From: Dan Rader
To: Regulatory Comments
Subject: Prompt Corrective Action Risk-Based Capital Comment Letter
Date: Friday, May 23, 2014 6:26:22 PM

Mr. Gerard Poliquin
Secretary, NCUA Board
1775 Duke Street
Alexandria, VA 22314

Mr. Poliquin:

SCE Federal Credit Union appreciates the opportunity to comment on the proposed rule: Prompt Corrective Action - Risk-Based Capital.

We support the NCUA's efforts to modernize the capital rules in place today as they are outdated and do not adequately account for varying degrees of risk inherent in a credit union's balance sheet. However, the assignment of certain risk-weightings under the proposed regulation appear to be arbitrary for a number of balance sheet items and out of sync with the NCUA's stated objectives to address risks in addition to interest rate risk. We are particularly concerned about the following:

1. The risk-weightings for investments. The risk-weightings for investments seem to ignore the NCUA's stated goals of addressing credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. Non-delinquent fixed rate first mortgage real estate loans less than or equal to 25 percent of total assets are assigned a risk-weight of 50 percent. U.S. Agency guaranteed investments with a weighted-average life of greater than three years, but less than or equal to five years are assigned a risk-weight of 75 percent. U.S. agency guaranteed investments have less credit risk, less liquidity risk, and often less interest rate risk than do fixed rate first mortgages. Investments with a weighted-average life of between five and ten years are assigned a risk-weight of 150 percent or three times the capital requirement of a 30 year fixed rate mortgage even though such investments have less credit risk, less liquidity risk, and similar interest rate risk. The NCUA should reduce the risk-weightings for certain investments to 20 percent to reflect their reduced level of risk.

2. The removal of the NCUSIF deposit from capital and assets. The capitalization of the NCUSIF in 1985 remains one of the credit union industry's great achievements. For many years the deposit paid dividends and it is still the case that a credit union can get its deposit balance returned to it if the credit union no longer uses the NCUSIF to insure shares. The NCUSIF deposit is a reserve of 1% on shares and available to cover losses, albeit industry losses, just as the allowance for loan losses is a reserve available to cover loan losses. Similar to the treatment of the ALLL, the NCUA should include the NCUSIF deposit in the risk-based capital numerator but as with the ALLL can limit it to 1.25% of total risk-weighted assets.

3. The risk-weighting for investments in CUSOs. CUSOs are formed for all sorts of reasons but most often are formed to create additional revenue streams and/or to reduce service costs. A 250 percent risk-weighting is practically classifying investments in CUSOs as impaired assets, and is significantly higher than the 150 percent risk-weighting assigned to delinquent unsecured loans - a $1 million investment in a CUSO would require $262,500 in capital. This is an extreme risk premium particularly if the accounting method used by the credit union captures the actual capital value of the investment on its

balance sheet.

4. Increased risk-weightings for member business loans (MBLs). The explanation for the risk-weightings for MBLs includes references to losses to the NCUSIF and bank failures between 2008 and 2011 and the shared characteristic of institutions having high concentrations of MBLs. The actual cause of bank failures is much more nuanced.

Researchers employed by the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System published a paper in April 2013 titled "An Analysis of the Impact of the Commercial Real Estate Concentration Guidance". The guidance identified criteria that increased the risk of institutional failure: *1) Loans for construction, land, and land development (construction loans) represent 100 percent or more of a banking institution's total risk-based capital; and 2) Total non-owner-occupied commercial real estate loans (including construction loans) represent 300 percent or more of the institution's total risk-based capital,* ***and*** *growth in total commercial real estate lending has increased by 50 percent or more during the previous 36 months.*

The findings found: "Among banks that exceeded both criteria, 23 percent failed during the three-year economic downturn, compared with 0.5 percent of banks for which neither of the criteria was exceeded. Banks exceeding the construction loan criterion alone accounted for an estimated 80 percent of the losses to the Federal Deposit Insurance Corporation insurance fund from 2007 to 2011."

The NCUA should revisit its risk-weightings for MBLs to be more closely aligned with the actual risk to the NCUSIF. If the NCUA used 300 percent of risk-based capital as a threshold, a risk-weight of 100 percent would be assigned to MBLs less than or equal to 31.5 percent of risk-adjusted assets (assuming the institution has a risk-based capital ratio of 10.5 percent. And, given the findings detailed above, the 100 percent risk-weighting could apply to an even greater concentration of MBLs for credit unions that have long had a large and stable MBL portfolio. At the same time, risk-weightings on construction loans could be increased when the amount exceeds a lower percent of risk-adjusted assets. Separating construction loans from other MBLs would not be burdensome since construction loans are reported separately on the Call Report.

5. Balances held at the Federal Reserve Bank. Perhaps there is language somewhere in the proposed rules, but I was unable to find a risk-weighting for balances held at the Federal Reserve Bank. I assume these will have a zero risk-weighting as an "unconditional U.S. Government obligation", but the proposal seems to be assigning a risk-weighting of 20 percent to these balances by identifying them as "balances on deposit in insured financial institutions" with an accompanying example being "overnight accounts." Clearly, overnight balances held at the Federal Reserve Bank are riskless assets and should be assigned a risk-weighting of zero percent.

I want to express my confidence that the NCUA Board will consider all the commentary received and make sensible changes to the proposed rule that reflect actual risks without constraining credit unions from fully serving current and future members.

Thank you for your consideration.

Sincerely,

Daniel Rader
Chief Financial Officer
SCE Federal Credit Union

Daniel Rader • Chief Financial Officer