May 16, 2014

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

RE: Comments on Proposed Rule: PCA - Risk-Based Capital; RIN 3133-AD77

Dear Gerald Poliquin,

We wish to go on record as not in favor of the regulatory changes to the Risk Based Capital Rule as they have been proposed. We strongly believe to proceed with implementation of this rule will do harm to individual credit unions and weaken the overall credit union charter by restricting and discouraging important lending activities and even discourage certain important investment decisions.

The risk based capital rules, and the formulas that have been proposed will result in over regulation of some credit unions and under regulation of others. The proposal attempts to address credit risk, liquidity risk and interest rate risk (and other risks) through the use of the one metric, required capital. Since each of these risks are distinctly different in the way they are measured and in the methods that credit unions use to mitigate each of these risks, the regulation is not going to be effective.

For example; under the proposed rule an investment in a U.S. Treasury Bond with a weighted average life of greater than 10 years requires a 0% reserve, however, an Agency backed Bond of similar duration would require a reserve of 200%. Both bonds pose a substantial risk of devaluation during periods of increasing interest rates; however, they are treated vastly different in the RBC calculation. This disparity completely misses the interest rate risk that an organization takes when purchasing a longer term bond, and probably does not even realistically address the credit risk, if any. Only a comprehensive evaluation of both assets and liabilities could determine the appropriateness of both of those investments for a given credit union.

The proposed regulation has more flaws; for example, limiting the amount of a credit union's Allowance for Loan Loss (ALL) account to 1.25% of risk assets arbitrarily lowers the capital ratio calculation. Just a few short years ago, NCUA demanded that credit unions substantially increase the amount of reserves placed into their Allowance for Loan Loss Account in anticipation of higher losses as a result of the economic downturn. In many cases, a new Quantitative and Environmental (Q & E) factor was required resulting in many credit unions substantially increasing ALL balances. Now as the economy recovers many credit unions, including ours are reversing these Q & E additions, as we see that they were unnecessary. This is another illustration why these arbitrary limitations will undoubtedly skew the RBC calculation, in this illustration causing a credit union to hold higher reserves than may be needed.

Another example of a new capital penalty to credit unions is the exclusion / deduction of our NCUSIF Capital Deposit from the numerator in the RBC calculation. This asset is on the asset side of the balance sheet because it represents funds on deposit with our insurer, the National Credit Union Share Insurance Fund. This asset is equal to 1% of insured deposits and should be counted as part of capital. The NCUSIF deposit is designated as a “reserve” or “capital” to be used for covering and insuring members’ deposits. What is the logic for excluding this capital from the Risk Based Capital calculation?

A review of the RBC metrics shows that duration is a primary factor in determining the level of capital required for investments that a credit union makes. This ignores a credit unions loan-to-share or loan-to-asset ratio, applying a “one size fits all” metric to all credit unions. Certainly a credit union that has a low loan-to-share ratio and or a low concentration of longer term real estate loans may need to invest much longer in the investment portfolio than a credit union with a longer duration and perhaps a higher percentage of direct to member real estate loans. Again, this method will likely result in an unnecessary capital penalty for some credit unions.

The RBC metric for real estate loans increases the reserve requirement for credit unions that have greater percentages of real estate loans, again punishing an organization for serving its members real estate loan needs, discouraging making real estate loans over 25% or 35% of total assets. Credit unions are in business to make loans to members, including real estate loans and this seemingly arbitrary ramping up of capital requirements for organizations that are being successful in meeting their member needs will be penalized with higher capital requirements. This is not good, and does harm to credit unions.

Perhaps the most significant flaw in the entire proposal is that the RBC metrics focus entirely on “Assets” and ignores the liability side of the balance sheet altogether. In a well-managed credit union, as much focus is given to structuring member deposits as is given to making good loans of a variety of duration, including both fixed and variable. How can we look at only half of the picture of a credit unions financial “balance sheet” and conclude that it does or does not have adequate capital? Only a comprehensive Asset Liability analysis can model what may happen in different interest rate scenarios. And even this analysis must consider the individual credit unions actual member behavior, account longevity and interest rate sensitivity. Every credit union pays for and invests a significant amount of management and board of director’s time to evaluate the various risks in their respective balance sheet, and the proposed RBC system ignores the liability side of the balance sheet completely. Again this is not good, it is not comprehensive and does harm to credit unions.

There are other flaws in this proposed regulation that are bring pointed out by other credit unions and organizations that support the credit union industry. We are not in favor of this proposed regulation and implore NCUA to slow down before forcing poorly crafted regulation into law. NCUA should use the tools available in the quarterly reporting process and through the examination process to comprehensively evaluate the adequacy of capital in each credit union. This is difficult but achievable, and will not result in further over regulation of credit unions.

Sincerely,

Brian Hall
CEO
Foothill FCU

cc: CCUL