



April 15, 2014

The Honorable Gerard Poliquin
Secretary of the Board
National Credit Union Administration
regcomments@NCUA.gov
RIN 3133-AD77

Re: Prompt Corrective Action – Risk-Based Capital

Sterne Agee appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) proposed rule "Prompt Corrective Action – Risk-Based Capital". Sterne, Agee & Leach, Inc. is a full service investment banking and broker/dealer firm headquartered in Birmingham, AL and founded in 1901. We have over 200 institutional fixed income professionals working in 14 cities. We work with credit unions across the country on a range of issues including fixed income portfolio management, interest rate risk management, credit analysis, capital raising and M&A activities.

We commend the NCUA's efforts to enforce strong capital requirements within the industry. However, there are certain aspects within the proposal that would likely put the industry at a disadvantage. Within the following letter, we will address the proposal in the following sequence:

1. Contrast risk-based capital structure for banks (Basel 3 rules) relative to the NCUA's proposed rule
2. Illustrate the primary differences between the standards and explore the implications for certain hypothetical examples given an alignment of the standards
3. Debate the benefits/costs of such an alignment
4. Concluding thoughts

Capital Structure – NCUA Proposal vs. Bank Basel 3

The proposal states one of its overriding goals as building a structure "more consistent with the risk-based capital measure for corporate credit unions and the risk-based capital measures used by the Other Federal Banking Regulatory Agencies"¹. The numerator for total risk-based capital (for banks, inclusive of Tier 1 Common, Additional Tier 1 and Tier 2 capital components under Basel 3) is very similar between both industries.

1. Both have the following exclusions:
 - a. Unrealized gains/losses on available for sale securities

¹ NPR Prompt Corrective Action – Risk-Based Capital, Page 4

- b. Unrealized gains/losses on cash flow hedges
- c. Other comprehensive income
- 2. Both have the following deductions:
 - a. Goodwill
 - b. Certain other intangible assets
- 3. Both have the following inclusions:
 - a. Allowance for Lease and Loan Loss (ALLL) at 1.25% of risk weighted assets

Several other items unique to the credit union industry are part of this calculation (NCUSIF Capitalization Deposit, etc.). However, on the whole, the numerator constructs are very similar.

On the other hand, once one begins to deconstruct the denominator in the calculation as well as the total required ratio, significant differences begin to emerge that could lead to competitive disadvantages. Beginning with the denominator in the calculation (risk-weighted assets), note the following grid contrasting the risk-weighted asset requirements by category as constructed within the NCUA proposal with that required by the banking agencies under Basel 3. We denote the categories in which the risk weights are disadvantaged with a gold highlight (more punitive for credit unions) and the categories in which the risk weights are advantaged with a green highlight (less punitive for credit unions). Additionally, the fourth column “Comment” contains relevant notes associated with the risk weights as well as numbers in certain locations that correspond to our comments following the grid on the next page.

Category	Credit Union Proposal	Bank (Basel 3)	Comment
Cash on Hand	0%	0%	
NCUSIF Capitalization Deposit	0%	N/A	
Debt Instruments unconditionally guaranteed by NCUA and FDIC	0%	0%	
U.S. Gov't obligations directly and unconditionally guaranteed by full faith and credit of the US government, including US T-bills, notes, bonds, zero coupon bonds, and STRIPS	0%	0%	1
Non-delinquent student loans unconditionally guaranteed by a US government agency	0%	20%	(Bank - Dept of Education reinsured loans)
Cash on deposit, including balances on deposit in insured financial institutions and deposits in transit	20%	0%	(Bank - Zero for insured, 20% for anything beyond)
Cash equivalents (investments with original maturities of three months or less).	20%	Dependent on Instrument	2a
Total amount of investments with a weighted average life of one year or less	20%	Dependent on Instrument	2b
Residential mortgages guaranteed by the federal government through the FHA or the VA	20%	20%	
Loans guaranteed 75 percent or more by the SBA, Dept of Agriculture, or other US government agency	20%	0% or 20% for only guaranteed portion	(Bank - 0% for "Guaranteed Interest Certificate" secondary purchase and 20% for originated and held by reporting bank)

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Category	Credit Union Proposal	Bank (Basel 3)	Comment
Total amount of investments with a weighted average life greater than one year, but less than or equal to three years	50%	Dependent on Instrument	2c
The total amount of current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short term, small amount loans, new vehicle loans, used vehicle loans, leases and receivable and all other loans (excluding MBLs)	50%	100%	
Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets	50%	50% or 100%	(Bank - Dependent upon underwriting standard of loan)
Corp credit union nonperpetual capital	100%	N/A	
Total outstanding principal amount loaned to CUSO's	100%	N/A	
Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets	100%	50% or 100%	
Delinquent first mortgage real estate loans	100%	150%	
Other real estate secured loans less than or equal to 10 percent of assets	100%	100%	
MBLs less than or equal to 15 percent of assets	100%	100%	
Loans held for sale	100%	Dependent on the Loan	
Total amount of any foreclosures and repossessed assets	100%	100%	
Land and building, less depreciation on building	100%	100%	
Any other fixed assets such as furniture and fixtures and leasehold improvements, less related depreciation	100%	100%	
Current non-federally insured student loans	100%	100%	
All other assets not specifically assigned a risk weight but included in the balance sheet	100%	100%	
Total amount of all other real estate secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets	125%	100%	3a
Total amount of investments with a weighted average life of greater than five years but less than or equal to ten years	150%	Dependent on Instrument	2d
Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short term, small amount loans; non federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding MBLs)	150%	150%	
Total amount of all other real estate secured loans greater than 20 percent of assets	150%	100%	3b
Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets	150%	100%	
Corporate credit union perpetual capital	200%	N/A	
Total amount of investments with a weighted average life greater than 10 years	200%	Dependent on Instrument	2e
Total amount of MBLs greater than 25 percent of assets other than MBLs included in category 3 above	200%	100%	
Total value of investments in CUSOs	250%	N/A	
Total value of MSA	250%	250%	
ABS for which CU is unable to demonstrate a comprehensive understanding of the features of the ABS investment that would materially affect its performance	1250%	N/A	

Comment #1 – 0% risk weight for U.S. Gov’t obligations directly and unconditionally guaranteed by full faith and credit of the U.S. government, including U.S. T-bills, notes, bonds, zero coupon bonds, and STRIPS. When contrasting this with the banking structure, a major distinction is visible while examining the items excluded from this category by the NCUA. Instruments guaranteed by entities such as the Small Business Administration (SBAP, SBIC) and Government National Mortgage Association (GNMA) have an explicit “full faith and credit of the United States government” guarantee yet are excluded from this list. We would question this

exclusion as they are of equivalent credit quality to U.S. Treasuries and in several instances, carry lesser interest rate risk. (i.e., 10 yr US Treasury vs. 15 yr GNMA Passthru Certificate or SBA floating rate pools)

Comment #2 (a, b, c, d, e) – the proposal provides for a range of risk weights across investments based upon their corresponding average lives (from 20% - 200%). Although we appreciate this approach exists within the current framework (and therefore is perhaps easy to facilitate in transition), we would argue the relevance of interest rate risk, across primarily one asset class (investments) while ignoring certain other asset classes, is inconsistent. As the agency appropriately points out on page 15 of the proposal, “the current RBNW measure focuses primarily on interest rate risk. However, the proposed capital ratio measure would focus more broadly on the various types of risks to credit unions by addressing additional risk factors...” Below, we state our argument for the removal of interest rate risk parameters within the new risk-based capital calculation.

Our logic for this removal is first supported by the calculation’s indifference to an institution’s liability structure. For institutions that have established longer funding positions (either organically or wholesale), the institution should have the ability to lengthen its asset duration in a commensurate manner as the residual interest rate risk position would be minimal. However, the proposed calculation simply assumes an institution has shorter liability profiles and therefore creates a disincentive for management to optimize its asset/liability position (solely pushes them into shorter asset classes). In a steep yield curve such as today’s, this results in a sacrifice of current income which would otherwise assist in building net worth positions over time through retained earnings. One might argue this issue lead several credit unions to invest in private label mortgage backed securities before the financial crisis in an effort to maximize return under the given capital constraints. Credit risk, not mismanaged interest rate risk, was the driving factor resulting in losses within the securities portfolio in the time period following.

Second, we would argue the agency should not ignore its own significant efforts over the previous years to establish appropriate interest rate risk modeling/management requirements². Additionally, the agency has enhanced the the permissible tools with which one can manage this interest rate risk via the Derivatives³ final ruling. Lastly, technology/modeling capabilities have also improved significantly since the original RBNW standard’s establishment. Therefore, we would broadly argue the safety and soundness concerns resulting from interest rate risk can and should be handled within the examination process, thereby allowing the capital standard to focus its efforts towards credit/concentration risk.

Below, we highlight a hypothetical asset composition and corresponding risk weight asset position. We focus on the corresponding change that would occur if the ruling simply aligned the risk weights for investments to that applied within the banking universe (given the permissible investment set, they would likely receive at worst a 20% risk weighting). Note the significant change in the total risk-based capital ratios as a result of this simple change:

² 12 CFR Part 741, Interest Rate Risk, RIN 3133-AD66

³ 12 CFR Parts 703, 715, and 741, Derivatives, RIN 3133-AD90

Sample Credit Union					
		Equity	\$	60,000,000.00	
		ALLL 1.25% RW assets	\$	750,000.00	
		NCUSIF	\$	(2,000,000.00)	
		Total Capital	\$	58,750,000.00	
Account	Value	Proposed Risk Weight	Calculation	Bank Risk Weight	Calculation
0 - 1 Year	\$ 110,000,000.00	20%	\$ 22,000,000.00	20%	\$ 22,000,000.00
> 1 to 3 Years	\$ 45,000,000.00	50%	\$ 22,500,000.00	20%	\$ 9,000,000.00
> 3 to 5 Years	\$ 45,000,000.00	75%	\$ 33,750,000.00	20%	\$ 9,000,000.00
> 5 to 10 Years	\$ 65,000,000.00	150%	\$ 97,500,000.00	20%	\$ 13,000,000.00
> 10 Years	\$ 15,000,000.00	200%	\$ 30,000,000.00	20%	\$ 3,000,000.00
			\$ 205,750,000.00		\$ 56,000,000.00
		Total RW assets	\$ 450,000,000.00	Total RW assets	\$ 300,250,000.00
		Proposed Ratio	13.06%	Proposed Ratio	19.57%

As can be seen, a simple alignment to the banking Basel 3 risk weight standards for investments provided under the banking capital structure would increase this sample credit union’s ratio by 6.51%, which is not insignificant.

Clearly this would put the onus on proper interest rate risk management. However, for all the aforementioned reasons, we would expect this to be a reasonable solution.

Comment #3 (a, b) – the proposed risk weight for higher concentrations of “other real estate secured loans” category disadvantages credit unions (specifically, junior liens in residential space). Although Basel 3 proposed rules originally intended to increase risk weighting for the banking sector, the final rule reconsidered and maintained a 100% risk weight. We would argue for a simple alignment for this particular asset class in light of the successful revolving home equity line of credit (HELOC) origination programs currently in place at many credit unions.

Finally, when one examines the total risk-based capital ratios required under the proposal, there is a key difference. The grid below contrasts the Prompt Corrective Action ratios under the proposed rule to the banking sector’s Basel 3 standards (effective January 1, 2015 for all community banks). Note the difference in the Well Capitalized standard, 10.5% vs. 10%.

	Net Worth Credit Union	Proposed Total RB Capital Credit Union	Bank Total RB Capital Basel 3
Prompt Corrective Action Levels			
Well Capitalized	7% or above	≥10.5%	≥10%
Adequately Capitalized	6% to 6.99%	8% - 10.49%	8% - 9.99%
Undercapitalized	4% to 5.99%	<8%	6% - 7.99%
Significantly Undercapitalized	2% to 3.99%	N/A	<6%
Critically Undercapitalized	Less than 2%	N/A	N/A

The proposal speaks to this as an alignment to the Basel 3 capital conservation buffer. The conservation buffer requires banks to maintain a total risk-based capital ratio of at least 10.5% in order to have no restrictions on their dividend policy or executive compensation. However, a bank can remain classified as well capitalized despite residing beneath this threshold (i.e., a bank could have a 10.25% total risk based capital ratio, thereby achieving well capitalized status, yet have restrictions on their dividend policy/executive compensation). We would argue that a true alignment of PCA standards would lead to both credit unions and banks having the same 10% total risk-based capital requirement in order to be classified as well capitalized.

Conclusion

Again, we applaud the NCUA for its efforts to encourage strong capital standards within the credit union industry. However, we fear for the reasons cited above, the proposal in its current form would lead to several competitive disadvantages. In general, we argue for greater alignment between the two standards (bank Basel 3 vs. credit union) especially within the investment portfolio (which proven by the example highlighted above, leads to considerable differences). We ask the agency to acknowledge its own excellent efforts in improving the interest rate risk management process within the industry (through both policy requirements and new permissible hedging instruments) and therefore choose to enforce this effort through the examination process as opposed to the capital standard requirement.

Once again, we are grateful for the opportunity to comment on the proposals as presented and look forward to working together with the agency and industry. Below, please find the institutions that have co-signed this comment letter. If there are any questions or requests for more information, please contact us at the numbers below.

Respectfully submitted,



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