Tuesday, May 6, 2014

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

Subject: Proposed Rule on Prompt Corrective Action (PCA) – Risked Based Capital

Mr. Poliquin

We applaud NCUA's attempt to revise and replace the current PCA rules for federally insured credit unions. However, the current proposal is inconsistent with Basel III, does not provide adequate time for implementation, constricts credit union lending, unjustifiably classifies complex credit unions, and fails to provide a means for credit unions to access supplemental capital.

The objective of the financial reforms from Basel III "is to improve the banking sector's ability to absorb shocks arising from financial and economic stress…"[i] Despite NCUA's assertion that the NCUSIF "…experienced several hundred millions of dollars in losses due to failures of individual credit union…" the NCUSIF actually performed well during the financial crisis while the FDIC technically became insolvent. This raises the question; why is NCUA pursuing this proposal with such urgency at this time? Nonetheless, we will attempt to elucidate our specific concerns about the risk based capital proposal.

The Federal Credit Union Act (FCUA) "requires NCUA to define the term "complex" credit union based on the portfolios of assets and liabilities of credit unions."[ii] In addition, "The design of the risk based net worth requirement should reflect a reasoned judgment about the actual risks involved" and "…requires the NCUA to prescribe, by regulation, a system of prompt corrective action for federally insured credit unions that is consistent with the specific restrictions and requirements of new section 216 and comparable to section 38 of the Federal Deposit Insurance Act. 'Comparable' here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor."[iii]

We believe the Congressional intent in designing a RBNW system has not been prudently used by NCUA in designing a risk based capital framework in the following ways:

Complex Credit Unions

The proposal would redefine a credit union as complex based on its asset size alone without consideration for its portfolio mix of assets and liabilities, which contradicts the FCUA's requirement that NCUA define the term complex based on the portfolio of assets and liabilities. A credit union that engages in short-term consumer lending with excess deposits invested in federally insured institutions and treasury securities and whose liabilities consist of a mix of non-maturing deposits and share certificates should not be considered complex; while, another credit union that engages in funding long term loans and complicated asset backed securities with short term liabilities would have a completely different risk profile. Reasoned judgment of the actual risk involved between these two hypothetical credit unions require that criterion other than asset size be used to define a complex credit union.

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NCUSIF Deposit

We are concerned that removing a credit union's NCUSIF deposit from the numerator and denominator of the risk based capital calculation sends a signal to users of financial statements that the deposit is a worthless asset on the balance sheet of a credit union. In the event of a credit union's liquidation the NFUSIF deposit would be available to cover losses. However, we do not believe our NCUSIF deposit is worthless because upon conversion from or termination of federal share insurance we would "Receive the full amount of its [our] NCUSIF deposit paid, less any amounts applied to cover NCUSIF losses that exceed NCUSIF retained earnings, immediately after the final date on which any shares of the credit union are NCUSIF-insured."[iv] Therefore, we would like to see the NCUSIF deposit retained in the numerator of the risk based capital calculation and removed from the denominator.

Risk Weighting of First Lien Real Estate Loans

The proposed risk weighting of first lien real estate loans is inconsistent with FDIC's guidance on residential mortgage exposure of 1-4 family mortgages for community banks, which includes a 50% risk weight for prudently underwritten loans that are not past due, reported as nonaccrual, or restructured, and a 100% risk weight for all other residential mortgages. Under NCUA's proposal our credit union would be at a competitive disadvantage to community banks. Relying on just concentration risk to determine is a ham-handed approach to mitigating risk by arbitrarily assigning concentration risk limits on real estate loans. Nonetheless, we recognize interest rate risk is a serious threat to the industry but there are many tools to mitigate that risk such as net interest income (NII) modeling to ensure measuring, monitoring and managing the potential impact of possible future changes in interest rates to a credit union.

Additionally, 52% of our credit union's first lien real estate loans were written as 10-year fully amortizing fixed-rate mortgages. The 10-year loans tend to have higher FICO and lower LTV than longer-term first lien real estate loans and tend to have a faster conditional prepayment rate (CPR). Risk weighting our credit union's real estate loan portfolio based exclusively on concentration ignores credit, collateral, interest rate, liquidity, and other risks inherent in this type of portfolio. Additionally, under the proposed risk weighting no consideration is being given to whether or not a real estate loan is fixed-rate versus variable-rate. Therefore, we do not agree that concentration risk should be the only measurement in a risk based capital framework. If so, then it should be on par with community banks with a 50% risk weight regardless of concentration.

Delinquency/Credit Risk

We disagree with NCUA's assertion that the ALLL is intended to cover only "estimated, incurred losses…rather than unexpected losses. Management's estimate of future losses is in fact based on a loan portfolio's past performance to project future losses. Nonetheless, credit unions should be given the same consideration as community banks when calculating risk based capital by not considering a loan impaired and subject to risk based capital consideration until it is 90-days past due.

Individual Minimum Capital Requirements

Under the proposed rule, subjective judgment[v] would be allowed in determining individual minimum capital requirement (IMCR) for a credit union. We object to allowing individual examiners to determine the IMCR for credit unions. There has been a long history of complaints to NCUA and within the industry of individual examiners injecting personal biases into the examination process. It's inconceivable to imagine any situation where all NCUA examiners could determine an appropriate level of IMCR for any individual credit union.

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Allowing subjective examiner opinions about IMCR would create confusion and uncertainty in the industry and potentially cause well-capitalized credit unions to not engage in the merger of distressed credit unions due to how examiners may view acquired assets. Additionally, credit unions may be slow to create or adopt innovative lending products to meet the ever-changing needs of members due to uncertainty of their examiners' opinions about the new products.

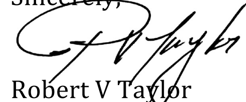
Implementation Period

The short implementation period is unjust and unnecessary given the complexity of the proposed risk based capital rule. The implementation period is not consistent with Basel III because banks were given a much longer period for implementation. We encourage NCUA to provide the same amount of time to implement the new risk based capital rule, in whatever form the final rule takes, to ensure credit unions have ample time to make the necessary adjustment to the balance sheets and strategic plans.

Conclusion

The proposed risk based capital rule is complex and radically different from PCA. NCUA has been repeatedly asked by CUNA and NAFCU to extend the comment period by 90 days, which has been repeatedly denied. We have spent a great many hours researching and pondering the impact of the proposed rule and do not believe that we have had ample time to thoroughly evaluate the many nuances of the proposal. We also add our voice to the chorus of credit unions asking for additional time to evaluate the proposal to submit comments to the NCUA Board. However, from out limited review we have identified several issues above that will negatively impact our credit union and the industry, and respectfully ask NCUA to withdraw the proposal altogether. A new proposal should follow the intent of Congress relating to PCA as well as including provisions for supplemental capital for all credit unions in capital reform.

Sincerely,



Robert V Taylor
President/CEO
Idaho State University FCU

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[i] Basel III: A global regulatory framework for more resilient banks and banking systems. December 2010 (rev Jun 2011)

[ii] FCUA Section 1790d(d)

[iii] Senate Report 193, 105yh Congress., 2nd Session 13 (1998)

[iv] 12 CFR §741.4

[v] §702.105(c)

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