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# NCUA Proposed Regulation 704: Surviving an 80-year Flood or Living in a Cinderblock House

March 8, 2010

Matthew Davidson, CPA

*On behalf of the Louisiana Credit Union League*



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## Facilitated by Matt Davidson

- 20-year credit union veteran
- Assists credit union management and boards in improving performance and net worth
  - CEO/conservatorship manager for credit unions from \$7m to \$1.7bn in assets
  - EVP of the California & Nevada Credit Union Leagues
  - COO of \$4.8bn robustly healthy San Diego County Credit Union
- Served on American Share Insurance Board
- Superintendent of Ohio Division of Credit Unions
- Certified Public Accountant



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# National Credit Union Administration

*As an insurance company, some  
losses are inevitable*



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## Failure of a Credit Union



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## It's the Economy, Stupid...



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## The 80-year Flood or Market Dislocation...



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## Never again...

- Legacy Assets
  - Damage that's already done
- Current proposal
  - Condemns all properties regardless of damage
  - Makes everyone drive Volvos with dozens of airbags, while living in cement block houses far from rivers and lakes



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## What about Citizens of Bedford Falls?



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## What about Citizens of Bedford Falls?

- NCUA doesn't know how credit unions and their members will be affected
- Leagues can't tell them, differing opinions
- Corporates can't tell them, concerned about their survival

***Only You Can Tell The Agency How  
This Will Affect Your Credit Union***



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## NCUA Proposed Regulation 704 TOP 7 ISSUES



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# 1. Legacy Assets

- Regulation does not resolve this issue
- Having a resolution plan without knowing the fate of legacy assets is not feasible
  - Rebuilding after flood without knowing the conditions of the foundations
  - Must at least delay regulation until solution found and/or announced



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# 1. Legacy Assets

Agree with proposal:

“Corporate operational issues are not affected by the disposal of legacy assets.”



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# 1. Legacy Assets

Disagree with proposal:

“It would be in my credit union’s (and in NCUA’s) best interests to have a Corporate credit union that provides some investment alternatives, liquidity assistance, and certain clearing/settlement services.”



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# 2. Net Economic Value Tests

## 704.8 (d), (e), (f), (h)

- Impose two Net Economic Value (NEV) tests on the Corporates
  1. Shocks assets by 100, 200, and 300 bps, AND
  2. Adds across-the-board 50% slowdown
- Prohibits a decline in NEV of more than 15%; and NEV ratio must be above 2%



## 2. Net Economic Value Tests

### Corporates

- Won't (can't) generate sufficient interest margin to meet capital requirements
  - Floating rate instruments tested as a fixed rate, thereby eliminating attractiveness of these investments altogether
  - There is no combination of assets with a two-year average life and limited extension risk that can generate sufficient margin to attract funding and pass a 300 bps shock
  - Ignores ways that Corporates can shelter themselves from risk (e.g., derivatives)
  - Tests do not differentiate between the liquidity of assets (e.g., GSE v. non-GSE)

*Eliminates Interest Rate Risk*



## 2. Net Economic Value Tests

### Natural Person Credit Union (NPCUs)

- Easier to find higher rate, safe, allowable investments at banks and brokerages
- Managing interest rate risk yourselves



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## 2. Net Economic Value Tests

Agree with proposal:

“I agree, it makes the Corporate system safer. I have the expertise and desire to invest in allowable investments, and am confident I can get a fair price from broker/dealer/banks.”



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## 2. Net Economic Value Tests

Disagree with proposal:

“Want to invest through my Corporate because their staff has most expertise finding appropriate investments; and they will give me a fairer price than if I had to go to banks or brokerages. I recommend that NCUA requires more capital, changes the rate shock to a 100bps rate shock and increase the NEV volatility limit to 30%. These requirements are stricter than past practice but allows for the Corporates to have a ‘smart’ amount of interest rate risk”



## 3. Weighted Average Asset Life

### 704.8 (h)

- Weighted average life (WAL) of the Corporates' investment portfolio, excluding derivatives and equity investments, may not exceed two years



## 3. Weighted Average Asset Life

### Corporates

- Will only issue short-term loans to be below two-year WAL ceiling
- Long-term loan would have significantly higher interest/fees
- Corporates would reduce the asset mix, hinder diversification

### NPCUs

- Corporates would no longer be primary issuer of cheap liquidity
- Must turn to:
  - Federal Home Loan Banks (FHLBs), themselves suffering and increasing rates/fees
  - More expensive banks, giving competitors credit unions' liquidity

*Eliminates Liquidity Risk*



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### 3. Weighted Average Asset Life

Agree with proposal:

“It makes the Corporate system safer. I have the expertise and desire to manage my liquidity risk in any circumstance. In emergency, I am comfortable going to my competitor for liquidity knowing that liquidity will be available.”



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### 3. Weighted Average Asset Life

Disagree with proposal:

“Remove the WAL restrictions, especially if NEV tests remain and other limitations on investments are kept in the final rule. This allows appropriate asset liability management of mismatches and will allow Corporates to safely act as a source of liquidity for credit unions.”



## 4. Concentration Limits

### 704.6 (c) & (d)

- Limit Corporates holding instruments from a single obligor to only 25% or \$5 million, whichever is greater
- Limits aggregate holdings in selected investments to the lower of 100% of capital or 5% of assets



## 4. Concentration Limits

### Corporates

- The limit is small and restrictive, and may serve to drive up costs in search for alternatives
- Corporates will be severely challenged to invest short-term liquidity at reasonable rates
  - E.g., Federal Fund transactions would be restricted

### NPCUs

- W/Corporate investment opportunities limited—including through other measures in proposal—negative impact on overnight rates NPCUs receive
  - Not high now but in a normal or higher rate environment...

*Eliminates Credit Risk*



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## 4. Concentration Limits

Agree with proposal

“Having Corporates rely on a single obligor is a risk, and a safe Corporate system is essential”



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## 4. Concentration Limits

Disagree with proposal:

Suggest alternatives...

- Exempt Federal Funds or Federal Funds transactions from concentration limits
- Allow larger single obligor limit (e.g., 200 percent of capital) on money market transactions with a term of 90 days or less



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## “Never Again” ... Again

*Eliminate Credit Risk*  
*Eliminate Interest Rate Risk*  
*Eliminate Liquidity Risk*



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## 5. Early Withdrawal Penalties

### 704.8 (c)

- Prohibits a Corporate from redeeming an outstanding certificate at the market rate for a NPCU, even at a premium



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## 5. Early Withdrawal Penalties

### Corporates

- Eliminates ability to pay a premium on early withdrawals
- Most likely eliminates the Corporate certificate market for all but the shortest maturities and the smallest NPCUs
- Eliminates the ability to fund NPCUs' lines of credit, reduced overall liquidity

### NPCUs

- Removes NPCUs' motivation to withdraw funds prior to maturity
- Would no longer use Corporate system for long-term liquidity, which currently offers ease of use, higher yields compared to U.S. agency-issued debt, and specialized instruments
- Eliminates Corporates' ability to fund NPCUs' lines of credit



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## 5. Early Withdrawal Penalties

Agree with proposal:

“This section would stop a run on Corporates in time of crisis and ensure stability.”



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## 5. Early Withdrawal Penalties

Disagree with proposal:

“Based upon all the restrictions and elimination of risk, credit unions would be forced to use banks for long-term funding. This proposal would have the effect of reducing liquidity in the credit union system.”



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## 6. Limit on Individual CU Business

### 704.8 (k)

- Corporate would be prohibited from having a single member or entity make up more than 10 percent of its moving daily average net assets



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## 6. Limit on Individual CU Business

### Corporates

- Negatively affect the Corporates' short-term borrowing ability, extremely important
  - E.g., Corporate balance sheets can fluctuate by as much as 25 percent of assets within a month
- Force Corporate to accept less favorable terms regarding price, maturity, and collateral

### NPCUs

- Limit NPCUs short-term borrowing choices
- Less favorable service and terms from Corporates



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## 6. Limit on Individual CU Business

Agree with proposal:

“This makes the remaining ‘system’ safer and reduces the Corporates dependence on a single client or entity. (E.g., U.S. Central)



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## 6. Limit on Individual CU Business

Disagree with proposal:

“This may undermine Corporate stability due to normal balance sheet fluctuations, despite that being a primary regulatory goal.” Should consider:

- Exemptions for the Federal Reserve, Federal Home Loan Bank, *et al.* by eliminating the clause “or other entities.”
- Increased borrowing limit (e.g., 20 percent of the Corporate’s moving daily average net assets)
- Allow NPCUs’ deposits to be offset against borrowings
- Any limits on business generated should be netted and not analyzed on a gross basis.



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## 7. Unintended Consequences

- Elimination of risk, more expensive clearing processes
  - This service subsidized by investing spreads
  - May be disrupted, staffing losses, etc.
  - May mean increased expense for smaller NPCUs



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## 7. Unintended Consequences

*How realistic is it for credit unions to re-capitalize Corporates?*



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## 7. Unintended Consequences

- 250 PAGES, 90 DAYS, LEGACY ASSETS
- Taken in pieces, may be reasonable, but taken in total...

**What do *YOU* think?**



# Alternatives

## Where Credit Unions Can Turn Instead?

- Federal Reserve Window
- Federal Home Loan Banks
- Banks

## How Would You Structure The Corporates?

- Same
- Consolidate
- Eliminate



# How to Respond?

- Deadline for comment – March 9, 2010.
- To submit a comment, use one of the following:
  - Federal eRulemaking Portal: <http://www.regulations.gov>
  - NCUA website
  - E-mail: Address to [regcomments@ncua.gov](mailto:regcomments@ncua.gov). “[Your name] Comments on Part 704 Corporate Credit Unions” in e-mail subject line
  - Fax: (703) 518-6319. [Your name] Comments on Part 704 Corporate Credit Unions
  - Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314
- Full Proposed Regulation from NCUA: [http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed\\_regs/FINALPart704\\_12-8-2009WebVersion.pdf](http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/FINALPart704_12-8-2009WebVersion.pdf)



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