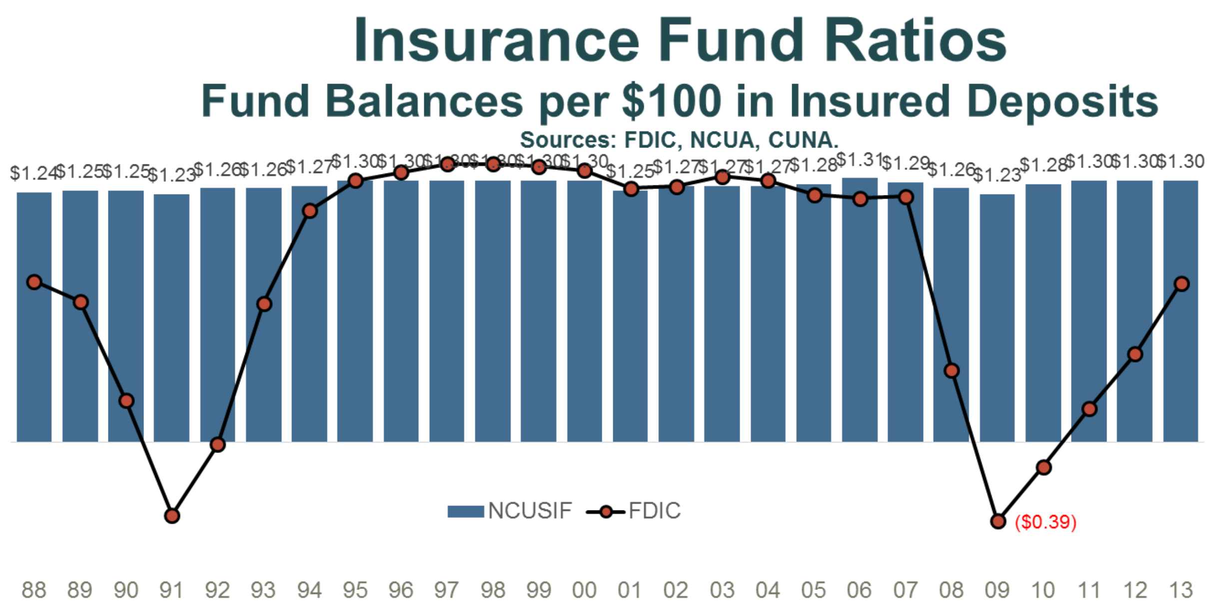
NCUA's Prompt Corrective Action - Risk Based Capital (RBC) Proposal:

A Solution Looking for a Problem

Prologue

During the great recession, natural person credit unions served as an important source of liquidity in local communities in America. The overwhelming majority of credit unions emerged from the downturn with strong capital levels proving that increasing capital reserve requirements in natural person credit unions is completely unnecessary. The NCUA's proposed across-the-board, one size fits all RBC approach would be unnecessarily burdensome. Having our Regulator even suggest it raises serious concerns about their concern for the future of our industry. There is no compelling evidence given to justify a need to change the method of risk-rating natural person credit unions' capital. Making it even worse is the fact that this proposal excludes adequate explanation of the logic behind its calculations and assumptions.

Losses barely budged the liquidity levels of the NCUSIF during the worst economic downturn in eight decades. As illustrated in the following graph, the NCUSIF performed much better than the FDIC deposit insurance fund during the crisis. Credit unions do not need more capital scrutiny.



There is growing widespread agreement among bank regulators and academicians that RBC is not as effective as simple leverage ratios for regulatory oversight. According to testimony given by FDIC Director Jerimiah O. Norton on April 8, 2104 to the FDIC board "A leverage ratio is a statistically significant predictor of bank default while the Basel Tier 1 risk-based capital is not." (Andrew Haldane, Economist and Executive Director of Financial Stability The Dog and the Frisbee, Speech given at the FRB of Kansas City's 36th Economic Policy Symposium, Jackson Hole, Wyoming (2012) available at http://www.oecd.org/finance/BanksBusinessModels.pdf.) The bank pundits have learned that bank risk-based capital standards are ineffective at predicting capital risk. This RBC proposal would result in the same outcome for credit unions.

RBC standards recently imposed on corporate credit unions already have made them less relevant for their member natural person credit unions. This proposal, if enacted would make natural person credit unions less relevant for Americans.

There possibly is a need for the development and implementation of Basel III as it relates to large, complex, internationally active financial institutions. But a close analysis of the regulatory requirements and burden as well as the resultant economic effects that the Basel III rules would have on smaller community banks, has caused FDIC Vice-Chairman Thomas Hoenig, to advocate scrapping Basel III and starting anew. He stated, "Each new Basel standard attempts to correct the errors and unintended consequences of earlier versions. But instead of resulting in better outcomes, each do-over has been more complicated and less effective than the last. Unfortunately, the weightings are more arcane than ever and therefore, even less useful." (See "Statement by Thomas Hoenig: Basel III Capital Interim Final Rule and Notice of Proposed Rulemaking" at https://www.fdic.gov/about/learn/board/hoenig/statement7-9-2013.html)

Bottom line: America's credit unions do not need this RBC proposal and its certain subsequent short-term and long-term devastating consequences.

Goodwill treatment – An Immediate Adverse Strategic Impact on Achieva Credit Union

In 2009, Achieva Credit Union consolidated Sarasota Coastal Credit Union, which was at the time around $200 million in assets. They were located in a very economically hard-hit area. The consolidation made good business sense for us since we had no presence in the counties represented by FOM which was contiguous to our FOM here on the west coast of Florida. Had they not found a consolidation partner they possibly would have been one more credit union taken over by regulators during the economic downturn. This could have cost the NCUSIF millions of dollars. Their 20,000 plus members might have been uprooted and forced to find another financial institution on their own.

When we were considering this consolidation, we personally visited then NCUA Region 3 Director Alonzo Swan and other regional staff in the NCUA's Atlanta Regional Office to present our pro-forma financial statements that illustrated how, under the then new acquisition accounting rules, this transaction would generate millions of dollars of goodwill on our balance sheet. At that time, the NCUA staff said that they had not been trained on the new accounting rules and did not have any advice regarding goodwill creation. They also emphasized that the NCUA was offering no assistance in transactions such as the one we were considering. They suggested we consult our CPA's. We asked our

CPA firm about the potential impact on our capital and were advised that goodwill is static and would have no impact on capital as long as it remained unimpaired.

The NCUA and Florida Office of Financial Regulation expeditiously approved the transaction thereby potentially saving the NCUSIF significant losses. The goodwill from this transaction has been evaluated according to GAAP standards each year since the consolidation and it continues to remain unimpaired.

Now our capital rating might be permanently damaged by a different type of safety and soundness threat on our capital funds; the proposed RBC rules. In an effort to align with new world order international banking capital requirements, the NCUA is proposing to change the rules of the game for all of America's credit unions. Ironically even though credit unions that merged challenged credit unions saved the NCUSIF from losses the NCUA's RBC proposal would permanently penalize them for their progressive, industry-supporting, business-savvy, strategic posture.

If enacted, healthy, progressive credit unions would be handcuffed by the RBC proposal to the point that many other mutually beneficial consolidations might be pre-empted due to the treatment of goodwill in the RBC proposal. Also, credit unions that might be considering a strategic consolidation with a community bank would have to think twice before moving forward. This is ironic since the NCUA's approval of several bank purchases in the last few years indicates that they favor this type of transaction.

<u>Myopic View</u>

By this proposal our Regulator is indicating they do not support the future of our industry but would rather impair a successful strategy of increasing economies of scale and market penetration. It is a bias that supports stagnation and missed opportunity. Five or ten years from now and beyond, generations of credit union leadership will find it exponentially more difficult to compete in an already extremely competitive financial marketplace due to reasons such as new entrants in the payments and banking space, technology costs, increased burdensome and costly regulation and fraud. If implemented, adding to that struggle would be the capital restraints the RBC proposal would place on them. It takes a credit union much longer to raise capital than it does our banking counterparts. The time that would be required to offset implications from the treatment of goodwill or CUSO investments would be prohibitive. Making RBC proposal permanent will endanger, or at best hamper, the positive impact on Americans the industry could have in the future.

Justifying an Alternative Charter

The fact that our Regulator would has made this capital regulation proposal and given the impending potential implications from the proposed RBC rules, it is certain that many credit union boards of directors will feel it is their fiduciary responsibility to their membership to study the long-term viability of a credit union charter.

Specific Examples of Why the RBC proposal is Flawed (Page numbers below are from the RBC proposal itself.)

The following should not be taken as suggestions to improve the RBC proposal. They simply are some examples of the many reasons why the entire RBC proposal is a bad idea.

Page 11 – "to help credit unions better absorb losses and establish a safer, more resilient, and more stable credit union system…will enhance credit unions' ability to function during periods of financial stress and reduce risks to the NCUSIF." We just experienced the toughest economic downturn in over eight decades. The vast majority of credit unions survived it. Had a similar proposal been in effect several years ago, that might not have been the case. The growth credit unions need to gain the scale that will enable them to weather the next storm would be stunted by this RBC proposal. This RBC proposal would force credit unions to diminish certain profitable business lines. For example, some successful financial institutions build their entire business model around sound business lending. If the RBC proposal is adopted, even though business loans are a profitable growth area for credit unions, that business line would be in jeopardy. Also, credit unions would need to consider reducing the volume of mortgage business. These are profitable products, growth areas and currently are in high demand.

Any lost income would be extremely difficult to replace. Credit unions can only add capital through profit. Oddly, the NCUA implies that their proposed regulation supports stronger capital levels, not weakened levels.

Page 12 – "…the requirement should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk and market risk." Credit Unions already have safeguards in place. The RBC proposal is an unnecessary double-down on credit unions' existing risk mitigation policies, procedures and practices. Examiners annually review these policies and their effectiveness. Credit unions enforce them.

Page 12 –"…the requirement should enhance the stability of the credit union system." Real capital dollars, not a risk based capital ratio, will pay for losses during turbulent times that are caused by unforeseen forces. America's credit unions need more capital dollars and this RBC proposal would be a barrier to obtaining them. The stability of our credit unions system has just been proven beyond doubt by our performance during the past recession.

Page 23 – "First mortgage real estate loan." To lump all first mortgages into one risk category is both extremely punitive and illogical. Adjustable Rate Mortgages (ARM's) that will re-price in less than 3, 5 or 7 years in no way hold the same interest rate risk as a 30, 20 or even a 15 year fixed rate mortgage.

Page 24 – "Goodwill" The resulting goodwill from a successful consolidation is evaluated for impairment every year. If this evaluation consistently supports its value it is not at risk. Business loans, including those guaranteed by the Small Business Administration, are made on a business' goodwill. Goodwill adds value to an entity. Unimpaired goodwill should not be a deduction from the nominator in the proposal.

To deduct goodwill from capital would be an affront to a business practice that provides a mutually beneficial solution the consolidated credit union's members, the NCUA, the NCUSIF and the continuing entity. Some of these transactions have saved America's credit union members and the NCUSIF from significant losses. The RBC proposal would greatly discourage similar transactions going forward. Complex credit unions need scale. Consolidation helps move credit unions along in that direction.

Page 28 – "U.S. Government Agency" Private label investments do not carry the same risk as investments guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. The risk weighting for investments in non-private label mortgage securities, i.e. agencies, should be drastically reduced.

Page 35 – "…the 2.5% capital conservation buffer which is expected to be fully implemented in 2019". It is egregious that the NCUA would propose that a high well-capitalized standard be enforced in eighteen months (page 106) after adoption when the banking industry is being given several years to build a capital buffer. This is especially obvious since banks have access to capital markets and credit unions can only raise capital through retained earnings or shrinking assets.

Items in Table 6

Page 48 – Category 5 - This regulation is egregiously aggressive toward investments in corporate credit unions and Credit Union Service Organizations. For example, an investment in corporate credit union non-perpetual capital is considered at risk dollar-for-dollar.

Page 48 – Category 5 - Even during the worst real estate meltdown when home values were plummeting in Florida, much of the real estate retained 40% or more of pre-recession values. Rating all first mortgage loans at 100% up to only 10% of assets is excessive. Additionally, combining all types of first mortgages together makes even less sense from a risk rating perspective. Also, very few delinquent first mortgage loans end up as a total loss.

Page 48 – Category 5 -To risk weight land the same as net book value of buildings is extremely excessive. Many times land is a large percentage of the value of a building site.

Page 49 – Category 7- As mentioned previously, private label investments do not carry the same risk as investments guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. Risk weighting for investments in non-private label mortgage securities, i.e. agencies, should be carried at 0% risk, not 150%, regardless of the weighted average life. Our Investment policy addresses interest rate risk so limitations would not be needed here.

Page 49 – Category 8 - New and used vehicles have residual value even when repossessed. To risk weight these loans at 150% would be extremely excessive.

Page 49 – Category 8 - Weighting all of these assets at 200% is excessive. Aggregating all of the investments and all of the MBL's makes no sense.

The NCUA's capital requirements for corporate credit unions were carefully devised to mitigate what the NCUA considered excessive risk. Proposing this weight causes serious doubt about how thorough the NCUA's efforts really were.

Pages 80 – 83 – Sections 702.105(a), (b) and (c) – The entire concept called Individual Minimum Capital Requirements (IMCR) would be dangerous. As these sections are written, the NCUA examiners would have unlimited discretion to require different levels of capital simply because they deem it necessary based on a list of items on pages 81 – 183, none of which have any boundaries or guidelines. Most of these items lend themselves to individual interpretation and are subjective (rather uber-subjective) as section (c) points out. The NCUA would be inviting controversy and conflict by enacting such a concept in their RBC proposal.

Summary

The NCUA is overreaching on the RBC proposal. This would not be unlike their overreach on the corporate stabilization assessments which credit unions are now learning took an extra billion dollars or more from credit union capital over the past several years.

In an industry where the charter is already in many ways comparatively unfavorable to a bank charter, impacts such as effectively reducing real estate lending, investments in CUSO's and business loan balances may look good relative to the NCUA, but the long-term and unintended consequences are immeasurable. It would force many progressive and business-minded credit union boards of directors to consider charter alternatives.

America's future will be more consumer and business-friendly with a stronger credit union industry. If this proposal were made permanent our industry would be weakened. That would adversely impact American consumers in the future.

The backdrop of this proposed regulation is the Basel Accords which primarily addressed capital concerns for large, complex financial institutions doing business internationally. Credit unions do not have access to capital markets. Therefore the proposed RBC does not belong in our industry.

It is unimaginable that this is the legacy the current NCUA Board will leave America's credit union industry.