



April 6, 2009

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

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

Dear Ms. Rupp:

We appreciate the National Credit Union Administration (NCUA) affording the State Department Federal Credit Union (SDFCU) the opportunity to comment on the Advanced Notice of Proposed Rulemaking (ANPR). We stress that any corporate credit union (CCU) restructuring should focus on reducing risks to natural person credit unions (FCU) from CCUs while ensuring that all FCUs retain a similar level of access to important services currently available from CCUs. The importance of CCU restructuring is magnified by perceptions of safety and soundness issues attributed to the entire credit union industry from risk and costs introduced into the system by (presently) two CCUs.

We suggest taking the CCU restructuring a step further by performing a cost benefit analysis on the CCU system. **The NCUA and credit union community should study whether the FCUs have received more than \$5.9 billion in value from the entire portfolio of services offered by CCUs since inception.** The study should also look at the value of CCUs over different intervals and project into the future. We do not advocate disbanding CCUs; however, we advocate for that option if the risks and costs to the credit union system outweigh the benefits received. Thus, the needs and desires of CCUs should only be considered when they move in lockstep with needs of FCUs.

The Role of Corporates in the Credit Union System

SDFCU supports any restructuring to the CCUs that strengthens the credit union system while providing necessary services to both small and large FCUs. We believe CCUs should focus on investment, liquidity and other necessary services that can be more efficiently provided by CCUs.

CCUs supply important liquidity, investment and payment services to FCUs of all sizes. Many FCUs, especially larger institutions, can obtain these services at competitive prices outside of the credit union system. Unfortunately, not all FCUs have access to service providers outside the of the credit union system and thus rely

on CCUs for many services. We feel that the end result of any restructuring should ensure FCUs retain the same ability to obtain services that are currently available.

Payment System

All non core CCU activities should be reviewed and changes should be made to the current system if the benefits to the credit union system outweigh risks. **If offering payment system services strengthens CCUs and, by extension, the credit union system then we support status quo.** Unfortunately, we have difficulty imagining scenarios where offering payment services benefits a CCU's liquidity, investment and risk management operations.

From a simple management perspective a larger and more complex organization becomes less focused and more difficult to manage. Limiting services offered by CCUs would ensure that CCU management has fewer distractions, which should help management to focus efforts on core investment activities. Furthermore, single service CCUs would not have the ability to prop up less successful services with more successful services. Last, separating services precludes CCUs from using one service to attract other activities and forces more focused organizations to be skilled at their core services.

Eliminating payment systems would make it easier to let a CCU fail and simplify unwinding a failed or conserved CCU. We suggest at a minimum that CCUs be restructured where services are placed into a separate wholly owned entity with its own management and board. This would enable NCUA to easily remove services from a CCU in the event failure, conservatorship or if it is decided in the future that CCUs should not offer services beyond liquidity and investment management.

Liquidity and Liquidity Management.

The most important function for CCUs is to supply services that FCUs cannot easily find outside of the credit union industry, which was originally investment services and liquidity management. Small FCUs rely on CCUs for liquidity and other necessary services and probably have difficulty finding some services outside of the CCU system because of size. **As a consequence, the real issue with services is whether smaller FCUs can survive if services offered by CCUs are limited. If CCUs are needed to support small FCUs by providing services then less costly alternates should be explored if risk to the credit union system can be reduced from an alternative service provider.** Nonetheless, CCUs should only be allowed to offer a service if there is a demonstrated need from FCUs that the service cannot be found elsewhere and the credit union system will suffer if CCUs do not offer the service.

Field of Membership

The current field of membership scheme is not a major issue adding risk to the credit union system and may be an advantage in reducing risk to the system in the future by ensuring less geographic and single financial institution risk. Limiting FCUs to CCUs in their region would, however, adversely impact FCUs that cannot leave the CCU system for investment and liquidity services. These FCUs would be left with far

fewer choices for services. Fewer choices could result in CCU services that are not competitive, which could weaken FCUs. Also, decreasing competition could allow weaker CCUs to stay in business because of guaranteed demand from a captive audience. Most likely the result of a return to defined fields of membership will result in poorer service from CCUs and more FCUs utilizing organizations outside of the credit union system for investment and liquidity services.

We feel the following points should be taken into consideration when deciding on the number of CCUs that are necessary:

- Chartering enough CCUs so that FCUs have several options to spread investments;
- Limiting the number of CCUs so economies to scale can be taken advantage of to some degree; and
- Consider limiting the size of individual CCUs to minimize damage from possible failures.

Our best estimate of the proper number of CCUs is 12 to 15.

Expanded Investment Authority and Permissible Investments

SDFCU does not support expanded investment authority unless major changes are made to the corporate system. These changes, at the very least, must limit the risk to FCUs that do not use the investment services of CCUs that have this expanded authority. Currently all FCUs appear to have financial liability for the investments of all CCUs. This is true whether or not an FCU had funds invested with a CCU. Expanding investment authority could inject more risk into the system without corresponding benefits and we think that FCUs do not want to be responsible for additional CCU investment risk.

Expanded investment authority could be beneficial if constructed properly and limited to a few sophisticated CCUs. Taking on additional risk should only be permitted if a risk-based model approach is utilized – one that is quantitative with proper procedures and regulations in place. It may also be worth considering allowing only certain well capitalized FCUs to deposit funds at CCUs with expanded investment authority.

We suggest that FCUs be limited by dollar and/or (depending on size) percentage of assets that can be invested in a given CCU. This coupled with the elimination of the two tiered system would spread a given FCUs investments across many CCUs and decrease the impact on the credit union system from single CCU failure. Theoretically, absent a wholesale CCU, the CCUs' investments would be diverse enough to reduce risk to the system. This diversification of investment and limits on FCUs investments in any one CCU would, hopefully, reduce risk to the credit union system enough where a CCU could be allowed to fail without causing major losses to FCUs that are not depositors in the failed CCU. **Furthermore, this diversification should limit FCUs losses to their funds on deposit at a CCU and reduce the chance that FCUs will have to, in the future, provide liquidity to CCUs where they do not have funds on deposit.**

Structure: two-tiered system.

At one time the US Central Credit Union investment services were filling a need for investment expertise that was absent in the corporate system. Now it appears that the current system has allowed for the creation of a “super corporate” that has enough size to pose risk to the entire credit union system. Furthermore, it appears, that some aspects of CCU investing were little more than simple arbitrage plays for CCUs thereby ensuring that some CCUs function as little more than middlemen and thus concentrating risk in one large entity.

We think that CCUs should be sophisticated enough to have skills necessary to handle investments and liquidity without the need of the wholesale CCU. It is possible that this might require the consolidation of CCUs for scale, which we support. **Our ultimate goal is to create corporate system that poses less risk to FCUs than the current system. Decreasing the concentration of risk in one institution seems to further this goal while ensuring that FCUs receive investment and liquidity services necessary to operate.**

Corporate Capital and Permissible Investments

The most important issue that the Corporate Stabilization brings to light is the unlimited financial liability for the possible failures of the CCUs. FCUs currently have very little input into the risk taken by CCUs, yet all FCUs are ultimately financially liable for a CCUs bad or unlucky decisions. There should be a known, reasonable, maximum premium assessed to FCUs instead of a large emergency payment assessed with little warning. This would give FCUs the ability to properly budget expenses and adjust operations accordingly.

Major avenues to approach this unlimited liability problem are to:

- Control the risk that is allowed in the credit union system;
- Make sure the risk taken has the appropriate premiums and capital requirements applied; and
- Find a way to cap the liability of FCUs so it is more aligned with what can be controlled.

Control the Risk

We suggest that NCUA require CCUs to employ an outside independent committee to review investments and assign a risk grade to each investment per an agreed upon risk table. **Specifically, individual risk grades for each investment could be used to develop an overall summary of the risk of a CCUs portfolio.** This report would be provided on quarterly or semi-annually and made available to all FCUs in a timely manner. This way an FCU with deposits or membership capital at a CCU can understand the institution’s risks, which will allow an FCU to decide if this risk is acceptable and if the returns justify the risk. Similarly, this type of review could be performed periodically at the corporate system level, which would allow the NCUA to determine the risk from the entire corporate system.

Limits also should be placed on each type of investment that make up a CCU's investment portfolio. These limits and types of permissible investments should be studied and adjusted at periodic intervals to ensure that a CCUs risk management strategy for permissible investments reflect that latest risk analysis.

Premiums & Capital Should Match the Risk

Increased investment risk should be accompanied by greater capital requirements. The present core capital ratio of 2% no longer applies in today's market environment, and needs to be increased to allow for adequate coverage. Currently, 4% is the standard for the financial industry tied to a risk-based formula. CCUs should adopt the Basel standard measure at a higher percentage.

The NCUA did not increase CCU capital requirements in conjunction with CCUs' increase appetite for investment risk. Some CCUs may balk at the required additional capital and argue it will limit their competitiveness and increase operating costs. This slight increase in cost will be borne in the short term and decrease when capital reserves reach new required limits. These higher short term costs will provide a long term insurance benefits to FCUs by limiting risk attributed to FCU from CCUs.

We urge the NCUA to study and push for increasing the limit of the Nation Credit Union Share Insurance Fund (NCUSIF) beyond the current 1.3% of insured shares. In many of the past years the credit union industry could have afforded a small premium instead of paying no premium. The larger NCUSIF fund would function as a rainy day fund and eliminate possible large one time charges that we see today. We feel the current political environment is friendly to passing higher capital requirements for FCUs and CCUs and may be agreeable to increasing the NCUSIF maximum beyond 1.3 %.

Shock testing and modeling should be used as part of CCU risk management. The following shocks to a CCU's financials should be used at pre determined intervals:

- Loss of investment value
- Sudden loss of shares
- Interest rate change

The results of these shock tests should also be factors in deciding the required capital a CCU should carry.

Cap Annual Liability on Natural Person Credit Unions

FCUs should only be at risk for their membership capital and deposits placed in a CCU. The transparency in the above mentioned investment risk report on CCUs' portfolios provides FCUs important information that is needed when performing due diligence on a CCU, which is necessary in deciding whether to deposit funds at a CCU.

Investment of membership capital should not be required to receive services from a CCU. CCUs should be allowed to offer discounts on services as incentive for FCUs to invest membership capital, but limitations on the discounts should be in place.

CCUs should be required to return membership capital to an FCU within one year of a request by an FCU to cash out its membership capital in a CCU. These rules will allow FCUs to easier utilize multiple CCUs and recover membership capital.

Credit Risk and Asset Liability Management

CCUs should be required to use two ratings agencies to rate investments in order to make a quality decision regarding a particular investment. If the rating by one of the two ratings agencies is beyond a certain tolerance level, then a third opinion should be incorporated, thus making a sound investment decision. Ratings agencies used should be rotated on a predetermined basis. Furthermore, the same ratings agency's opinions should be applied across an entire portfolio to eliminate opinion shopping for a good rating on a specific security. Last, if an opinion is obtained, it must be used, which should eliminate choosing the best of three or more opinions.

Corporate Governance

A well laid out corporate governance policy will encourage trust and confidence in the CCU system. **The NCUA should issue guidelines on Corporate Governance without imposing onerous regulatory mandates.** CCUs should be encouraged to improve corporate governance practices by self-assessing, training and guiding its board and management.

Recommended Areas of Focus on Corporate Governance

The NCUA can lessen the anxiety of industry changes by implementing a few broad requirements:

- This industry should define what it means by “corporate governance” and create common language of corporate governance. We would prefer not to see another layer of rules and regulations, rather we would like to see useable, scalable framework with guidelines, principles and/or codes.
- NCUA should encourage and provide training and guideline to boards on how to properly perform self-assessment of their CCU's corporate governance framework.
- NCUA should lay out a timetable to perform period surveys of corporate governance within the industry. We believe surveys are the only effective means of measuring the impact of any governance initiatives.
- Lessons learned should be timely communicated back to the CU industry.

Categories such as external governance, internal governance or individual governance could be included as a sub-set of each element where appropriate and applicable. For example, disclosure requirements should assert a CCU's compliance with applicable laws (external governance), whereas communication and methods communicating fiscal and fiduciary responsibilities are internal governance matters. The same can be done for codes of conduct, conflicts of interest and board qualifications.

Director Requirements

SDFCU supports NCUA's proposal regarding setting minimum requirements for experience and independence. Although these are two separate and different characteristics, they are both equally important. NCUA's Rules and Regulations, Appendix A to Part 701 -- Federal Credit Union Bylaws Article V contains limited requirements for experience (i.e. qualification and/or skills) and independence. The bylaws do not suggest any standards for CCUs to follow to ensure that board members are qualified. The NCUA should require CCU boards to document and review on an annual basis, the functions of their individual directors and sub-committees. This could be in the form of a self-assessment. Specific examples of examples of application could be:

- Documented assessment of board member attendance;
- Documented skills and knowledge requirements needed in order to perform the job well; and
- Continuing education requirement of specific to their roles should be documents.

This information should be made available to membership and depositors on an annual basis to help them make an informed decision on whether to utilize the services of a CCU.

Outside Director

SDFCU supports the establishment of an "outside director" category. We support requiring at least two outside directors for a CCU. Two positions should help alleviate the possibility of a board bullying or marginalizing a single outside director. NCUA should approve outside directors to ensure independence.

Executive Compensation

SDFCU remains neutral on point of capping executive compensation although we support full disclosure of executives' compensation.

Public Disclosure

SDFCU believes that a framework which covers categories of external, internal and individual governance guidelines/standards would improve public trust. Specific examples of each category could include:

- External governance (assurances to regulators and members)
 - Full financial disclosure
 - Independent external auditor reporting
 - Legal and Regulatory Compliance reporting
- Internal governance (policies and procedures)
 - Board of director nomination and election processes
 - Responsibilities and accountabilities of the Board and management

- Annual business planning
- Guidelines for budget and strategic planning
- Business continuity/disaster recovery planning
- Performance evaluations

- Individual governance (indicator of integrity)
 - Signed Codes of conduct for the Board and committee members
 - Board and member qualification documentation
 - Annual self-assessment of the Board and committee members' performance

Term limits for corporate directors

We believe board members should serve no more than three consecutive terms. Limiting directors' ability to serve indefinitely will ensure a constant influx of new directors with fresh ideas.

SDFCU appreciates the opportunity to comment on this important topic. We believe, in light of recent events, that risks to credit union system from CCUs is the single most important issue to face the credit union industry in recent memory. Restructuring the CCUs to reduce or limit risks to FCUs from CCU is necessary to ensure the survival of the credit union industry.

Best regards,

A handwritten signature in black ink, appearing to read 'Jan N. Roche', with a long horizontal flourish extending to the right.

Jan N. Roche
President/CEO