



southwest corporate
FEDERAL CREDIT UNION

Southwest Corporate's Comments on the Proposed Regulation 12 CFR Part 704

Executive Summary

Introduction

The proposed NCUA regulation contains several new requirements that, if not modified, will severely limit a corporate credit union's ability to provide valuable products and services to its member credit unions. **Two provisions of the Proposed Rule are of critical concern to Southwest Corporate.** They are:

1. The proposed new cash flow mismatch limitations, and
2. The proposed 1-year transition period to meet new risk-based capital ratios.

This Executive Summary of Southwest Corporate's comment letter includes two parts highlighting the proposed regulation's provisions that we classified as critical, and other significant issues. A brief overview of each proposed rule is shown accompanied by Southwest Corporate's comments and recommendations. In total, Southwest Corporate has provided comments and recommendations for 14 provisions of the proposed regulation in its full comment letter. Members are encouraged to review Southwest Corporate's complete comment letter.

Southwest Corporate's full comment letter includes observations and alternative recommendations on other sections of the proposed regulation. These include: i) cash flow mismatch sensitivity analysis with a 50 percent slowdown in prepayments speeds; ii) issuer concentration limits; iii) sector concentration limits; iv) corporate CUSOs; and v) Appendix B to Part 704 – expanded authorities and requirements (Part III).

A. Critical Issues

Comment 1: 704.8(e) - Cash Flow Mismatch Sensitivity Analysis.

The Proposed Rule would impose a restriction on the mismatch between the principal cash flows of a corporate credit union's assets and liabilities, in order to limit the corporate's exposure to credit spread duration. Proposed paragraph 704.8(e) would require an average life NEV stress test that would measure the

economic impact on capital resulting from a credit spread widening of 300 basis points. A corporate credit union would be required to limit its risk exposure so that when the spread widening shock was applied, the corporate's NEV ratio did not decline below 2 percent and the NEV itself did not decline more than 15 percent. In effect, the rule would limit the mismatch between a corporate's assets and liabilities to **only** two months.

Southwest Corporate does not believe that an investment portfolio can be created that would comply with the Proposed Rule's investment and ALM limitations and would also allow the corporate credit union to generate sufficient net income to meet the new retained earnings requirements over the 10-year phase-in period (i.e., 45 basis points after 3 years, 100 basis points after 6 years, and 200 basis points after 10 years) that is proposed in the Preamble. Southwest Corporate also does not agree with NCUA comments that corporates have the ability to raise fees to achieve retained earnings requirements, because it believes that its pricing is heavily influenced by market factors, and that any attempt to raise its prices would conflict with its recapitalization efforts.

704.8(e) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.8(e)(1)(i) of the Proposed Rule in order to require a corporate credit union to evaluate the risk in its balance sheet by measuring the impact of an instantaneous spread widening of both assets and liabilities by 100 basis points (i.e., rather than by 300 basis points) on its NEV and NEV ratio. Additionally, that NCUA require a more limited shock test (perhaps 50 basis points; i.e., 50 percent of the standard test) for government-sponsored entity debt.

That NCUA amend paragraph 704.8(e)(1)(iii) of the Proposed Rule in order to limit a corporate credit union's risk exposure to levels that do not result in a decline in NEV of more than 35 percent (i.e., rather than 15 percent).

Comment 2: 704. 3 Corporate Credit Union Capital - The One-Year Transition Period To Meet New Risk-Based Capital Ratios.

The effective date for the two new risk-based capital requirements would be 1 year after the publication of Part 704 in Final Rule form. That date could require corporate credit unions to recapitalize before the potential for additional losses on corporate credit union legacy assets (e.g., on the corporate's non-agency mortgage-backed securities) was known. Southwest Corporate believes that successful recapitalization efforts will require that newly-contributed capital not be exposed to potential losses from legacy assets. Southwest Corporate acknowledges and appreciates recent public comments indicating that NCUA is working on a solution to the legacy assets problem, and that credit unions should assume that future contributed capital will not be exposed to potential legacy asset losses. However, Southwest Corporate is still concerned about the timing

between the yet unknown implementation of a legacy asset solution and corporate recapitalization.

704.3 - Southwest Corporate's Recommendations:

Southwest Corporate assumes that NCUA will implement a legacy asset solution in order to legally isolate all new member-contributed capital from potential future impairment losses caused by currently-existing non-agency RMBS (i.e., caused by a corporate credit union's legacy assets), thereby significantly reducing the risk-weighting of the legacy assets and greatly facilitating the corporates' recapitalization efforts.

In light of that assumption, Southwest Corporate recommends that the transition period required to meet the Proposed Rule's minimum risk-based capital requirements be specified as the later of two time periods: (i) 1 year after the effective date of the publication of revised Part 704 in Final Rule form; or (ii) 1 year after the implementation of a legacy asset solution. Such a transition period would provide all credit union industry participants with sufficient time to communicate, to implement a recapitalization plan, and to revise their respective business models.

B. Other Significant Issues

Comment 3: 704.2 (Definitions) – “Available to cover losses that exceed retained earnings”.

The definitions set forth in the Proposed Rule include a new term: “Available to cover losses that exceed retained earnings”. The proposed application of this newly-defined term would mean that member-contributed capital must be exhausted in order to cover operating losses realized by a corporate credit union if those losses exceed the corporate's retained earnings. To the extent that any member-contributed capital was used to cover losses, the corporate credit union would not be allowed to restore or replenish the impacted capital accounts under any circumstances, and member credit unions could make no claim for the impacted capital against a liquidated corporate credit union. In addition, contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate. This new definition incorporates within the Proposed Rule the depletion guidance that NCUA provided in Letter No. 09-CU-10.

704.2 - Southwest Corporate's Recommendations (Depletion/Replenishment):

That NCUA not require depletion, and instead allow a corporate credit union to maintain a retained earnings deficit. In addition, that NCUA prohibit nonperpetual contributed capital withdrawals if a corporate credit union's leverage ratio fell below 4 percent.

If depletion remains a requirement of the Final Rule, that a corporate credit union be allowed to restore depleted funds if and when projected losses are known to have overstated actual losses, provided that the corporate credit union would continue to meet minimum regulatory capital requirements after restoring the depleted funds.

704.2 - Southwest Corporate's Recommendations (Non-Extinguishment):

That NCUA remove the final sentence of the proposed definition of "Available to cover losses that exceed retained earnings", in order to remove the implication that if a corporate credit union used contributed capital in order to cover losses, that use of the funds would extinguish the corporate's liability for those funds.

Additionally, that NCUA add a provision to the Proposed Rule that specifies that if a credit union or other entity contributed capital to a corporate credit union, and the corporate subsequently was placed into liquidation, the entity that had contributed capital would have a claim against the liquidation estate.

Comment 4: 704.8(c) - Penalty For Early Withdrawals.

Paragraph 704.8(c) of the Proposed Rule would establish a maximum redemption value for share certificates. The Proposed Rule would permit redemption only at the lesser of (i) the share certificate's book value plus accrued dividends, or (ii) the share certificate's "value based on a market-based penalty sufficient to cover the estimated replacement cost of the certificate redeemed". This means that corporate credit unions will no longer be able to pay a premium (i.e., a price higher than book value) on early withdrawals of certificates. The Preamble to the Proposed Rule states that the potential liquidity drains that are faced by corporate credit unions could be exacerbated if a corporate's members were permitted to redeem share certificates at a premium. This comment in the Preamble implies that the Proposed Rule would provide corporates with more stability within the liabilities on their balance sheets.

Southwest Corporate is concerned that paragraph 704.8(c) of the Proposed Rule would have exactly the opposite effect on a corporate credit union's overall liquidity position.

704.8(c) - Southwest Corporate's Recommendations:

That NCUA retain the current rule for share certificate redemptions that requires corporates to assess a market-based penalty sufficient to cover the estimated replacement cost of the share certificate that is being redeemed, and thereby permit the redemption of certain share certificates at a premium.

Comment 5: 704.8(h) - Weighted Average Asset Life.

Paragraph 704.8(h) of the Proposed Rule would require that the weighted average life of a corporate credit union's investment portfolio, excluding derivative contracts and equity investments, not exceed 2 years.

704.8(h) - Southwest Corporate's Recommendations:

That NCUA eliminate the 2-year weighted average asset life requirement from paragraph 704.8(h) of the Proposed Rule, because paragraph 704.8(e) of the Proposed Rule already limits the weighted average life of a corporate credit union's assets, based on the weighted average life of the corporate's liabilities.

Comment 6: 704.8(k) - Overall Limit On Business Generated From Individual Credit Unions.

Paragraph 704.8(k) of the Proposed Rule would prohibit a corporate credit union, after a 30-month phase-in period, from accepting from a member or other entity any investment (e.g., shares, loans, perpetual contributed capital, or nonperpetual capital accounts) if the aggregate of all investments from that member or entity would exceed 10 percent of the corporate's moving daily average net assets.

Southwest Corporate is concerned that the 10 percent limit on the amount that a corporate credit union can borrow from any one entity (e.g., from a Federal Home Loan Bank) could unnecessarily restrict the corporate from having full access to all available external liquidity sources, and could also limit the corporate's ability to effectively manage its liquidity (e.g., during seasonal and intra-month fluctuations in member share balances).

704.8(k) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.8(k) of the Proposed Rule in order to remove the paragraph's limit on a corporate credit union's ability to access external liquidity sources when funds are needed to meet liquidity shortfalls that result from seasonal and intra-month fluctuations in member share balances.

Comment 7: 704.14(a)(2) - Representation.

Paragraph 704.14(a)(2) of the Proposed Rule would require, as a qualification for service on a corporate credit union's Board of Directors, that each candidate currently hold the position of CEO, CFO, or chief operating officer (COO) at a member institution.

Southwest Corporate believes that limiting access to service on a corporate credit union's Board of Directors, based solely on an individual candidate's current job title, would unnecessarily prevent certain otherwise highly-qualified candidates from serving as directors.

704.14(a)(2) Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.14(a)(2) of the Proposed Rule in order to eliminate the requirement that would limit board candidates to those currently holding the position of CEO, CFO, or COO at a member institution.

Comment 8: 704.14 (a)(3) - Representation.

Paragraph 704.14(a)(3) of the Proposed Rule would require that members of a corporate credit union's Board of Directors be limited to service of no more than 6 consecutive years. Southwest Corporate believes that although there is good reason for the introduction of term limits, the proposed 6-year term limit is too short.

As stated in the Preamble to the Proposed Rule, corporate credit unions are complex entities that have a significant impact on the functioning of the entire credit union system. In light of the underlying complexity and significance of corporate credit union operations, Southwest Corporate recommends that NCUA strive for more balance between the experience of established directors and the fresh approach that new directors would bring. Also, a longer term limit would enable a less disruptive transition to the new restriction over the next several years.

704.14(a)(3) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.14(a)(3) of the Proposed Rule in order to change the term limit for positions on a corporate credit union's Board of Directors, to 9 consecutive years (i.e., rather than 6 consecutive years), and that for an appointed board member, any partial year of service not be considered when computing the number of consecutive years the individual has served.