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February 23, 2010

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314–3428

re: National Credit Union Administration; Corporate Credit Unions; 12 CFR Part 702, 0703, 704 709 and 747; 74 Federal Register 65210, December 9, 2009

Dear Ms. Rupp:

The National Credit Union Administration Board (the Board) has issued a proposed rule to amend its rule governing corporate credit unions. Major revisions involve corporate credit union capital, investments, asset-liability management, governance, and credit union service organizations. The proposed rule is being issued at a time when the corporate credit union system has come under serious financial stress and has imposed a significant financial cost on natural person credit unions. More than a decade ago, the National Credit Union Administration (NCUA) was forewarned by the U.S. Department of the Treasury of the risk corporate credit unions posed to natural person credit unions, but the NCUA failed to address these problems.

The American Bankers Association's (ABA) [1] comments will focus on capital regulation of corporate credit unions. ABA believes the proposed changes to the capital regulations of corporate credit unions (corporates) represent a significant improvement, and ABA is supportive of the Board's proposal to align corporate capital standards with that of the other federal banking agencies and to subject corporates to prompt corrective action (PCA) standards. ABA believes that the Board should move in an expeditious fashion to adopt the proposed changes to corporate credit union capital to strengthen the capital regulation of corporates. However, ABA believes that NCUA should make several modifications to its proposed corporate credit union capital rules so as to strengthen the safety and soundness of corporate credit unions and limit the cascading of losses from corporate credit unions to natural person credit unions (NPCU). Specifically, ABA believes that:

- NCUA should change the calculation of the capital ratios from using daily average net assets (DANA) to the value of net assets at an end of the period.

[1] ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.2 trillion in assets and employ over 2 million men and women.

- NCUA should lower the percentage of supplementary capital for unrealized gains on available-for-sales equity securities from 45 percent to 30 percent.

- In lieu of the proposed retained earnings ratio, NCUA should require NPCUs to subtract their equity investments in corporate credit unions when calculating their net worth (leverage) ratio.

NCUA's Current Corporate Credit Union Capital Regulations

Currently, corporate credit unions are only subject to a leverage ratio of 4 percent of moving daily net assets.[2] Capital includes retained earnings, paid-in capital[3] and membership capital accounts.[4] Corporates are also subject to a 2 percent retained earnings ratio. Failure to meet the four percent leverage ratio requires the filing of a capital restoration plan with the NCUA. But unlike banking entities or natural person credit unions, undercapitalized corporates are not subject to Prompt Corrective Action. Additionally, corporate credit unions are not required to comply with risk-based capital requirements.

Key Points in ABA's Comment Letter regarding the ANPR

As a result of the problems in the corporate credit union system, NCUA published on February 4, 2009 an advanced notice of proposed rulemaking (ANPR) to evaluate the role of corporate credit unions in the credit union system. In response to NCUA's Corporate Credit Union Advance Notice of Proposed Rules, ABA made the following points regarding capital rules of corporate credit unions, which are summarized below:

1. NCUA should participate with the Federal Financial Institutions Examination Council in the development of capital standards and then should apply the new requirements to corporate credit unions.
2. The definition of capital for corporate credit unions should be analogous to that used by regulators of other federally-insured depository institutions.
3. NCUA should establish minimum standards for the permanent capital of corporate credit unions.
4. Corporate credit unions should be subjected to a risk-based capital standard, as well as a meaningful leverage ratio requirement.

In response to the comments received from the ANPR, NCUA's purposed rule moved to address many of these recommendations.

NCUA's Proposed Rule on Capital

The failure of the corporate credit union system clearly demonstrated the deficiency of its capital structure and the correlated nature of risk. The proposed rule intends to change the corporate capital

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[2] Moving daily average net assets means the average of daily average net assets exclusive of identifiable intangibles and goodwill for the month being measured and the previous eleven (11) months.
[3] Paid-in capital means accounts or other interests of a corporate that: are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.
[4] Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

requirements to make them stronger and more consistent with the requirements of the banking regulators.

The proposal replaces the current four percent capital requirement with a four percent leverage ratio and limits the capital that can be used to calculate the leverage ratio to more permanent forms of corporate capital. The proposal also includes new minimum risk-based capital ratios that are calculated based on risk-weighted assets. Failure to meet these minimum ratios will trigger a capital restoration plan requirement, potential capital restoration directives, and other new prompt corrective action provisions. The new PCA provisions are similar to those currently applicable to banks.

The proposed rule defines core capital (used synonymously with Tier 1 capital) as the sum of a corporate's retained earnings, as calculated under GAAP, and perpetual contributed capital (PCC). PCC was formerly called paid-in capital. NCUA proposes that core capital be used when calculating compliance with the leverage ratio and Tier 1 risk-based capital ratio. The four percent leverage ratio requirement is intended to ensure that credit unions maintain a minimum amount of capital as protection against risks other than credit risk.

The proposal will also toughen the requirements for Tier 2 capital accounts that can be used in part to satisfy the new total risk-based capital ratio. Membership capital accounts (MCAs) are renamed as nonperpetual capital accounts (NCAs) and no longer treated as core capital. NCAs are now part of supplementary capital, along with allowance for loan and lease losses accounts and accumulated unrealized gains and losses on available-for-sale securities. Additionally, the proposed rule extends the required holding time for NCAs from 3 to 5 years.

Effective six years after the date of publication of the final rule, the proposed rule will require that a corporate deduct from core capital any amount of PCC that causes PCC minus retained earnings, all divided by moving daily average net assets, to exceed two percent. The effect of this provision is that a corporate must have at least 100 b.p. of retained earnings at the six-year mark in order to achieve the minimum four percent leverage ratio necessary for adequate capitalization. This adjustment will force corporates to work toward building their retained earnings.

NCUA's Estimated Impact of the Proposal on Corporate Capital

Using the known U.S. Central losses, and adjusting the retail corporate's capital levels based upon 5,310 Call Report data from August 2009, the NCUA projected that 18 retail corporates had zero retained earnings. Nine of the 18 faced a complete elimination of paid-in and a partial elimination of existing member capital accounts. However, Other Than Temporary Impairment losses at U.S. Central and losses in its investment portfolio are likely to further erode the capital positions of corporates.

The NCUA's analysis projects that, with the adoption of the proposed capital standards only two of the 28 corporates would be well capitalized or adequately capitalized. Meanwhile, 16 of 28 corporates would fall into the category of critically undercapitalized.

ABA's Position

In reviewing the NCUA's Corporate Credit Union Capital proposal, ABA believes the adoption of the leverage ratio and risk-based capital measurements are clear improvements over the existing rules governing the capital standards of corporates. The proposal aligns NCUA's standards with those of the federal banking agencies and Basel I.

In our April 3, 2009 letter to NCUA, ABA recommended establishing a core capital (tier-one) requirement that would consist of retained earnings and permanent paid-in capital. MCAs should not be included as core capital. ABA wrote that "it is inappropriate to categorize as core capital any instrument that can be withdrawn; rather membership capital accounts should be treated as secondary or supplemental capital in the calculation of risk-based capital ratios analogous to risk-based tier-two capital requirement for banks." The proposed rule adopts ABA's position.

ABA also applauds the effort to toughen the requirements for Tier 2 capital accounts by such actions as amending the Tier 2 requirements and making MCAs conform to standards similar to the banking agencies. These higher supplementary capital standards will benefit the corporate and natural person credit union industry by helping to manage volatility of capital holdings and by supporting the avoidance of future risk.

Additionally, ABA recognizes the value of a phase-in of PCA requirements for corporate credit unions. ABA does not object to the NCUA's mandate for corporates transitioning to the new capital standards and ultimately being in compliance with the leverage ratio, the risk-based capital provisions and the PCA provisions, by the end of the rule's third anniversary.

Although the ABA approves of many of the new NCUA capital rules, it strongly urges NCUA to continue to align itself more closely with the supervisory policies of the other members of the Federal Financial Institutions Examination Council (Examination Council). ABA believes that closer coordination with the banking agencies in developing capital standards for corporate credit unions would benefit both NCUA and the credit union industry, especially as the bank regulators continue to refine bank capital standards. Full participation in the Examination Council's redevelopment of capital requirements would ensure that all depository institutions are bound by sound and competitively equivalent capital requirements.

Other revisions that ABA would recommend to the proposed rule are:

1. NCUA should change the calculation of the capital ratios from using DANA to the end of period net asset value.

2. NCUA should lower the percentage of supplementary capital for unrealized gains on available-for-sales equity securities from 45 percent to 30 percent.

3. In lieu of the proposed retained earnings requirement, NCUA should require NPCUs to subtract their equity investment in corporate credit unions when calculating their net worth (leverage) ratio.

The Capital Rules Should be Shifted from the use of DANA to End of Period Net Assets

The proposed rule establishes the use of DANA and the daily average net risk-based assets as standards for calculating the leverage ratio, the Tier 1 risk-based capital ratio and the total risk-based capital ratio. In a 1996 comment letter to the NCUA, ABA expressed its opposition to the establishment of DANA as a basis for calculating capital ratios:

> ABA also objects to NCUA's proposal to calculate the leverage ratio based on a moving daily average of net assets for the previous 12 months. During periods of asset volatility, a capital ratio calculated

> in this manner will not accurately reflect the true capital position of the institution. For example, suppose a $1 billion corporate credit union grew by $20 million per month, ending the year at $1.22 billion. Using the proposed 12-month moving average asset calculation, the credit union would meet its 4 percent leverage requirement by holding $44.4 million in capital. Using an end-of-period asset calculation -- as banks do -- the institution would have to hold $48.8 million in capital to satisfy a 4 percent leverage requirement. In this case, using the NCUA's method would require $4.4 million less capital than appropriate.[5]

ABA believes that rather than using a 12-month moving daily average of net assets, the denominator of the leverage ratio and any other capital measurement, such as the Tier 1 and total risk-based capital ratios, should be based on end of period net assets. The movement away from DANA would fall in-line with the accounting methods used by the federal banking agencies, creating consistency amongst depository institutions.

The Unrealized Gain Threshold for Supplementary Capital Should be Reduced

As a part of the restructuring of the corporate capital structure, the NCUA's proposal creates Tier 2 capital, which is also referred to as supplementary capital. The proposal defines supplementary capital as including portions of nonperpetual contributed capital accounts, GAAP allowance for loans and lease losses to 1.25 percent of risk-weighted assets, and 45 percent of unrealized gains on available-for-sale equity securities with readily determinable fair values.

NCUA requested comment on whether it should lower the threshold of unrealized gains on available-for-sales equity securities that can count as supplementary capital. ABA takes issue with setting the limitation at 45 percent. If banks realize gains on available-for-sale equity securities, that income is subject to taxation. However, since corporate credit unions are tax-exempt, ABA recommends that NCUA reduce the threshold to a level of 30 percent, which would yield treatment comparable to banks.

Exclude Natural Person CUs Investment When Calculating Net Worth Requirement

In 1997, Treasury commented that the tiered cooperative structure of the credit union system creates an interdependence risk among and within the various levels:

> Specifically, a credit union's deposits at its corporate credit union, and its membership capital account, are assets on its books. At the same time, the credit union's corporate credit union carries these funds as (largely uninsured) deposits and secondary capital, respectively, on its balance sheet. The same relationship holds between corporate credit unions and U.S. Central. Thus, if U.S. Central were to fail, its member corporate credit unions could face losses on their deposits – reducing their own net worth. Similarly, if a corporate credit union were to fail, its member credit unions could face losses on their deposits and thus a reduction in their net worth.[6]

With the conservatorship of U.S. Central and WesCorp, corporate credit unions have had to expense their equity investments in U.S. Central, and natural person credit unions have written down portions of

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[5] ABA Comment Letter to Proposed Rule, Federal Register, June 4, 1996 (Volume 61, Number 108) 28085. http://frwebgate3.access.gpo.gov/cgi-bin/TEXTgate.cgi?WAISdocID=85705620511+0+1+0&WAISaction=retrieve

[6] "Credit Unions", U.S. Department of the Treasury, December 1997. http://www.ustreas.gov/press/releases/docs/cu_study.pdf

their equity positions in corporate credit unions which have experienced losses in excess of their retained earnings balances. This interpendence of risk mandates that each level within the tiered cooperative structure of the credit union industry needs to have sufficient net worth relative to the risk undertaken.

NCUA is proposing to establish a minimum retained earnings requirement as a means of mitigating the ability of losses to cascade from a corporate to a NPCU. NCUA believes that this will encourage corporate credit unions to build their retained earnings balances and thus provide a buffer to NPCUs' equity investments in the corporate.

However, corporate credit unions were already subject to retained earnings requirements under the current capital rules. These retained earnings requirements failed to keep losses from cascading from corporates to NPCUs. ABA recommends that the ties in capital holdings between corporates and natural person credit unions need to be severed. To separate those ties, it is advised that the contributed capital from natural person credit unions to a corporate credit union be excluded from a NPCU's calculation of its net worth (leverage) ratio for PCA purposes. In fact, NCUA is requiring that corporate credit unions deduct their equity investments in other corporate credit unions when calculating their core capital requirement. The proposal states:

> …if the corporate credit union, on or after twelve months following the publication of the final rule, contributes new capital or renews existing capital to another corporate credit union, the corporate must deduct an amount equal to the aggregate of such new or renewed capital. Because the corporate universe is so small, and may get even smaller in the future, the Board is concerned that capital investment between two or more corporates can endanger the stability of the entire corporate system and, ultimately, the stability of the entire credit union system. Accordingly, this proposed deduction from corporate capital discourages capital investment between corporates.

NCUA should apply the same logic to NPCUs with regard to their equity investments in corporates when calculating their net worth requirements. This would reduce the risk of losses cascading through the entire credit union system.

Conclusion

In conclusion, ABA believes the proposed corporate capital rules represent a significant improvement over the current capital standards for corporate credit unions. However, ABA would recommend NCUA make the following changes before finalizing its rule: use of end of period net assets, lower the unrealized gains threshold to 30 percent, and alleviate the systemic capital risk by severing the contributed capital relationship between corporate and natural person credit unions.

Sincerely

Keith Leggett

Keith Leggett
Vice President and Senior Economist