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

re: National Credit Union Administration; Fixed Assets, Member Business Loans, and Regulatory Flexibility Programs; 12 C.F.R. Parts 701, 723, and 742; 74 Federal Register 14372, March 25, 2010

Dear Ms. Rupp:

The National Credit Union Administration (NCUA) Board (the Board) issued a proposed rule to revise the Regulatory Flexibility Program (RegFlex) in an effort to enhance safety and soundness of credit unions. RegFlex was established to allow federal credit unions (FCU) to bypass certain regulatory restrictions. The proposed rule will rescind RegFlex exemptions in four areas: fixed assets, member business loans (MBL), stress testing of investments, and discretionary control of investments. The proposed rule is being issued at a time when the credit union system has come under serious financial stress due in part to lenient regulatory policies, which have resulted in significant financial costs on the credit union industry and to the National Credit Union Share Insurance Fund (NCUSIF).

The American Bankers Association (ABA)<sup>1</sup> applauds NCUA's effort to revise the RegFlex program and to impose stronger regulations. ABA believes that the Agency's effort to rescind the exemptions in these four areas will improve the safety and soundness standards of credit unions. In particular, ABA strongly supports reinstating the requirement to obtain a personal guarantee in the underwriting of member business loans. It is very important in the context of the justification of credit union member business loans as being an extension of the personal relationship that a credit union member has with his or her credit union. At a time when the credit union industry is pushing for expanded MBL authority, rescinding the exemption highlights the negative consequences of eroding the membership and cooperative nature of the credit union franchise. The higher levels of delinquencies and charge-offs amongst RegFlex MBL portfolios support ABA's concern that credit unions lack the underwriting expertise for business loans and that this business area falls outside of a credit union's core mission of supporting those of modest means.

The Board set forth the following reasons for rescinding its RegFlex authorities in the following four areas.

➤ Provisions Regarding Fixed Assets

Section 701.36 of NCUA's regulations prohibits a federal credit union (FCU) with \$1 million or more in assets from investing in fixed assets, the aggregate of which exceeds five percent

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<sup>1</sup>The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13

of the FCU's shares and retained earnings. However, RegFlex credit unions are exempt from the rule. NCUA believes that the viability of credit unions may be jeopardized if they invest in higher levels of non-earning assets. NCUA has found that credit unions with fixed assets in excess of 5 percent of shares and retained earnings have a higher percentage of earnings problems, and the percentage of earnings problems increases as the level of fixed assets increases.

➤ Provisions Regarding Member Business Lending

The MBL rule requires a credit union making a business loan to obtain the personal guarantee of the borrower's principals as part of the rule's collateral requirements. However, RegFlex credit unions are exempt from this requirement. NCUA has found that credit unions that break the key credit union member-business connection by failing to obtain the personal guarantee subject themselves to increased risk as demonstrated by higher MBL delinquencies and MBL charge-offs rates.

➤ Provisions Regarding Stress Testing of Investments

NCUA's investment rule requires an FCU to stress test its securities. RegFlex credit unions are exempt from this requirement. Because of the low investment yields, NCUA is concerned that many credit unions are taking on increased risk as they stretch for yield by investing in long-term securities. NCUA believes many credit unions are purchasing investment products they do not fully understand and are incurring significant interest rate and liquidity risk.

➤ Provisions Regarding Discretionary Control of Investments

NCUA's investment rule requires an FCU to retain discretionary control over its purchase and sale of investments. NCUA regulations permit an FCU to delegate discretionary control to a person if the person is an investment advisor registered with the Securities and Exchange Commission and the amount delegated is limited to no more than 100 percent of its net worth at the time of delegation. RegFlex credit unions are exempt from this requirement pertaining to the 100 percent of net worth limitation. In light of the current investment climate and reports of fraudulent practices in the securities industry, the Board is becoming increasingly concerned about the safety and soundness of credit unions and their investments.

ABA supports these revisions to the RegFlex program. While NCUA is making an effort to strengthen its regulations, the Board has taken corrective actions only *after problems materialized* at RegFlex credit unions. For this reason, ABA believes that more aspects of the RegFlex program need to be changed so that the Agency will be more proactive in addressing other potential oversight concerns. ABA recommends that NCUA raise the net worth standards for credit unions to qualify for the RegFlex program and that NCUA should rescind its exemptions on commercial mortgage related securities.

The remainder of this letter will address these suggested recommendations.

## **Re-establish 2002 RegFlex Net Worth Requirements**

The Board in November 2002 established RegFlex to allow federal credit unions (FCU) to bypass certain regulatory restrictions. These powers were given to FCUs that demonstrated sustained superior performance as measured by CAMEL ratings (a 1 or 2 rating for two preceding examinations) and net worth ratio of 9 percent or more for one call report period (200 basis points above the minimum regulatory standard for being “well-capitalized”).

In January 2006, through the rule-writing process, the Board relaxed the net worth portion of the RegFlex qualifications from a minimum 9 percent net worth ratio for one quarter to exceeding a minimum 7 percent ratio for six consecutive quarters.<sup>2</sup> During the comment period, ABA opposed the reduction in the net worth benchmark by highlighting the safety and soundness issues – a concern that has now been actualized. Additionally, ABA contested NCUA’s effort to standardize the RegFlex net worth requirement with the Prompt Corrective Action definition of well-capitalized.<sup>3</sup> This action by the Agency eased the qualification criteria for RegFlex authority allowing more credit unions to bypass safety and soundness restrictions.

As NCUA revisits its RegFlex rules, ABA believes that this is an opportune time for the Board to revert to the net worth requirements that it once relaxed. The standards of the program have been watered-down, and the NCUA is now allowing FCUs to engage in activities that expose them to higher levels of risk based on lower qualifications. The only justification for participating in the RegFlex program should be that it is reserved for the healthiest and strongest FCUs – those that demonstrate superior examination ratings and a net worth ratio above the statutory minimum.

From the 2000 RegFlex Advanced Notice of Proposed Rule (ANPR), the NCUA stated the rationale for the 9 percent net worth threshold. The ANPR states, “[T]his cushion of 200 basis points or greater represents a significant decrease in risk to both the credit union and the NCUSIF.”<sup>4</sup> The NCUA Board recognized a decade ago, it should require that FCUs be at least 200 basis points above the minimum standard for being well-capitalized to exercise RegFlex authorities. As acknowledged in the ANPR, credit unions that consistently maintain a high net worth ratio and a high CAMEL rating pose less risk to the NCUSIF. The NCUA should revise upward the net worth requirements for credit unions to participate in the RegFlex program. Some FCUs, through their expanded authorities, have assumed excessive risk relative to their capital (net worth) position.

### **Withdrawal of the Commercial Mortgage Related Securities Exemption**

The current RegFlex rule identifies commercial mortgage related securities as one of the ten areas where the NCUA provides regulatory relief. As the NCUA is reviewing the proposed RegFlex provisions, ABA recommends revoking the exemption on commercial mortgage related securities. Currently, NCUA regulations limit a federal credit union’s holdings in commercial mortgage related securities. NCUA regulations—

- Prohibit the purchase of a commercial mortgage related security of an issuer other than a government-sponsored enterprise;

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<sup>2</sup> The Board’s decisions to lower the qualifications were based on standardizing the “well-capitalized” qualifications with the net worth qualifications for the Prompt Corrective Action standards.

<sup>3</sup> Senate Report 105-193, May 21, 1998, pp.13.

<sup>4</sup> Federal Register, Vol. 65, No. 56, March 22, 2000, 15276

- Require the security to be rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization;
- Require the security's underlying a pool of loans to contain more than 50 loans with no one loan representing more than 10 percent of the pool; and
- Require an aggregate total of commercial mortgage related securities, purchased by the federal credit union that does not exceed 50 percent of its net worth.

However, federal credit unions with RegFlex authority can circumvent these precautionary measures.

Federal banking agencies and private industry analysts are expressing concerns about stresses in the commercial real estate market. The economic recession has taken a toll on the commercial real estate market. Commercial real estate values are down sharply from their 2007 peak, and commercial real estate vacancy rates are rising and rents are down. As a result, delinquency and charge-off rates on commercial mortgage backed securities are on the rise.

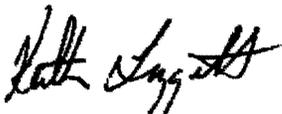
Over the last two years, NCUA reported that the commercial mortgage securities holdings of federal credit unions have experienced rapid growth. Without the aforementioned limiting provisions, RegFlex credit unions might be over-exposed to this risky market. Rather than waiting for problems to materialize, ABA is of the opinion that NCUA should proactively rescind the exemption on investing in commercial mortgage related securities.

ABA found that the market place impact of rescinding the RegFlex authority for investing in commercial mortgage related securities on credit unions would be minimal. Based on NCUA call report data, only 15 federal credit unions, with an average asset size of nearly \$400 million, have a commercial mortgage related securities to net worth ratio over the statutory 50 percent threshold. Furthermore, a mere 81 federal credit unions out of 7,700 hold commercial mortgage related securities. Therefore, this regulatory exception is benefiting a small number of institutions and revoking it would mitigate the risk exposure of the NCUSIF.

## Conclusion

In conclusion, ABA supports NCUA's proposed rule to rescind the exemptions on the four areas of the RegFlex Program. However, while NCUA is revisiting the provisions in the RegFlex program, ABA recommends the Agency increase the RegFlex net worth ratio requirement to the original level and that it withdraw the commercial mortgage related securities exemption.

Sincerely,



Keith Leggett  
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