Proposed Regulations for Corporate Credit Unions
High Level Review

With its release of **12 C.F.R. Part 704** (Proposed Regulation), NCUA has begun the process of enacting the most far reaching regulation of the credit union industry in recent memory. While the changes contemplated apply directly to only corporate credit unions (corporates), the effects of the regulations will be felt by most natural person credit unions (credit unions) because it will alter the way that corporates can operate, the services that can be provided, and the costs associated with providing those services.

We agree that change is necessary. However, in our opinion, there are several areas that, if changed, would make for a better regulation. But ***in a few key areas, changes are absolutely necessary to avoid the substantive unintended consequences that will affect your credit union if the regulation is enacted as it is today***.

NCUA has dedicated tremendous time and effort into formulating a good start, but the job is not done. Now more than ever, your input is vital. NCUA is soliciting public comments from stakeholders. The comment period ends March 9, 2010, and without a high volume of credit union input, the Proposed Regulation may be adopted as originally drafted.

Summary of Key Points

The intent of the regulation to strengthen risk controls and increase capital are well intentioned, however there are unintended consequences in the current form. Without changes, credit unions will see:

- Significantly ***higher fees*** for products and services. So high, in fact, that the services would not be competitive, forcing credit unions to turn to non-cooperative solutions (i.e. banks).
- ***Lower rates*** on investments, (20-25 basis points based on our estimates), costing member credit unions between $18 and $23 million in lost income annually based on 2009 year-end balances. Coupled with other restrictions in the Proposed Regulation, these offerings would generally be uncompetitive and unacceptable to credit unions.
- It is likely that ***term lending*** would need to be significantly ***curtailed*** or abandoned.

The business model that NCUA uses to justify the new controls is flawed in the following areas:

- Corporates cannot make the return necessary to meet capital growth with the new more stringent risk controls.
  - Weighted average life limits are too restrictive to allow appropriate returns.
  - Net economic value testing limits (with and without prepayment shocks) are too restrictive to allow appropriate returns.
- The model used has errors in the assumptions.
  - No cost of capital- Member credit unions are presumed to provide capital at the equivalent of the Fed Funds/Libor rate.

  - Certificates represent 66% of corporate funding which may be overly optimistic due to proposed restrictions on certificate redemptions and investment terms (see below).
  - The majority of income from investments comes from a single asset class (Private Student Loans). This asset class does not have the market depth to support broad based investment at these spreads.
- There is no provision for shielding new capital from continuing losses from the legacy assets.
- Corporates cannot redeem certificates issued at a premium. This will have significant negative impact as all other investment instruments allow recognition of changing markets either up or down. This would make corporate certificates less competitive to other investment alternatives.
- As corporates work to re-build capital there are limits within the Proposed Regulation based on capital for both investments and borrowings by corporates. These limits will be overly restrictive and may actually increase risk through broader investments and more limited borrowing capacity.
- The Proposed Regulation has provided for the extensive ability of NCUA staff to revise the regulation with limited due process. This vests too much authority in NCUA staff with limited NCUA board oversight and a limited appeals process.
- The Proposed Regulation limits terms of board members to six years. This will require excessive board turnover without ensuring a well qualified and diversified board.
- The Proposed Regulation limits indemnification for volunteer directors and officers. This in conjunction with term limits (above) will greatly reduce the willingness of qualified credit union executives to participate in corporate boards as well as attracting and keeping strong management.
- Required senior management compensation disclosure for corporates may translate to credit unions. Additionally, the definition is overly broad in its current form extending to all vice president positions, instead of the CEO and direct reports.

Suggested changes

Below are suggested changes to the Proposed Regulation (in order of importance):

- Drop the average-life requirement while maintaining the 300 basis point credit shock test, ensuring strong risk management ***and*** provide credit for core deposits in the credit shock test or significantly relax the NEV testing requirements.
- Allow for certificate redemptions to allow corporate credit union certificates to be at parity with other providers.
- Disclose NCUA's plan for legacy assets and/or eliminating the depletion requirement, which is a non-starter for credit union re-capitalization of the corporate system.
- Provide additional due process regarding application of arbitrary regulatory authority.

- Increase volunteer term limits to retain qualified directors. In addition, the regulation should require nominating committees to establish more stringent director qualifications.
- Eliminate indemnification limitations as this, when combined with other suggested corporate governance changes, makes it exceedingly difficult to find qualified, interested volunteer directors.