FC CU First Community Credit Union

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Life is better with community.

May 19, 2014

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

Dear Mr. Poliquin,

First Community Credit Union ("FCCU"), Charter 60103, is pleased to have the opportunity to comment on the NCUA's Proposed Rule: PCA-Risk-Based Capital. FCCU is the largest credit union in North Dakota and is celebrating its 75th anniversary in 2014. Consolidated assets at March 31, 2014 were $491,623,075 and net worth was $58,364,229. FCCU has 15 branches and serves over 30,000 members. Its field of membership, roughly 45,000 square miles, is mostly rural but includes North Dakota's three largest cities, Fargo, Bismarck and Grand Forks and portions of western Minnesota and northeastern South Dakota. FCCU is an exempt credit union, and at March 31, 2014 it held member business loans of $245,468,365.

<u>The key issue: Risk-rating of Assets</u>

We strongly disagree with NCUA's proposed risk weighting of assets, which diverges markedly from the Basel III risk-weighting methodology. The most egregious example is NCUA's proposed treatment of business loans ("MBL"). Rating MBL risk as high as 200% and even 150% would materially damage our capital adequacy and force us to discontinue most, if not all, business lending. Why? Two reasons: (a) continuing to add 150% or 200% assets would prevent us from growing our capital ratios, and (b) because substantially all of our commercial bank competitors' business loans are risk-rated at 100% under Basel III, we would simply be unable to compete profitably.

The impact of NCUA's proposal on FCCU's capital adequacy is profound. Our December 31, 2013 Call Report shows our Net Worth Ratio at 11.69% and our Risk Based Net Worth Requirement at 8.27%. FCCU exceeded its Net Worth Requirement by 342 basis points and was deemed Well Capitalized. However, using NCUA's proposal lowered our Risk-Based Capital Ratio to 9.27% and reduced our capital status to Adequately Capitalized. From being 342 basis points above the current standard to be considered Well Capitalized, FCCU fell below the proposed Well Capitalized minimum by 123 basis points: a swing of 465 basis points. We then proceeded to calculate our capital adequacy under Basel III, using our balance sheet as of December 31, 2013 and all Basel III rules to be effective at January 1, 2015. Our Common Equity and Tier 1 Risk Based Capital ratios were both 12.83%; the requirement for Well Capitalized is 8%. Additionally, our Total Risk Based Capital Ratio was 13.79%; the Basel III requirement for Well Capitalized is 10% (10.5% when fully phased in). The only difference between our *capital* under Basel III and under the NCUA proposal is the treatment of the NCUSIF asset. The amount is small and thus the numerators are very similar. The differences arise in the denominators—the *risk-rating of the assets*. The sum of FCCU's risk-weighted assets was $430 million under Basel III and $603 million under NCUA's proposal. Of the $173 million difference, $156 million arises from the risk-weighting of business loans and $17 million arises from the risk-weighting of unused commitments for business loans. There are other instances of proposed items that we believe should be revised, but our principal, overriding concern is the exceptionally adverse treatment of MBLs. We discuss all of this in greater detail below.

Asset Quality and Interest Rate Risk

There appear to be several contradictions or anomalies in NCUA's asset risk ratings. As an example, consider the following scenario. Imagine two $1,000,000 investments: the purchase of (i) five 30 year first mortgages on five new single family homes in Fargo, ND or (ii) a $1,000,000 portion of a new $50,000,000 FNMA MBS collateralized by 250 mortgages in 11 different states. Both of their weighted average lives are, say, 6 years. The bond is backed by a Government Sponsored Enterprise, so its credit risk is less than that of the whole loans. It would be faster and easier to sell the bond than to sell the five mortgages, so the bond is more liquid. And because the bond's mortgages are spread through 11 states rather than one city, the bond provides greater diversification. The bond is clearly the less risky asset. The NCUA proposal assigns a 50% risk rating to the five mortgages and a 125% risk rating to the bond while Basel III only assigns a 20% risk rating to the bond and a 50% risk rating to the five mortgages.

It appears that NCUA is hoping to lower interest rate risk in securities portfolios. However, either choice would add identical interest rate risk to the institution—only the location of the risk would differ—but the acquired whole loans would earn a lower (50%) risk rating even though their asset quality is inferior to that of the MBS which requires a higher (125%) risk rating. This is clearly a perverse result.

Past history has shown that FCCU turns over about 50% of its loan portfolio annually, and that loan portfolio comprises about 90% of its earning assets. As a consequence, our institutional interest rate risk is quite low. Our securities are of very high quality and provide the collateral for much of our liquidity and borrowing capacity. Their weighted average lives tend to exceed those of most of our loans. NCUA's proposal to risk-rate securities with WALs above three years at 75% and even 150% is likely to be counter-productive. It will punish credit unions with low interest rate risk in their loan portfolios and prompt others to replace securities with WALs greater than three years with less liquid, lower quality whole loans or short term securities with much lower yields. Basel III's emphasis on asset quality instead of WAL is a better alternative. In our opinion, carefully and critically reviewing interest rate risk management during annual examinations is preferable to establishing a risk-rating system that may ultimately suffer from the law of unintended consequences.

Unused Commitments

There is a considerable disparity between Basel III and NCUA's proposal in regard to the treatment of unused commitments for business purposes. There seems to be no reason for this, other than that NCUA's MBL-related proposals are consistently more onerous than those of Basel III. NCUA's proposal risk-rates all unfunded MBL commitments at 75%. Using greater finesse, Basel III rates unfunded commitments of less than one year at 20% and of greater than one year at 50%. Our experience is much more consistent with the Basel III treatment than with NCUA's proposal and we request that NCUA conform to the Basel III standard.

Guarantees

For CUs with MBLs greater than 25% of assets, the proposed marginal risk-weighting is 200%. However, as we read the Calculator at the NCUA website, if the marginal MBL carries, say, an 80% guarantee, the guarantee only reduces the net value of the asset by 40% rather than the full 80%. This appears to be an oversight, and is easily corrected. Also, although the Calculator names a single source of guarantees (SBA), we assume that guarantees from all other federal instrumentalities (FSA, USDA et al.) receive equal treatment.

Timing

An 18 month implementation period is inadequate and could prove to be somewhat reckless when you consider the significant change required in many credit union balance sheets. To bring our own balance sheet into compliance with the proposed rule will require the decrease of our business loan portfolio by approximately 20% or $50,000,000. Doing so in a short order would have a drastic impact on our earnings not to mention we would lose many high performing loans, while loans with any "credit issues" would be less likely to find a new home; thereby increasing the credit risk in our portfolio incrementally. In addition, while FCCU does not hold much in terms of long-term investments, other credit unions do and selling these assets at a loss would also have a detrimental effect to earnings. We feel a 3 - 5 year phased in approach to be a much safer alternative.

MBLs and Losses

With respect to the acquisition of MBLs, there are two categories of credit unions: those at which MBLs may not exceed 12.25% of assets ("non-exempt") and those that are not subject to an MBL limit ("exempt"). Exempt CUs are relatively small in number. NCUA references indicate approximately 70 exempt CUs currently, and our research indicates that as of June 30, 2013 there were only 21 exempt FICUs whose MBLs exceeded $100,000,000 and comprised more than 15% of total assets; FCCU is among the 21. Only CUs with an established history of making business loans were granted an exemption from the 12.25% cap on MBLs. The key fact here is that exempt CUs have many decades of experience in business lending. The same cannot be said of non-exempt CUs.

Referring to footnotes 49 and 50, NCUA's proposal states that smaller banks and CUs with "high concentrations of MBLs" incurred significant losses in the period 2008-2011. We read the cited reports, and they clearly state that the culprits were not "high concentrations of MBLs" but rather concentrations of a small subset of commercial real estate loans: ADC (Acquisition, Development and Construction) loans. Many/most of these bad loans were out-of-state, poorly underwritten and overseen, and funded by institutions with little experience in business lending, much less ADC lending. (Inadequate practices by examiners were called out in certain cases, as well.)

In light of this less-than-stellar performance by certain non-exempt smaller CUs, it is useful to review and compare the experience of the previously-mentioned 21 large exempt CUs during that same period. One might expect that the Great Recession and its immediate aftermath would have materially damaged CUs with such large commitments to business lending. But that did not happen. Eighteen of the 21 large exempt CUs, including FCCU, had positive earnings in each of the four years. Two of the 21 suffered a loss in one year, and one incurred losses in three of the four years. Throughout the four years, all 21 maintained a Well Capitalized rating.

We believe that the risk of loss from business lending is far greater from non-exempt CUs than from exempt CUs. Exempt CUs have been making MBLs for decades. They have learned from their mistakes and are thus less likely to repeat them. They understand ag and/or commercial underwriting and the importance of relationship management and oversight. They hire experienced staff and provide quality training and mentoring for those who are less experienced. They understand risk and risk management. By contrast, business lending comprises a relatively small share of a non-exempt CU's activities. Inevitably, staff is less experienced, underwriting is less thorough and risk aversion often takes a back seat to the prospect of loan fees and loan yields that exceed those available on consumer loans. Our occasional discussions with NCUA examiners and staff generally confirm our estimate of where the bulk of the MBL risk lies. This being the case, FCCU is greatly concerned with NCUA's proposed risk-weighting of MBLs, under which the greater the commitment of an exempt CU to business lending, the greater the penalty in terms of capital adequacy.

MBLs, Concentrations, Diversification and Risk-weighting

Throughout its proposal, NCUA refers to MBLs as a "concentration." This is a fundamental misunderstanding that permeates every discussion about MBLs. If business loans are considered and treated as a single concentration—which is the implicit assumption behind NCUA's proposed 150% and 200% MBL risk ratings—why do commercial bank regulatory agencies in the United States (OCC, FDIC and the Federal Reserve) and Europe rate virtually all business loan risks at 100%? If NCUA fears business loans, it can take steps to better focus its concern. One of the first is to recognize that business loans have great diversity. At FCCU, for example, we recognize 21 distinct classes/concentrations within our loan portfolio, of which nine are commercial and seven are agricultural. We believe it is equally important from a risk point of view that NCUA differentiate between risks posed by well-diversified exempt CUs on the one hand, and by non-exempt and poorly-diversified exempt CUs on the other. The bulk of the risk to NCUSIF is from the latter, not the former.

Data from the Call Report can provide some real insight into MBL diversification. For example, on page 15, Rows 1a-1e and 1g-1j, and 2a-2e and 2g-2j contain very useful data on the diversification of a CU's MBL portfolio. (If you think of MBLs as one big concentration, page 15 provides no such information at all!) Particularly in Line 1 of page 15, how many of the rows (especially in the NMBLB column) have zeros? Other things being equal, the more zeros, the less diversified the MBL portfolio.

Even after drawing out diversification data from the Call Report, other evidence of diversification is available from management, and should be gathered and considered at each annual examination. How does the CU determine its loan segments and classes for purposes of concentration management? How geographically diversified are its MBL exposures? How does the CU manage purchases and sales of participations to aid its diversification efforts?

At the risk of being repetitive, it is absolutely critical that NCUA cast aside the notion that business loans make up a single concentration. Particularly with respect to exempt CUs, there is a world of difference between an ag equipment loan and an owner-occupied real estate loan, or between a 48-unit apartment complex and an operating line of credit. We understand there are a few large CUs that *do* have extreme loan concentrations. We believe the appropriate NCUA response is to use its authority to demand that such CUs hold considerably more-than-normal equity. The totally inappropriate response is to risk-weight MBLs at 150% and 200%, thereby demanding such incremental equity of *all* exempt CUs, including those with diversified portfolios, strong underwriting and portfolio management experience and proven earnings capacity. For us, the most fundamental question is whether NCUA's final risk-rating of MBLs will allow FCCU to continue to serve its members as it has for 75 years, or force FCCU to make decisions that will fundamentally alter its activities going forward; requiring us to radically adjust our balance sheet and significantly reduce the number of business loans we do to bring us into compliance with the proposed rule. In several of our communities, we are one of only two financial institutions in that town and if we pull back, the effects will be felt immediately in rural ND – increasing prices on loans and decreasing services offered to the farmers, small businesses, and citizens of these communities. Risk-rating performing MBLs at 150% and 200% will cause this. Risk-ratings of 100% for performing MBLs and 150% for non-performing MBLs and all ADC loans are acceptable.

In conclusion, I am confident that we can find a solution that will work for NCUA in identifying risky behaviors and assuring adequate capital to cover these risks while allowing credit unions with strong business lending histories and practices to continue serving our members as we have over the past decades. Thank you for the opportunity to express our comments.

Sincerely,

Steve Schmitz
President/CEO
First Community Credit Union