Advanced Notice of Proposed Rulemaking for Part 704
Public Service Credit Union Board of Directors and Management

1. <u>The role of Corporates in the Credit Union system</u>

Recent events have highlighted structural vulnerabilities in the corporate credit union system. NCUA is considering whether comprehensive changes to the structure of the corporate system are warranted. Possible approaches the agency is considering include eliminating the second or wholesale tier from the corporate system, modifying the level of required capital, isolating payment services from the risks associated with other lines of business, determining which product and service offerings are appropriate for corporates, requiring a restructure of corporate boards, and tightening or eliminating the expanded investment authority that is currently available to corporates.

<u>Payment system.</u> Some of the questions and issues arising in this context, on which the Board is seeking comment, include matters such as whether payment system services should be isolated from other services to separate the risks. If so, what is the best structure for isolating these services from other business risks?

<u>Comment:</u> The payment system services provided by corporates generate revenues which are isolated from market and credit risks associated with investment and lending activities. Since net worth is one of the challenges currently facing most corporates, removing that source of revenue would create new challenges related to generating capital.

However, there are ongoing risks to the system in allowing payment system services to remain combined with other services within each corporate. Consideration should be given to consolidating payment system services to a limited number of corporates. With options made available through Check 21, demand for local check processing is significantly reduced. Other payment services such as ACH, bill payment, and card services do not have geographic limitations. There needs to be enough duplication in processing to provide adequate business continuity protection for natural person credit unions. Corporates should have to bid to provide these services to the industry. To be eligible to bid, the corporate must agree to refrain from investment activities that would be outside of basic cash management and liquidity management.

Another option would be to spin the payment services off into CUSO's that could be owned by credit unions, leagues, and other credit union related entities. The sale of these services from the corporate to the CUSOs would generate an infusion of capital into those corporates currently providing payment services. The effect of this would be to transfer the risk associated with payment services out of the corporate system while providing an infusion of capital.

In summary, we recognize the value of aggregating credit union payment services but do not feel that the corporate network under the current structure is the most efficient way to achieve the optimum results with the least amount of risk to the system.

Liquidity and liquidity management. One question for consideration and comment is whether liquidity ought to be considered a core service of the corporate system, and if so, what steps should be taken, and by whom, to preserve and strengthen corporates' ability to offer that service? For example, should NCUA consider limiting a corporate's ability to offer other specific types of products and services in order to preserve and defend the liquidity function? What specific types of products and services should corporates be authorized to provide? In this respect, comment is specifically solicited on the question of whether NCUA should add aggregate cash flow duration limitations to Part 704.

Comment: One of the primary purposes for establishing a corporate was to provide liquidity to natural person credit unions. During the current liquidity crunch, the corporates have not been able to meet this need as effectively as other financial institutions such as the FHLB. If providing a primary source of liquidity is to continue to be a corporate function, which we support, then a new business model must developed that limits the funds that can be placed in investments that cannot be quickly liquidated without loss of principal.

Corporates which have expanded authorities should be allowed to offer accounts specifically tied to those investments. These accounts would not be eligible for share insurance. Deposits in these "higher risk" accounts should be subject to the gains or losses tied to the portfolio of investments bought under expanded authorities. Investments made under expanded authorities would be limited to the funds deposited in these associated accounts. Natural person credit unions would have to demonstrate a level of understanding of the risks associated with these higher risk accounts before being allowed to invest in this type of corporate account. ALM policies would have to address limitations on the investments in these higher risk accounts to ensure a natural person credit union did not assume an inappropriate amount of risk.

Field of Membership Issues. NCUA also seeks comment on whether and how to restructure the corporate credit union system. To address this development, should the agency return to defined FOMs, for example, state or regional FOMs?

Comment: In an effort to attract new members and grow, corporates have competed with each other instead of competing with banks and other institutions providing correspondent banking services. In this instance the competition has resulted in the corporates taking on more risk to become more competitive which has not been healthy for the industry.

Like all consumers, natural person credit unions would like the option of choosing whom they do business with. However, when looking at the Federal Reserve System or the FHLB system, institutions must deal with the bank serving their region for certain services such as cash. Other services such as check processing, ACH, and savings bond redemptions have been consolidated into a limited number of banks. A similar model for the corporate network might be appropriate. For this to be an effective solution, corporates would have to have more parity than exists in the system today.

Since the financial strength and the services offered vary significantly by corporate, forcing a credit union to work with a specific corporate might have the unintended consequence of driving business from the credit union system. Changing the structure of the corporate network whereby all corporates become branches of the same institution would allow for more even access to products and services. This consolidation into a single institution would reduce the current level of staffing, especially Sr. Management, and would contribute to additional capital growth.

Expanded Investment Authority. At present, Part 704 provides for an option by which corporates meeting certain criteria can qualify for expanded investment authority. If so, should NCUA modify the procedures and qualifications, such as higher capital standards, by which corporates currently qualify for expanded authorities? If so, what should the new standards be? Should NCUA reduce the expanded authorities available? If so, which ones? Alternatively, should any of the limits in existing expanded authorities be reduced or increased? If so, which ones? Once granted, should NCUA require periodic requalification for expanded authorities? If so, what should be the timeframe?

Comment: The corporate system should be allowed to continue to operate with expanded authorities. As mentioned in the comment under the liquidity section, these investments should be limited to the deposits in higher risk, uninsured accounts. Periodic requalification should be required. A change in Sr. Investment personnel or bi-annual requalification would seem to be appropriate triggers for requalification. Additional capital requirements should be implemented. The increase in capital requirements should be proportional to the amount of assets being managed under expanded authorities.

Structure; two-tiered system. Over time, the corporate system has evolved into two tiers: a retail network of corporates that provide products and services to natural person credit unions, and a single, wholesale corporate that exclusively services the retail corporates. NCUA seeks input from commenters about whether there is a continuing need for a wholesale corporate credit union. If so, what should be its primary role? Should there be a differentiation in powers and authorities between retail and wholesale corporates? Commenters should also address whether, assuming the two-tiered system is retained, capital requirements and risk measurement criteria (e.g., NEV volatility), as well as the range of permissible investments, for the wholesale corporate credit union should be different from those requirements that apply to a retail corporate credit union.

Comment: In the current environment it does not appear that a two tiered system is necessary to provide the cost benefits of aggregation. Under the current two tier system, the whole sale corporate and the retail corporate are both making a profit on each product and service provided to a natural person credit union. This diminishes the value natural person credit unions are able to deliver to their members. The elimination of one of these tiers could make financial services more affordable for all credit union members. There is a need to have consolidated management of the corporate network. This would allow the industry to respond appropriately to changes in markets, consumer behavior, manage effective research and development, and ensure support for natural person credit unions.

2. Corporate Capital

NCUA is considering revising various definitions and standards for determining appropriate capital requirements for corporate credit unions. For example, the agency could establish a new required capital ratio consisting only of core capital excluding membership capital accounts as a component of regulatory capital; the agency could also determine to increase the required capital ratio to more than four percent. The agency could also establish a new ratio based on risk-weighted asset classifications, which could include some form of membership capital. These changes would bring the corporate capital requirements more into line with standards applied by other federal financial regulators, such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation (recognizing, however, that there are other accounting differences that apply with respect to the calculation of regulatory capital for banks). Another issue under consideration is whether to require a certain level of contributed capital from any natural person credit union seeking either membership or services from a corporate.

Comment: Based on the recent events it seems only prudent to require corporates to maintain higher levels of capital. If the corporates remain as separate entities, a risk based capital system should be developed. This risk based system would require each corporate to maintain capital commensurate with risks related to the products, services, and investment portfolios offered by the corporate.

If the corporates are restructured to become a network of branches of a more centralized entity, then capital requirements should be based on the network as a whole.

Under any scenario we support the corporate capital requirements becoming more consistent with standards applied to other similar financial institutions.

Requiring natural person credit unions to contribute some level of capital to a corporate from which they wish to obtain products and services is acceptable in concept. The current method for calculating membership shares would make the contribution of capital in two corporates cost prohibitive. More comments on this are below in the core capital section below.

Core capital. The Board is considering several issues relating to the agency's approach to core capital (i.e., the traditional "tier one capital" definition as used by the several federal financial institution regulators). Under the current rule, core capital is defined as retained earnings plus paid-in capital. 12 CFR 704.2. Comment is invited concerning whether NCUA should establish a new capital ratio that corporates must meet consisting only of core capital, and if so, what would be the appropriate level to require. Commenters should offer their view concerning what actions are necessary to enable corporates to attain a sufficient core capital ratio as described above, as well as their thought about what would be an appropriate time frame for corporates to attain sufficient capital. The Board invites comment also on the question of what is the appropriate method to measure core capital given the significant fluctuation in corporate assets that occur. Commenters are invited to offer their view on the correct degree of emphasis that ought to be placed on generating core capital through undivided earnings. Finally, NCUA Is considering whether to require that a corporate limit its services only to members maintaining contributed core capital with the corporate. Commenters are invited to react to that idea, and to offer any other suggestions or comments relative to the issue of core capital for corporates.

Comment: If corporates are to remain a primary source of liquidity, there will continue to be substantial fluctuations in asset size which will obviously affect capital ratios if the ratio continues to be based on asset size. Unlike stock issuing institutions, it is much more difficult for a corporate to raise capital quickly. It would seem there are three options:

- Allow corporate capital ratios to fall below the regulatory requirement during times of excess liquidity.
- Allow corporates to aggressively seek outside paid in capital, especially during times of excess liquidity.
- Develop a risk based capital system that is based on activities and balances in specific portfolios which is not specifically based on asset size.

The first option appears to create too much risk for the system as we have seen. The second option creates the potential to increase costs of funds on a long term basis to solve a short term issue. It also potentially creates the risk of outside investors gaining undue control over the corporate system. Therefore we would support the third option of developing a new risk based capital system which would include a component that calculates ratios based total deposits and total insured deposits.

Membership capital. The Board is also considering several issues involving membership capital. 12 CFR 704.3(b). Issues under consideration and for which comment is sought include whether NCUA should continue to allow membership capital in its current configuration, or should the agency eliminate or modify certain features, such as the adjustment feature, so that membership capital meets the traditionally accepted definition of tier two capital. Other questions include whether to tie adjusted balance requirements, as set out currently in §704.3(b)(8), only to assets, as well as whether to impose limits on the frequency of adjustments. The agency is considering whether to require that any attempted reduction in membership capital based on downward adjustment automatically result in the account being placed on notice, within the meaning of current §704.3(b)(3), so that only a delayed payout after the three-year notice expires is permissible. Comment is also sought on whether to require that any withdrawal of membership capital be conditioned on the corporate's ability to meet all applicable capital requirements following withdrawal. Comment is invited on all these issues and on any revisions NCUA should consider for the definition and operation of membership capital.

Comment: Any change in the core capital requirements would have an impact on many natural person credit unions. Calculations for membership shares will likely increase a natural person credit union's funding requirements for membership shares. Since the burden of recapitalizing the NCUSIF is falling on the natural person credit unions, requiring an additional recapitalization of the corporate network by the credit unions seems to be an unfair burden to impose at this time.

As stated previously, we believe that natural person credit unions should have the option of choosing where they obtain products and services. This is especially important for credit unions operating in regions where the corporate offers limited products and services. Requiring a natural person credit union to contribute capital to a secondary corporate is not unreasonable, but should be based on the services used and the corresponding risk. Current membership shares or PIC subscriptions do not appear to be adequate to address this issue.

Risk-based capital and contributed capital requirements. Comment is solicited with respect to the following issues pertaining to risk-based capital and contributed capital requirements. Should NCUA consider risk-based capital for corporates consistent with that currently required of other federally regulated financial institutions? What regulatory and statutory changes, if any, would be required to effectuate such a change? Should a natural person credit union be required to maintain a contributed capital account with its corporate as a prerequisite to obtaining services from the corporate? Should contributed capital be calculated as a function of share balances maintained with the corporate? What about using asset size?

Comment: NCUA should implement a risk based capital system. We do not consider ourselves qualified to determine regulatory and statutory changes necessary to effectuate this change. However changes to bring capital requirements that would be consistent with other financial institutions should result in granting authorities consistent with other financial institutions.

If a natural person credit union is required to maintain some form of contributed capital in a corporate, some credit unions may choose to obtain services from another financial institution outside of the corporate credit union system. A pricing differential would seem a more appropriate way to encourage natural person credit unions to contribute capital.

We do not believe that NCUA should require a contributed capital account based on shares or assets.

3. Permissible Investments

NCUA is considering whether the corporate investment authorities should be constrained or restricted. Presently, corporates have the authority to purchase and hold investments that would not be permissible for natural person FCU members under Part 703 (or, in some cases, outside of what is authorized for a state chartered credit union). This increases a corporate member's exposure to these risks commensurate with their level of investment in the corporate. Questions on which comment is solicited in this context include whether NCUA should limit corporate credit union investment authorities to those allowed for natural person credit unions. NCUA is also considering whether to prohibit certain categories of, or specific, investments, for example: collateralized debt obligations (CDOs), net interest margin securities (NIMs), and subprime and Alt-A asset-backed securities. Comment is solicited on that issue, as well as on whether NCUA should modify existing permissibility or prohibitions for investments.

Comment: Corporate investment authorities should not be changed. The current process for granting expanded authorities would appear to be adequate. As mentioned previously, greater oversight, requalification, and higher capital levels should be required. Corporates should be required to maintain adequate ALM policies that adjust investment instruments and limits as market conditions change.

4. Credit Risk Management

The reliability of credit ratings for investments has become more questionable in light of events in the financial industry and the current absence of regulatory oversight for rating organizations. Consequently, NCUA is considering curbing the extent to which a corporate may rely on credit ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs). Comment is requested on whether NCUA should require more than one rating for an investment, or require that the lowest rating meet the minimum rating requirements of Part 704. NCUA also solicits comment on whether to require additional stress modeling tools in the regulation to enhance credit risk management.

Several specific aspects of this issue are under consideration, for which comment is solicited, including whether Part 704 should be revised to lessen the reliance on NRSRO ratings. Commenters are invited to identify any other changes they believe may be prudent to help assure adequate management of credit risk. In this respect, commenters should consider whether Part 704 should be revised to provide specific concentration limits, including sector and obligor limits. If so, what specific limits would be appropriate for corporate credit unions? Comments are also solicited on the question of whether corporates should be required to obtain independent evaluations of credit risk in their investment portfolios. If so, what would be appropriate standards for these contractors? Another issue under consideration is whether corporates should be required to test sensitivities to credit spread widening, and if so, what standards should apply to that effort.

Comment: It does not appear that credit risk is as significant as liquidity risk in the current environment. Requiring additional ratings for an investment would not necessarily prevent this situation from reoccurring. Additional tools and modeling seem appropriate when large and complicated investments exist in a corporate's portfolio. Corporates need to hire competent people and have a board and ALCO committee that are capable of providing appropriate oversight. A periodic review of the investment portfolio by outside professionals would seem to be a prudent component of the oversight of investment activities. Since each corporate has a unique portfolio, we believe it would be difficult to regulate specific concentration limits, testing and other monitoring that may be needed based on the complexities of each individual portfolio.

5. Asset Liability Management

In a previous version of its corporate rule, NCUA required corporate credit unions to perform net interest income modeling and stress testing. Because one of the problems leading to the current market dislocation is a widening of credit spreads, the agency is considering re-instating this requirement. Alternatively, the agency may consider some form of mandatory modeling and testing of credit spread increases. Comment is solicited on whether NCUA should require corporates to use monitoring tools to identify these types of trends, including specifically comments about tangible benefits, if any, that would flow from these types of modeling requirements.

Comment: Requirements for net interest income modeling and other simulation and modeling requirements are appropriate. Modeling should be appropriate for the level of risk and authorities granted to the corporate. Monitoring should be appropriate for the economy. No amount of modeling would have predicted the current environment; however more than a year ago, there were signs of a worsening economy and liquidity concerns. Corporate resources need to be utilized effectively. As mentioned previously, appropriate policies and oversight of their implementation would provide the network the flexibility to react to market conditions without being over burdened with simulations and models that may not be the best indicator of the correct course of action.

6. Corporate Governance

The sophistication and far-reaching impact of corporate activities requires a governing board with appropriate knowledge and expertise. NCUA is considering minimum standards for directors that would require a director possess an appropriate level of experience and independence. The agency is also considering term limits, allowing

compensation for corporate directors, and requiring greater transparency for executive compensation. Comment is sought on all these issues.
In addition, commenters are invited to respond to the question of whether or not the current structure of retail and wholesale corporate credit union boards is appropriate given the corporate business model. Should NCUA establish more stringent minimum qualifications and training requirements for individuals serving as corporate credit union directors? If so, what should the minimum qualifications be? NCUA is also considering whether to establish a category of “outside director,” i.e., persons who are not officers of that corporate, officers of member natural person credit unions, and/or individuals from entirely outside the credit union industry. Commenters should offer their view on whether that approach is wise, and, if so whether NCUA should require that corporates select some minimum number of outside directors for their boards. Should a wholesale corporate credit union be required to have some directors from natural person credit unions? Comment is sought on whether NCUA should impose term limits on corporate directors, and, if so, what the maximum term should be. Comment is also sought on whether corporate directors should be compensated, and, if so, whether such compensation should be limited to outside directors only. Another issue under consideration, for which reaction from commenters is sought, is whether NCUA should allow members of corporate credit unions greater access to salary and benefit information for senior management.

Comment: We support specific qualifications and training for corporate board members. Corporate boards should be comprised of credit union executives with a variety of skills and industry expertise. Training should be tailored to the specific corporate business model; i.e. if the corporate has expanded authorities, some board members should be required complete training on derivatives and other complex investments that are in the corporate’s investment portfolio.

We do not support outside board members or compensation for board members. We do support the idea of having paid experts serve as advisors to the ALCO committee or board. This should function in a similar manner that an outside audit firm is engaged to support the supervisory committee.

It would appear that additional transparency will be required throughout the financial services industry. Requirements on corporates should be no greater than those being applied to the rest of the industry with the exception of a merger. If a merger is proposed, bonuses and retirement incentives should be disclosed as part of the merger package.

Other Comments: We support the concept of the proposed Corporate Credit Union Stabilization Fund (CCUSF.) Separation of the corporate stabilization fund from the current NCUSIF will lessen the immediate impact of the anticipated costs of recapitalizing the corporate network. Regardless of the final structure of this proposal, we believe the corporates must contribute to the NCUSIF under a different formula than the current one applied to natural person credit unions. It seems clear that the risk to the share insurance fund is not based on the amount of insured shares (prior to extending the insurance for corporate deposits) but based on other risk factors such as the investment portfolio. The required corporate contribution to the NCUSIF is disproportionate to the risk the corporates pose to the fund. Corporates should have to contribute to the NCUSIF under a different formula or permanently maintain a separate share insurance fund.