May 15, 2014

Part II - FAQ on NCUA's Proposed RBC Rule

Examples of Different Risk-Weights

Under Basel III for Banks	Proposed For CUs	Proposed Risk-Weight
Investments = 20% to 50% (depending on type)	Investments (Weighted Average life)	WAL 0-1 yr 20% WAL 1-3 yr 50% WAL 3-5 yr 75% WAL 5-10 yr 150% WAL 10+ yr 200%
Current 1st Lien mortgages = 50%	Current 1st Mortgage	< 25% Assets – 50% 25%-35% - 75% >35% Assets – 100%
Junior Lien Real Estate and Delinquent RE = 100%	Junior Real Estate and Delinquent 1st	<10% Assets – 100% 10-20% - 125% >20% - 150%
Commercial Loans = 100% High Volatility Commercial real Estate Loans = 150%	MBLs	<15% Assets – 100% 15% to 25% - 150% >25% Assets – 200%

NCUA's proposed risk weights also reflect non-credit material risks, such as concentration risk or price sensitivity (interest rate risk)

NATIONAL CREDIT UNION ADMINISTRATION

13:06 / 17:11

After watching the video on the RBC proposal I felt the need to comment. It seems as though the NCUA is overweighting interest rate risk (IRR) and not considering underwriting. It is understood that IRR is potentially the "next" biggest risk facing credit unions but please remember that risks move in cycles just as interest rates do (credit, IRR, liquidity, concentration etc.). I copied the above graph in to highlight a few items. First, you seem to be overemphasizing short-term investment products. While I fully understand that credit unions in general should not extend investment maturities due to IRR, you are by regulation reducing viable earnings potential. You are advocating keeping investment purchases very short. It is even mentioned in the video that short-term Treasuries are a good place to keep funds and are risk weighted at zero. You're right,

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but there is no risk / reward to short-term Treasuries. Financial institutions make money on spread. The typical medium to small credit union makes 80%+ of their revenues on the net interest margin. If managers and boards follow this guidance you will have a significant increase in low earning credit unions. There are numerous credit unions who have very low loan to share ratios, and because of this invest in mortgage backed securities – thus increasing the investment portfolios WAL and earnings without significantly affecting their liquidity position. I would suggest that you leave the RBC ratings the same as they are under Basel and do not totally rely on WAL for risk weighting measures. Potentially you could put an "outlier" WAL risk assessment penalty on those credit unions that disregard IRR measurements. Maybe the NCUA could assess a capital requirement if a credit union doesn't have enough short term investments to allow for an adequate liquidity program.

Second, in regard to mortgages you are assuming that all mortgages are long term loans, thus creating significant IRR. This is not the case with my credit union and others. We have a significant portion of 1st mortgages and home equity (junior liens) loans that we originated with a 10 year term. We do not do 25 or 30 year mortgages because we currently cannot sell them. We also have a product that amortizes up to 30 years but reprices every 5 years, which reduces the IRR dramatically. Mortgages and home equity loans have historically had the lowest delinquency rates. These are typically the safest credit risk loans to originate. By regulation you are suggesting that credit unions should not have a significant portion of their assets in mortgages regardless of term. The result of that, again, is low earnings. We all should know that long term mortgages carry significant IRR. I would hope that the NCUA not put risk weightings higher than the suggestions under the Basel model. I would submit that you could put an "outlier" WAL risk assessment penalty on those credit unions that disregard IRR measurements. Maybe the NCUA could assess a capital requirement if a credit union doesn't have enough short term investments to allow for an adequate liquidity program.

Third, MBLs don't need to have a higher risk weighting if the underwriting is done correctly. A lot of risk in MBLs comes from not having experienced lenders. And we are already held to 12.25% of our assets for MBLs. I would advocate keeping the Basel measurements.

Fourth, holdings at the Federal Reserve should have a zero risk weighting. I can't think of any reason why the NCUA would suggest any rating besides a zero. There is no safer, shorter term, more liquid investment available. U.S. Treasury securities are rated at zero, why wouldn't Federal Reserve holdings be?

In summary, I think that moving to a risk based capital model is appropriate as the rest of the financial institutions in our country have been using one for quite some time. I think there are items that need to be considered for change in the current model proposed by the NCUA. I would like to see the NCUA take into account the ramifications to earnings by implementing the rules suggested. I understand that a regulatory body would ultimately push for safer low risk transactions but that is usually opposite of the earnings potential available. Credit unions need to be able to make enough in earnings to support continued growth. Lower earnings mixed with growth will lead to eventual poor capital positions and an increase in low rated credit unions.

Thank you for your attention,

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