May 20, 2014

Local Government Federal Credit Union
Charter Number: 24003
323 West Jones Street
Suite 600
Raleigh, NC 27603

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

Re: Commentary for further consideration of NCUA's proposed rule changes on Risk-Based Capital 12 CFR Parts 700, 701, 702, 703, 713, 723, and 747.

Dear Mr. Poliquin:

Local Government Federal Credit Union ("LGFCU") appreciates the opportunity to comment on the National Credit Union Administration Board's ("NCUA") request for comments on its proposed amendments to the Prompt Corrective Action – Risk Based Capital Proposed Rule. For informational purposes, LGFCU was founded in 1983 as a not-for-profit, federally-insured financial cooperative, chartered specifically to serve North Carolina's local government employees, elected/appointed officials, volunteers and their families. LGFCU is a $1.4 Billion dollar credit union serving 240,965 members, with the majority of its members located in North Carolina.

As requested, LGFCU has made several comments to NCUA's proposed questions regarding the rule changes on Risk Based Capital. LGFCU is in support of a Risk Based approach to capital management as this can help provide transparency and clarity as to why an institution is, or needs to be, capitalized at a particular level. However, LGFCU believes the Risk Based Capital proposal by NCUA is too rigid and restrictive in certain areas, particularly when evaluated in the context of the Basel capital rule adopted by US banking regulators.

We believe that substantive changes to the rule, as provided by our comments and recommendations outlined below, will provide a more effective and significant rule for credit unions, while still upholding the intent of the risk based capital requirements of the Federal Credit Union Act.

LGFCU breaks the issues down into four broad categories.

1. **Exclusion of NCUSIF Deposit Reserve**
2. **Punitive and inconsistent application of risk weightings**
3. **Timing of implementation for a change to risk based capital system**
4. **Access to additional sources of capital [supplemental to retained earnings]**

Exclusion of NCUSIF Deposit Reserve

Comment:

The requirement within the proposed rule that the NCUSIF deposit and offsetting reserve be deducted from the calculation of risk based capital has an adverse and unnecessary impact on the risk based capital calculation for what is effectively an on-balance sheet reserve for credit unions. While the NCUSIF deposit is deducted from both the numerator and denominator of the calculation, thereby having a seemingly innocuous affect, such a deduction will have a material impact on a Credit Union's RBC ratios. To help illustrate this point, LGFCU would experience a capital reduction of nearly 100 bps if both sides of the RBC Ratio are reduced. To illustrate it another way, the impact would be the equivalent of including the NCUSIF deposit in the ratio with it having a capital weighting of 925%.

Recommendation:

Because the NCUSIF deposit is an on-balance sheet asset of credit unions drawn from operating earnings to serve as a loss reserve, LGFCU recommends NCUA include the NCUSIF deposit asset as a component of the denominator and the offsetting reserve as a component of capital in the numerator of the risk based capital calculation. The practical effect of doing otherwise would be to regard the NCUSIF deposit as a risk asset with the equivalent of nearly 1,000% capitalization. As such, the deposit should be regarded as a component of capital for risk based calculation purposes and afforded a zero percent risk weighting from an asset perspective. This notion is further supported by looking through to the underlying holdings of the NCUSIF, which is comprised of US Treasury bonds as well as cash on deposit with the US Treasury.

Risk Weightings

LGFCU appreciates NCUA's desire to be more consistent with the risk based capital requirements of our US Federal banking agencies while still applying a level of simplicity appropriate for credit unions. However, there are some inconsistencies with the proposed Asset Risk Weightings that we feel require attention. They can be broken down into four areas of focus:

1. Cash on Deposits
2. Investments

3. MBL's
4. Current 1st Mortgage
5. CUSO Investment

Comment re: Cash on Deposits:

A 20% risk weighting broadly applied to cash on deposit is very inconsistent with US Federal Banking regulations. In fact, there is no logical explanation for why cash on deposit with the Federal Reserve should require a risk weighting above zero. The US Treasury department maintains its own operating cash account with the Federal Reserve as the Fed serves as the backbone of the US payments and settlements system. A case could be made to require a non-zero risk weighting for cash held in "correspondent" account relationships other than those directly with the Federal Reserve, such as a corporate credit union that serves the cash management needs of downstream credit unions. Differentiation between such cash accounts are important to incorporate in the risk weightings if the NCUA is attempting to address counterparty credit risk associated with cash on deposit.

Recommendation:

LGFCU recommends NCUA bifurcate cash on deposits between "Cash Held on deposit with Federal Reserve" and "Cash Held on deposit with Other Financial Institutions," with "Cash Held on deposit with Federal Reserve" attracting a 0% risk weighting, and "Cash Held on deposit with Other Financial Institutions" attracting a 20% risk weighting.

Comment re: Investments:

The proposed risk weights associated with investments is another area of discrepancy with US federal banking regulations. Additionally, and importantly, the proposed investments risk weights focus solely on addressing interest rate risk without consideration of credit quality.

Specifically, differentiation between US Agency MBS, Callable and Bullet Securities (issued by Freddie Mac and Fannie Mae) is appropriate relative to any Non-Agency issued mortgage securities or other corporate debt. With these two housing finance agencies remaining in Conservatorship since September 7th, 2008, the U.S. government continues to stand behind all of the GSE issued debt, with a guarantee backstop that is akin to the support provided to NCUA issued guaranteed notes which are afforded a 0% risk weighting.

LGFCU, as well as the markets at large, recognize distinct difference between US Agency (Freddie Mac & Fannie Mae) securities and Non-Agency issued MBS (and certainly corporate credit as well), and thus believe it is reasonable for such delineations to be incorporated within the proposed Investment Risk Weighting Matrix.

***Recommendation*:**

Accounting for the difference of Agency credit quality while incorporating scaled weighting for concentration of long dated exposures, LGFCU recommends the following alternative risk weighted matrices for Investments beyond direct, unconditional, U.S Government obligations or NCUA issued guaranteed notes, which are afforded 0% risk weightings.

Proposed: Freddie Mac & Fannie Mae Agency MBS.
WAL 0-7yrs – 20%
WAL 7-10yrs – 50%
WAL 10+yrs – 100%

Proposed: Exposures to U.S. public sector entities (PSEs), including U.S. states and municipalities.	
General Obligations	Revenue Obligations
WAL 0-7yrs – 20%	WAL 0-7yrs – 50%
WAL 7-10yrs – 50%	WAL 7-10yrs –100%
WAL 10+yrs – 100%	WAL 10+yrs – 150%

Proposed: All Other Investments.
WAL 0-1yrs – 20%
WAL 1-3yrs – 50%
WAL 3-5yrs – 75%
WAL 5-7yrs – 100%
WAL 7-10yrs – 150%
WAL 10+yrs – 200%

***Comment re: MBLs*:**

With respect to Member Business Loans, LGFCU feels it is important to for NCUA to articulate and bring greater clarity as to why there are "bright lines" drawn for concentration thresholds when determining the proposed matrix risk weightings.

Specifically, it is important to understand the historical loss perspectives that the NCUA is evaluating and incorporating to derive the proposed MBLs risk weight matrix.

***Recommendation*:**

LGFCU's specific recommendation for MBLs pertains to delineating loans to U.S. Public Sector Entities (PSEs) from other commercial type lending. We would suggest the same risk weighting matrix be used for PSEs, whether in loan form or security form.

Proposed: MBLs to U.S. PSEs, including U.S. states and municipalities.	
General Obligations	Revenue Obligations
WAL 0-7yrs – 20%	WAL 0-7yrs – 50%
WAL 7-10yrs – 50%	WAL 7-10yrs –100%
WAL 10+yrs – 100%	WAL 10+yrs – 150%

Comment re: 1st Mortgages:

As with MBLs, LGFCU also feels that, with regard to Current 1st Mortgage Loans, NCUA should articulate and provide greater clarity as to why "bright lines" are drawn to determine concentration thresholds that result in the proposed matrix risk weightings.

LGFCU's own 30yr history of first lien residential mortgage exposure has little evidence of high correlations of default, or contagion, even considering the worst default vintage period of 2007-2008. LGFCU recognizes that consumer behavior, economic drivers and resulting correlations of default may change over time.

***Recommendation*:**

LGFCU feels a more appropriate bright line delineation of 1st mortgage exposure should be as represented in the following risk weighting matrix.

Current 1st Mortgage
< 50% Assets – 50%
50%-75% Assets – 75%
>75% Assets – 100%

Comment re: CUSO Investment:

In the 250% risk weighted category, CUSOs deliver a much lower earnings volatility than mortgage servicing rights, and thus CUSOs should be afforded this distinction in risk weightings. Specifically, CUSO Equity investment risk weightings should not exceed the 100% risk weighting afforded to delinquent consumer loans. Instead, their risk weighting should be equivalent to a commercial or corporate credit risk weight.

Recommendation:

A CUSO Equity Investment should be included within Other Assets at the 100% risk weighting.

Timing of Implementation

Comment:

Within the CU Membership Act of 1998 contains the directive "If the NCUA increased any Net Worth Ratio for Credit Unions, it must give credit unions reasonable time to meet the increased ratio."

The most direct reference to any benchmark for implementing a capital framework change to the financial system comes from the Basel framework. While US banking regulatory adoption of Basel III set forth an 18-month implementation period from the date of the final rule, the bulk of the capital increase for banks comes with the 2.5% Capital Conservation Buffer over and above the 6% Tier 1 Capital and 8% total Risk-based Capital implementation requirements for banks.

While this Capital Conservation Buffer is not explicitly mandatory for banking institutions under the standardized approach, the limitations it imposes on institutions not operating with the 2.5% buffer effectively makes it a requirement for most community banking institutions. Importantly, the Basel III final rule allowed for a 4-year linear phase-in period from the implementation date, or 5.5 years from the dating of the final rule. In effect, the bulk of the capital increase required under Basel III is allowed to occur over a multi-year basis, not just an 18-month implementation period.

This has relevance to an NCUA RBC requirement as it sets the regulatory benchmark for a multi-year phase in period for increasing capital cushions from current levels. This is important for credit unions as supplemental sources of capital are limited as compared to our bank counterparts.

While the NCUA's preliminary analysis indicates the vast majority of credit unions would fall into the "Well Capitalized" category under the proposed Risk Based Capital rule, the practical implications of the rule, as written, are not inconsequential and could cause a broad-based increase in capital across the system. The impacts of the proposed rule can be equally relevant to credit unions that would need to build capital to achieve well capitalized status under the proposed Risk Based Capital treatment, as well as credit unions that fall into the well capitalized category but find it necessary to rebuild an adequate cushion above the new requirement because of the marginal impact the proposed concentration factors have on expanding existing portfolios.

Recommendation:

LGFCU recommends NCUA amend the draft rule to include a **3-5yr phase in period** from the Final Rule. Again, the likely impact is not inconsequential and therefore a multi-year phase in period that minimizes the potential for constraining of credit availability and short run rationing of services would be more appropriate.

Higher levels of credit union capital provide a greater risk cushion; however, if the Risk Based Capital rule puts the system in capital building mode, and forces that capital building too quickly, the practical effect is that credit to members will be constrained as the additional capital is built. The knock on effect is greater rationing of services to credit union members, which has a direct impact on the US economy.

In effect, rapid increases in capital cushions over a short time frame, such as 18-months, has the potential for economic harm to the credit union system as resources are diverted to quickly to capital building. This is an important element in implementing the proposed Risk Based Capital framework as credit unions balance the management of capital against shorter run earnings risks with that of value risks, which impacts earnings over a longer term horizon.

In the summary statements to the draft rulemaking document for PCA – Risk Based Capital, it is noted "The proposed risk-based capital requirements would be more consistent with ... the regulatory risk-based capital measures used by the (Other Federal Banking Regulatory Agencies)." Allowing for a multi-year phase in period to achieve 10.5% risk weighted capital aligns best with the spirit of that statement.

Additional Sources of Capital

***Comment*:**

As noted above, too quick of an implementation period can cause adverse economic effects on the credit union system and the US economy at large. A countermeasure to this, and an important tool in realizing NCUA's objective of continued stabilization and capitalization of risks across the system, would be to authorize a substantive supplemental capital program for the credit union system in coordination with the release of a Risk Based Capital rule. Credit Unions are currently the only financial institutions within the U.S. financial system that do not have the authority to raise supplemental capital and have it count statutorily towards an institution's capital requirement.

NCUA has recognized the importance of Supplemental Capital. In fact, in its April 2010 Supplemental Capital White Paper, NCUA recognized three important instruments that can serve as valuable tools for capital purposes: Mandatory Membership Capital, Voluntary Patronage Capital and Subordinated Debt. Of these three recognized tools, Mandatory Membership Capital (MMC) has the most utility as equity and is the most suitable for the credit union model.

Recommendation:

In coordination with its advancement towards a Final Risk Based Capital Rule, the NCUA should re-affirm with Congress its legal authority to authorize Federal Credit Unions to use Mandatory Membership Capital as a tool for secondary capital.

Supplemental capital, such as MMC, can be an important tool in the capital management of credit unions. Evidence of the historical behavior of credit union share balances supports the notion that share deposits have equity like behavior. Specifically for LGFCU, a significant portion of our share balances have equity like characteristics with respect to their longevity and their sensitivity between rate and balance.

We believe credit unions' interests are aligned with NCUA's with respect to ensuring sufficient capital is maintained, so that ultimately, credit unions can serve their members over the long run. Additionally, capital reserves should be based on a stressed version of reality, but also grounded in actual experience nonetheless. This is particularly true with respect to impacts from balance sheet concentrations.

In summary, LGFCU supports a Risk Based Capital framework and NCUA's efforts to enhance it. However, as the rule is currently constructed, we believe there are a number of areas in need of improvement. By considering our recommendations for the rule, we believe a more effective and significant rule for credit unions can be established, while still upholding the meaning and intent of the risk based capital requirements of the Federal Credit Union Act.

Once again, LGFCU would like to thank you for the opportunity to provide comments on the proposed amendments to the RBCA Rule. Should you have any questions, please feel free to contact me at (919) 755-0534.

Sincerely,

Sander Casino
Senior Vice President, Finance