

September 26, 2014

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

Re: National Credit Union Administration; Federal Credit Unions Ownership of Fixed Assets; 12 C.F.R. Part 701; 79 Federal Register 46727, August 11, 2014

Dear Mr. Poliquin:

The National Credit Union Administration (NCUA) has requested comments on a proposal which would amend its regulation governing federal credit union (FCU) ownership of fixed assets. The proposed rule would remove the waiver requirement for FCUs to exceed the five percent aggregate limit on investments in fixed assets. An FCU that chooses to exceed the five percent aggregate limit would be able to do so without prior NCUA approval provided it implements a fixed assets management (FAM) program. In addition, the proposal simplifies the partial occupancy requirement for premises acquired for future expansion by establishing a single time period for *any* property—improved or unimproved—of five years.

While the American Bankers Association¹ (ABA) is supportive of efforts to reduce regulatory burdens, ABA believes that allowing an FCU to invest unlimited amounts into fixed assets poses a risk to the safety and soundness of an FCU. In addition, ABA believes that “simplifying” the partial occupancy requirements for premises acquired for future expansion to five years creates opportunities for credit unions to more easily participate in impermissible real estate activities.

Furthermore, ABA would note that the proposed rule is inconsistent with the statutory requirement that an FCU purchase, hold and dispose of property necessary or incidental to its operations.² As the NCUA Board stated in 2004, “[f]ederal credit unions are chartered for the purpose of providing financial services to their members and it is not permissible for them to engage in real estate activities that do not support that purpose.”³

ABA’s Position

To begin with, ABA strongly encourages NCUA to **not** eliminate the fixed asset threshold requirement. Secondly, ABA would recommend that NCUA strengthen the waiver process which permits an FCU to exceed the current fixed asset threshold. Only FCUs meeting the prompt corrective action (PCA) definition of well-capitalized and maintaining a CAMEL rating of 1 or 2 who can demonstrate an ability to manage fixed asset investments and have established

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$15 trillion banking industry and its 2 million employees. Learn more at aba.com.

² 12 U.S.C. 1757(4).

³ 69 Federal Register 58041, September 29, 2004.

the necessary tools (e.g., risk management and audit systems) should be granted a waiver. In addition, because investing unlimited amounts into fixed assets could adversely affect the safety and soundness of an FCU, NCUA should require an application and prior approval for each investment that exceed the current five percent threshold. This would ensure FCUs that do exceed the threshold are properly prepared to handle the risks involved. Further, if an FCU is making an investment in a fixed asset that will not exceed the current five percent threshold, the FCU should be required to notify NCUA of the investment within 30 days after the investment was made.

Eliminating the Fixed Asset Threshold Could Adversely Affect Safety & Soundness of FCUs

ABA believes that allowing an FCU to invest unlimited amounts into fixed assets poses a risk to the safety and soundness of an FCU.

NCUA has previously commented “that investing in higher levels of non-earning assets can materially affect a credit union’s earnings ability and, therefore, its viability. Call report data collected by NCUA shows a higher percentage of earnings problems among credit unions with more than five percent of shares and retained earnings in fixed assets; the percentage of earnings problems increases as the level of fixed assets increases.”

For example, between 2005 and 2006 an FCU substantially increased its investment in fixed assets to 14.77 percent of total assets by relocating its main office, opening a new branch and converting the old main office into a branch. This caused operating expenses to increase to 99.85 percent of gross income, leaving insufficient earnings to cover loan losses, pay dividends and maintain net worth. The FCU was placed under supervision by NCUA’s Division of Special Actions as its net worth dropped from 10.76 percent in 2005 to 6.10 percent in 2010.⁴

Moreover, the Material Loss Reviews (MLRs) of several failed credit unions noted the contributory role excessive investment in fixed assets played in the demise of several credit unions.

- Beehive Credit Union’s Board failed to adequately take into consideration a \$3 million branch expansion, an annual budget containing high operating costs that included new computer and phone systems and the continued operation of all nine branches had on the deterioration in the credit union’s liquidity and earnings.
- The MLR of Telesis Community Credit Union found that excessive operating expenses contributed to the credit union’s failure. The MLR concluded that “management contributed further to the excessive operating costs by constructing two buildings that were far bigger than necessary and the construction costs went far over budget because material costs, particularly steel costs, were not set prior to building and increased dramatically during the period of construction.”

⁴ 75 Federal Register 14372, March 25, 2010

- Fixed assets were cited as a cause of Eastern New York (ENY) FCU’s failure. According to its MLR, “[t]he Credit Union acquired the Liberty branch office through a merger with Catskill Regional Credit Union. As a result of the acquisition, the Credit Union exceeded the maximum allowable fixed asset ratio. ENY FCU management later sold the building to an investor and then entered into a capital lease arrangement for the same building with the same investor. Management did not properly record the lease as a capital lease, misrepresenting the Credit Union’s financial statements. Compounding the already high fixed asset position of ENY FCU, management set about a branch modernization plan that resulted in nearly \$1 million in additional leasehold improvements to this branch.”
- The NCUA’s Office of Inspector General cites the expansion of fixed assets as a contributor to the failure of Ensign FCU. The MLR noted that between 2004 and 2009 the credit union went from two branches to five branches. The acceleration in fixed asset growth caused an increase in operating expenses and reduced income earning assets. At the time of Ensign’s failure, total fixed assets, including operating leases, totaled \$11.8 million or 11 percent of total assets, which exceed the regulator limits.

These examples demonstrate the adverse effect lifting the fixed asset threshold requirement could have on the safety and soundness of credit unions.

Regardless, whether under the existing authorities or those presented in the proposal, NCUA should at the very least require an application and prior regulatory approval for fixed asset investments beyond a reasonable level.

Simplifying Partial Occupancy Requirement Opens Door to Impermissible Real Estate Activities

ABA would like to reiterate that the current requirement for partial occupancy is meant to ensure that FCUs are not engaged in impermissible activities. The proposed amendments could be subject to abuses and could enable an FCU to make impermissible real estate investments, which is beyond the statutory authority of an FCU.

ABA encourages NCUA to leave the partial occupancy timeframe requirement as is—permitting an FCU up to three years from the date it obtains the property to meet the partial occupancy requirement, or six years if the premises are unimproved land or unimproved real property. ABA recognizes the need for additional time when working with unimproved real estate.

However, ABA recommends that the NCUA issue additional guidance on partial occupancy as the current guidance is sufficiently vague.⁵ ABA believes the guidance should require an FCU, or a combination of an FCU, credit union service corporations (CUSOs) and credit union vendors, to occupy at least 51 percent of the premises to meet partial occupancy requirements.

Furthermore, the current rule does not set a specific time period within which an FCU must achieve full occupancy of premises acquired for future expansion. Rather an FCU must

⁵ See 12 CFR 701.36(d)(2) and 12 CFR 701.36(6)

demonstrate, among other things, that it will fully occupy the premises “within a reasonable time.” Historically, a reasonable time has been three years for national banks.⁶ ABA believes the NCUA should require full occupancy within three years of reaching partial occupancy. This measure would ensure FCUs are not participating in impermissible real estate activities.

Moreover, relaxing the partial occupancy requirement will incentivize FCUs to maximize non-mission related income from leasing out their properties. The leasing of unoccupied space is neither necessary nor incidental to the operation of a FCU and would represent unrelated business income. However, FCUs are not subject to Unrelated Business Income Taxes (UBIT), and therefore face an incentive to maximize leasing income by delaying occupancy as long as regulators allow. This is a clear abuse of the credit union industry’s tax exempt status. ABA is well aware that congressional action is needed to address the application of UBIT to FCUs, but believes it is NCUA’s affirmative obligation to the American taxpayers to limit income from unrelated business sources by FCUs.

Conclusion

In conclusion, ABA believes that NCUA’s proposal to amend its regulation governing FCU ownership of fixed assets could adversely affect the safety and soundness of a FCU. ABA strongly encourages NCUA to not eliminate the current fixed asset threshold requirements and would instead recommend that NCUA strengthen its waiver process for FCUs wishing to exceed the current five percent threshold.

Moreover, ABA believes that “simplifying” the partial occupancy requirements could create opportunities for credit unions to more easily participate in impermissible real estate investments. ABA encourages NCUA to issue additional guidance on the definition of partial occupancy and to require full occupancy within three years of partial occupancy of any premises acquired for future expansion in an attempt to further deter FCUs from participating in impermissible investments.

ABA appreciates the opportunity to share its views and would be happy to discuss any of them further at your convenience. If you have any questions, please contact Brittany Dengler at (202) 663-5356 (e-mail: bdengler@aba.com) or Keith Leggett at (202) 663-5506 (e-mail: kleggett@aba.com).

Sincerely,



Brittany Dengler
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⁶ http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/bankprem.pdf