LAKE TRUST
CREDIT UNION
Your future. Our priority.

May 23, 2014

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

Comments on Proposed Rule: PCA – Risk-Based Capital

Dear Mr. Poliquin:

I am writing on behalf of Lake Trust Credit Union, which serves 35 counties in Michigan, and has 166,000 Members and $1.5 billion in assets. Lake Trust Credit Union appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) on its proposed rule, Prompt Corrective Action - Risk-Based Capital (RBC).

Our letter is comprised of three sections: Comments on Risk-Based Capital (the RBC Numerator), Comments on Risk-Based Assets (the RBC Denominator) and Other Items. In the first section, we have highlighted our concerns about the reduction of capital for goodwill and other intangible assets, the reduction of capital for the NCUSIF deposit and the limitation on the addition to capital related to the allowance for loan and lease losses.

In the second section of our letter, we have highlighted our concerns related to tiered levels of risk for certain loan types, high risk weightings assigned to investments in credit union service organizations (CUSOs), risk weightings assigned to investments based on maturities, risk weighting assigned to cash in the Federal Reserve banking system which bears no risk and risk weightings assigned to mortgage servicing rights.

In the final section of our letter, we have highlighted our concerns related to the need for supplemental capital, NCUA's ability to require even higher capital on a case-by-case basis, the need for a longer time to implement the final rule and a request for the revised rule to be reissued for comments before being finalized.

COMMENTS ON RISK-BASED CAPITAL (THE RBC NUMERATOR)

Reduction of Capital for Goodwill and Other Intangible Assets

Under the proposed rules, risk-based capital (the numerator) is reduced by any intangible assets, which can include both goodwill and other intangible assets such as core deposit intangibles. Although these assets bear risk, they also undergo considerable testing each year to ensure that their value is still appropriate and if there is any impairment, the assets must be written down through the income statement.

First the background

Effective January 1, 2009, any credit union that merges with another credit union is required to follow the purchase accounting rules under generally accepted accounting principles typically resulting in intangible assets; whereas prior to that date, mergers were accounted for under the pooling of interests rules typically resulting in no intangible assets (since the book value of the assets for each merged credit union were retained). In addition, any credit union that enters into a purchase and assumption agreement with NCUA to purchase part or all of a troubled credit union is also required to utilize the purchase accounting rules, even before the January 1, 2009 date. These purchase accounting rules typically result in the assignment of a premium related to the acquired credit union's core deposits, resulting in an intangible asset called a core deposit intangible. A merger or a purchase and assumption agreement can also result in goodwill, based on the market valuation of the assets and liabilities as well as the enterprise value of the acquired credit union.

Any intangible assets resulting from these transactions undergo considerable testing each year to determine whether there has been any impairment requiring write-down of the asset through the income statement. To determine whether goodwill is impaired, a credit union must, at a minimum, complete a qualitative evaluation of its goodwill, and based on the results of that evaluation may need to proceed to a full quantitative test to determine whether the estimated fair value of the credit union exceeds its book value. If a quantitative test is required and that test indicates that estimated fair value does not exceed book value, an impairment of goodwill would be deemed to exist. The credit union would then be required to write down a portion of the goodwill to the estimated fair value through the income statement. Typically both the qualitative and quantitative evaluations are completed by a third party, with the quantitative valuation being performed in accordance with the Professional Standards of the National Association of Certified Valuation Analysts.

The core deposit intangible is amortized over the average lives of the core deposits, with the amortization being recorded through the income statement. In addition, an annual test must be completed to determine whether the unamortized portion of the asset is potentially impaired. This test involves determining whether the core deposits related to the members of the acquired credit union at the merger or acquisition date have declined more than the core deposit intangible has been amortized through the date of the test. If the decline is greater, then an impairment of the asset may exist requiring a write down through the income statement.

Information related to Lake Trust.

Lake Trust has completed one purchase and assumption agreement with NCUA and one merger which resulted in the application of purchase accounting rules. The first transaction was a purchase and assumption agreement entered into with NCUA in 2007 when Lake Trust (under Detroit Edison CU) relieved NCUA of a very troubled Huron River Area Credit Union. Lake Trust received no net worth related to Huron River as well as paid a premium to NCUA under a competitive bidding process. As a result of a fair valuation process plus the premium paid, Lake Trust recorded both a core deposit intangible and goodwill as of the date of the purchase.

Lake Trust has had quantitative valuations of the goodwill completed each year from 2008 through 2011 and each valuation indicated that the fair value of our credit union exceeded our book value and thus there was no impairment of our goodwill. This was the case despite the very difficult and turbulent economy that the nation and especially the state of Michigan encountered during most of those years. We have completed qualitative evaluations for the past two years and concluded that it was more likely than not that the fair value of Lake Trust exceeded our book value. All of the valuations were completed by qualified third parties in accordance with both the accounting and independent valuation rules and our external CPAs concurred with the conclusions reached each year.

Lake Trust also has tested the core deposit intangible annually for impairment, of which there has been none. In fact, we have more core deposits from the Huron River members today than we obtained through the 2007 transaction.

When Lake Trust completed the Huron River transaction with NCUA, our net worth dropped from a very healthy 14.23% to a still very healthy and well capitalized 9.79%. We knew that we would receive no Huron River net worth and that our net worth would decline and were very comfortable with the resulting net worth. However, if the proposed risk-based capital rules had been in effect at the time, our risk-based capital would have declined from a very healthy 21.18% to 6.73%, resulting in an undercapitalized position. If these proposed rules had been in effect at the time, we would have reduced the premium that we were willing to pay to NCUA by about $16 million in order to retain risk-based capital of 11% and it is likely that other bidders would have reduced their bids as well. ***As a result, the NCUSIF fund would likely have suffered additional losses of as much as $16 million related to this transaction.***

Lake Trust also completed a merger in 2010 that created Lake Trust CU through the healthy combination of NuUnion CU into Detroit Edison CU. This merger happened smoothly under the existing PCA rules, with our post-merger net worth totaling 8.02% at the end of 2010, which is considered well capitalized, and three years later, our net worth has climbed to 9.37%. Under the proposed risk-based capital rules, the merger probably would not have happened because the purchase accounting rules required us to add an additional $29 million of core deposit intangibles, which would have immediately reduced our risk-based capital to 6.9% causing Lake Trust to be classified as undercapitalized under the proposed rules.

Lake Trust has also tested the core deposit intangible related to the NuUnion members annually for impairment, of which there has been none. In fact, just like with Huron River, we have more core deposits from the NuUnion members today than we obtained through the 2010 merger.

Clearly these mergers were good for the members of Lake Trust, including the former NuUnion, Detroit Edison and Huron River members. Lake Trust is a stronger credit union today than it was just three short years ago and is stronger than the individual credit unions were. Lake Trust weathered the very difficult economic climate of 2008 through 2010 and came out of the recession in very good shape. We have continued to serve our members well and continue to develop new products and services that meet their needs.

Our conclusion related to goodwill / intangible assets and the proposed rules.

We believe that the proposed treatment of deducting goodwill and intangible assets from risk based capital should be eliminated. Credit unions with these assets on their books undertake stringent testing on the assets each year and if the assets are impaired, an appropriate charge would be made through the income statement. In addition, the core deposit intangible asset is amortized through the income statement based on the average lives of the related core deposits. This expense is one that only credit unions involved in acquisitions or mergers have in their results.

This proposed rule related to goodwill and intangible assets being deducted from risk-based capital is likely to have a chilling effect on mergers and especially on transactions with NCUA related to troubled credit unions. If credit unions are less able to assist NCUA with taking over troubled credit unions, then there will likely be more losses that the NCUSIF will have to absorb and then potentially more NCUSIF assessments made on natural person credit unions, creating more potentially troubled credit unions. We encourage NCUA to review past merger activities and evaluate how the proposed rule might have impacted the cost to the NCUSIF. Quantifying those costs will serve to illustrate the impact of this proposed rule going forward.

We recognize that these assets do have an element of risk attached to them and so an alternative to the current proposal might be to risk weight these assets and include them in risk-based assets, perhaps assigning the 250% risk weighting currently recommended for assets deemed riskier in the proposal.

Reduction of Capital for NCUSIF Deposit

The proposed rule would immediately deduct from capital our National Credit Union Share Insurance Fund (NCUSIF) deposit. The manner in which this deposit is handled implies these assets are incredibly risky. On the contrary, the NCUSIF recently endured a very deep economic recession and did not lose its value.

As demonstrated throughout the recession, the NCUA can assess (over time) insurance premiums to ensure the safety of the insurance fund. As of today, the fund is positioned to allow credit unions to change their deposit insurance and receive a full refund of these assets. The NCUSIF position confirms these assets are strong and reliable.

We are seriously concerned the new rule may motivate stronger credit unions to withdraw from the NCUSIF and leave it weaker than it currently stands. This would certainly result in a very negative unintended consequence.

Limitation of Addition to Capital related to Allowance for Loan and Lease Losses

The proposed rule limits the inclusion (as capital) of the loan loss reserve to no more than 1.25% of risk assets. We believe the entire loan loss reserve should be included as risk-based capital. The loan loss reserve is established through direct expenses from earnings and has already been deducted from undivided earnings.

New rules being developed by the Financial Accounting Standards Board (FASB) could exasperate the negative impact of not including the full loan loss reserve as a component of capital. The developing FASB rule may significantly increase the need for higher reserves. The higher reserves would come straight from earnings and further limit a credit union's ability to maintain strong capital and properly serve its members.

Overall, the loan loss reserve is established to recognize and respond to risk. As a reserve for risk we believe it should be fully included as risk-based capital.

COMMENTS ON RISK-BASED ASSETS (THE RBC DENOMINATOR)

Tiered Levels of Risk Ratings for Loan Types

Under the proposed rules, three major loan groupings (first mortgage loans, second real estate loans and member business loans) are given increasing risk weights based on the concentration level whereas Basel III rules do not differentiate based on the concentration level. The weightings for the first tier under the proposed rule are the same as the Basel III rules but then increase. The first mortgage weightings range from 50% to 100%, the second real estate weightings range from 100% to 150% and member business loans weightings range from 100% to 200%.

We are concerned that there is no differentiation related to the loan to value (LTV) of any of these loans (first or second real estate loans or member business loans) or to the term of the loan. A 50% LTV loan is given the same weighting as a 100% LTV and a 10 year mortgage loan is given the same weighting as a 30 year mortgage loan. Also one question which must be asked is whether the first loan that moves to the next risk weighting tier is really more risky than the previous loan. In our opinion, that is not the case and so utilizing these tiers does not make sense.

In looking at Lake Trust's first mortgage loans, we have a good diversity of mortgage loan terms with only 43% having 30 year terms and approximately 50% having terms from 10 to 15 years. We also periodically sell 30 year mortgages rather than keep them in our portfolio. Our decision to retain or sell is typically based on our amount of total mortgages in our portfolio, interest rates and the percentage of 30 year mortgages in portfolio.

We also have a fairly small portfolio of second real estate loans (about 4% of total assets). The lower level of second real estate loans is due to the depth that the Michigan real estate market declined in the recession, resulting in many members not qualifying for these loans due to LTV issues. However, as the Michigan real estate market and prices have now started to increase, our members will likely start to request more of these types of loans.

Our member business loans represent about 8% of our total assets. We have significant resources dedicated to these loans, both in-house and through a CUSO in which we have a significant ownership. Our commercial loans provide a good source of earnings for our credit union and are a profitable product line for Lake Trust. Also, it should be noted that credit unions helped many businesses during the economic crisis by providing loans to smaller businesses that other financial institutions stopped making.

There is one additional limitation related to member business loans: if a credit union wanted to exceed 15% of total assets, they would potentially need a waiver from NCUA since most credit unions are not allowed to hold more than the lesser of 12.25% of total assets or 1.75 times net worth. So without a waiver or a low income designation, most credit unions cannot hold more member business loans than 12.25% of total assets, which is below the first tier in the proposal which is set at 15% of total assets. Based on these additional requirements for member business loans, we question whether these loans really need to have tiered levels of risk weightings.

As it is articulated in existing rules and regulations, we have a concentration policy which sets maximum concentration limits compared to net worth. Our concentrations of first mortgages, second real estate loans and member business loans are well below our policy limits. Since all credit unions are required to have concentration policies and limits, we think that tiers are not needed. Adherence to existing concentration limits are already monitored in today's examinations.

Each quarter we analyze the estimated amount of first mortgages lacking adequate collateral value and only about 5% of our first mortgage loans are considered to be potentially inadequate. For these mortgages, we have provided extra reserves in our allowance for loan and lease losses for these loans. Also our net charge-off ratios and total net charge-offs for these loan types (first mortgage loans, second real estate loans and member business loans) are relatively low, both for the last 12 months and the last 60 months.

Although Lake Trust's first mortgage loans, second real estate loans and member business loans are only risk weighted in the first tier, we still believe that that there is no need to have higher risk weightings related to higher concentrations. We believe that the risk is properly managed through adhering to appropriate policies and practices. As our credit union grows, we will continue to evaluate the amount of each of these loan types that we should hold. If the risk weightings remain tiered as they are, we may choose to make fewer first mortgage loans, second real estate loans and member business loans, which would be acting contrary to the needs of our members.

Investments in CUSOs

The proposed rule imposes a significant risk rating to assets invested in Credit Union Service Organizations (CUSOs). The vast majority of CUSOs are used by credit unions to share costs of important services provided to our members. Sharing costs produces high quality solutions with a lower impact on net earnings and allows capital to grow stronger. In many cases, CUSOs help credit unions provide member services and products they could not deliver on their own without burdensome costs. In addition, CUSOs are commonly used to manage and mitigate the risks inherent in the core business performed by credit unions.

A good example of such benefits is our member business loan CUSO (Michigan Business Connection). This multi-owner CUSO provides the necessary scale to retain high caliber professionals to analyze and support the ongoing risk with each loan. Without this scale, all of the involved credit unions would be in a position to settle for lower expertise, higher costs or forgo lending to very strong members.

While it may seem reasonable to apply some level of risk weighting to a CUSO, the proposed level is almost punitive. We are seriously concerned the proposed risk weighting would have the effect of discouraging and reducing the use of CUSOs. Such a reduction in the use of CUSOs will limit the services and products provided to members and reduce net earnings and the generation of capital.

Investment Risk Weightings Based on Maturities

Under the proposed rules, investment risk weightings are significantly higher than those for banks under Basel III. NCUA appears to be trying to control interest rate risk on balance sheets through these risk weightings, which we do not believe should be the rationale used to establish the risk weightings. The risk weightings proposed are assigned based on the weighted average life (WAL) of the investments, starting at 20% for investment with a WAL one year or less and rising to 200% for investments with a WAL greater than 10 years.

The rule does not delineate between types of investments in these WAL buckets except for NCUA and FDIC guaranteed notes and direct unconditional U.S. government obligations, to which the proposal assigns a 0% risk weighting regardless of the maturity date or WAL. The use of a 0% risk weighting for NCUA and FDIC guaranteed notes and direct unconditional government obligations would bear the same potential interest rate risk as other investments but yet they are risk rated 0%.

The proposal also implies that an investment issued by one of the agencies (for instance Fannie Mae, Freddie Mac, etc.) is more risky than the NCUA or FDIC guaranteed notes or U.S. government obligations. However, all obligations of Freddie Mac and Fannie Mae are implicitly guaranteed by the government since the companies were conserved by the U.S. government.

In addition, mortgage-backed securities with a WAL greater than three years would be risk weighted at 75%. If the mortgage-backed investments were issued by one of the government agencies, these investments would then have the implicit guarantee noted above as well as have collateral backing the investment. This investment seems far more secure than other investments.

For many credit unions with low loan to share ratios, investments make up a significant portion of their balance sheet and provide an important source of income. Compared to banks, credit unions are already limited in the types of investments they can purchase and those investments tend to be less risky. This proposal will significantly impact their ability to invest in securities with WALs greater than five years. Under current rules and regulations, these credit unions have policies in place to ensure the diversification of their investments, both as to type and WAL. These limits are regularly reviewed within each annual examination.

We recommend that risk weightings for investments be better aligned with Basel III risk weightings for investments.

Cash in the Federal Reserve Banking System

Under the proposed rules, cash at the Federal Reserve is given a 20% risk weighting. Lake Trust maintains its excess cash at the Federal Reserve as an alternative to other short term investments and also to maintain liquidity for loans or for any potential outflow of deposits once rates start to rise. Given that the NCUA has indicated that the Federal Reserve has been designated as an emergency liquidity source for the credit union industry, there appears to be no risk in holding cash at the Federal Reserve. In addition under Basel III, cash at the Federal Reserve is given a 0% risk rating.

The application of the 20% risk rating by NCUA may be an oversight given that any balances maintained at the Federal Reserve are grouped in with Cash on Deposit in Other Financial Institutions in the call report and it may be appropriate to give a 20% risk rating to cash held at financial institutions other than the Federal Reserve. Lake Trust believes that cash held at the Federal Reserve should be given a risk rating of 0% in the final rule.

Mortgage Servicing Rights

Under the proposed rules, mortgage servicing rights are risk weighted at 250% while a lower risk weighting is used under Basel III rules (100% for asset values up to 15% of capital and 250% for asset values over 15% of capital). By selling mortgages, a credit union can limit their concentration level and manage their interest rate risk. But by retaining servicing which is how the mortgage servicing right occurs, a credit union can still service the loans for their members and ensure an excellent credit union experience for their members.

Accounting for mortgage servicing rights require marking to the lower of book value or market value usually annually (or more often if needed) and as a result the values assigned should be either below or at market value, allowing the sale of these rights if needed or appropriate with limited risk. If mortgage servicing rights are risk weighted at 250%, then credit unions are less likely to retain servicing due to the impact on their risk-based capital or they may possibly choose to retain more mortgages on their balance sheets versus sell them.

Lake Trust has limited mortgage servicing rights on its balance sheet since our mortgage CUSO has the mortgage servicing rights on their balance sheet for loans that we tell them to sell. However, we still encourage NCUA to change the risk weightings to those used under Basel III for these assets.

OTHER ITEMS

Need for Supplemental Capital

The introduction of a risk-based capital system requires more options for all credit unions to raise supplemental capital. In conjunction with or prior to the implementation of the new risk-based capital system, we encourage NCUA to implement supplemental capital options that count toward risk-based capital and if possible net worth. Supplemental capital will provide an important tool for those credit unions that will no longer be well capitalized as a result of this rule. It will also provide strategic options for credit unions to raise capital to allow them to manage their future risk-based capital should their strategic plans cause their risk-based capital to fall into the adequately capitalized category.

Ability for NCUA to Require Even Higher Capital

Under the proposed rules, NCUA would have the ability to require higher minimum risk-based capital for an individual credit union on a case-by-case basis. This ability is highly subjective and would be dependent on the views of different examiners in the field. Even though we recognize that this requirement would likely be monitored at a higher level, the decision to start the process to require higher capital would start at the examiner level and not all examiners view facts and circumstances in the same way. As a result, inconsistency in the application of this proposed rule would be very possible throughout the system. Also this proposed rule could create uncertainty amongst credit union managements and boards in how to manage their day-to-day operations given the possibility that a higher individual minimum capital requirement could be required.

We recommend that NCUA delete this section or at a minimum provide clear rules outlining how this section would be applied so that credit unions know how to manage their operations to avoid a higher capital requirement.

Longer Time Needed to Implement the Policy once Finalized

NCUA's proposed rule would be a significant shift in the determination of capital adequacy for our nation's credit unions. Accordingly, such a shift should allow a reasonable length of time to fully adjust operating norms so as to assure compliance with the new standards. We believe the proposed implementation timeline of 18 months after the new rule's publication in the Federal Register would not provide a reasonable length of time to adjust in a strategic manner.

Credit Unions cannot raise capital from sources other than net earnings. Lake Trust currently maintains a "well capitalized" Prompt Corrective Action capital ratio of 9.37%. The new risk-based rules would compute to roughly the same ratio yet immediately categorize us as only "adequately capitalized." The time required for us to restore our rating as "well capitalized" would be approximately two years, assuming absolutely no growth in asset size. Accordingly, the need to quickly restore our rating will limit our ability to compete and grow and hinder our ability to succeed.

In contrast, new rules issued for community banks have a transition schedule which starts in 2015 and is not fully applicable until 2019. This timeline is much more reasonable for an orderly and strategic change in operating norms and standards.

Provide a Revised Draft for Comment

We anticipate and hope that NCUA will be making significant revisions to the risk-based capital proposal. Consequently, we recommend that NCUA issue the revised risk-based capital proposal to credit unions and others for comments once again. This practice to reissue a proposal is frequently used by rule-issuing bodies when significant changes have occurred from the first proposal.

FINAL THOUGHTS

In conclusion, we believe the proposed Prompt Corrective Action – Risk Based Capital rule would impose heavily restrictive capital definitions and asset risk weightings.

Restrictive capital definitions include the deduction of goodwill and other intangible assets from risk-based capital which will likely have a chilling effect on mergers and especially on transactions with NCUA related to troubled credit unions. Since the NCUSIF deposit was not impaired even during the depth of the recent economic recession, no need exists to reduce risk-based capital for the deposit. Reserves set aside for loan and lease losses have already reduced undivided earnings and so the addition of these reserves should not be limited, especially in light of potential changes in accounting rules which will likely significantly increase these reserves.

Asset risk weightings that are too restrictive include the tiered levels of risk assigned to first mortgages, second real estate loans and member business loans, building in concentration risks which other policies appropriately handle and are reviewed during examination and ignoring term length of the loans and supporting collateral. The risk weightings attached to investments in CUSOs seem almost punitive since CUSOs are used by credit unions to provide improved expertise, lower costs and/or additional products and services, many of which could not be accomplished by individual credit unions without significantly increased cost.

Risk weightings attached to investments are also too restrictive since they are based on maturities that do not appropriately take into consideration the type of investments and security attached to each investment or the fact that credit unions are already more restricted in the types of investments they can purchase which also tend to be less risky.

Cash in the Federal Reserve banking system should bear a zero risk rating especially since NCUA has indicated that the Federal Reserve has been designated as a emergency liquidity source. Last, mortgage servicing rights also have too restrictive of a risk weighting since these rights are marked to the lower of cost or market at least annually which means that they could be sold at minimum risk to their recorded value.

Other main concerns include the need for credit unions to be able to raise supplemental capital to provide strategic options to manage their risk-based capital. We are also concerned that NCUA has the ability under the proposed rules to require even higher capital on a case-by-case basis, with this process being very subjective. This new rule should also allow for a reasonable timeline for credit unions to adjust their operating norms to comply with the requirements in an orderly and rational fashion. Last NCUA should reissue a draft of the revised rule for comments before issuing a final rule.

Lake Trust thanks you for the opportunity to comment on this proposed rule and for considering our views on risk-based capital requirements.

David A. Snodgrass
President & CEO

Copy to:
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