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

Via email to: regcomments@ncua.gov

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

Dear Mr. Poliquin:

On behalf of the United Nations Federal Credit Union (UNFCU), we would like to thank the National Credit Union Administration (NCUA) Board for inviting comments on the above referenced proposed rule for risk-based capital.

UNFCU supports NCUA's initiative to introduce risk-based standards into their capital calculations. It would seem prudent that NCUA as an insurer, review the balance sheet profile of each credit union and require higher levels of capital for those credit unions that choose to acquire higher risk assets. However, the focus of the new risk-based capital rule should be on overall soundness of the institutions and industry. The current applications of risk weighting will negatively effect the business decisions of credit unions in how they currently invest and diversify their asset classes in the future. The proposed risk-based capital rule may discourage credit unions from engaging in businesses that are stable and benefit members, and will furthermore stymie the industry by curtailing future growth in areas such as investments with longer maturities and member business loans. Additionally, we believe the proposed rule should provide greater clarity regarding the risk weighting of certain types of investments and parity with other standards the proposed rule is based upon.

New Risk-Based Capital Rule and Lack of Parity with Other Standards

In the very first paragraph of the proposed rule NCUA states, "the proposed risk-based capital requirements would be more consistent with NCUA's risk-based capital measure for corporate credit unions and the regulatory risk-based measures used by the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, and Office of the Comptroller of Currency". Unfortunately, the proposed NCUA rule does not achieve parity with the Federal Deposit Insurance Corporations (FDIC) risk-based requirements in a number of areas, which are more fully detailed throughout this letter including but not limited to the treatment of investment assets and the time period allotted for compliance with the proposed changes. In

order to achieve its goal of uniformity NCUA may look to align itself closer to the FDIC risk-based requirements.

Cash

For cash and cash equivalent holdings, the risk weight applied to overnight cash that is deposited at a Federal Reserve Bank (either required or excess reserves) and not otherwise lent out as fed funds sold to insured financial institutions, should be treated as Category 1. However, it is not clear if the proposed rule intends to assign such cash held at a Federal Reserve Bank as Category 2 assets, similar to the proposed treatment of fed funds sold to insured financial institutions, which in this case may be overly punitive. Meanwhile, cash held within certain money market mutual funds that invest entirely in U.S. Government obligations, as mandated by such funds' investment policies, should also be treated as Category 1 assets as opposed to the blanket Category 2 classification for all money market fund holdings suggested by the proposal. It is also important to note that many money market mutual funds invest in assets that are not otherwise permissible by Part 703 (e.g. corporate commercial paper, short-term consumer asset-backed securities, etc), and thus perhaps the guidance for risk-based capital rules should include an acknowledgement that the placement of cash within such funds is not allowed.

Investments

In regard to the risk classifications assigned to investment securities, NCUA is incorporating a maturity component as the primary driver of the ultimate risk weighting. In their equivalent analysis of risk weighting for investments the FDIC does not rely on maturity information but instead looks to the underlying credit worthiness of the issuer of the instrument. As an example for an FDIC insured bank, a residential mortgage pass-through security issued by FNMA or FHLMC would be assigned to the 20% risk weighting category. Under the proposed NCUA rule the same security could be assigned a risk weighting as low as 20% (if the security had an average weighted life of one year or less) and up to 200% (if the average weighted life of the investment was greater than 10 years). From the perspective of an insurer it would seem logical that it would be more inclined to consider the credit worthiness of the issuer rather than an arbitrary weighted-average life schedule to gauge the ultimate return of the principal, especially when proposing that NCUA will reserve the right to apply additional capital requirements for insured credit unions that have higher levels of interest rate risk. In short, NCUA introduced an interest rate risk component to risk weighting that is not necessary. Curiously NCUA does adopt the FDIC's approach of looking to the issuer for their Category 1 risk weighing by including U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government and goes on to identify U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS).

The proposed rule does not consider the various levels of credit risks within an investment portfolio while instead placing the risk classification primarily on the interest rate risk of individual security holdings. Furthermore, while a focus is placed on credit risks of the lending portfolio and the interest rates risks within an investment portfolio, it appears that the Board does not place an equal consideration on interest rate risk for the lending portfolio or a reasonably comparable credit risk assessment on the investment portfolio.

More specifically, the rule does not appear to make any mention on which risk weights should be applied to holdings of GSE debt obligations or GSE mortgage-backed securities. It also does not explicitly state if Ginnie Mae mortgage-backed securities can be treated as Category 2 assets along with FHA and VA insured residential mortgages held directly on a credit union's balance sheet. Similarly, while the proposed rule states that loans that are at least 75% guaranteed by the Small Business Administration (SBA) should receive a Category 2 classification, there is no indication if the same treatment would be applied to investment securities guaranteed by SBA, which can either be securitizations of small business loan pools or pools of other fixed rate debentures or securities issued by SBA approved investment conduits. If indeed NCUA intends for the risk weights of GSE debt obligations and GSE mortgage-backed securities to be based on its described method of calculating weighted-average lives, then this falls short of adequately capturing the reduced credit risk component of investment securities. For example, while assuming that most investment securities are solely subjected to weighted-average life risk classifications, if a GSE fixed rate MBS security had a seven year weighted average life it potentially may receive a 150% risk weight within Category 7, however its credit risk may be explicitly or implicitly guaranteed by the U.S. government (depending on the agency) and thus should rather receive a lower weight in practice. Meanwhile, despite most likely having more credit risk embedded within a retained loan portfolio than when compared to GSE supported MBS investments, mortgage loans that are less than 25% of total credit union assets would receive a lower 50% risk weight within Category 3. It is worth reiterating that FDIC capital regulations state that GSE obligations receive a 20% risk weighting and that specifically GNMA MBS investments receive a 0% weighting, without any special consideration to the weighted-average lives of such obligations.

Another application of where the proposed rule may not meet its intention is in introducing risk weights that capture both investment credit and interest rate risk. This can be exhibited when considering three hypothetical investment securities of similar term and coupon structure, however from three separate issuers within three different sectors. Moreover, would four year fixed rate ordinary debentures issued by an agency, a municipality, and a bank, all have the same risk weighting? If so, the proposed rule provides no mechanism in order to differentiate between the varying credit risks across these investments sectors in general, while also implying that the NCUA's key concern for these three investments is interest rate risk.

Additionally, applying a 100% risk weighting, or a Category 5 classification, to loan and investment interest accruals that are typically accounted for as receivables on a credit union's balance sheet appears misguided. Moreover, we consider it to be unbalanced that interest accruals potentially may have a higher assigned risk classification than the remaining principal balance of the asset itself. For example, Category 3 is proposed to have a 50% risk-weighting for principal balances of current real estate loans that are less than 25% of total assets and investments having one-through-three year weighted-average lives, yet their associated interest accruals (which would likely be paid within six months or less) are treated as Category 5 assets and are injudiciously deemed riskier in the eyes of NCUA. Although accruals are naturally smaller than principal balances, it is even more concerning that interest accruals on risk-free U.S. Treasury obligations would be treated as Category 5 classifications and not also themselves deemed risk-free by being placed in Category 1. Finally, outside of the accruals for U.S. Government obligations, investment and loan interest accruals for payments due in one year or less should be treated as Category 2 assets, which would compare more reasonably to cash and cash equivalents in general and investments with weighted-average lives of one year or less.

Despite the above concern on the lack of clarity of certain agency securities, either obligations or mortgage-or-asset-backed, we applaud NCUA for placing the onus on credit union investors to understand the overall structure, waterfall mechanics, and embedded credit risks of asset-backed-securities. Although the proposed rule should also make mention of agency collateralize mortgaged obligations to some degree, in that these structures also have complicated features which credit unions should certainly consider in terms of interest rate risk prior to purchase and on an ongoing basis. Simultaneously, regarding Category 10, it would be difficult to imagine a situation where a credit union would voluntarily self assess that they had purchased an asset backed investment which would be placed in the risk weighting of 1,250 percent. An unintended consequence of such a high risk weighting could result in sales of these types of instruments. A more moderate risk weighting for asset backed investments would still curtail major investments in these vehicles but not act as a complete deterrent to investments in this asset class.

Finally, complicating the interpretation of the proposed regulation is the lack of a bifurcation for explicit versus implicit government guarantees, the unacknowledged conservatorship of Fannie Mae and Freddie Mac, and the missing recognition that certain debt issues of Federal agencies (e.g. Federal Home Loan Bank, Federal Farm Credit Bank) indeed have lower credit risk than other investment security issuers. In fact the only mention of Fannie Mae and Freddie Mac at all in the proposal is within the discussion points for the proposed section 702(c)(3), Risk-Weights for Off-Balance Activities, in terms of "loans sold to the secondary mortgage market that feature representations and warranties customarily required by the U.S. Government (e.g., Ginnie Mae) and government sponsored enterprises (e.g. Fannie Mae and Freddie Mac)."

Loans

Looking at NCUA's proposed risk weights for mortgage loans also presents a contrast to FDIC's approach. NCUA is proposing a tiered approach whereby the current and non-delinquent first mortgage real estate loans that are less than or equal to 25 percent of total assets would be assigned a risk weighting of 50 percent. Current and non-delinquent first mortgage real estate loans greater than 25 percent but less than or equal to 35 percent of total assets would be assigned to the 75 percent risk weighting category. Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets would be assigned to the 100 percent risk weighting category. FDIC has adopted a more straightforward approach where loans secured by 1 – 4 family residential properties are assigned to the 50 percent risk weighting category. NCUA is making the calculation more complicated than necessary and by assigning higher risk weightings to segments of the portfolio above a certain percent of total assets is, unwittingly, discouraging credit unions from originating first mortgage real estate loans to members.

While we are pleased to see that investments with variable or hybrid coupon structures will have weighted-average lives according to their next reset date in order to determine their risk classification, thus potentially identifying that there are varying interest rate risk profiles across different investment structures, real estate loans such as adjustable-rate-mortgages should also have a similar treatment. Also, the interest rate risk of significant exposures to long-term fixed rate mortgages is not directly considered in the proposed classifications, but perhaps it is NCUA's intention within Section 702.105, Individual Minimum Capital Requirements, to address such concerns by penalizing certain credit unions that have high concentrations in such long-term fixed rate mortgage (which are at risk of severe extension and resulting margin compression) with added capital requirements.

Member Business Loans

NCUA has also taken a tiered risk weighting approach for member business loans. Member business loans that are less than or equal to 15 percent of assets would be assigned to the 100 percent risk weighting category. Any member business loans greater than 15 percent of assets and less than or equal to 25 percent of assets would be assigned to the 150 percent risk weighting and any member business loans greater than 25 percent of assets would be assigned to the 200 percent category. Similar to the non-delinquent first mortgage real estate loan analysis, this tiered approach is over complicating what should be a more straightforward calculation and is also discouraging the origination of these types of loans.

CUSOs

CUSOs were created to provide credit union members with products and services that the credit union could not otherwise provide. The proposed risk weighting of 250 percent for the total value of investments in CUSOs will cause credit unions to reconsider their current investments in CUSOs and possibly have the unintended affect of discouraging any future investments in CUSOs while totally ignoring the upside potential of creating member value through the economies of scale that CUSOs provide.

Imposing Individual Minimum Capital Requirements

Under the proposed rule NCUA can on a case by case basis further analyze a credit union's assets and require higher minimum capital reserves. There is little that a credit union can do to plan for the supervisory assessment without an examination and leaves the entire industry open to arbitrary and uneven standards enforced by individual examiners instead of an industry wide accepted standard. This allows for subjective rulings effectively creating a way for amendments to the proposed rule without formal Board approval and commentary which does not help the industry at large and can greatly harm an individual credit union without much recourse. The individual minimum capital requirements process is inapposite to the stated purposes of the proposed risk-based capital rule and should be amended.

Time Period for Compliance

The time period for compliance with this new rule once it's effective is a mere 18 months. FDIC institutions, many of which have deeper resources and an existing familiarly with the application of risk-based capital, have approximately five years to comply with the new BASEL III requirements that were also introduced over a period of years. The length of time that credit unions have been given to comply with these new standards almost guarantees non-compliance as credit unions won't have adequate time to supplement additional capital or engage in businesses which have a lower risk weighting in order to maintain their current capitalized status. More time is needed to fully implement lasting changes after the rule takes effect that will positively benefit the credit union industry and maintain proper capitalization protecting against systemic risks.

Conclusion

While UNFCU supports NCUA's introduction of risk-based capital standards we believe that several changes to the proposed rule are warranted. Accordingly, we respectfully request that you give strong consideration to aligning the risk weighting percentages for loans and investments with what the FDIC has adopted and give further consideration to lowering the risk weighting percentages for MBLs, asset backed and CUSO investments. We would also respectfully request that NCUA provide greater clarity surrounding the risk weights of certain types of investments. Additionally, credit unions should be provided with more time to comply with the rule after it takes effect that is more in line with the BASEL III capital standards for FDIC insured institutions.

Thank you again for the opportunity to comment and for your consideration of UNFCU's position on this proposed rule.

Very truly yours,

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cc: William Predmore, President/CEO, UNFCU