Gerald Poliquin
Secretary of the Board
National Credit Union Administration

Mr. Poliquin,

We appreciate the opportunity to comment on the proposed changes to 12 CFR Parts 700, 701, 702, 703, 713, 723 and 747; Prompt Corrective Action: Risk-Based Capital.

Honda Federal Credit Union serves the Associates of the Honda Companies and members of their families. We have 62,309 members holding $655 million in assets. We also have the distinction of being the only credit union to have received risk mitigation credit under Section 702.108 Risk Mitigation Credit.[1]

We applaud NCUA's efforts to modernize the current Prompt Corrective Action scheme. We have long felt that the current method of measuring Risk Based Net Worth was wholly inadequate and put U.S. credit unions at a decided disadvantage as financial institutions worldwide moved toward adoption of Basel III standards. We were heartened to see several references throughout the proposed rule indicative of NCUA's desire to more closely align credit union capital standards to those of other financial institutions[2],[3],[4]. Unfortunately, as we delved deeper into the proposed rule, we found many instances where NCUA has deviated from the spirit and intent of Basel III exacerbating the disadvantage credit unions already face in comparison to other financial institutions and having the potential to greatly hamper our ability to serve our members.

In the proposed rule, you make note of the fact that NCUA is required to "…take into account that credit unions do not issue capital stock, must rely on retained earnings…" The implication seems to be that the capital requirements for credit unions needs to be considerably more stringent because we do not have the ability to access alternative forms of capital.

Filene Research Institute recently published a report entitled, "Credit Union Capital Adequacy: What's New and What's Next?"[5] The report makes several important comparisons between the Basel III

---

[1] NCUA Prompt Corrective Action: Risk Based Capital: Page 88 – "Credit unions have rarely taken advantage of risk mitigations credits, with only one credit union receiving a risk mitigation credit."
[2] Ibid, Page 4 – "The proposed revisions would include a new method for computing NCUA's risk-based capital measure that is 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."
[3] ibid, Page 12 "The proposed rule would replace the RBNW method currently used by credit unions to apply risk-weightings to their assets with a new risk-based capital ratio that is more commonly applied to depository institutions worldwide."
[4] ibid, Page 17 "As proposed, the rule would modify the current calculation method for computing RBNW to be more consistent with the risk-based capital measures used by the Other Federal Banking Regulatory Agencies."
[5] Credit Union Capital Adequacy: What's New and What's Next?. Authored by A. Michael Andrews, A. Michael Andrews and Associates Limited. Published by Filene Research Institute, February 13, 2014

requirements and the current credit union capital requirements. It also contains conclusions based on research that appears to refute the need for requiring credit unions to hold levels of capital in excess of that of other financial institutions. The following are the points made by the report:

- "From 2008 through mid-2011 there were 85 US credit unions failures, just over 1% of the 7,400 total credit unions operating at year-end 2007. During the same period 369 banks failed, about 5% of the year-end 2007 total. Thus, from both a theoretical and practical perspective, there is no case for higher capital requirements for credit unions relative to banks."[6]
- "Thus, for most US credit unions, capital for the purposes of PCA triggers is entirely comprised of the highest-quality capital, CET1[Common Equity Tier 1]. In a world emphasizing the importance of the highest-quality capital, credit unions already meet a leverage standard more than double the Basel III agreement on a minimum of 3% Tier 1 capital to total assets, with access to only a single element of CET1: retained earnings."[7]
- "In addition to being restricted to only the highest-quality capital for regulatory purposes, credit unions are subject to a leverage limit that is more stringent than the one applicable to banks (Figure 3)."

Figure 3

PCA TRIGGERS – BANKS AND CREDIT UNIONS		
PCA Category	**Credit union net worth ratio*(percent)**	**Bank leverage ratio**(percent)**
Well Capitalized	≥7	≥5
Adequately capitalized	≥6	≥4
Undercapitalized	≥4	<4
Significantly undercapitalized	≥2	<3
Critically undercapitalized	<2	<2

*Retained earnings/total assets

**Tier 1 capital/total assets[8]

- "During the recent crisis, natural person credit unions proved more resilient than banks, calling into question the premise that credit unions have a higher risk profile and thus require additional capital relative to banks."[9]
- "The GAO's conclusion in 2004 was that there was insufficient experience with PCA to reach firm conclusions. With 15 years having passed since the introduction of the CUMAA, including a major financial crisis on which credit unions fared better than banks, there is now evidence that

---

[6] Filene Research Institute, "Credit Union Capital Adequacy: What's New and What's Next", page 9
[7] ibid, page 19
[8] ibid, page 19
[9] ibid, page 23

the risks posed by credit unions do not warrant more stringent PCA triggers than those that apply to banks."[10]

- "In the relatively small number of jurisdictions where credit unions have developed into larger institutions that compete with banks, the merits of a Basel III-type regime should be carefully considered. From the perspective of the credit union system, the main benefit would be ensuring that credit unions face no more stringent capital requirements than their bank competitors."[11]

In light of the above, we feel it will be instructional to look at some of the glaring differences between the proposed rule and actual Basel III standards:

- Investments:

Basel III Weights	NCUA Weights
20%	Maturities of 0 to 1 years – 20%
	Maturities of 1 to 3 years – 50%
	Maturities of 3 to 5 years – 75%
	Maturities of 5 to 10 years – 150%
	Maturities >10 years – 200%

- Nondelinquent First Mortgage Loans:

Basel III Weights	NCUA Weights
50%	Total book balances <25% of assets – 50%
	Book balance in excess of 25% and less than 35% of assets – 75%
	Book balances in excess of 35% of assets – 100%

- Other Real Estate Loans and Delinquent Real Estate Loans

Basel III Weights	NCUA Weights
100%	Total book balances <10% of assets – 100%
	Book balance in excess of 10% of assets and less than 20% of assets - 125%
	Book balances in excess of 20% of assets – 150%

- Delinquent loans – Both Basel III and NCUA use a risk weight of 150%. However, a loan at a bank is not classified as delinquent until it is more than 90 days past due. NCUA considers a loan past due at 60 days. (In actual practice the disparity is even greater. At a bank, if your loan due date is, for example, the last day of the month and you don't make the payment, by the first day of

[10] ibid, page 24
[11] ibid, page 31

the next month you are one day late. Using the same example at a credit union, you are now 31 days late!)

- Member Business Loans:

Basel III Weights	NCUA Weights
100%	Total book balances <15% of assets – 100%
	Book balance in excess of 15% of assets and less than 25% of assets - 150%
	Book balances in excess of 25% of assets – 200%

The proposed rule suggests eliminating Section 702.108, Risk Mitigation Credit. Perhaps we are overly sensitive to this being the one credit union to have received the credit. Be that as it may, many credit unions, including ours, now have very robust systems and policies in place to measure and mitigate risks. In fact, NCUA recently approved the use of derivatives as a tool to mitigate interest rate risk. By not allowing for some method of recognizing credit unions' ability to manage risks, NCUA runs the risk of de-incentivizing credit unions to invest in the resources necessary to manage and mitigate risks. We feel this puts credit unions into a very dangerous mind-set of using additional capital in place of a well-managed risk mitigation program. For example, a credit union might find the use of derivatives to be an effective interest rate risk mitigation tool. However, when faced with the resource burden in managing the derivatives and still having to maintain the same level of capital, the credit union may well choose to forego utilizing the derivative tool.

The proposed rule suggests removing the NCUSIF deposit from both the numerator and denominator when calculating the risk-based capital ratio. We feel that the treatment of the NCUSIF deposit should not be handled in this manner. It is unnecessary and lends credence to critics of the credit union movement that the NCUSIF deposit should not be treated as an asset. To again quote from the Filene Research Institute study; "The suggestion that the NCUSIF deposits should be notionally deducted from capital equates them to intangible assets such as goodwill. This is an inappropriate treatment of an asset that would, in fact, be available to meet the claims of members and other creditors in the winding up of a credit union. "[12]

In summary, as we noted earlier, we are of the opinion that NCUA should take this opportunity to fix the, arguably, flawed current Prompt Corrective Action rule by adopting a modified version of Basel III as have many jurisdictions within Canada as well as the entire credit union movement in Australia. While this proposed rule attempts to move toward a Basel III-like capital scheme, it deviates from the spirit of Basel III by attempting to require additional capital against risks not intended under Basel. For example, concentration risk. Risks outside the intent of Basel would best be addressed through policies, procedures and robust measurement systems. Requiring additional levels of capital in lieu of the management of risk puts credit unions at a severe competitive disadvantage and decreases the overall value of credit union membership.

[12] ibid, page 20

Thank you again for the opportunity to comment on the proposed rule.

Sincerely,

Steve Brandon
CEO
Honda Federal Credit Union