From: Jim Harris [JHarris@usecu.org]
Sent: Monday, April 06, 2009 2:01 PM
To: _Regulatory Comments
Cc: Brad Miller
Subject: Jim Harris -- Comments on Advanced Notice of Proposed Rulemaking for Part 704

April 6, 2009

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

RE: Comments on the Corporate Credit Union System Strategy

Dear Ms. Rupp;

Thank you for the opportunity to provide comment on what will likely be a drastic overhaul of corporate credit union regulations and the corporate credit union network.

Following are the comments of USE Credit Union, a California state chartered institution:

Payment Systems:

From the perspective of capital, current regulations appear to deal only with adequacy as it relates to investment and liquidity functions. There is no separate carve out for Payment Systems. Enterprise risk management requirements which would compel a corporate to determine the amount of capital necessary to support its Payment Systems are also lacking. While we do not believe that it is necessary to hold the Payment systems functions in a separate legal entity or to establish a capital firewall, there is without question a need to have a capital requirement which addresses the associated risks. Frankly, any activities a corporate conducts which result in risks should be required to have an appropriate capital allocation.

Competition and the demands of the marketplace should be the determining factor in the potential sufficiency of earnings of a stand alone payment systems business model. We recommend that the regulator instead evaluate capital and risk management adequacies as opposed to establishing a requirement that a payment systems focused enterprise be embedded as part of another business.

Liquidity and Liquidity Management:

The corporate credit union network is well positioned to transfer excess liquidity to constrained credit unions from those in excess liquidity positions. However, it lacks the competitive advantages of other liquidity providers such as the Federal Reserve or the Federal Home Loan Bank system, which can provide funds in times of tight systemic liquidity due to their ability to draw on the U.S. Treasury. This is evidenced by the fact that many larger credit unions have relied on these entities rather than on their corporates for liquidity in recent years.

While they do have competitive disadvantages to government affiliated liquidity providers, corporates are a critical provider, especially to smaller credit unions in times of stressed systemic liquidity. For this reason, the liquidity role must remain a core service of corporates.

We recommend that corporates continue to be allowed to offer collateralized term and overnight borrowing products to their member credit unions. In the current crisis, at least one corporate saw its ability to provide liquidity limited by their decision to leverage their thinly capitalized balance sheet. For this reason, there should be consideration given to restricting the leveraging of a corporate's balance sheet with the exception of leverage to support member borrowing activities.

Corporates should be required to have appropriate liquidity risk measurement and management processes in place. We do not favor specific limitations.

Field of Membership Issues:

From our perspective, the investment objective of corporate credit unions should be to provide virtually credit risk free products which provide returns which are similar to those with similar risk profiles in the marketplace. Whether it was intentional or coincidental, that goal seems to have changed for a handful of corporates. That goal was to offer products that would allow for growth of market share. Such goals are not necessarily congruent.

The reason that this goal is so important is that during economic downturns, credit unions have increased exposure to credit risk via our own lending activities. The corporates' activities exacerbated this exposure at a particularly inopportune time. Without question, the incentive to take on the risks which led to the current problems would have been diminished, but certainly not eliminated. It should be noted that many credit unions identified the excessive risks which were being taken and took steps to reduce exposure to the affected corporates long before the conservatorships. In this manner, excessive risk taking actually led to reduced market share.

While it is true to say that certain corporates may have taken excessive risk in order to gain market share, they were only able to do so because natural person credit unions typically did not have access to the information they needed to evaluate the risks on the balance sheets of corporate credit unions. Instead, we were typically told by examiners that unless we heard otherwise, we could assume that corporates provided safe investments. It was this utter lack of transparency and the cavalier attitude of the regulator (NCUA) and the regulated (some corporates) which led to the current situation and not broad fields of membership. However, limiting fields of membership via geography would have avoided many issues and such a restriction is recommended in the new structure.

Expanded Investment Authority:

As the current situation so eloquently illustrates, simply understanding risk does not reduce it. The current Part 704 is focused on ensuring that the corporates understand the risks they are taking. However, the ability to take risk is determined by capital level in addition to the ability to measure and manage risk. Without all three, there is simply a disaster waiting to happen.

As stated earlier in this letter, there is really no room for significant credit risk on a corporate's balance sheet. In addition, the infrastructure for measuring and managing risk is very expensive and the corporate network simply lacks the scale to provide such a function at multiple corporates. For that reason, expanded authority is appropriate assuming appropriate scale, investment in risk management infrastructure and capital. Without these, expanded authority is not appropriate. The advisability of expanded authority is dependent upon the size of the surviving corporates and any comment would be dependent upon the final structure of the network.

Structure/Two-Tiered System:

From a structural framework, the network is/was a two-tiered system. From a functional perspective, it was a three business model system. One business model saw large corporates duplicating much of the infrastructure available at U.S. Central and trying to compete on scale and price. Another business model saw smaller corporates acting as pass throughs of U.S. Central products. The third business model saw intermediate sized corporates taking advantage of U.S. Central's strengths, but utilizing their own resources to add value in the products they offered their credit unions, relying somewhat on U.S. Central, but largely controlling their own destiny.

To a significant extent, the corporates that have been most successful in not harming their members have been the intermediate sized corporates who elected not to take excess risk, and thus avoided the cost and burden of large risk management and measurement infrastructures. This is not to say that these corporates did not have effective risk management, their results prove that they did. Instead, they simply avoided the excessive risks, and the subsequent failure associated with them.

Based on observations from the current calamity, a single tiered system of moderately sized corporates appears to have the best survival characteristics in stressed times. It eliminates the need to have two layers of capital which proved to be insufficient. It avoids an over-duplication of infrastructure within the industry, and it provides corporates which are small enough to pay heed to the needs of their members, but large enough to provide economies of scale.

Corporate Capital:

Within the credit union system, capital exists in excess at the natural person credit union level, and has been in short supply at the corporate level. This is due to the nature of the business in which corporates operate, competing with rates offered on alternative investment options and margins on payment systems businesses being to narrow to allow for accumulation. Pragmatically, it would be difficult for corporates to accumulate significant capital through Retained Earnings for a very long period of time, if ever, unless they were willing to offer less than competitive rates. As a result, most of the capital a corporate should have would be contributed by credit unions in the form of capital shares rather than relying on earnings accumulation.

From the perspective of Tier I and Tier II capital, there should be a requirement for both. Retained earnings and permanent capital should continue within Tier I. Tier II should be utilized to adjust up and down the capital position of corporates over business cycles in a manner analogous to that used by the FHLB system. The total amount of capital is dependent upon the risks of the institution and we encourage the NCUA to utilize its existing authority under the Federal Credit Union Act to apply the Basel model in determining appropriate capital levels.

Such a structure could have required affected corporates to 1) require additional capital from their members as the securities some corporates held experienced downgrades or 2) incented corporates to be more proactive in restructuring their balance sheets as the calamity unfolded and when there was still time to act to reduce the need for additional capital.

Except under special circumstances for community development or new credit unions, there should be a requirement that any credit union utilizing a corporate have capital commensurate with its business activity with the institution. This would prevent the opportunity for a credit union to elect to 'free ride' on the good graces of other credit unions that have placed their member funds at risk.

Permissible Investments:

The current crisis resulted from certain corporates purchasing and holding investments with risks that they simply did not adequately measure and/or manage. Having greater investment authorities than NPCU's allows corporates the opportunity to add value to credit unions which would otherwise be unavailable to them. At a minimum, the NCUA needs to require that a corporate have risk management capabilities which are commensurate with its investment authorities.

It is unrealistic to anticipate that future problems can be avoided by specifically prohibiting certain types of investments. CDOs, Alt-A's and Sub-Prime securities did not exist in their current forms during the last corporate debacle in 1994, and those that will bring about the next period of hardship do not likely exist today. Again, requiring and overseeing appropriate risk management practices are the key to avoiding situations similar to the current one.

Credit Risk Management:

Rating agencies are inherently unreliable as a one-stop source of managing credit risk and this is why many corporates had their own credit risk management functions (many of which failed to identify the risks that led to the current situation). Ratings typically change significantly after market prices reflect the change in risk, making it difficult to rebalance the credit risk in a portfolio. Rating agencies also make mistakes.

We strongly recommend that corporates electing to take credit risk have their own credit risk management functions and perform their own analysis. Stress testing of credit risk exposure would have prevented the current problem and should be required going forward. For example, stress testing the loss given default assumptions on the mortgages backing many of the securities owned by corporates would have illuminated the inherent risks and avoided the current situation. Having said this, corporates should still consider ratings as a meaningful second opinion but should not rely exclusively on them.

It is also recommended that corporates taking credit risk have their management practices reviewed by qualified third parties on a periodic basis. At a minimum, the contractors utilized should have significant experience performing such evaluations and appropriate professional and academic credentials.

Asset-Liability Management:

The current Part 704 already does an adequate job of addressing these risks. The current debacle was caused by lack of appropriate regulatory and board supervision of the credit risks assumed by certain corporates.

The overwhelming majority of corporates already consider the widening of credit risk spreads in their ALM modeling. They simply did not anticipate investing in instruments that would experience such calamitous widening. The practice of modeling this risk should be continued.

Corporate Governance:

If this fiasco can be blamed on one issue, that issue is lack of board accountability. Board members were simply not held accountable for their oversight of the affected corporates, did not understand the risks their corporates were taking and did not demand appropriate risk management practices. In short, the lack of potential personal loss owing to misguided decisions was not significant enough to produce better oversight.

While it is not necessary that all board members be investment specialists, it is likely that few board members at the affected corporates had qualifying investment management designations such as CFA charters or significant advanced education in the field of investment finance. It is highly recommended that at least a plurality of board members have investment expertise commensurate with the types of investment activities that a corporate wishes to pursue. Such a requirement could have avoided the current situation.

Similarly, if a corporate has a payment systems business, there should be a reasonable amount of such expertise represented on the board. It is also appropriate that some board members have expertise which is in either payment systems or investments. For example, corporates are complex organizations and individuals with various types of executive management experience could add significant value as board members. However, there is an unquestionable need for specific expertise in the businesses in which a corporate engages at the board level.

Because requiring such expertise limits the pool of available candidates, it would be appropriate to allow board members who are not credit union CEOs to serve as corporate board members. However, these board members should at a minimum be from within the industry, either as professionals or volunteers at NPCU's. It is not appropriate that these volunteers receive compensation. These board members should however be held accountable for their actions.

From the perspective of transparency, it is not required for executive compensation. Lack of transparency of executive compensation did not lead to the current problems. Instead, it was lack of transparency around the risks that the affected corporates were taking. The NCUA didn't require transparency and many credit unions didn't realize the lack of transparency until it was too late. Transparency is essential when it comes to the level of risk.

Summary:

As we did in 1995, credit unions are providing input to a regulatory change concerning corporate credit unions. There are three basic factors which if present prevent the types of problems we saw then, and that we see now. The first factor is that an investor must understand the risks which are being taken. The second factor is that investors must be able to measure and quantify the risks. The third factor is the ability to manage the risks. It is apparent that these factors were not present in sufficient magnitudes at some corporates. As a result, all federally insured credit unions are paying a high price. We encourage the NCUA to keep these factors top of mind as they draft the potential new regulation.

Again, thank you for the opportunity to provide comment.

Regards,

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