Affinity Federal Credit Union

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May 22, 2014

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Proposed Rule: PCA- Risk-Based Capital

Dear Mr. Poliquin:

**EXECUTIVE SUMMARY**

We appreciate the opportunity to comment on the National Credit Union Administration ("NCUA") Board's proposal to revise and replace NCUA's current prompt corrective action ("PCA") rules, including a new method for computing NCUA's risk-based capital measure, for federally insured natural person credit unions (the "proposed rule").

Affinity is an ardent supporter of risk based capital and has modeled the credit union under the Basel standardized as well as Internal Ratings Based (IRB) methodologies for several years. Stress testing is incorporated into the ALM process. The credit union constructs various scenarios to assess capital adequacy. *Assessing the probability of disaster possibilities is critical to balancing the risk return trade-off.* Taking action based on the potential impact of stress scenarios without considering probability will lead to risk avoidance and risk reduction and have a detrimental impact on an institution's ability to capitalize on market opportunities and build capital. Managing a financial institution based on the worst case scenarios will lead to obsolescence.

We endorse the risk based capital approach that federal regulators enacted for community banks[1]. The common international practice in regulating credit unions is to use risk weightings that are generally similar or identical to those applicable to banks under the Basel standardized approach.[2] It is unclear why NCUA would like to depart from the global community of regulators that adopted the Basel approach and NCUA believes that credit unions in the US require more

[1] https://www.federalregister.gov/articles/2013/10/22/2013-24532/regulatory-capital-rules-regulatory-capital-implementation-of-basel-iii-capital-adequacy-transition.

[2] Credit Union Capital Adequacy: What's New and What's Next? Filene Research Institute. Michael Andrews, A. Michael Andrews and Associates Limited

onerous risk weighted asset calculations relative to credit unions in other countries or the community banks in the United States. An unintended consequence will be relegation of our industry to the sidelines because its regulator imposes requirements that thwart the ability to compete, grow or increase capital.

Affinity is the largest credit union in New Jersey with assets of $2.2 billion. We have invested in the people, systems and governance required to support the risks we underwrite. Large credit unions compete with banks every day, have sophisticated risk management expertise and lower risk profiles than banks. The lower risk profile is demonstrated in Attachment 1. This shows that delinquency ratios, Net Charge-Off Ratios and Failed Institution Percentage have been lower in the credit union community when compared to FDIC insured institutions. Natural person credit unions did not require any federal assistance during the financial crisis and were a continuous source of loans and a safe haven for deposits throughout that time period. Credit availability to the very sectors of the economy that are critical to GDP growth—mortgages and loans to small businesses—will be reduced given the penal risk weights for these assets that are included in the proposed rule.

Imposing more stringent risk weighted asset calculations on institutions with less risk is unwarranted and fails to support the objective of Financial Stability Oversight Council for coordinated supervision of regulated financials. The current guidelines for community banks are an appropriate standard for credit unions. The community bank risk based capital model will avoid curtailment of service to members and enable us to manage the credit union and build capital.

As of December 2013, Affinity's 8.72% leverage ratio provides the credit union with a substantial cushion above the 5% minimum that banks require and the 7% minimum that NCUA requires to be considered well-capitalized. However under NCUA's proposal, our risk based capital ratio (RBC) is 10.41% and the credit union falls into the adequately capitalized zone. Under community bank guidelines Affinity's RBC is 12.64%[3] and enjoys a substantial cushion above both the leverage and risk based capital ratio requirements that qualify an institution as "well-capitalized". NCUA's treatment of investments and mortgages are much more stringent than banks, causing the disparity in RBC under the alternative models.

Maintaining a cushion above well capitalized is a priority for Affinity's board of directors. Under NCUA's proposal, the credit union would fall to adequately capitalized for the risk based metric and remain well-capitalized under the leverage/Net-Worth measure. This could result in a modification of our strategic plan and affect our ability to invest in and grow the business in order to serve members today and over the long run.

[3] For purposes of this analysis, we are assuming that the NCUSIF is deducted from the numerator and denominator in both NCUA proposed calculation and the Bank model. If this valuable asset is not deducted from capital, all RBC ratios would be 100 basis points higher.

**Specific issues include:**

**Individual Minimum Capital Ratio (IMCR):** The biggest and most dangerous proposal is the IMCR. It provides examiners & the NCUA Board with totally subjective authority that can override all risk weighting or leverage ratio outcomes. In addition, a review of the Federal Credit Union Act does not specifically authorize the NCUA Board to provide different minimum capital requirements for individual credit unions. *This part of the rule must be removed and never be allowed in any regulatory environment.*

**Inconsistency with bank calculation of Risk Weighted Assets (RWA):** The proposed rule attempts to incorporate multiple types of financial risk exposures into one set of metrics. One of NCUA's goals is to have PCA metrics that address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. Neither Basel III nor the FDIC Interim Final Rule attempts to capture interest rate risk, liquidity risk, market risk, or operational risk in its risk weightings. The bank rules address credit risk in the PCA metrics. FDIC acknowledges that risk exposures and factors other than credit risk may call for an institution to increase its capital levels but employs supervisory assessments, rather than PCA risk weightings, to tailor an individual institution's required capital to its risk profile.

The FCU Act requires that the NCUA Board "shall, by regulation, prescribe a system of prompt corrective action for insured credit unions that is—(i) consistent with this section; and (ii) comparable to section 1831o of this title."[4] This reference to 12 U.S.C. §1831o is to the PCA requirements of the Federal Deposit Insurance Act, as implemented through the Federal Deposit Insurance Corporation (FDIC) regulations. NCUA's proposed risk weights are far from comparable relative to bank requirements as our credit union would require 5X the amount of capital than a bank to support the same investment portfolio and at 31% more capital to support real estate loans. NCUA has proposed a rule that is inconsistent with the Act.

The following chart compares Risk Weighted Assets under NCUA's proposal relative to the Bank model. NCUA's proposed risk weights are not comparable to bank requirements as our credit union would require 519% of the amount of capital that a bank would require to support the same investment portfolio. Non-delinquent 1st mortgages would require 31% more capital relative to the bank model. Overall, the RWA is 124% of what would be required under the bank model. At 10.5%, that is nearly $40 million. That is equivalent to multiple years of Net Income for Affinity.

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[4] 12 U.S.C. § 1790d(b)(1)(A).

| | NCUA | Banks | NCUA/Banks |
|---|---|---|---|
| **Investments** | **$369,081,326** | **$71,171,089** | **519%** |
| Nondelinquent Nonfederally Guaranteed Student Loans | $78,905,872 | $78,905,872 | 100% |
| Nondelinquent Other Loans | $243,338,025 | $307,901,628 | 79% |
| Reportable Delinquent Other Loans | $5,815,989 | $5,815,989 | 100% |
| Nondelinquent 1st Mortgage Real Estate Loans | $635,918,814 | $484,083,667 | 131% |
| Other Real Estate Loans and Delinquent Real Estate Loans | $193,031,151 | $193,031,151 | 100% |
| Small Business Administration Loans | -$13,239,258 | -$13,239,258 | 100% |
| Member Business Loans | $178,629,441 | $178,629,441 | 100% |
| TOTAL LOANS | **$1,322,400,035** | **$1,235,128,490** | **107%** |
| Other Assets | **$130,692,896** | **$112,768,293** | **116%** |
| Off Balance Sheet Items | **$64,625,003** | **$98,251,848** | **66%** |
| **Risk Weighted Assets** | **$1,886,799,260** | **$1,517,319,720** | **124%** |
| **Capital at 10.5%** | **$198,113,922** | **$159,318,571** | **$38,795,352** |

*Specific recommendations regarding risk weighted assets include: Eliminate concentration risk and interest rate risk multipliers from the risk weighted asset calculation. Adopt the FDIC 0% risk weight for exposures that are unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency, including exposures insured or otherwise unconditionally guaranteed by the FDIC or National Credit Union Administration[5]. Recognize the true risk of CUSO activities and differentiate between true equity investments and majority owned CUSOs that follow consolidation accounting.*

**Impedes ability to build capital:** The proposed rule creates a bias in favor of consumer loans. It is clear that NCUA prefers assets that are short term and is partial to retail unsecured exposures. This, along with the severe investment portfolio risk weights, will force credit unions down the yield curve to short duration assets and impede the ability to build capital.

**Interferes with role of the credit union board and its management:** This overly prescriptive and onerous regulation essentially dictates the credit union's balance sheet structure and minimizes the board and management's ability to take calculated risk on behalf of members or structure an investment portfolio that balances risk and return. That is not the job of a regulator.

**CUSOs:** The risk weight applicable to CUSOs is flawed. Not only is the 250% excessive but NCUA double counts exposure for majority owned CUSOs. NCUA's approach is contrary to the DNA of our industry--cooperative efforts to serve members, reduce costs and enhance the industry.

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[5] For risk-based capital purposes U.S. Government agency is defined as an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. These agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Farmers Home Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA). U.S. Government agencies generally do not directly issue securities to the public; however, a number of U.S. Government agencies, such as GNMA, guarantee securities that are publicly held.

*NCUA must differentiate between CUSOs that follow consolidation accounting vs. the equity method.*

**Numerator:** Deducting the NCUSIF from capital assumes that this asset is essentially worthless. Treating this asset as impaired is contrary to GAAP and irrational given that its value is continually preserved through assessments. *We recommend that NCUA reconsider deducting this asset from the numerator and denominator.*

**Supplemental Capital:** The proposed solution should be accompanied by a sincere effort that will result in access to supplemental capital so that there are capital formation alternatives to increase leverage and risk based capital metrics. Capital access is a more constructive approach to achieving capital objectives than actions such as driving out deposits, shrinking assets, curtailing lending or reducing investments in the people, systems, marketing and branching required to win business, secure technology and serve members.

A credit union's net worth ratio is currently determined solely on the basis of retained earnings. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth can dilute a credit union's regulatory capital ratio and trigger non-discretionary supervisory actions under prompt corrective action (PCA) rules. Allowing eligible credit unions access to supplemental capital, in addition to retained earning sources, will enable healthy credit unions to manage asset growth and continue to serve their member-owners efficiently as the country recovers from the financial crisis.

Increasing capital requirements and providing severe regulatory penalties as outlined in NCUA's proposal without enabling credit unions to access alternative capital sources will seriously constrain credit union's role in community based lending.

**Summary:** The focus of the NCUA proposal is very different from the Basel III capital requirements. Basel concentrates on increasing the quantity and quality of capital for banking organizations and addresses credit risk in the risk based capital requirements. Other risks are addressed through the supervision process, not through risk based capital regulations. The proposed regulation imposes onerous and illogical requirements in its attempt to protect the deposit insurance fund. Adopting the risk weights employed by the other federal banking regulators and enabling access to supplemental capital will result in a more vibrant credit union model that will enable credit unions to build their capital through earnings and support the economic recovery. The alternative, to constrain growth and impede capital formation by employing severe capital requirements, will further marginalize the industry.

NCUA officials have at their disposal various supervisory enforcement measures (e.g. warning letters, letters of understanding, and cease and desist orders) to compel a credit union to improve the alignment between its risk exposures and its available capital. NCUA can use these supervisory enforcement measures to more precisely address individual imbalances between risk exposure and capital adequacy rather than an across-the-board arbitrary framework that focuses on the size and maturity distributions of various assets without due consideration of other factors that have a significantly more direct bearing on loss, such as poor governance, insufficient credit and interest rate risk management expertise, and lack of internal controls.

**SECTION BY SECTION ANALYSIS**

**702.102 (a) Capital Categories**
Consistent with the Act, NCUA maintains the statutory Net Worth PCA levels in the proposed rule. Attachment 2 compares PCA metrics for the NCUA relative to bank PCA metrics. The minimum leverage ratio (Tier 1 capital/Total Assets) required to be considered well capitalized is 7% at a credit union and 5% at a bank. The 7% vs. 5% leverage requirement means that credit unions are permitted to lend $14 dollars for every $ of capital while banks can lend $20 per $ of capital. Thus, the NCUSIF is protected by 40% more of the highest quality capital relative to bank regulators. Credit unions understand that the 2% spread is in recognition that credit unions do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers. However, further restricting lending by implementing the proposed risk weighted asset calculations is unduly harsh.

NCUA explains that the proposed PCA metrics for the Total Capital Ratio is equivalent to banks. ***However, the NCUA calculation for risk weighted assets (denominator) is much more conservative than banks.*** Thus, for a given balance sheet the risk weighted assets (denominator) is usually higher than the risk weighted asset under the bank model. Affinity's risk weighted assets are substantially higher relative to the bank model.

**Section 702.104(b) (2) Risk-based Capital Deductions**
Deducting the NCUSIF from capital assumes that this asset is essentially worthless. Treating this asset as impaired is contrary to GAAP and baseless given that its value is continually preserved through assessments. This is a more troublesome issue for strong credit unions. This asset is refunded to a credit union undertaking conversion to a bank charter and thus has value to a going concern and should not be deemed worthless. Deducting the asset from the numerator is a worst case approach. Continuing to force credit unions to hold capital to accommodate the Armageddon scenario affects the ability to compete in markets that price on expected returns. If one prices based on worst case outcomes, they would be out of business in an efficient market such as the US financial markets.

**Section 702.104 (c) (2)**
**Category 1, 0% Risk Weight:** Direct and unconditional claims on the U.S. Government, its agencies, and the Federal Reserve should be risk weighted at zero percent. The proposed rule does not distinguish credit union deposits in Federal Reserve Banks from deposits in other financial institutions. We believe this approach fails to take into consideration the substantial differences between Federal Reserve Banks (which are integral parts of the Federal Reserve System – the world's leading central bank) and other financial institutions. In addition, NCUA's penal risk weightings for securities that carry the unconditional guarantee of the US government will influence the liquidity of these securities. The securities of these agencies carry

the guarantee to enhance liquidity and support certain segments of our economy. NCUA should not undermine the liquidity of these securities. It defies the intent of the unconditional guarantee.

**Concentration Risk multipliers for real estate and member business loans:** NCUA requires increasing risk weights for concentrations in real estate and member business loans. Risk weights increase as the % of assets in these loan categories increase. The bank model does not impose these increasing risk weights. Credit unions would require 2x the capital relative to bank competitors for each $ of current 1st mortgage exposure over 35% of assets if the concentration risk multipliers for real estate loans are not modified. Concentration above 20% of assets for other real estate exposures results in 150% of what is required under bank rules. More importantly it assumes that any individual loan above the thresholds have greater risk purely based on the structure of the credit union's balance sheet which is absolutely false from a credit risk perspective.

**Interest Rate Risk multipliers for investments:** NCUA incorporates interest rate risk multipliers into the investment portfolio. Risk weights for investments increase as a function of weighted average life of the investment. NCUA would risk weight our investment portfolio at 5X what the bank model suggests as the bank model does not include interest rate risk in the calculation of risk weighted assets. A ten year agency debenture under the NCUA proposal would be risk weighted at 10 times what the community bank model requires. An unintended consequence of the onerous risk weights for investments in GSE securities and securities that are unconditionally guaranteed by the US Government is a reduction in liquidity in these markets. Impacting liquidity for GSE paper is not something our legislators would support. It defies the intent of the legislators that put the guarantees in place and strive to support critical sectors of our economy.

Interest rate risk is adequately addressed in NCUA's interest rate risk regulation and is amply analyzed in the supervisory exam. Furthermore, including interest rate risk in PCA requirements without including the offsetting liability metric is not sound. Ignoring the use of derivatives, term borrowings and impact of non-maturity shares will give a conservative but extremely misleading picture of interest rate risk. We understand that NCUA is concerned about an immediate increase of 300 Basis Points in rates. However, the risk associated with a 300 Basis Point move in rates for 10 years is 26% not 150%. (PV. N=10. I=2.5%. PMT =3%). NCUA is suggesting the risk weighted asset requires nearly 6 times the amount of actual risk associated with an immediate rate increase of 300 basis points because they believe that a credit union should have a $ for $ match for risks to capital resulting from a 300 basis point increase in rates. Assigning no probability to the potential for an immediate 300 basis point increase in rates requires a credit union to have capital for the worst case result. Again, this is not the way a market works and will not enable credit unions to invest wisely with a realistic calibration of risk vs. return.

A more rational approach: If NCUA adds must add additional weight for interest rate risk, the scale should escalate from 23% at 1 year (3% + 20%) to 46% at 10 years (20% + 26%) for GSE securities.

**Category 9, 250% Risk Weight: Total Value of Investments in CUSO's:** Majority owned CUSOs are accounted for under the consolidation method of accounting whereby the assets of the Credit Union and its majority owned CUSOs are combined in a single statement of financial condition. When a majority owned CUSO is initially capitalized, an investment in CUSO account is established on the books of the Credit Union. The CUSO records the asset and related equity. Subsequent earnings are recorded in that investment in CUSO account to coincide with the increased equity of the CUSO. In the consolidation process, the Credit Union and all of its CUSOs are added together and the investment in CUSO account is eliminated against the equity of the CUSO to avoid double counting. Assigning a risk weighting to an asset that is eliminated in consolidation is flawed. The assets of the CUSO are already included in the combined single statement of financial condition.

We have an 80% owned CUSO with cash on its books. Under NCUA's method we would have to hold 250% against that cash. We own the cash and can dividend it up at any time. Why would NCUA impose a capital charge on that? But that is the effect of imposing a risk weight of 250% for Investment in CUSOs for CUSOs that are fully consolidated. The 250% risk weight should be limited to unconsolidated CUSOs.

**Logical Inconsistencies**: Assigning risk to investments based on maturity but ignoring interest rate risk in the mortgage portfolio leads to logical inconsistencies in measurements of risk. Consider the following:

- Credit union A has $100 million in 30 year fixed rate mortgages. Less liquid asset, retains all credit and interest rate risk. At a 50% risk weight, this results in a $50 million risk weighted asset.
- Credit union B has $100 million in 30 year fixed rate mortgages BUT sells to Fannie Mae and takes back a $100 million mortgage backed security (7 year average life) backed by the same mortgages. Liquid asset, NO credit risk and same interest rate risk. This results in a 150% risk weight and $150 million risk weighted asset.
- Credit union B has less risk and 3X the risk weighted asset.

Should unsecured credit risk be weighted at 75% while the top end of 1st mortgages be risk weighted at 100%? Should a 30 year US Treasury security be risk weighted at 0% while a GSE security with a lesser average life carry up to a 200% risk weight?

**Section 702.105 (c) Standards for Determination of Individual Minimum Capital Requirements (IMCR):** Lastly, one of the more troublesome elements of this proposal is Section 702.105. This section provides examiners discretionary authority to impose Individual Minimum Capital Requirements (IMCR). Providing examiners with broad based authority to impose subjective requirements on what capital should be will lead to inconsistent treatment of credit unions and inhibit a credit union's ability to manage the business. It renders the risk-based weighting process outlined in the regulation as a mere guide from which examiners can start in requiring additional capital and, if not complied with, imposing corrective actions on the credit union without reasonable appeal options. It is unfair if the regulator can move the goal posts as the board and Management attempt to define and implement strategic decisions to serve members and increase capital.

Thank you for the opportunity to share our thoughts.

Kind regards,

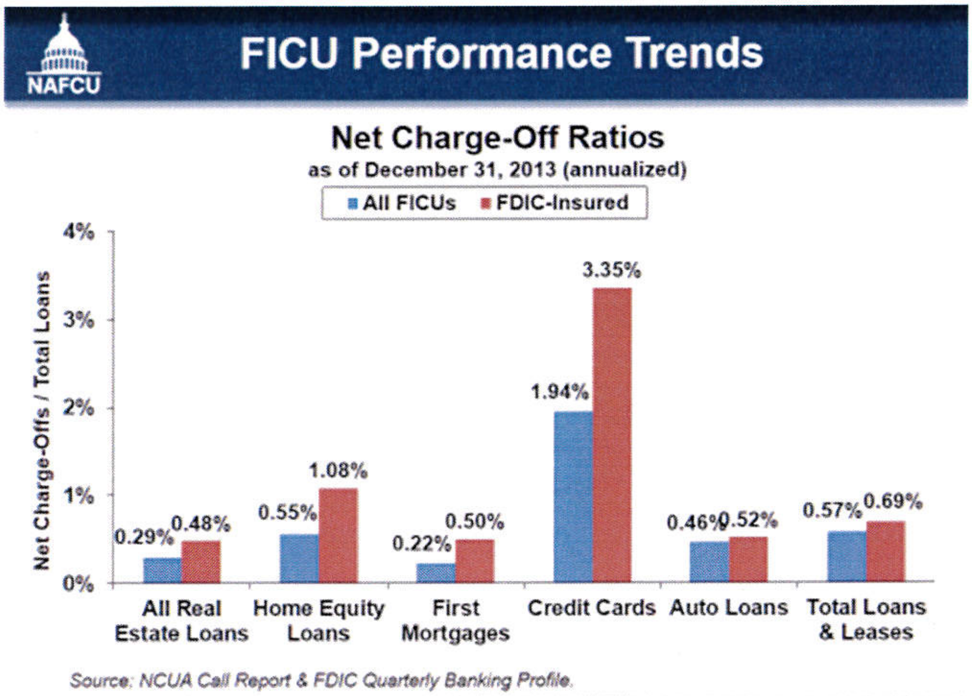
John T. Fenton
President & Chief Executive Officer

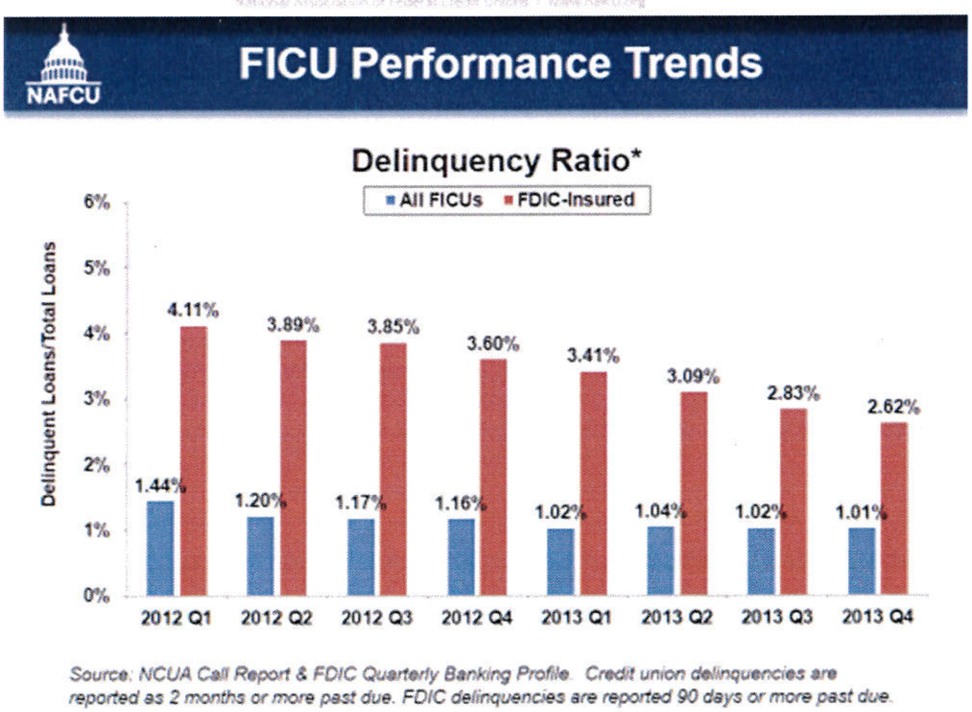
Denise McGlone
Denise McGlone
EVP, Chief Financial Officer

cc Members of Congress

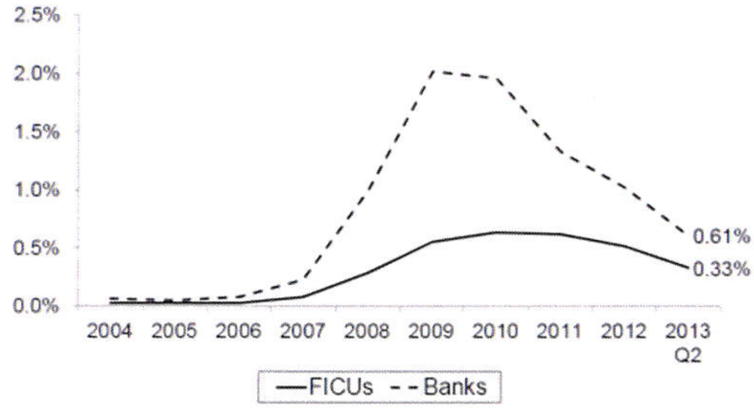
Attachment 1

**CREDIT UNION VS BANK CREDIT RISK**



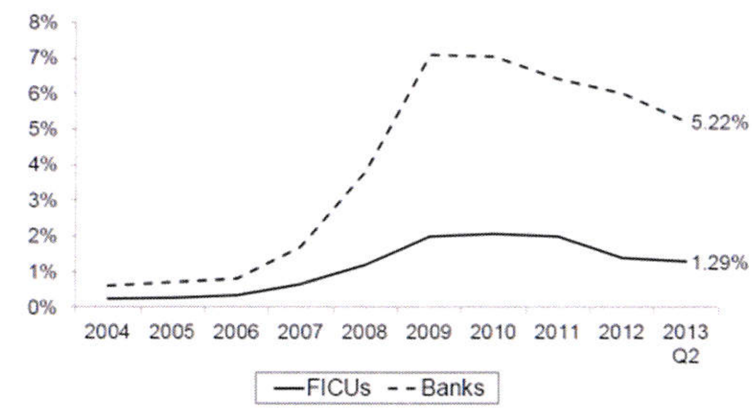



## Real Estate Charge-offs



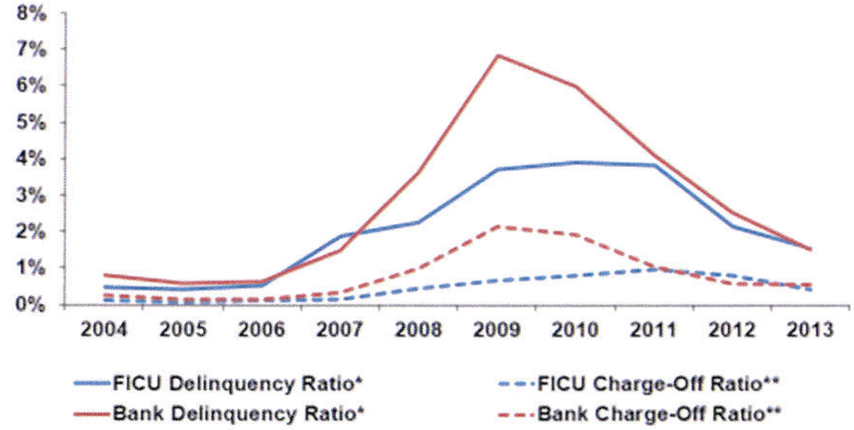

Source: NCUA, FDIC

## Real Estate Delinquencies*




FICU delinquencies are 60 days or more late; bank delinquencies are 90 days or more late
Source: NCUA, FDIC

## Member Business Loans



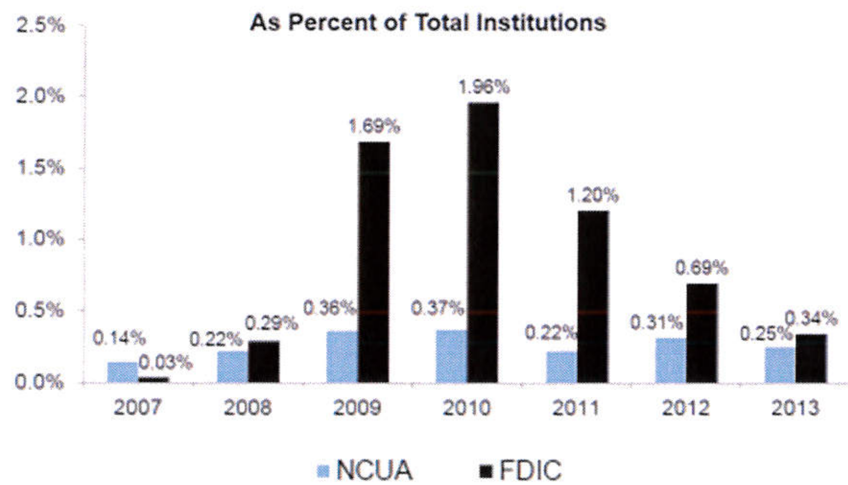

*Note: FICU delinquencies are reported as 2 months or more past due, while FDIC delinquencies are reported 90 days or more past due

** Annualized

Source: NCUA 5300 Data, FDIC Quarterly Banking Profile



## Failed Financial Institutions




Source: NCUA Share Insurance Reports and Statements, FDIC Failed Bank List

Attachment 2

**PROMPT CORRECTIVE ACTION**

| | BASEL III Community Banks Capital Rule | NCUA Proposed |
|---|---|---|
| **Prompt corrective action levels: Leverage ratio** | | |
| Well capitalized | ≥ 5% | ≥ 7% |
| Adequately capitalized | ≥ 4% | ≥6% |
| Undercapitalized | < 4% | ≥4% |
| Significantly undercapitalized | < 3% | < 4% |
| Critically undercapitalized | < 2% | < 2% |
| **Prompt corrective action levels: Tier 1 capital ratio** | | |
| Well capitalized | ≥ 8% | N/A |
| Adequately capitalized | ≥ 6% | N/A |
| Undercapitalized | < 6% | N/A |
| Significantly undercapitalized | < 4% | N/A |
| **Prompt corrective action levels: Total capital ratio** | | |
| Well capitalized | ≥ 10% | ≥10.5% |
| Adequately capitalized | ≥ 8% | ≥ 8% |
| Undercapitalized | < 8% | < 8% |
| Significantly undercapitalized | < 6% | N/A |

| | |
|---|---|
| **Leverage Ratio** | **Tier 1 Capital/Assets** |
| **Tier 1 Capital Ratio** | **Tier 1/Risk Weighted Assets** |
| **Total Capital Ratio** | **Tier 1 + Tier 2/RWA** |