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May 20, 2014

Board of the National Credit Union Administration
c/o Gerard Poliquin, Secretary of the Board
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comment Letter to Proposed Regulation regarding
Prompt Corrective Action; Risk Based Capital

Dear Board Members of the National Credit Union Administration:

On behalf of Evangelical Christian Credit Union (ECCU), we respectfully submit these comments to the proposed regulation regarding prompt corrective action and risk based capital issued by the National Credit Union Administration (NCUA) and published on February 27, 2014.

ECCU generally supports NCUA's proposal to replace the current risk-based net worth framework with a risk-based capital approach consistent with Basel III standards recently adopted by federal banking regulators. However, the significant differences in risk-based capital requirements between the NCUA's proposal and the federal banking regulation will result in competitive disadvantages for credit unions and poorer quality of service for millions of credit union members.

This comment letter analyzes the NCUA's proposed risk-weights for member business loans (MBLs) which result in substantially higher capital requirements for credit unions with concentrations above 15%. In some cases, the proposal would require credit unions set aside 21 cents in capital for every dollar of MBL, which is extraordinary considering the historically low charge-off rates of commercial loans and the other sources available which absorb loan losses prior to capital: allowance for loan losses and net income. For ECCU's 1,600 member churches, schools, and charities, the proposed regulation will result in significantly reduced funding for projects which support our members' service to congregations, local communities, and persons in need. We believe this result violates the congressional intent of the Credit Union Membership Access Act which directs the NCUA to avoid undue restrictions on financing for worthy projects by credit unions exempt from the MBL cap.

Concentration risk should not be mitigated through a one-size-fits-all risk-based capital regulation. As the NCUA noted in the proposed regulation's commentary, there are several means by which loan concentration risk can be mitigated. Relying on higher capital requirements to address concentration risk is simplistic and imprecise. An analysis of the performance of credit unions with different MBL concentration levels reveals that those with higher concentrations experienced lower loan losses than other credit unions. In addition, the 2012 Government Accountability Office's (GAO's) report of credit union failures concluded that credit union failures were overwhelmingly caused by poor management, not concentration. In fact, the GAO did not find MBL concentration was an early warning indicator of a troubled credit union. Because measuring, monitoring, and mitigating concentration risk is a complex task, management of this risk should be addressed through the supervision process, and not through a one-dimensional capital requirement.

For these reasons, we recommend the NCUA adopt MBL risk-weights that are equivalent to the risk-weights assigned to commercial loans by the federal banking regulators.

In this letter, we also ask that the NCUA adopt: (i) an MBL unfunded commitment conversion factor equivalent to the federal banking regulation, (ii) a five year transition period for credit unions to raise the earnings necessary to meet new capital requirements, and (iii) an exemption from risk weighted assets for loans which have been legally sold without recourse. We also describe our general support for positions advocated by the Credit Union National Association (CUNA), other trade associations, and credit unions across the country.

ECCU's Service to Member Churches, Schools, and Charities

For the past fifty years, ECCU has provided financial services to churches, schools, and charities within our faith-based field of membership that have traditionally been underserved by banks. ECCU's members include 1,600 churches, schools, and charities that serve over 1,000,000 congregants, students, and people in need around the country. Our credit union also provides financial services to 3,700 missionaries and humanitarian relief workers serving in 130 countries.

Since the 1990s, ECCU's member business lending program has provided over $4 billion in financing to hundreds of churches, schools, and charities. These loans have funded various projects including first-time purchases for growing churches, development of distribution centers for food banks, and refinancing high-rate bonds for schools. In addition, ECCU has actively provided funding for organizations in underserved communities, resulting in 59% of our loans being made to member organizations serving in low income areas. ECCU has also kept its commitment to support our members through charitable grants which have totaled $3.75 million since 2005.

In the passage of the Credit Union Membership Access Act, the Senate Banking Committee provided the following statement in support of the exception to the statutory MBL cap: "The Committee intends for the [NCUA] Board to interpret the exceptions under new section 107A(b), to permit worthy projects access to affordable credit union financing. Loans for such purposes as agriculture, self-employment, small business establishment, large up-front investment or maintenance of equipment such as fishing or shrimp boats, taxi cab medallions, tractor trailers, or <u>church construction</u> should not be unduly constricted as a result of the Board's actions." *Senate Banking Report on the Credit Union Membership Access Act (Senate Report 105-193) (emphasis added).*

Through this Act, Congress directed the NCUA to permit affordable credit union financing for worthy projects - such as church financing – without undue restrictions. However, if the NCUA's proposed risk based capital regulation is finalized without the changes described herein, the impact on ECCU's member churches, schools, and charities will be severe. Significantly reduced availability of funding will slow the development of worthy projects that support communities, while reduced competition will increase loan rates for those non-profit organizations seeking new loans or refinancing.

ECCU Supports Risk-Based Capital Standards Consistent with Federal Banking Regulation

ECCU believes a modern risk-based capital approach for credit unions is necessary. However, new capital standards should be consistent for all federally insured financial institutions. Significant differences in risk-based capital requirements for credit unions as compared to the Basel III standards required of community banks will result in competitive disadvantages for credit unions which will impact service to members.

Since the Basel Committee on Banking Supervision first issued Basel III capital proposals in July 2009, regulators, banks, consultants, academia, and other industry observers have exhaustively studied the proposal's impact on domestic and global markets. Based on this feedback, the Basel III standards and resulting federal banking regulations have been clarified, revised, and finalized. After years of preparation banks are now shifting their practices in order to comply with the new capital standards by the deadlines provided. All told, banks in the United States will have had 9½ years to prepare for full implementation of Basel III.

In contrast, the credit union industry lacks sufficient time and resources to adequately analyze the impact of the NCUA's proposed deviations from the Basel III standards. It is clear, however, that credit unions will be required to raise and hold more capital for similar product types (e.g., consumer mortgages, commercial mortgages) than banking counterparts. The need for more capital will generally result in: (i) fewer services to meet the financial needs of members, (ii) the reduction of service levels and customer convenience, (iii) lower dividends and higher fees and interest rates to members, and

(iv) the reduction of staff which will increase compliance and operational risk to credit unions. Ironically, the proposed capital requirements will cause credit unions to favor product and service choices that will result in reduced income and slower capital growth.

The Lack of Supplemental Capital and the Removal of the Capital Conservation Buffer Makes the New Capital Targets Harder for Credit Unions to Satisfy

Although the NCUA's proposed risk-based capital levels for prompt corrective action (e.g., 10.5% to be well-capitalized) are similar to the Basel III standards, the nature of the capital required of credit unions makes the NCUA's capital targets more difficult to achieve.

Credit union risk-based capital is made up solely of higher quality capital, namely retained earnings and the allowance for loan and lease losses (up to 1.25%). This excludes other forms of supplemental capital available to banks, such as Tier 1 (common stock, preferred stock) and Tier 2 (subordinated debt), which come with consequences from investors if profitability targets are not achieved.

Because supplemental capital is not available to credit unions, the well-capitalized standards proposed by the NCUA will be more challenging and take longer for credit unions to achieve than their bank counterparts.

NCUA Should Adopt Member Business Loan Risk Weights Consistent with Commercial Loan Risk Weights for Banks

NCUA's proposal requires significantly more capital for MBLs than that required of other federally insured financial institutions for commercial real estate loans. Additionally, the NCUA's proposed MBL capital requirements are internally inconsistent with risk weights for other loan product types and are unsupported by empirical data.

Table 8 in the proposed regulation's commentary, showing current and future MBL risk weights, fails to take into account changes in well-capitalized levels. In order to maintain capital at "well-capitalized" levels under the proposed regulation, significantly more capital will be required for member business loans:

MBL Concentration	Current Requirements: Min of (i) RBNW weight or (i) Well Capitalized level	Proposed RBC to be Well Capitalized	Increase
0-15%	7.00%	10.50%	150%
>15-25%	8.00%	15.75%	197%
>25%	14.00%	21.00%	150%

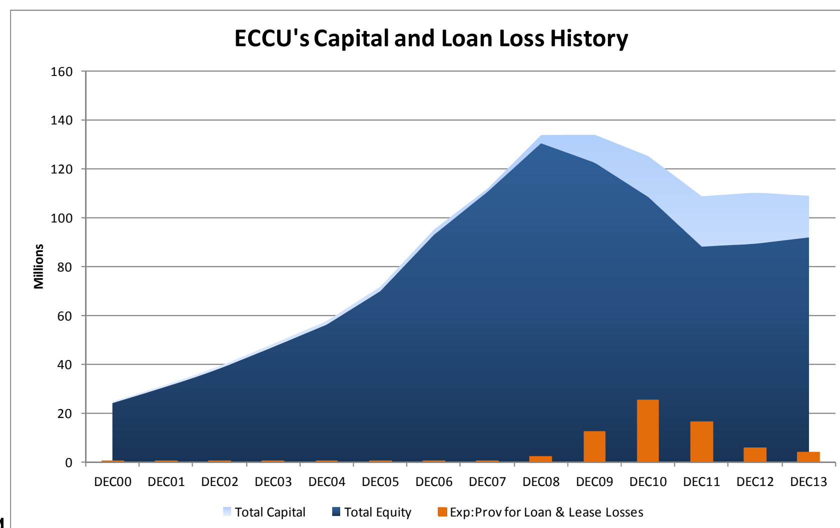
Essentially, NCUA asserts that performing MBLs above the 25% concentration level (200% risk weight) are more risky than delinquent credit card loans (150% risk weight), delinquent residential mortgages (100% risk weight), and foreclosed assets (100% risk weight).

NCUA also implies that an MBL concentration above 25% may result in a capital exposure of 21 cents for every dollar loaned, even after other sources to absorb losses are exhausted. Requiring this level of capital for MBLs is not supported by industry data.

Sources to Absorb Loan Losses
1. Specific Allowance for Loan and Lease Losses (FAS 114 - expected losses for impaired loans)
2. General Allowance for Loan and Lease Losses (FAS 5 – reasonably estimated losses on unimpaired loans)
3. Earnings
4. Capital

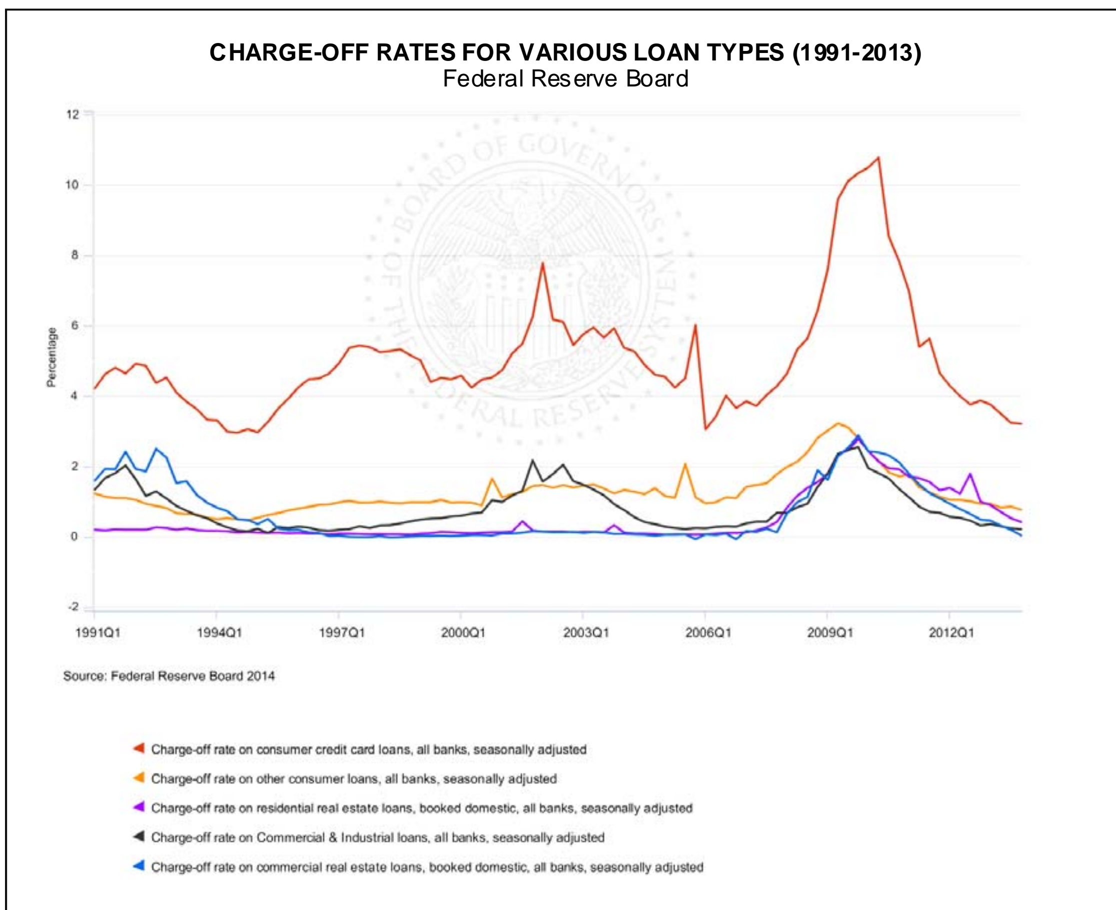
ECCU's experience with member business loans demonstrates the effectiveness of these buffers to capital and the excessive nature of the proposed capital requirements. Loan losses resulting from the Great Recession were primarily offset by the allowance for loan losses and earnings. The remaining losses absorbed by capital amounted to 2 cents for every MBL dollar, less than 10% of the 21 cents of capital per dollar of MBL that the proposed regulation would require.

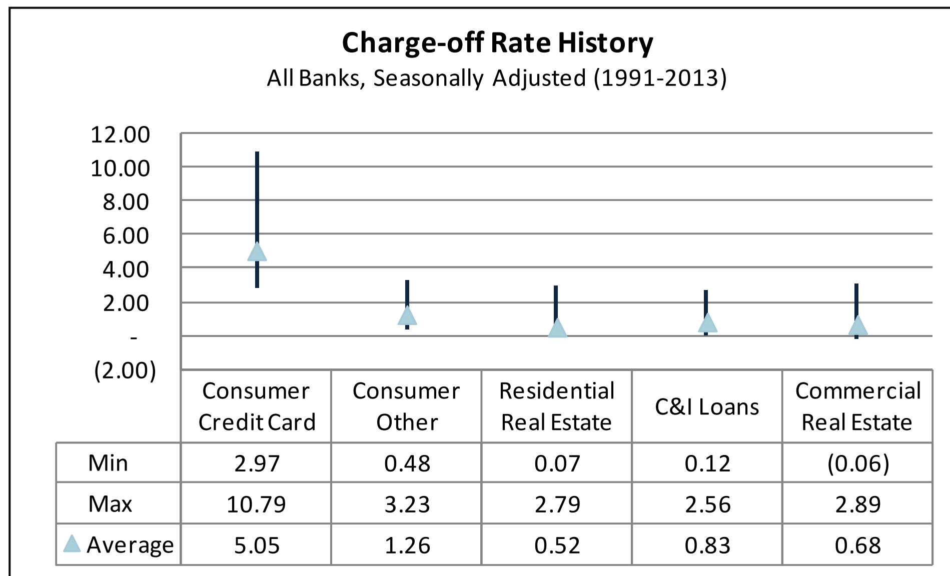
As shown in the graph below, ECCU's capital has been more than sufficient to absorb the MBL losses experienced as a result of the Great Recession.

q 

Analysis of Empirical Data Reveals MBL Losses Are Substantially Less than Consumer Loans and Consistent with Residential Mortgages

Empirical data support a conclusion that commercial real estate (CRE) loans have not been significantly more or less risky than other common asset classes. The Federal Reserve Board's charge-off data demonstrates that since 1991 consumer credit card and other loans have had consistently higher charge off rates than residential real estate, commercial real estate, and commercial and industrial loans.





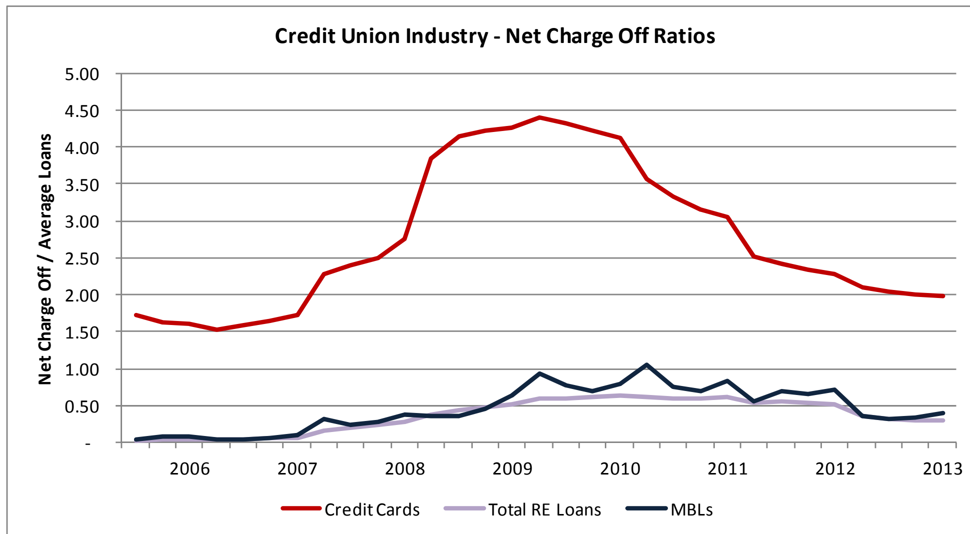
	Consumer Credit Card	Consumer Other	Residential Real Estate	C&I Loans	Commercial Real Estate
Min	2.97	0.48	0.07	0.12	(0.06)
Max	10.79	3.23	2.79	2.56	2.89
Average	5.05	1.26	0.52	0.83	0.68

From 1991 to 2013, the average consumer credit card charge-off rate was 643% higher than commercial real estate loans. The average charge-off rate for other consumer credit was 85% higher than commercial real estate loans. This empirical data is in direct contrast to the proposed capital required for consumer loans and MBLs.

Annualized Charge-Off Rate, All Banks, Seasonally Adjusted (1991-2013)				
Loan Type	Average	Max	Average 2008-2010	NCUA Proposed RBC to be Well Capitalized
Residential RE	0.52%	2.79% (Q4 2009)	1.91%	5.25% to 10.5%
Consumer Credit Cards	5.05%	10.79% (Q2 2010)	8.12%	7.875%
Other Consumer Loans	1.26%	3.23% (Q2 2009)	2.48%	7.875%
C&I	0.83%	2.56% (Q4 2009)	1.66%	10.50% to 21.00%
Commercial RE	0.68%	2.89% (Q4 2009)	1.95%	10.50% to 21.00%

Source: Federal Reserve Board 2014

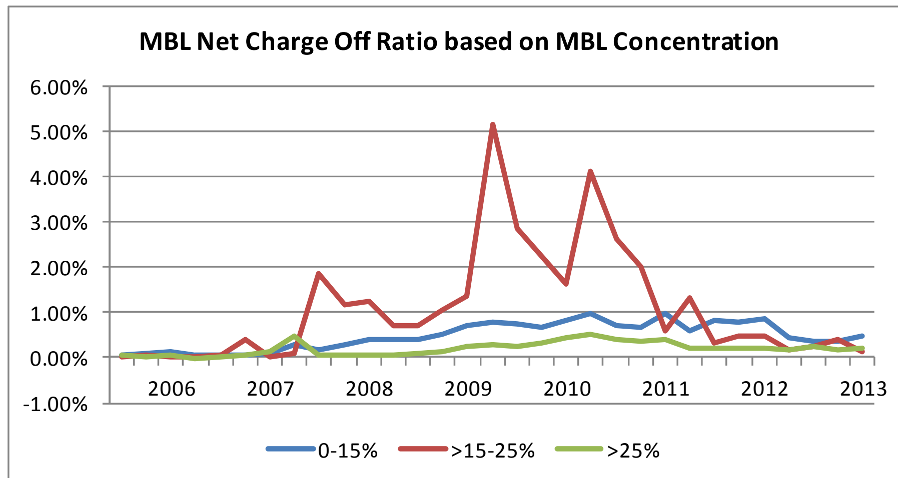
As the chart above reveals, the NCUA's proposed risk based capital requirements for various loan types are unsupported by, and are inconsistent with, historical loss experience. Based on this data, the risk based capital requirement for MBLs should be significantly lower than for consumer loans and in line with residential real estate loans.



Credit union industry data shows similar results. Charge off trends for MBLs have been consistent with charge-offs for credit union real estate loans. It is clear that credit unions experienced significantly lower charge off levels for both MBLs and real estate loans than for credit cards. All of the data fails to support the proposed regulation's higher risk weights for MBLs than for consumer loans generally.

Analysis of Empirical Data Reveals Lower Loan Losses with Higher MBL Concentration

An analysis of credit union industry data demonstrates that credit unions with higher MBL concentration have experienced consistently lower loan losses than other credit unions. The chart below follows MBL net charge-off ratios for credit unions which had 0-15%, >15%-25%, and >25% MBL-to-asset concentration. Since 2006, the highest concentration group has regularly experienced lower charge-off ratios than the two lower concentration groups. This result is intuitive. Well-managed credit unions which focus on a particular product and market will improve their ability to mitigate associated risks over time. The proposed MBL concentration-based risk weights conflict with the data presented below.



Concentration Adjustments Do Not Address the Root Cause of MBL-Linked Credit Union Failures – Poor Management

In support of concentration-based adjustments to MBL risk weights, NCUA makes anecdotal references to certain bank and credit union failures. However, in its January 2012 report, the Government Accountability Office (GAO) made clear that the primary reason for the 85 credit union failures from January 2008 to June 2011 was “poor management.” The GAO further specified the following factors which contributed to the credit union failures:

- operational/control issues (89%)
- credit (68%)
- liquidity (36%)
- fraud (34%)
- concentration (32%)
- MBLs (15%)

The GAO’s report identifies a number of contributors to credit union failures, of which MBL concentration is a small fraction. The GAO concluded that the most meaningful MBL-related early indicator of credit union distress is MBL delinquency, not concentration. MBL delinquency should be addressed in the proposed risk based capital rule with a risk weight more in line with recently adopted bank regulations.

NCUA’s conclusion that MBL concentration is a material risk to the credit union industry oversimplifies the factors driving failures of a small handful of credit unions. As the GAO noted, effective management of an MBL program is much more critical than MBL concentration. The key to avoiding credit union failures related to MBLs is effective management and supervision ensuring that proper operations, credit/underwriting, compliance, and risk management functions are in place to manage the program.

NCUA's Concentration Adjustments Impose a One-Size-Fits-All Approach to a Complex Issue

Concentration risk can be effectively mitigated by creating diversification within an asset class, such as by industry, geography, and collateral type. In addition, many financial institutions address concentration risk by imposing stricter underwriting guidelines, such as stronger debt coverage ratios, lower loan-to-value ratios, and guaranties. NCUA acknowledged that its staff reviewed potential adjustments for well-diversified MBL portfolios, but lacked the information necessary to do so.

The Basel Committee on Banking Supervision and federal banking regulators declined to address concentration risk in their risk based capital framework. Instead, federal bank regulators monitor these risks through the supervision and examination process, which can more effectively assess concentration risk, taking into account the unique characteristics of an individual financial institution.

We urge the NCUA to take a similar approach: manage concentration risk through the supervision process.

NCUA Should Adopt an MBL Unfunded Commitment Conversion Factor Equivalent to the Federal Banking Regulation

NCUA proposes an MBL unfunded commitment conversion factor which is 50% greater than that of the federal banking regulation. In support of this proposal, NCUA stated that commercial loan documents do not typically have materially adverse conditions clauses as a condition to draws. In our experience, this is not true. ECCU and many credit unions (and banks, for that matter) use the standard commercial loan documents provided by the Harland Corporation's LaserPro program. These documents have a condition to funding draws on lines of credit and construction loans that no material adverse conditions exist. We ask that NCUA adopt the same conversation factors as used by federal banking regulators.

NCUA Should Remove from Risk Weighted Assets Those Loans Which Have Been Legally Sold, but Are Retained on the Balance Sheet

Esoteric accounting rules (i.e., FAS 166) require that a loan remain on the selling credit union's balance sheet even though all risk of loss has been legally transferred to a third party purchaser. For example, the sale of participation interests in a single loan at different net yields would require that loan to remain on the seller's balance sheet because of disproportionate cash flows to the purchasers. Loans which have been legally sold with risk of loss transferred to a third party should not be included in risk

weighted assets, even if accounting rules require these loans to remain on the credit union's balance sheet.

NCUA Should Adopt a Five Year Transition Period for Any New Risk Based Capital Rule

NCUA should adopt a five year transition period after final adoption of the regulation for credit unions to raise the risk based capital required. The federal banking regulators provided a transition period of 5½ years for the Basel III standards – adoption in July 2013 with final implementation in January 2019. Two significant differences suggest credit unions will need at least as much time, if not more.

First, NCUA's proposal removes the "capital conservation buffer" distinction and requires an additional 2.5% of capital be a component of the "well capitalized" requirement. For banks, the capital conservation buffer is effectively an optional target. However, for credit unions the full 10.5% will be required in order to be considered well capitalized.

Second, as credit unions can only increase capital through earnings, they should be given more, not less time to raise capital.

ECCU Supports the Positions Advocated by CUNA and Others

ECCU is in full support of the positions taken by CUNA, other trade associations, and credit unions across the country on the following topics:

- ***Eliminate risk weight adjustments based on the duration of underlying assets***. The proposal's attempt to address interest rate risk by adjusting risk weights for asset duration oversimplifies the asset liability management challenge that credit unions face. While interest rate risk is a concern for all financial institutions, this risk is better managed through the supervisory/examination process, and not a simplistic approach to asset-liability management.
- ***Elimination of the Individual Minimum Capital Requirements***. This power is unnecessary in light of NCUA's broad supervisory powers.
- ***Permit Credit Unions to Raise Supplemental Capital***. Even though supplemental capital is not applicable to the leverage ratio, NCUA should allow or support legislation that would allow supplemental capital to qualify for the risk based capital requirements.
- ***0% Risk Weight for US Government Claims.*** The final regulation should clarify that all direct and unconditional claims on US Governmental agencies and the Federal Reserve have the same 0% risk weight given to obligations of the NCUA.

We appreciate your commitment to consider these comments and make changes to the proposed risk based capital rule for the benefit of the credit union industry and the members we serve. Please contact us if you have further questions.

Sincerely,

Mark G. Holbrook
President/CEO

James LePere
Chairman, Board of Directors

cc: The Honorable Edward Royce, United States House of Representatives
The Honorable Jeb Hensarling, Chairman, The Committee on Financial Services, United States House of Representatives
The Honorable Kevin McCarthy, United States House of Representatives
Mr. Richard McCarthy, Chairman, ECCU Supervisory Committee
Mr. Bill Cheney, President/CEO, Credit Union National Association
Ms. Diana Dykstra, President/CEO, California Credit Union League
The Honorable Brad Sherman, United States House of Representatives
The Honorable Gary Miller, Vice-Chairman, The Committee on Financial Services, United States House of Representatives
The Honorable Maxine Waters, Ranking Member, The Committee on Financial Services, United States House of Representatives,
The Honorable Timothy Johnson, Chairman, The United States Senate Committee on Banking, Housing, and Urban Affairs
The Honorable Michael Crapo, Ranking Member, The United States Senate Committee on Banking, Housing, and Urban Affairs