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Via Fax – 703.518.6319

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

Re: Comments on Proposed Rule: PCA – Risk-Based Capital

Dear Mr. Poliquin:

For the past fifteen years, I have represented over one hundred federal and state credit unions nationwide in connection with special investment programs permitted by NCUA Rule 701.19(c) and corresponding state rules, and I also represent several firms which provide investment advisory and other consulting services related to the design and management of such programs. I am writing to comment on the proposed new capital adequacy regulation, insofar as it relates to such special investment programs and individual arrangements.

Although the vast majority of credit unions are strongly capitalized, both by historic industry measures and in relation to the Basel III targets, I support the NCUA's attempt to develop a more refined measure of capital adequacy, one that looks beyond generalized net worth to the granular composition and risk characteristics of each insured credit union's assets. However, for the reasons noted below, I believe the proposed rule fails to achieve its stated objective and should be withdrawn for reconsideration, revision and re-issuance for further public comment.

Different classes of assets pose varying degrees of risk, risk being defined as potentially rapid and material decline in asset value related to certain future contingencies. Equity securities by nature carry greater risk in the event of issuer insolvency than do debt securities, and within equities common stocks pose greater insolvency risks than most preferred stocks (which typically enjoy some sort of liquidation preference over common). Unfortunately, the proposed new regulation draws no distinction in risk weightings between preferred and common equities, and bonds with greater than 10-year maturities are assigned a much higher risk weight (200%) than equities (presumably being in the "other assets" category) at 100%. It seems that within the category of non-loan investments, the principal distinction drawn by the draft regulation is maturity, a variable tied mostly to interest rate risk, while the proposal ignores other important risk-related characteristics of investments, including issuer operational/insolvency risk.

Within a given class of investment asset, be it debt, equities or funds aggregating such assets, there is a wide variation of investment risk, based upon the specific characteristics of the issuers of those securities. I have clients that assess these and other risks on an issuer-specific basis when designing and managing their client portfolios. Yet, the risk weighting asset categories contained in the proposed PCA rule do not incent or reward credit unions for informed, issuer-specific risk assessments. Rather, the proposed new regulation treats all issuers of a broadly-defined security – say, a seven-year corporate bond – the same, whether the issuer is AAA-rated and has been accessing the public capital markets for decades, is an old-line company in sustained decline, or is a highly successful business new to the public capital markets. To be effective, the final rule must take account of issuer-specific investment risk variations.

Beyond the failure of the proposed regulation to draw necessary distinctions between and within investment asset classes, there seems to be a policy conflict created by the PCA. Credit unions seeking to "pre-fund" their future employee benefit costs are given broad investment discretion by NCUA Rule 701.19(c), which frees those pre-funding investments from the restrictions which are imposed by the Federal Credit Union Act and Rule 703 on investments made for the credit union's own account, to enhance its earnings. While Rule 701.19(c) reflects a deliberate and longstanding policy judgment by NCUA to permit credit unions to invest more flexibly when doing so to fund employee benefits, the proposed PCA risk weightings will penalize credit unions which invest in higher-yielding, longer-term investments permitted by that existing rule, by raising the reserves required to carry such investments. Rule 701.19(c) and the proposed new PCA rule thus seem to be in conflict, with the likely outcome being many credit unions will shift pre-funding investments away from higher-yielding, longer-term securities to lower-yielding, shorter-term investments that provoke less regulatory scrutiny and cost less in mandated reserves, but that fail to address the need for credit unions to take a more strategic approach to funding their rising employee benefit obligations.

The nature and investment risk of credit union assets varies widely, and needs to be more accurately assessed and managed. Unfortunately, the proposed new PCA rule does not provide credit unions or examiners the tools needed to make those assessments. The risk weighting categories are too general, lumping together very different assets with widely varying risks (eg, all "other assets" being assigned the same 100%, Category 5, risk weighting as delinquent first mortgage loans and repossessed collateral), especially when considering risks beyond those tied to interest rate fluctuations. Several additional risk weighting categories are needed to properly take account of equity investments, including preferred and common stocks, REIT shares, public and private debt instruments, as well as mutual funds, which assets are, at least in pre-funding investment portfolios common elements. Further, mechanisms must be developed to take account of the wide variations of investment risks associated with different issuers.

Suggested Changes.

1. Additional risk weighting asset categories are needed, and the asset types within them should be more harmonious. Among those new categories should be (i) equities, each varying by ranges of market capitalization of the issuer and perhaps also by how long the issuer has been a public company. A case can be made for different risk weights for

preferred and common shares, but preferred shares tend to be such unique legal instruments that efforts to categorize them separately may be too complicated; (ii) debt securities, varying by years to maturity, debt rating (if any) of issuer, and absent a debt rating other measures of financial capacity of the issuer, and also whether there are letters of credit or other third-party payment assurances supporting an un-rated bond; (iii) mutual funds, varying by the basic nature of the underlying investments as well as the fund's duration as a public issuer.

2. Obviously, some sort of "other asset" residual risk asset category is needed, but NCUA should in the revised draft rule endeavor to substantially reduce the number of potential investments in it, since by definition it is a catch-all of unrelated investments that presumably do not merit the same risk weightings, and as additional discrete investment classes emerge, especially in the broader, Rule 701.19(c) arena, they should be assigned to suitable existing risk categories or new categories should be created for them.
3. The proposed risk weightings need to be harmonized to address a variety of anomalies – for instance, a zero risk weighting for any debt instruments, including treasuries, makes no sense, since while US direct and guaranteed obligations may be considered to have no credit risk, they surely have interest rate risk. Further, it's not at all clear why logically a 50% weight should apply to both one to three year investments as well as non-guaranteed mortgage loans, which typically will have a much longer maturity and are subject to a variety of interest rate and credit risks not associated with shorter term debt. Additionally, assigning a 100% risk weight to delinquent mortgage loans/foreclosed assets and to the catch-all category of "all other assets" seems arbitrary, especially where those "other assets" are performing. Assigning the same 150% risk weight to performing debt securities which happen to have a five to ten year maturity, and also to delinquent credit card loans seems highly questionable. And assigning a 200% risk weight to all investments with more than ten years to maturity, without regard to any other relevant aspects of the investment, seems punitive and unjustified, and can be expected to drive many credit unions to dump perfectly sound, high-earning investments to capture the much lower reserves required of shorter-term, lower earning securities. Any risk weightings above 100%, which effectively assign a penalty to the affected investment, should be justified by a detailed explanation from the NCUA.
4. Once risk weights are more logically assigned among asset classes in a revised draft of the rule, they should be presumptive only, so that if a credit union can present persuasive reasons why a lower risk weight should be assigned to its investments in a certain category, those lower weights will be applied going forward. Examples include credit unions with assets in a diversified portfolio under professional investment management, where the credit union can demonstrate that risks have been duly identified and effectively managed by assets class, industry and issuer diversification and other strategies. This process will more accurately assess asset quality and capital adequacy, but obviously will involve more interaction between insured credit unions and the NCUA, but the associated administrative demands can be managed by limiting the frequency of risk asset "appeals" by any credit union.

5. $50 million in assets, at least standing alone, seems too low a threshold for applying the expanded PCA rule. In my experience, credit unions with less than $100 million in assets tend not to be operationally or financially complex. A more nuanced measure of complexity, taking into account a combination of gross assets, non-loan investments, existence of one or more CUSOs, lower CAMEL ratings and high concentrations of real estate and/or member business loans would seem a better way to identify the kind of operational and asset complexity/risk the new PCA rule is directed at.
6. Any discretion for an examiner to require 100% capital reserves for specific investments should require detailed findings by the relevant Regional office that the credit union is materially at risk with regard to the specific investment, by reason of a failure to understand its workings, it being objectively a very high-risk investment and the absence of less burdensome alternative regulatory actions, such as negotiated intermediate reserves, mandated retention of external investment management expertise or disposition of the investment within a defined period.
7. Many credit unions have in place life insurance-related supplemental income/benefit plans for key employees, whether the policies are owned by the credit union or merely pledged to it as collateral, and those "split dollar" arrangements are sufficiently distinct in design and funding assets (the insurance policies) as to merit their own risk asset weighting. Since the issuers of those policies tend in my experience to be extremely well-capitalized, highly-regulated financial institutions, I suggest that any risk weighting be very low, certainly 50 or below.

Very truly yours,

Steven D. Eimert