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Federal Credit Union®

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Ms. Mary Rupp
Secretary to the Board
National Credit Union Administration
1776 Duke Street
Alexandria, VA 22314

August 18, 2006

Dear Members of the Board:

Thank you for the opportunity to comment on the proposed rule regarding Permissible Investments for Federal Credit Unions. Alaska USA is highly supportive of the Board's proposal to permit credit unions to enter into investment repurchase transactions collateralized by first-lien mortgage notes. Alaska USA has long advocated for regulatory authority to use this type of collateral as part of a securities lending transaction. This authority will allow credit unions the opportunity to generate additional investment revenue without material additional risk.

Background

NCUA Rules and Regulations at Part 703.13 currently permit both securities lending (703.13 (e)) and investing in repurchase agreements (703.13 (c)). With this proposed amendment, a type of first-lien mortgage note known as "Whole Loans" will be available to collateralize repurchase agreements. Whole Loans are individual mortgage loans that meet the requirements of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), as defined in the Securities and Exchange Act of 1934 and referenced in the Federal Credit Union Act. These Whole Loans are in the process of being securitized into mortgage-backed securities (MBSs) for sale to investors. Typically, the originators of such securities look to finance the loans during this securitization process by issuing corporate repurchase agreements collateralized by the individual loans.

According to the ASTEC Consulting Group, a recognized national expert in securities lending, between $30 billion and $100 billion worth of Whole Loans are financed every month by way of these repurchase agreements. The repurchase agreements are industry standard agreements that specify the collateral to be given by the seller of the repurchase agreement (firm financing their Whole Loans). The ownership rights for such loans are held for and on the behalf of the buyer (the credit union) by a third-party custodian who verifies that the collateral meets the requirements spelled out in the agreement and is consistent with the credit union's investment policies. The sellers of repurchase agreements are some of the world's largest investment bankers and, according to ASTEC, the buyers of such repurchase agreements run the gamut from banks, insurance and finance companies to public units and retirement funds.

Whole Loans are used as collateral in repurchase agreements just as a vehicle is used as collateral for an auto loan. The collateral is available to the buyer only in the event of the seller's default. The terms of repurchase agreements call for the fair market value of the collateral to be marked to market daily, and to be maintained at an amount in excess of the principal amount of the agreement (typically 2-5% in excess of market value).

Generally speaking, the risks associated with taking Whole Loans as collateral are the same risks a lender assumes when accepting any type of collateral in connection with a lending transaction. In such transactions, if the borrower fails to pay, the lender will take possession of the collateral and liquidate it to

obtain proceeds sufficient to pay the amount of the default. As such, the lender is taking a risk that the collateral is available, can be readily liquidated and will have a value upon liquidation that will cover the default.

The Whole Loans taken as collateral in repurchase transactions are readily traded in the secondary market for mortgage loans, and multiple competing bids on such loans can be obtained on any business day. Since legal title to the Whole Loans is assigned to the credit union and held on behalf of the credit union by an independent third-party safekeeper, obtaining possession of such loans in the event of default is not an issue.

Accordingly, the only risk in the event of default is if the Whole Loans do not have sufficient value upon liquidation to satisfy the amount owed. In order to mitigate this risk as required by NCUA Rules and Regulations at 703.13 (c) (1), the collateral is marked to market daily by the third-party safekeeper who obtains market value information from major broker dealers and is responsible for obtaining additional collateral, when necessary.

Alaska USA has been involved with permissible securities lending activities since 1988. Based on our experience and knowledge of the market, under current market conditions a federal credit union participating in a Whole Loan Securities Lending Program could expect to receive a net return between 10 and 15 basis points (bps) of the value of the securities loaned. Participants may, at times, receive up to 40 bps or more for certain securities in demand by the market. As you can see, the authority to use Whole Loans as collateral provides credit unions a good opportunity to leverage their investment portfolios and return greater benefits to their membership.

Specific Comments on the Proposed Regulation

While we strongly support the intent of the proposal, there are several important areas where we believe the rule can be improved to make this investment activity of more practical benefit to credit unions. Following are our comments with respect to each of the specific questions posed in the proposed rule, as well as comments with respect to each of the six proposed conditions.

Questions

1. *By what means can the party investing in mortgage note repurchase agreements easily identify the underlying loans, and is it necessary to require more than a tri-party custodial arrangement to accomplish? If so what additional requirement should be identified?*

   The identity of underlying mortgage loans used as collateral for each repurchase agreement is standard information contained in tri-party custodial statements provided to the owner of the securities being loaned (credit union). These custodial statements provide all the necessary information to identify the collateral.

2. *What minimum underwriting criteria, if any, should the rule address?*

   We do not believe it is necessary to establish additional minimum underwriting criteria since it is already embedded in the provisions of the Secondary Mortgage Marketing Enhancement Act as incorporated into the Federal Credit Union Act. The underwriting criteria are those established to make the mortgage notes eligible for sale to the secondary market.

3. *What requirements, if any, should the rule address regarding the quality of the mortgage notes and their monitoring?*

   It is unnecessary to re-state or re-regulate the quality of the mortgage notes since it is already established within the parameters in SMMEA.

4. *The proposed minimum long-term credit rating for the counterparty is higher than has been previously included in Part 703 for municipal securities. Given that the mortgage note repurchase transactions are typically short term, should the agency consider excluding long-term credit requirements for counterparties in mortgage note repurchase transactions?*

   Yes.

Conditions

Several of the conditions set forth in the proposal are standard industry practice and pose no barriers to practical implementation. However, others are either impractical or inconsistent to such a degree as to render the benefits of this investment strategy marginal at best. Our comments and suggestions follow.

1. The aggregate of the investments with any one counterparty is limited to 25 percent of the credit union's net worth and 100 percent of its net worth with all counterparties.

   We believe that the proposed limitation on the amount available for investment is inconsistent with existing NCUA Rules and Regulations in part 703. Currently, Part 703.13 authorizes a FCU to invest in "investment repurchase transactions" as long as the securities the credit union receives "are permissible investments," they or their agent obtain "possession or control," the securities are valued daily, "and the Federal credit union maintains adequate margins that reflect a risk assessment of the securities and the term of the transaction." Part 703.3 requires that credit unions develop investment policies that spell out "how the federal credit union will manage credit risk including specifically listing institutions, issuers, counterparties that may be used, or criteria for their selection, and limits on the amounts that may be invested with each."

   This proposed rule classifies mortgage notes used in repurchase agreements as permissible investments; thus, we believe the current rules and regulations as referenced above are sufficient. Current regulations appropriately place the responsibility on the credit union and its board of directors to conduct risk assessments and adopt investment policies that clearly define their understanding of the investment activity and factor in safety and soundness considerations.

   However, should the Board feel compelled to create limits on this activity, we strongly believe that the concentration limit of 25 percent per counterparty and the 100 percent of net worth on all counterparties is unnecessarily restrictive and will diminish the usefulness of the proposed rule. These limits would, from a practical standpoint, allow only a few very large credit unions to benefit from the income potential of this activity.

   Given the restrictive credit requirements of counterparties and the short-term nature of the activity, a concentration limit, if required at all, would more appropriately be 50% of net worth per counterparty and a total limit for all counterparties similar to the borrowing limit defined in 107(9) of the Federal Credit Union Act (50% of paid-in and unimpaired capital and surplus). This would permit the use of Whole Loan repurchase agreements in a diversified securities lending program that meets industry standards and provides a prudent means of maximizing investment income with no material additional risk.

   We suggest the following wording:

   (1) The credit union's board of directors must establish by way of the investment policy specific limits to the amount of investment with any one counterparty and overall limits for such investments. The policy must also specify adequate minimum margins (value of securities taken versus amounts invested) that must be maintained on a daily basis.

2. At the time a federal credit union purchases the securities, the counterparty cannot have debt with a long-term rating lower than A- or its equivalent, or a short-term rating lower than A-1 or its equivalent.

This requirement also seems inconsistent with other provisions of 703. The proposal requires a firm to have a certain credit rating when acting as counterparty for an "investment repurchase transaction" collateralized by mortgage notes. However, when the same firm acts as counterparty for an "investment repurchase transaction" collateralized by mortgage backed securities, no such credit ratings are required. Additionally, since the proposal requires the transactions to be short term and requires the highest short term credit rating under the S&P rating system (or its equivalent), the added requirement to have a specific long-term credit rating is unnecessary.

3. The federal credit union must obtain a daily assessment of the market value of the securities under section 703.13(c)(1) using an independent qualified agent.

   We agree. This is a standard part of such transactions.

4. The mortgage note repurchase transaction is limited to a maximum term of 30 days.

   In the current market (August 2006), the 30-day term limit would be an acceptable parameter since the majority of all counterparties are attempting to keep their repurchase agreements short because of the current uncertain interest rate environment and abnormal yield curve. However, traditionally, the markets have looked to finance Whole Loans for a period of time that more closely mirrors the overall holding period. This period is typically 45 to 90 days. When used as a reinvestment in a securities lending transaction, it is desirable to have the terms of the borrowing transaction and the reinvestment match in order to eliminate interest rate risk. Securities lending borrowers typically borrow in standard market time periods, such as overnight, 10 days, 30 days, 60 days and 90 days. As a result, the term limit in such situations should be extended to 90 days. Such an extension would produce no calculable additional risk.

   A proposed amendment is:

   (4) The mortgage note repurchase transaction is limited to a maximum term of 30 days; except when the transaction is being used as a reinvestment of funds received from a borrower as part of a securities lending transaction where both the borrowing agreement and the "mortgage note repurchase" agreement are originated on the same day and have the same maturity and both the borrowing and the repurchase agreement have fixed rates. In such an exception, the maximum term is limited to no more than 90 days.

5. All mortgage note repurchase transactions will be conducted under tri-party custodial agreements.

   We agree. This is standard industry practice.

6. A federal credit union must obtain an undivided interest in the securities.

   We agree. This is standard industry practice.

We appreciate the Board's initiative in proposing this investment opportunity for credit unions. The proposal is progressive yet conservative in expanding access to safe and sound investments. Leveraging and improving investment income contributes to a credit union's financial strength, thereby enhancing its ability to serve members.

Thank you for the opportunity to comment and for your consideration.

Sincerely,

William B. Eckhardt
President