May 28, 2014

Missoula Federal Credit Union

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

Re: Proposed Rule – Prompt Corrective Action – Risk-Based Capital (RIN 3133-AD77)

Dear Mr. Poliquin:

Missoula Federal Credit Union (MFCU) appreciates the opportunity to submit comments on the proposed risk-based capital requirements rule. MFCU is based in Missoula, Montana, with assets approaching $400 million and a net worth Ratio of 8.9%. We are Montana's second largest credit union in terms of asset size. We serve roughly 45,000 members, with a penetration rate of about 29% in our field of membership.

MFCU supports the NCUA's efforts to improve the current prompt corrective action (PCA) capital framework. In particular, MFCU agrees that a change in the PCA framework to put more emphasize on credit risk is appropriate and helpful. MFCU supports aligning capital requirements with those in the Basel III standards for the banks and thrifts promulgated by the joint banking agencies. We also applaud NCUA for recognizing that secondary capital should be included as capital for the thousands of low-income designated credit unions that have statutory authority to include secondary capital as net worth. We hope that these changes can lead to clearer, more effective, transparent, and consistent capital requirements.

In the summary section of the proposal, NCUA states five specific goals. The majority of our comments below will revolve around the second goal: "...(T)he requirement should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk". MFCU is concerned about such a goal. We believe that a framework designed to address all of those risks in a standardized fashion will create incentives to increase credit risk in order to reduce the other stated risks. Of course these other risks are important, but MFCU believes they are best addressed through credit union policy along with seasoned and knowledgeable supervision. In particular, interest rate risk is very difficult to address in a standardized fashion, especially in a framework that ignores liabilities. We believe a singular focus on credit risk would make the framework more consistent with the Basel III standards for banks and thrifts. This is important to MFCU, and indeed to all credit unions subject to the proposed rule, because these are our competitors. If credit unions face higher capital mandates than do banks for the same activities, we will be at a competitive disadvantage, which will result in slower accumulation of capital and more risk to the NCUSIF.

In the following sections we offer comments and recommendations that we believe will help improve and focus the proposed rule. The comments are sorted by section of the proposed rule, followed by a summary.

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Section 702.102(a)(1) – Capital Classification: Well Capitalized
Section 702.102 of the proposed rule discusses capital classifications, with subsection 102(a)(1) specifically defining "Well Capitalized". MFCU agrees with, and appreciates, the simplified approach of using 10.5% as the classification for a well capitalized credit union instead of the more complicated approach with a 2.5% capital conservation buffer used by the joint banking agencies.

Section 702.103 – Applicability of Risk-Based Capital Ratio Measure
Section 702.103, among other things, specifies which credit unions will be subject to the proposed rule. In it, a credit union is "complex", and hence subject to the rule, if total assets exceed $50 million.

MFCU believes this definition of complexity should not be based simply on assets, and in any case the asset limit is much too low. To be sure, any reasonable definition of a complex credit union would include MFCU, so our observation is offered in the spirit of improving the proposed rule to help smaller credit unions that struggle under an already difficult regulatory burden. Complexity is about assets with risks that are less predictable. Asset size is not a direct cause of complexity, and in any case $50 million is not a large balance sheet today. Indeed, credit unions under $250 million do not create substantial risk to the NCUSIF.

MFCU recommends that NCUA either creates a classification rule that incorporates explicitly the actual causes of balance sheet complexity, or at the least raises the asset size threshold to $250 million.

Section 702.104(b)(2) – Risk-Based Capital Numerator Deductions
In this section of the proposed rule, NCUA lists the four elements that are deducted from capital in order to calculate the numerator for the capital requirement. One of the deductions is the NCUSIF Capitalization Deposit.

The purpose of deducting these elements is to exclude assets that are unavailable to the NCUSIF in the event of a credit union's liquidation. Goodwill is an example of such an asset. However, the NCUSIF deposit is available to the insurance fund to cover losses. This provision penalizes credit unions with a large share base – those that serve well members who save – as opposed to those more reliant on wholesale funding. As an example, a quick calculation suggests that this deduction alone reduces MFCU's ratio by as much as 1 percentage point, as our share to asset ratio is more than 86%.

MFCU recommends that the NCUA not deduct the NCUSIF deposit from the capital ratio numerator as doing so incentivizes credit unions to emphasize wholesale funding at the expense of retail depositors.

Section 702.104(c) – Total Risk-Weighted Assets
NCUA assigns risk weights in this section of the proposed rule. As stated in the proposal, NCUA explicitly puts higher weights on higher concentrations and on investments with longer weighted average lives (WALs). The purpose of the higher weights is to address concentration and interest rate risks on credit union balance sheets. These weights are higher than those in the Basel III standards for banks and thrifts, as the joint banking agencies do not attempt to manage risks other than credit risk with this framework.

MFCU believes, as stated above, that the proposed rule is trying to address too many risks with one rule. Besides complicating an effort that was meant to simplify and standardize, penalizing concentration and interest rate risk with this rule weakens the emphasis on credit risk, which is the primary risk to the NCUSIF. The rule would incentivize credit unions to take on more credit risk in order to avoid the capital costs imposed by the higher weights on other risks. It is particularly difficult to understand how this rule can usefully control interest rate risk without any reference to the liability structure on a balance sheet. It is also important to note that the proposed rule would put credit unions at a disadvantage relative to banks and thrifts, which hurts the movement, the membership, and in turn the NCUSIF. With a diminished ability to accrete retained earnings, credit unions will be less able to grow capital.

The risk weights seem to be inconsistent across asset classes, which leads to perverse incentives and induces more risky activities. Two examples are below:

- The risk weights appear to have a strong bias toward consumer lending, regardless of whether the consumer loan is secured or unsecured. As an example, an unsecured, non-delinquent consumer loan receives a risk-weight of 75%, which is lower than either a secured member business loan or a secured other real estate loan at 100%. Furthermore, if either of these latter loan classes exceeds 25% of total assets, their risk-weights increase to 150% and 200%, respectively. This incentivizes a credit union to originate unsecured consumer loans at the expense of secured business or real estate loans, especially if concentration leads to higher risk weights, no matter the quality of the collateral. In other words, the ability of a particular credit union to manage credit risk according to its core competencies and market is sacrificed in order to steer the credit union product and service offerings toward a globally regulated mix.
- Thirty year first mortgages, even if delinquent, face a lower capital requirement, at no more than 100%, than a new U.S. Government Sponsored Agency mortgage backed security, which as a pool very likely would have a WAL greater than 5 years and thus face a risk weight of at least 150%. Again, control of credit risk is sacrificed –the security is free of credit-risk – in this case in order to avoid interest rate risk.

There are numerous other examples of inconsistencies that we have seen in other comment letters to the NCUA.

MFCU believes that the risk weight on Mortgage Servicing Rights (MSRs), at 250%, is too high and would induce perverse incentives. Firstly, the valuation of MSRs is negatively correlated with most other assets on the balance sheet. As rate increase, most asset values decline, but MSR values increase. This makes MSRs a counter-cyclical source of risk reduction. Additionally, such a high weight on MSRs incents credit unions to sell servicing to an outside company or a large bank, which could put memberships into lower quality servicing relationships, harming the credit union movement as a whole.

MFCU also believes that the risk weight on CUSO equity, at 250%, is high and would induce perverse incentives. CUSOs are a way for credit unions to combine forces in order to provide services to the membership for less cost and with less risk. For example, MFCU belongs to a CUSO that provides credit and debit card services to its membership. We could attempt to provide those services on our own. That would be far more costly and risky, but the assets we would use to provide those services would face only a capital requirement of 100%.

MFCU recommends that NCUA eliminate higher risk weights related to higher concentration and longer WALs. Concentration and interest rate risk, important as they are, can be addressed to the extent necessary through credit union policy along with seasoned and knowledgeable supervision. We also recommend that risk weights correspond as much as possible to those in the capital requirements in the

Basel III standards, so that credit unions and their membership are not put at a disadvantage relative to banks and thrifts.

Section 702.105 – Individual Minimum Capital Requirements
This section introduces a provision in the proposed rule that establishes the procedure to allow the NCUA to raise the capital requirement for any individual credit union, where the circumstances indicate that a higher requirement would be appropriate.

MFCU believes this section of the proposed rule is arbitrary, and defeats the purpose of standardizing the requirement. With this provision, there is no way a board or management team can be sure it understands what the capital requirements for its credit union really are. In subsection (b), one of the considerations for establishing an IMCR at a credit union is the existence of a portfolio "which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms". In truth, what financial institution does <u>not</u> meet this standard? Therefore, <u>any</u> credit union could be subject to an IMCR. This section of the proposed rule creates confusion and reduces clarity and transparency, effecting the very opposite of the NCUA's objectives.

MFCU recommends removing this provision from the proposed rule. We believe that the NCUA already has the authority it needs under the current enforcement process to require additional capital from credit unions that should have it.

Summary
MFCU supports the NCUA's effort to protect the NCUSIF through the use of a standardized and transparent capital requirement rule. We believe the greatest risk to the NCUSIF is from credit risk on credit union balance sheets. As a result, we would like to see the rule more focused on credit risk, by eliminating the higher weights associated with asset concentration and longer WALs. In particular, we believe the risk weights should follow the Basel III standards so that credit unions are not at a disadvantage with banks and thrifts. We also believe the NCUSIF deposit should remain part of the numerator in the capital ratio, in order to support those credit unions that provide retail deposit services to the membership. Finally, and in the interests of clarity and transparency, we believe section 702.105 and the IMCR should be removed from the proposed rule, as the NCUA already has the authority it needs to require additional capital from those credit unions that should have it.

MFCU appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at 406-523-3301 or jack.lawson@missoulafcu.org.

Sincerely,

Jack Lawson
President & CEO
Missoula Federal Credit Union