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 Advanced Notice of Proposed Rulemaking for Part 704

Chairman Fryzel, Vice Chairman Hood and Board Member Hyland:

Thank you for the opportunity to respond to the Advanced Notice of Proposed Rulemaking for Part 704.

As we have indicated in previous communication with the NCUA, most recently on March 4, 2009, the possible elimination or redesign of the corporate credit union system will have long-term implications on natural person credit unions (NPCUs) and, ultimately, on the millions of members that credit unions serve. While we recognize the urgency of the situation, we believe this type of decision cannot be made without critical thinking, debate and scenario planning. Such actions require a significant investment of time which has been curtailed due to the 60-day comment period.

Many of our principals have been working with financial institutions since the early 1980s. Since 1991, we have had the benefit of working with hundreds of credit unions, including about half of those over $1 billion in assets and more than 25% of those over $100 million. Please recognize that our comments are based on our experience and the information available in the public domain. We, as most respondents, are not privy to all necessary decision information. This makes it infinitely more difficult to recommend changes to a business model considering that additional information would reduce the potential unintended consequences of our recommendations.

Therefore, we have intentionally kept our comments at a high level. As we make our recommendations, we do not take lightly the impact on relatively healthy corporates that have unfortunately been caught up in this mess. We likewise ask NCUA to keep in mind that decision making cannot be completely regulated. While this may seem obvious, it is a key point to remember.

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Overview

It is apparent that the corporates with expanded investment authority are experiencing greater risk. However, the range of risk varies in those with similar expanded authority levels as does the extent of the burden they are placing on the industry. Such variance points to decision making with respect to risk management, each corporate's appetite for risk and timely action of risk mitigation—a point we explore more in-depth later. Unfortunately, healthy corporates with more conservative risk management strategies and processes may, in the end, cease to exist because of the actions, or lack thereof, taken by others.

If there continues to be a corporate structure, we recommend that the following decision drivers be used in determining how the system should be restructured. Corporates should be:

- Focused on providing support services only when viable alternatives are not available in the broader market for the masses of NPCUs
- Made to pose as little systemic risk to the industry as possible
- Designed to be not-for-profit

With these decision drivers in mind, we have formulated our recommendation for the restructuring of the corporate system. Our recommendation is to separate Payment Systems/Operational Support Services and Liquidity/Investment Services into two businesses. We believe institutional firewalls will not be adequate in an effort to limit systemic risks.

Ultimately, managements and boards should make decisions as to what is best for the entire enterprise, not components of an enterprise. It is common for business units to compete for resources as a result of their priorities which at times conflict with each other. Therefore, it is an unreasonable expectation of management and board to truly be able to separate issues as they arise in each main business unit without regard for what is best for the entire enterprise.

Before outlining the general structure of the two types of corporate models, we think it is important to analyze and offer recommendations concerning two recurring themes in the discussions of "what went wrong" at some of the corporates. These themes are Leadership and Risk Management.

Leadership and Risk Management

Many of the problems the corporate system is facing today are the result of the leadership and risk management practices the corporates retained. We recognize that credit risk and expanded authority may have been the catalyst of the most current crisis. However, the issues found with the leadership and risk management practices are more systemic in nature and could have just as easily created unreasonable risk in other areas.

The Root of the Problem

While there are many interconnected reasons for the current situation, we believe the two primary reasons are:

(1) Unsustainable decision drivers including how success is defined (typically being bigger and growing faster is better)

(2) The decision making during the entire risk management process including:

  - Appetite for risk

- View of risk – which relied heavily on probability-based modeling and assumptions that real estate values would not decline dramatically. Consider how much of what is happening in the market today was considered probable in 2004 and 2005
- Reliance on rating agencies as sufficient due diligence even though some of the real estate lending was based on irrational escalation of asset values
- Timing of appropriate action by management, boards and regulators to begin to resolve issues appears to have significantly reduced the number of viable options available

These two primary reasons have little to do with expertise which typically translates into higher education, advanced certifications and experience. It has more to do with perspective, judgment and decision making.

Leadership: Expertise of Management and Board

It is interesting that many people are saying that in any restructure management and boards must have appropriate expertise. By emphasizing the need for appropriate expertise, one could conclude that the people making these comments do not believe the managements and boards of the corporates were qualified for their positions. If that is true, action by the corporates themselves, NPCUs and regulatory authorities should have been taken long before now.

While it is a given that leaders need to be appropriately qualified for their positions, we do not believe this was at the root of the problems caused by select corporate credit unions. Consider the "expertise" companies such as FNMA, FHLMC, Countrywide, Bear Stearns, WAMU, AIG and others had in their managements and boards. Were their boards not comprised of "professional" and knowledgeable members/leaders?

The following excerpt from Guidelines for Submission of Requests for Expanded Authority, under the provisions of Appendix B, Part 704, NCUA Rules and Regulations dated October 17, 2002, exhibits the regulatory guidelines for "expertise" that were already in place prior to the current crisis:

> *NCUA will carefully evaluate the management team of a corporate seeking Part I expanded authority. It is expected that the corporate's board will have received adequate training, and is sufficiently knowledgeable regarding the proposed risk activities. Senior management must possess in-depth experience in its direct areas of responsibility and a working knowledge of key areas of the institution's operations. The asset/liability committee (ALCO) members are expected to have an understanding of investment activities and strategies such that they are capable of individually explaining and supporting the corporate's risk exposures.*
>
> *Investment and asset/liability managers responsible for overseeing the areas impacted by the proposed activity must have demonstrable knowledge and experience commensurate with those activities. Staff supporting asset/liability management functions must possess expert knowledge in developing and applying assumptions, methodologies, and interrelationships between financial and external factors driving risk measurement results. This expertise should include a process for periodically testing, evaluating, and adjusting modeling assumptions based on capital markets activity, and/or event risk.. Staff will exhibit the ability to adjust the model and customize applications consistent with the ability to perform the monthly tests…*

What other regulations regarding "expertise" could have prevented this situation?

Leaders must not only have the appropriate expertise, they must be trusted. If NPCUs are going to commit to voluntary recapitalization, they must feel they can trust the judgment of the new leadership. That judgment must respect the purpose of the corporates which is explained in subsequent sections of this document.

Risk Management

The new system should be focused on providing support services for NPCUs only when viable alternatives are not available for the masses of NPCUs in the broader market. The industry should not carry the risk of products and services where there are viable options outside the industry. Viable, in this case, includes options that are affordable, efficient and readily available to the masses of NPCUs.

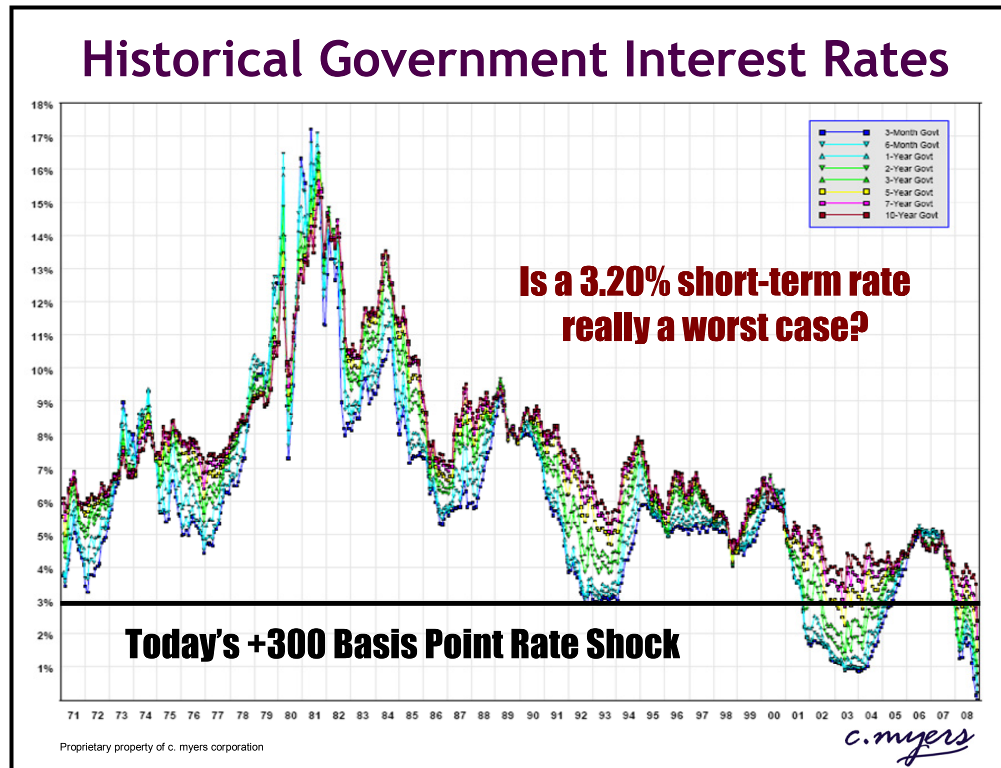
In restructuring the corporate system, we believe the new system should be able to weather the proverbial 25-year, 50-year and 100-year floods, which we call event risk. Having said this, we recognize that if there is a new corporate structure it may be materially smaller in assets. We say this because select corporates were able to offer yields significantly higher than agencies because of the risks they were taking. Many NPCUs that were drawn to this yield (that was assumed to be safe) may not repeat this action.

A complete autopsy of the risk quantification and decision-making process needs to be completed. The learnings should be applied to any revamp of these processes. Of course, as this autopsy is performed it will be with 20/20 hindsight. As noted before, our speculation is that you will find a material piece of the problem was the assumptions and judgment of decision makers of all parties with vested interests. Unfortunately, that is the toughest area in which to make sustainable changes.

Minimally the risk quantification parameters need to be broadened. Not just for credit risk but also for interest rate risk. We recognize that thousands of simulated paths are used in the risk management process of some corporates. However, the starting point for these thousands of simulated paths is based on what is probable, thus narrowing the range in which the thousands of simulations are conducted. Such constraints make it easier to ignore improbable, yet plausible, environments. This can, and has, resulted in a false sense of security and failure to withstand event risk.

As noted in our letter to you on January 27, 2009, we are concerned that an interest rate risk problem may develop as a means to boost current earnings. Established guidelines for modeling interest rate risk are +/- 300 basis points. Three-month government rates are currently 0.20%. A traditional 300 basis point shock would take short-term rates to 3.20% and assume a similar yield curve. While some corporates indicate they run thousands of simulations, assumptions for stochastic modeling will rarely encourage decision makers to look beyond 300 basis points.

Since our company's inception in 1991, we have recommended to our clients that they look beyond a 300 basis point rate shock in managing risks. The graph below highlights the importance of going beyond a 300 basis point change in rates, especially taking into account today's historically low rates.



Unprecedented levels of expectations for U.S. debt and heavy reliance on foreign investors cause concern for future interest rates. Consider the following excerpt from AP business writer Joe McDonalds' March 13, 2009 article, *China "worried" about U.S. Treasury holdings:*

> *Premier Wen Jiabao's message is unlikely to be misunderstood at the White House. It is counting on Beijing to help pay for its stimulus package by buying U.S. bonds. China already is Washington's biggest foreign creditor, with an estimated $1 trillion in U.S. government debt.*
>
> *'Inside China there has been a lot of debate about whether they should continue to buy Treasuries,' said Frank Gong, chief China economist for JP Morgan.*

While we recognize that the U.S. Government greatly influences market interest rates, the above quote is just one example that they do not have **complete control** over market interest rates. Therefore, we do not believe it is prudent risk management to assume, especially today, a worst-case interest rate change to be 300 basis points. This point is particularly salient when imagining the prospect of facing the current situation with materially higher interest rates.

If necessary, we will provide more detail on the risk management process once NCUA has gathered responses and subsequently publishes a new Notice of Proposed Rulemaking which will hopefully narrow the options for restructuring.

Liquidity/Investment Corporates

The following is our recommended business model outline for corporates focused on providing liquidity and investment services.

Purpose

- Not-for-profit organization focused on supporting investment and borrowing needs of NPCUs in any economic environment.
- Provide NPCUs with affordable options for:
    - Short-term borrowing to meet liquidity needs
    - Safe locations to hold overnight funds
    - Efficient purchasing of term investments

  …while limiting systemic risks that happen in various business cycles.

Target Market

- NPCUs that do not, or choose not to, have economies of scale or the ability to efficiently do business with external markets.

Leadership

- Regulating leadership is difficult at best especially when perspective, judgment and decision making are the keys to success or failure. However, leaders of the Liquidity/Investment Services corporates should make their decisions based on the purpose outlined above with an emphasis on minimizing systemic risk rather than "being all things" to all NPCUs.

Risk

- Since an objective of the restructuring of the corporate system is to minimize systemic risks, our recommendation is that NCUA not allow these entities to invest in anything that carries potentially more credit risk than agencies. If individual NPCUs want to take and manage additional credit risk in investments, they can do so within their defined policy limits with much less chance of posing systemic risks.
- Should NCUA decide the above recommendation is too restrictive then we recommend NCUA consider a risk-based insurance premium for corporates that decide to take on additional risks in addition to requiring those corporates to maintain higher capital ratios. We recognize these steps would not have eliminated the issues we are facing today. However, they may have softened the blow and possibly deterred some of the risk taking because the buy-in would have been materially more expensive.
- We are firm believers in capital requirements being commensurate with risk taking. Required capital levels should factor in credit risk, interest rate risk, liquidity risk and operational risk. Our emphasis is on risk which includes the improbable (event risk), not just what is likely.

Number of Corporates Providing Liquidity/Investment Services

- The current two-tiered system poses systemic risk. The recent write-off of U.S. Central capital by the corporates, resulting in write-off of corporate capital by many NPCUs, is evidence of this. One of the challenges of the current system is that the extra layer of a "wholesale" corporate clouds the complexity of investing that is occurring. If the current system is maintained, some corporates and NPCUs may again indirectly invest in products they do not understand. Our recommendation is to phase out the two-tiered system, which is consistent with directing the corporates to focus on the purpose outlined above.
- The final number of corporates should be determined based on market needs as well as:
  - NPCUs' desire and commitment to voluntarily recapitalize the restructured corporate system relative to the benefits provided with new restrictions in place.
    - NPCUs may decide to choose alternatives for short-term borrowings and overnight investments outside the corporate system. The day-to-day cost of doing this type of business outside the corporate system may be higher, but may also be considered by some as less risky than recapitalizing the restructured system.
  - Realizing true economies of scale to deliver on the purpose outlined above, with emphasis on minimizing systemic risk.
  - Diversification of geographic risks that could threaten the restructured corporate system if NPCUs within a particular geographical boundary suffer a serious downturn.
- Should the restructure result in more than one corporate, the issue of competition within the industry needs to be addressed. Competition typically results in more risk taking yet better choices for the end user which, in this case, is NPCUs. Even if the corporates do not compete with each other, they will continue to face fierce competition from outside the credit union industry.

  The following are a couple of considerations to keep in mind for non-competing corporates:

  - The possibility of driving NPCUs out of the credit union industry should they not like the corporate to which they are assigned.
  - The lack of a NPCU's ability to diversify risk within the corporate system. If the risk taking ability of corporates in this new structure is truly limited then this should not be a significant issue. However, since many NPCUs feel they have been burned, they may still want diversification options. As a result, non-competing corporates could drive more assets outside the industry.

  Based on this, we recommend that NPCUs be able to choose those corporates with which they wish to do business. A capital investment would be a requirement to do business with each corporate they choose.

We recognize that if the corporates are more restricted in their risk taking, over time they may be significantly smaller in terms of assets or may cease to provide any true value to the industry. Potentially, they would cease to exist. Ultimately, NPCUs should make this decision by voting with voluntary recapitalization and their business.

As NCUA weighs an appropriate course of action, an additional concern that needs to be addressed is reliable and affordable access to structured borrowings, especially in light of the financial woes the FHLBs are facing, combined with the interest rate risk that is being taken when market interest rates are historically low.

Payment Systems/Operational Support Corporates

The following is our recommended business model outline for corporates focused on providing payment systems and operational support services.

Purpose

- Not-for-profit organization focused on providing support services to meet the operational needs of NPCUs where viable options are not available in the broader market.
- To provide quality products and services delivered at prices that are **equal to or less than** primary competitors and service levels are **equal to or higher than** primary competitors.

Success factors include providing only products needed by a significant portion of the target market. Ancillary products and services that may be a distraction from primary business lines or a drain on earnings should not be provided so that financial and human resources are focused on the purpose, thus keeping prices down.

In a for-profit business with a more diverse target market, providing a lower-cost alternative with service levels higher than competitors is typically difficult to sustain. However, this objective may be achievable because of the narrowly defined target market, with a limited product and service offering and the not-for-profit focus.

If the purpose cannot be achieved, then it does not make sense for the industry to carry the burden. In this case, it may be wiser to orderly disband these services as we know them today. If this were to occur, no doubt, other entrants beyond the currently available alternatives, such as CUSOs, will come to market.

Target Market

- NPCUs that would not receive salient services at an affordable price in the broader market.

Leadership

- The leadership should make their decisions based on the purpose stated above while minimizing risks that could disrupt the flow of service. Like their Liquidity/Investment counterparts, they should not "be all things" to all NPCUs.

Risk

- Given the importance of payment systems and other operational support services, we recommend that these entities be structured to minimize systemic risk.
- A thorough analysis should be conducted of any new products or services these entities rollout to ensure that they do not threaten the primary purpose of providing payment systems to NPCUs.

Number of Corporates Providing Payment Systems/Operational Support Services

As noted earlier, there is not enough information available in the public domain to give a specific, objective recommendation on the appropriate number of entities, whether it is one or more. It appears there is great opportunity for consolidation in this area, with the intent of gaining economies of scale to keep costs down.

Closing

Whether a corporate system continues to exist depends heavily on the final cost of stabilization and the extent to which NPCUs are willing and able to voluntarily recapitalize. The latest update on the cost of stabilization is $5.9 billion. We are all well aware that there could be more to come. In our discussions with credit unions, it appears that most of the decision makers are not willing to recapitalize or have not had adequate time to consider how much they would contribute to voluntary recapitalization because they are focused on the cost of stabilization.

We appreciate the opportunity to participate in the discussion of restructuring the corporate credit union system, an issue with widespread impact for the entire industry. We look forward to continuing the discussion with the NCUA Board and credit union industry as the restructuring plan develops. Please contact us if you have any questions regarding our response.

Sincerely,

Sally Myers
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John Myers
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