance with the MCS requirements. However, Southwest Corporate believes the appropriate timetable for requiring all member credit unions to contribute capital is a time period long enough to allow existing contracts to expire and to provide member credit unions enough time to transition to other service providers if they choose not to capitalize a corporate credit union from which they are currently receiving services.

Risk-based capital and contributed capital requirements

Under a risk-based capital framework, the assets on a financial institution's balance sheet assets are assigned to one of four broad risk categories. The aggregate dollar amount in each category is multiplied by the risk-weight assigned to that category. The resulting weighted-asset values from each of the four risk categories are added together and the sum is the risk-weighted assets total that is included in the denominator of the risk-based capital ratio. The current minimum risk-based capital ratio requirement is 8 percent and to be considered well capitalized, a financial institution is required to maintain a 10 percent or greater risk-based capital ratio.

Southwest Corporate's recommendation:

1. A risk-based capital requirement should be implemented.

Southwest Corporate encourages NCUA to implement a risk-based capital requirement consistent with the requirements applicable to other federally regulated financial institutions (Basel Accords). A minimum risk-based capital requirement of 8 percent is recommended.

3. PERMISSIBLE INVESTMENTS

Permissible investments currently authorized under Part 704 are limited to high quality (AA- or better) investments and include a broad range of investment types. NCUA is considering whether to prohibit certain investment categories or specific investments including Alt-A mortgage-related securities.

A corporate credit union's ability to provide value to its member credit unions depends heavily on the corporate credit union's investment offerings. In order for corporate credit unions to provide this value, they need to have broader investment authority than natural person credit unions, coupled with demonstrated capabilities and resources. Rather than prohibiting certain investment types, Southwest Corporate recommends that investment concentration limits be significantly restrained. More widespread changes to investment authorities are not deemed necessary as the combined impact of the ANPR recommendations and broad financial market reforms are expected to significantly enhance corporate credit union safety and soundness.

Southwest Corporate's recommendations:

1. Establish concentration limits by investment sector and individual obligor.

Southwest Corporate believes it is difficult to utilize past performance as the basis for forward-looking regulation of the categories of investments and collateral that should be prohibited for corporate credit unions. An alternative approach is to establish regulatory concentration limits as to the amount of its capital a corporate credit union can invest in specific investment types. Southwest Corporate also recommends NCUA utilize a risk-based examination process and approach to identify and address potential rising concerns that relate to the quality and appropriateness of individual investment sectors.

Southwest Corporate recommends NCUA establish aggregate concentration limits that would apply to all categories of investments. Aggregate concentration limits would exclude Treasury and senior agency securities. Additionally, corporate credit unions should be required to establish internal concentration limits based on the type of mortgage collateral (e.g. subprime, Alt-A, and prime) subject to NCUA's on-going examination process.

Aggregate concentration limits by investment sector should be limited to 300 percent of total capital. Examples of investment sectors include: (i) non-agency mortgage-backed securities, (ii) credit card receivable asset-backed securities, (iii) auto loan asset-backed securities, (iv) corporate debt, and (v) student-loan asset-backed securities. If a concentration limit based on 300 percent of total capital for non-agency residential mortgage-backed securities had been prescribed in Part 704, the current aggregate exposure that exists in corporate credit unions' investment portfolios would have been drastically reduced. For example, based on NCUA 5300 Call Report data, the largest corporate credit unions had approximately $59 billion in non-agency mortgage-related securities in July 2007. This figure represents 1100 percent of the total capital of the largest corporate credit unions at that time. A concentration limit based on 300 percent of capital would have substantially reduced the aggregate exposure of non-agency mortgage-related securities for those large corporate credit unions to less than 30 percent of their actual exposure.

NCUA should also consider establishing individual obligor/issuer concentration limits equal to 12.5 percent of a corporate credit union's total capital.

Consideration should be given to prohibiting certain highly leveraged investment transactions such as collateralized debt obligations and net interest margin securities.

2. Major changes in current investment authorities are not warranted due to the combined impact of ANPR recommendations and broad global reforms.

Southwest Corporate believes that major changes to corporate credit unions' permissible investments are not warranted. Our conclusions are supported by the combined impact of the ANPR recommendations and significant regulatory and market reforms that are anticipated in response to recent credit and liquidity market dislocation. These anticipated reforms include the following:

- Broader regulatory oversight of the financial services industry and capital markets.
- More transparency from issuers.
- Significant reduction in leverage.
- More risk averse business models.
- Improvement in the quality of credit ratings from Nationally Recognized Statistical Rating Organizations (NRSRO) (new worst-case scenarios and elimination of conflict of interest).
- Higher capital requirements.

4. CREDIT RISK MANAGEMENT

As stated in the ANPR, recent events in the financial industry might support a lower degree of reliance on NRSROs. The quality of NRSRO ratings was compromised by the conflicts of interest that existed between the rating agencies and the issuers of debt being rated, and the absence of regulatory oversight for these organizations.

Southwest Corporate anticipates that comprehensive reform from financial regulators and Congress will address the conflicts of interest that currently exist. The overall quality of credit ratings should significantly increase as credit rating agencies' loss models incorporate the most recent loss experiences and as investors demand more transparency from all issuers, not just issuers of collateralized securities.

Southwest Corporate's recommendations:

1. NCUA should continue to rely on NRSROs ratings, but with additional requirements.

Southwest Corporate recommends NCUA continue to rely on NRSRO ratings, but also require corporate credit unions to have the staff and systems necessary to conduct a thorough review of any counterparty or structured debt offering. Such reviews should be conducted prior to the purchase of an investment and periodically throughout the expected holding period of the investment.

2. NCUA should adopt further regulatory requirements regarding the use of ratings.

Rating agencies are beginning to adapt to pressures for more reliable ratings. If the current conflicts of interest are adequately addressed, the use of ratings from multiple rating agencies is a sound idea. Multiple analyses from reliable sources are always an improvement. Southwest Corporate recommends NCUA require corporate credit unions to use more than one rating. Southwest Corporate also recommends NCUA adopt a regulatory requirement that corporate credit unions must use the lowest rating to meet the minimum rating requirement. In most distressed markets, the lowest rating is likely to be the most recent and possibly the most accurate. NRSRO ratings should not be the sole criteria for the purchase of any security, even agency securities. Corporate credit unions purchasing structured securities should be required to use third-party modeling tools to conduct and document credit stress tests.

3. Additional concentration limits should be adopted.

Concentration limits are some of the strongest portfolio management tools available to a financial institution. Corporate credit unions should estimate balance sheet concentration risk and the potential for loss of capital related to any new investment purchase, and for the corporate credit union's investment portfolio as a whole. While concentration limits are important, it is even more critical to reassess the impact evolving economic conditions have on the different elements of the portfolio and to rebalance as necessary to ensure the full benefits of diversification.

Concentration limits for specific sectors and obligors can provide an indispensable firewall against the risks of a particular industry or subindustry. As previously stated, Southwest Corporate recommends that sector concentrations be limited to 300 percent of total capital, and obligor concentrations limited to 12.5 percent of total capital. Credit functions at corporate credit unions should be independent of the investment function and should have the authority to require divestitures of individual investments or entire sectors.

4. Test sensitivities to credit spread widening and standards to apply to that effort.

The measurement of the risk from a widening of credit spreads is both a liquidity issue and a capital issue. Southwest Corporate has used the credit spread widening stress testing process for years and strongly recommends that sensitivities to credit spread widening be a mandatory measurement and regulatory reporting requirement. The impact of a one (1) basis point widening should be included on the 5310 Call Report so that all interested parties can perform scalable analysis on any corporate credit union. Corporate credit unions should be required to have an outside third party review of the process that generates the reported credit spread risk measurements.

5. ASSET LIABILITY MANAGEMENT

Southwest Corporate uses net interest income testing and monitoring and believes these techniques can provide important benefits and controls.

Southwest Corporate's recommendation:

1. <u>Require the use of net interest income modeling and stress testing.</u>

Risk management best practices include income projection modeling as a complement to NEV. Part 704 in its current form only requires corporate credit unions to measure and report risk from an NEV perspective where the fair value of shares and liabilities are subtracted from the fair value of assets. Southwest Corporate recommends NCUA require corporate credit unions to perform monthly net interest income modeling and shock tests.

6. CORPORATE GOVERNANCE

As with natural person credit unions, corporate credit union boards of directors are democratically elected representatives from the corporate credit union's member-owners. The number, terms and qualifications of the board members should be determined by the board and member-owners. None of the suggested governance changes would have shielded corporate credit unions from the credit market turmoil or improved current governance practices.

Southwest Corporate's recommendation:

1. <u>Representatives from a corporate credit union's member-owners continue to be the appropriate persons to serve on the corporate credit union's board of directors.</u>

The current credit market turmoil is a global event impacting every type of financial institution ranging from money-center banks, investment banks, mutual funds, insurance companies, government-sponsored entities, regional and community banks, corporate credit unions and natural person credit unions.

Every governance change presented for comment in the ANPR, including well-qualified and trained individuals, outside directors, directors with term limits, and compensated directors, was already used by some of the institutions currently impacted by the market turmoil. Accordingly, Southwest Corporate believes that none of the governance changes referenced in the ANPR would have shielded corporate credit unions from the credit market turmoil or represents an improvement over current governance practices.

There is an ample supply of qualified individuals within the credit union industry to fill corporate credit union volunteer roles. In addition, corporate credit union board members typically receive training on a range of topics.

Summary

The combination of sound regulation and effective supervision, amended in conjunction with global reforms, will ensure that corporate credit unions provide the products and services natural person credit unions need and to make sure they operate in a safe and sound manner.

In this Response to NCUA's ANPR, Southwest Corporate has recommended meaningful changes to Part 704 that are designed to strengthen corporate credit unions' core and total capital, reduce investment risk, and improve liquidity.

Southwest Corporate looks forward to further dialog and collaboration with NCUA throughout the rulemaking process.

Sincerely,

John Cassidy
President/CEO

cc: Brent Taylor, Chairman, Southwest Corporate FCU