PURDUE FEDERAL
CREDIT UNION

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May 19, 2014

Email to: regcomments@NCUA.gov
Mr. Gerard Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Prompt Corrective Action Risk-Based Capital Comment Letter

Dear Mr. Poliquin:

We are writing on behalf of Purdue Federal Credit Union (Purdue Federal), which primarily serves the faculty/staff/students/alumni of Purdue University. Purdue Federal has 64,157 members and $823.4 million in assets and provides a full suite of financial products developing member relationship depth to a diverse membership base within NCUA's designation as a Low Income Credit Union (LICU). Purdue Federal appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) on its proposed rule, Prompt Corrective Action - Risk-Based Capital (Proposed Rule).

After review of the Proposed Rule, we see several provisions where the rule deviates from our understanding of NCUA's spirit and intent of incorporating changes consistent with Basel III. Thus, if passed in its present form, Purdue Federal will be required to maintain excess capital in comparison to the risks within our balance sheet and in comparison to similarly structured banking competitors. A recent paper from the Filene Research Institute (Credit Union Capital Adequacy: What's New and What's Next?) notes that "from 2008 through mid-2011there were 85 US credit union failures, just over 1% of the 7,400 total credit unions operating at year-end 2007, and during the same period 369 banks failed or about 5% of the year-end 2007 total". This evidence alone should support credit union Risk Based Capital (RBC) standards *at or below* that of banks. The Proposed Rule does not provide sufficient evidence for credit union risk weights that are greater than banking competitors.

In our opinion the Proposed Rule is not needed for the credit union industry. If the NCUA Board determines to continue with implementing a final rule, scope for the final rule should address the following:

1. RBC standards should be limited to credit risk only, as consistent with the Basel III standards adopted by all other Federal Banking Regulatory Agencies

(including Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, and the Office of the Controller of Currency).

2. Risk weights should correspond to the potential loss exposure of the asset, which requires a quality rather than quantity analysis. Furthermore, minimum capital requirements should place credit unions on an even playing field with other financial institutions.
3. The final rule should contain a practical implementation schedule and retain the flexibility of the current rule's appeal process for risk mitigation credits.

General Comments

1. **We recommend that the final rule reassess asset class risk limits within Section 702.104 and establish risk weights using a scope of credit risk only.** The Proposed Rule's risk mitigation scope is inconsistent with Basel III and establishes punitive capital standards for credit unions.
   a. The Proposed Rule overstates the capital required for many risk assets when compared to the Basel III standard used by Other Federal Banking Regulatory Agencies. For example, Purdue Federal RBC as of March 31, 2014 is estimated at 13.20% under the Proposed Rule (Per Callahan RBC calculator). Using banking competitor risk weights Purdue Federal's RBC calculation would be 18.10%, a <u>37% or $27 million</u> increased use of capital when compared to a competitor with similar assets. Higher unjustified RBC requirements will create unnecessary capital constraints and competitive disadvantages for Purdue Federal and credit unions long term. A likely outcome, if the NCUA board moves ahead as proposed, will include increased charter conversions to mutual banks. A long term loss of credit union charters will not serve the members or their communities well.
   b. Multiple types of risk (Interest Rate, Liquidity, Concentration, Market, Operational, and Credit) are attempted to be addressed within the Proposed Rule's scope. Contrary to the Proposed Rule's approach, PCA systems across the banking industry are designed to address residual and unhedgable risks within balance sheets thus focusing on credit risk only. Neither Basel III nor the FDIC interim Final Rule attempt to capture risks other than credit risk when setting risk limits.
   c. NCUA regulation and supervisory guidance exists requiring credit unions to implement procedures and processes that mitigate interest rate and liquidity risks (NCUA Regulation Section 741). In addition, limited powers for derivative use have recently been approved by NCUA regulation for individual credit union approval. Therefore, balance sheet liabilities and off-balance sheet derivatives can be used to reduce and mitigate interest rate risk. The Proposed Rule provides no calculation basis for reducing RBC requirements when appropriate interest risk mitigation steps are taken. A credit union that appropriately mitigates

interest rate risk using acceptable asset and liability management hedging practices will be required under the Proposed Rule to set aside excess capital. In Purdue Federal's case, the Proposed Rules capital requirements will constrain the LICU designation benefits for influencing economic activity and growth within the communities we serve.

2. **Risk weights should correspond to the potential loss exposure of the asset, therefore requiring a quality rather than quantity calculation basis.**
    a. NCUA should maintain NCUSIF deposit as a category 1 risk weight and eliminate the deduction from both the numerator and denominator. Under Section 702.104(b)(2) a credit union's NCUSIF deposit balance is proposed as a deduction from both the numerator and denominator of the calculation. There is not sufficient justification provided for why the NCUSIF deposit asset, recognized by GAAP accounting as an asset, should be deducted from the RBC computation. If a credit union elects, the deposit is fully refundable if converting to a different charter or to private deposit insurance. In the event of an involuntary liquidation, the deposit asset is available for resolution of losses.
    b. NCUA should classify all investment portfolio assets using credit risk as the basis for category classifications. Specifically, we recommend the NCUA change Section 702.104(c) category classifications as follows:
        i. Move to Category 1 Risk Weight:
            1. Cash on deposit in a Federal Reserve operating account. As the central bank of the United States Government, Federal Reserve deposits should carry the same unconditional guarantee for full faith and credit of the U.S. Government similar to Treasury bills and notes. Even if NCUA's risk scope included other risks besides credit risk, a Federal Reserve deposit account should carry a 0% risk rating.
            2. Loans and debt securities guaranteed by all U.S. Government agencies such as FHA, VA, GNMA, SBA and USDA. These are direct obligations of the U.S. Government and do not contain credit risk.
        ii. Move to Category 2 Risk Weight:
            1. Debt securities from U.S. government sponsored agencies including Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal Home Loan Bank (FHLB), Tennessee Valley Authority (TVA), and Federal Farm Credit Banks (FFCB). These organizations are government regulated entities and require minimum standards for safe and sound operations with formal ongoing oversight.
        iii. Move to Category 3 Risk Weight:

1. Mortgage backed securities issued by government sponsored agencies such as FNMA and FHLMC regardless of weighted average life.
2. Municipal securities regardless of weighted average life.

iv. Move to Category 5 Risk Weight:

1. Other credit union investments not separately identified in another risk weight category and authorized under Regulation 703 and 701.19.

c. NCUA should risk weight secured first mortgage real estate loans based upon borrower credit worthiness and collateral sufficiency. Risk weighting merely on concentration does not directly correlate to loss exposure.

i. For instance, the new Basel III standard risk weight for first mortgage real estate loans is based upon loan to value as form of collateral sufficiency. Under the Proposed Rule NCUA completely ignores borrower credit worthiness and collateral sufficiency. Both measures are key indicators of potential loss exposure and can differ significantly by credit union

ii. Credit unions with higher concentrations of mortgages had a lower rate of charge-off experience during the Great Recession (See Callahan & Associates Peer-to-Peer Analytics % of Net Losses on 1st Mortgages (2011-2013) vs. 1st Mortgages as % of Assets (YE 2013) Data for CUs > $1B as of 12/31/13). The NCUA's Proposed Rule would require less RBC per dollar of asset for credit unions with higher loss experience merely because that credit union has a smaller concentration of mortgages. Credit unions with higher concentrations of mortgages often demonstrate better underwriting and loss mitigation practices. They can dedicate greater staff and resources to these practices because of the efficiencies gained from a higher concentration.

iii. Prudent underwriting practices and overall quality of a credit unions mortgage operation better correlates to actual exposures. Purdue Federal maintains a quality portfolio with average credit scores around 780. Throughout the Great Recession first mortgage charge-off loss experience of less than .03% was the 2nd lowest of all loan classes. Concentration of assets alone, which during 2009 was as high as 48%, was not indicative of Purdue Federal's actual loss experience and capital exposure. Loan credit scores would be a better measurement basis for RBC weightings.

d. NCUA should classify all member business loans in risk weight category 5. The proposed member business loan risk weights are again excessive when compared to the Basel III risk weight standard for banks. Similar to the mortgage concentration argument above, MBL concentration by itself does not correlate to loss exposure. Like most credit unions with higher concentrations of MBL, Purdue Federal Credit Union has invested in staff expertise, systems, and processes and is able to demonstrate better underwriting and loss mitigation practices than lower concentration credit unions. Punishment for higher concentration alone, negates the benefits of the authorities granted Purdue Federal under the low income credit union (LICU) designation. The Proposed Rule will excessively restrict Purdue Federal's ability to grant business loans in the communities we serve. Purdue Federal's growth of MBL will be limited by the proposed excessive capital requirements and may necessitate a charter change in order to remain competitive in our local community.

e. <u>NCUA should move CUSO investments to category 5 risk weight.</u> The risk weight is extremely punitive when considering that CUSO's now include a level of regulated oversight by NCUA. No benefit is given within the Proposed Rule for the strength of the CUSO balance sheet. The final rule should also clarify CUSO risk weight exclusions for any CUSO investment accounted for on credit union financials as consolidated according to GAAP accounting. For instance, Purdue Federal is 100% owner of a CUSO and prepares consolidated financial statements for Call Report filing and annual audited financial statements. As a result, CUSO assets are grouped with like-kind Purdue Federal assets during the consolidation process according to GAAP. Appropriate RBC risk weights will be applied to each CUSO asset separately.

f. <u>NCUA should move mortgage servicing rights to risk weight category 5.</u> Mortgage servicing rights according to GAAP require an independent market valuation and are recorded as an asset at the lower of cost or market. Any adjustment is recorded through income in the year of a valuation loss and reduces capital. Interest rate changes influence the value of the asset and the corresponding cash flows. Therefore, this is another example asset where value is influenced by interest rate risk and can be hedged appropriately using derivatives. Therefore, the existing 250% risk weight is too punitive.

3. **The final rule should contain a practical implementation schedule and retention of risk mitigation credit to allow flexibility.** The following are suggestions to allow credit unions some flexibility at meeting the spirit of RBC requirements and also meet the reasonable demands of the membership:

   a. <u>NCUA should extend the time for credit unions to meet new regulation requirements into 2019.</u> Many credit unions will be forced to raise capital in order to be considered well-capitalized under the new regulation. Credit unions are capital growth constrained in comparison to banks since the only way to raise capital for all credit unions not designated as a LICU is limited to net income. Other Federal Banking Regulatory Agencies are giving banks a phased implementation period ending in 2019 to meet new Basel III standards. Credit unions need far more than 18 months to modify their earnings stream to meet new capital requirements under the Proposed Rule.

b. NCUA should retain risk mitigation credit rules in Section 702.108 of the final rule, allowing individual credit unions flexibility at lowering RBC requirements. The present rule allows due process for safe and sound credit unions to appeal for modified risk limits. The proposed rule loses this nuance, dissuading credit union from properly mitigating risks if no credit is given. Credit union boards are tasked to make critical financial judgments, determine the strategic direction of the credit union, and oversee policy in order to serve the needs of the membership. Credit unions that prove individual asset class risks support a lower risk measure can then divert capital to expand other services to their membership. This flexibility is an important aspect to retain, especially if risk weight burdens are increased.

Thank you for the opportunity to comment on this proposed rule and for considering our views on RBC requirements.

Sincerely,

Robert A. Falk
President/CEO

Brian D. Musser
Vice President of Finance/CFO

Robert W. Bain
Board Chairman

Stephen E. Brewer
Board Treasurer

Christiane E. Keck
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