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Kirk Kordeleski
President and
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Mr. Gerard Poliquin
Secretary to the NCUA Board
1775 Duke Street
Alexandria, VA 22314

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

Dear Mr. Poliquin:

On behalf of Bethpage Federal Credit Union, I would like to provide the following comment letter regarding the National Credit Union Administration (NCUA) proposed risk based capital rule approved by the NCUA Board in January 2014 and published in the Federal Register on February 27, 2014. We very much appreciate the opportunity to provide our thoughts on this crucially important regulatory proposal. We feel the proposed regulation in its current proposed state needs considerable modification before it can result in a positive impact on federally insured credit unions and the National Credit Union Share Insurance Fund (NCUSIF) that insures them. Without significant changes, we believe that the proposed rule will have a negative impact on both.

First and foremost, we strongly recommend that you reconsider the actual numbers attached to the new risk weight categories. The 10.5% level proposed to be defined as "well capitalized" exceeds the corresponding number for banks under the widely accepted Basel III standards, and seems unwarranted given the relative risk profiles and complexities of the institutions involved. To assign credit unions a higher requirement appears to be a punitive barrier, rather than a prudent cushion that would appropriately reflect elevated risks. We encourage you to reduce the requirement for definition, proposed at 10.5%, to a number that is more suited to the realities of actual credit union balance sheet risk. We also ask that you lower the other category numbers in the proposal accordingly.

In that context, we believe that a 200 basis point increase from the current 7% Prompt Corrective Action (PCA) statutory level to be considered well-capitalized would certainly be a sufficient capital cushion for credit unions with “higher risk” assets on the balance sheet. We have similar concerns about the composition of, and rationale for, the actual risk weights within the proposed risk based capital regulation.

Therefore, we believe the NCUA risk based capital proposal is more onerous than similar regulation for the banking industry. In our view, this proposed rule could result in a demonstrable weakening of the credit union charter in comparison to the mutual savings bank charter, NCUA has elected to propose a risk based capital structure that goes far beyond “comparability” as specified in the Dodd-Frank Act and clearly lands the credit union capital structure into the arena of competitive disadvantage.

Overall, we strongly disagree with the approach the NCUA took to minimize changes to the current 5300 reporting. The NCUA has an opportunity to effectively address an important issue and instead is hamstrung by this guiding principle. Bethpage strongly believes the goal should be to produce the best risk based net worth proposal regardless of the current reporting structure. This proposal runs counter to the famous quote by Rahm Emanuel to “Never let a serious crisis go to waste.” This proposal is internally inconsistent and overly conservative. We believe the proposal should be rewritten and the effort begun anew without the instructions to minimize changes to the 5300. An example of the deficiencies in using the current 5300 is in the investment risk weights. The proposal assigns risk weights by investment maturity. The current 5300 has limited information on investment maturities. The result is a 5.5 year investment has twice the risk weight of a 4.5 year investment. Minimally, the 5300 should be revised to improve the investment reporting by maturity.

In the rest of this letter we will address specific concerns and then compare the Basel III risk-based capital requirement to the proposed NCUA regulation.

The investment risk weights in the NCUA risk based capital proposal are up to ten times higher than the Basel framework for community banks. Recognizing the risks appropriately in the various types of investments authorized by law and regulation (already much more conservative for credit unions than banks), the Basel standards do not take investment maturity into the calculation – only the credit risk of the investment itself. Therefore, unlike the NCUA proposed rule, the Basel standard does not result in a 5.5 year investment being assigned twice the risk weight as a 4.5 year investment. The investment weights are arbitrary and put well-managed credit unions at competitive disadvantage.

It would be our recommendation that proper assessment of credit risk in an investment portfolio would be to provide 0% risk weight for NCUA issued notes, 0% risk weight for US Treasury bonds up for 30 years in maturity and 0% risk weight for SBA, Ginnie Mae, Fannie and Freddie bonds. The investment average life can be reported on the 5300 Call Report and evaluated from a safety and soundness perspective through the supervisory examination process. NCUA has other newly enacted rules and regulations that deal specifically with the inherent interest rate and maturity risks of long-term assets. The attempt to fix the one-size-fits-all approach of the current net worth standards under PCA with a series of categorical one-size-fits-all risk weighting seems to be cumbersome and inadequate. It makes the current system (which remains in place alongside the proposed risk based capital system) more out of balance in the name of "comparability" and the stated goal of "simplification."

The loan concentration risks are also much higher than those required of community banks under Basel. The mortgage risk requirements are double those of banks, second lien mortgages are 50% higher and member business loans at their highest weight double the capital requirement of banks. It seems that the desire for simplicity has trumped accuracy and once again the overly proscribed regulations will put well-managed credit unions at a competitive disadvantage to other banking institutions that do not have the overly conservative capital requirements.

The proposed rule ignores interest rate risks in the real estate portfolio. For example, a 30-year fixed rate mortgage gets the same risk weight as a 1-year adjustable rate mortgage. A 30 year home equity loan gets the same risk weight as a HELOC which where rates change monthly. Nothing could be less comparable and further from simple than the NCUA proposal. This portion of the proposal itself should be modified dramatically or shelved until a later date when more empirical data is available to properly assess risk in the various categories of a credit union's balance sheet.

For example, to demonstrate how ignoring interest rate risk in real estate loans and assigning higher risk to 5+ year investments leads to incongruities, let's look at two similar credit unions with differing strategies. Credit union A holds $100 million in 30-year fixed rate mortgages and credit union B takes the same $100 million in 30-year fixed rate mortgages, sells them to Fannie Mae, receives back the $100 million in mortgage-backed securities backed by the same mortgages. Under the NCUA's proposed risk based capital formula, credit union A has $50 million in risk weighted assets even though they are holding a less liquid asset with thirty years of credit risk – while, at the same time, credit union B has liquid bonds and no credit risk yet their risk weighted assets are valued three times higher at $150 million.

Not only does the above example provide an incentive to holding thirty year mortgages versus selling in the secondary market and purchasing investments in that market, but this type of illogical risk weighting actually puts the NCUSIF at greater risk – much greater risk – than current regulation. Credit should be considered in real estate lending. Loan to Value ratios at origination is an available metric that could be incorporated into the risk weighting formula, as can some credit worthiness standard based upon historical performance of the mortgage portfolio.

Perhaps a system of credits could be incorporated into the system that would reduce the risk weight in each category of lending by 50% if the credit union has maintained a charge off ratio of less than 2% over the past three to five years. There may be a way to incorporate creditworthiness into the formula. At the very least, a 30-year fixed rate mortgage and a 1-year ARM should not be assessed the same risk weighting.

The risk weighting for both lending and investments, as specified above, need considerable work or they will leave credit unions, their members and the NCUSIF at a considerable disadvantage in comparison to the capital standards in place for community banks and insured by the FDIC.

We also have concerns about the one-size-fits-all approach to CUSO investments and mortgage servicing rights. For example, a 250% risk weight for all CUSOs does not recognize the obvious and historical risk differential in operational CUSOs versus lending CUSOs. It makes no sense whatsoever to allocate the same risk weighting for a business lending CUSO as a land title CUSO that does the research as a part of a loan's underwriting. Operational CUSOs and lending CUSOs should not carry the same risk weighting. We recommend all operational CUSOs to be weighted at 50% as they are replacing at a savings operational costs that the credit union would otherwise carry. Lending CUSOs should be weighted at 100% and poor performance of CUSO investments in a lending CUSO supervised through the examination process.

Likewise, it appears that the 250% risk weighting for mortgage servicing rights is another attempt at function following form. There are two accounting methods under GAAP for mortgage servicing rights – fair value and amortization. Amortization is a more conservative approach than fair value and should not be assessed at the same risk weight as fair value accounted mortgage servicing rights. Again, it appears that the desire to "simplify" has placed form over function. The NCUSIF is best protected by a system that properly assesses and recognizes the risk differential within the balance sheet.

In order to ascertain the impact of the proposed regulation on Bethpage risk-based net worth was calculated based on the current balance sheet as well as the projected balance sheets for 12/31/14 and 12/31/15. The results were compared to the Basel III calculations.

Date	NCUA Proposal	Basel III
03/31/14	11.32%	16.53%
12/31/14	11.13%	15.99%
12/31/15	10.86%	15.65%

The Basel III calculation results in a substantially higher risk-based capital position – 46% higher as of 3/31/14. The primary reason for this startling difference is that the NCUA investment risk weights are a multiple of the Basel III risk weights. The proposal will unnecessarily negatively impact Bethpage and harm our ability to serve our member owners. Additionally, the second lien real estate portfolio is forecast to exceed 10% of assets by the end of 2014 further decreasing our net worth ratio. As noted previously we disagree with the concentration risks in the proposal. Bethpage has historically been a real estate lender, both first and second lien mortgages. In 2006 second lien mortgages comprised 24% of assets. Despite what the proposal considers to be a high concentration in risky assets Bethpage came out of the financial crisis with flying colors – experiencing well above industry average growth while increasing net worth. Clearly, this concentration of "risky assets" did not impact our performance.

If Bethpage's RNNW ratio drops below 11.00% in 2015 as we forecast Bethpage will be forced into making decisions which are not in the credit union's and\or the members' best interests. It doesn't make sense from a risk perspective to hold more 30 year fixed rate mortgages as opposed to 6 year investments but doing so would increase the RBNW. It doesn't make sense to reduce the amount of HELOCs on our books as these loans serve our member owners, help the credit union's interest rate risk profile and have performed well from a credit perspective but otherwise our RBNW would be uncomfortably low. It doesn't serve the members' interests to lower deposit rates to decrease deposit growth but it would increase the RBNW. We believe these changes are not in Bethpage's interest or the interest of the member owners. The only reason to make these changes are to meet these poorly constructed capital requirements.

At 10.86% in 2015, too close for comfort to 10.5% requirement, Bethpage would automatically change its strategy (investments, etc) or it's organic growth. The only reason to make these changes are to meet these poorly constructed capital requirements.

If NCUA is going to proceed with establishing a risk based capital system to run alongside the current PCA net worth based system, it is incumbent on the agency to get it right. The future of the credit union charter depends upon it.

Bethpage Federal Credit Union has long supported the need for a balanced and workable risk based capital system to replace the current inflexible PCA net worth formula. We have added our institutional support to congressional efforts to reform and modernize the credit union capital system through legislative action.

Our concern about this regulatory proposal is that, without legislative authority to truly structure a risk based capital system specific to credit unions without the statutory 7% requirement to be well-capitalized or the regulatory approval of supplemental capital instruments to be incorporated into any NCUA imposed risk based capital system, it takes a well-defined statutory net worth requirement – albeit a flawed and arbitrary one under PCA and adds to it a second regulatory capital ratio calculated at 10.5% of at risk assets without clearly establishing which requirement is the one upon which credit unions should focus their strategic management. Credit unions will be incented to manage the credit union for the members instead of what is best for the members.

There is indeed a legitimate question that this proposal brings to the forefront for strategic decision making at federally insured credit unions. Should the statutory PCA requirement established by Congress in 1998 be the dominant criteria to meet or should NCUA's new risk-based requirement be the key formula to which a balance sheet should be managed?

Of course, if the answer is as we expect that both should be equally complied with, what would happen if a credit union's capital falls below 10.5% of risk assets but is well above 7% net worth of total assets in accordance with the statute? The answer does not appear to be clear in the proposed regulation.

Credit unions need to know clearly what the capital requirements are that they must manage to. This proposed rule leaves this pivotal management question up in the air, to the detriment of both the safety and soundness requirements of the credit union and the members who it serves.

Yet, this proposal adds an even greater area of uncertainty for management teams and board of directors acting in their fiduciary roles. The provision that will allow a credit union's examiners to add additional capital requirements on a subjective basis to a credit union's risk-based ratio leaves no clarity whatsoever as to where the capital retention goal line should be. The examiner discretion provision of this proposed rule must be removed or no credit union leadership team in a federally insured credit union will be able to make strategic decisions based upon their capital position. Why? Because even being above the statutory net worth level of 7% and the risk based capital ratio of 10.5% does not mean the credit union is sufficiently well capitalized until the examiner has so opined in his or her annual visit. There have been many documented cases about differences in the interpretation of NCUA Rules and Regulations and how it is enforced in the field. This is an untenable position for a credit union board and senior team to find themselves in as they attempt to build and maintain a viable, safe and sound financial institution.

We would like to also question the reason NCUA did not elect to include some parameters for the issuance of supplemental capital in this proposal or at least in a companion proposal. While we recognize that subordinated debt or other forms of GAAP recognized capital cannot be considered for the statutory PCA net worth requirements (other than for low-income designated credit unions of which almost one-third of all credit unions now qualify), there seems to be no statutory or regulatory impediment to authorizing supplemental capital that can be counted toward meeting the regulatory risk based capital standard being imposed by this proposed regulation.

If NCUA truly believes now is the time for capital modernization (a concept that we support in principle, if the metrics established are truly reflective of the risk in the balance sheet), then certainly now is also the time to consider supplemental capital sources for the risk-based capital system seeking to be implemented under this proposal.

We recommend that NCUA allow subordinated debt instruments to be offered to members and non-members as a source of supplemental capital, provided the instruments meet GAAP capital requirements that will be included in available capital to meet the regulatory requirements of any risk based capital system implemented by NCUA as the federal insurer. Again, we recognize that this supplemental capital cannot help meet the statutory PCA net worth requirements; however, it is NCUA that is now seeking in the name of capital modernization to implement a second regulatory capital standard to overlay the statutory requirements. There is no reason why capital modernization cannot be truly modernizing.

Credit unions would benefit from a supplemental capital option. Credit union members would benefit from stronger credit unions with more capital. The NCUSIF would benefit from the additional cushion against potential credit union losses. Supplemental capital is an idea whose time has come. Risk based capital is the vehicle upon which it can be implemented.

In conclusion, we like the idea of risk based capital, but see fatal flaws in the proposal as presently out for public comment. We do not believe that proposed rule, in its current form, improves the capital system for credit unions in any significant way from a safety and soundness perspective. In fact, we feel that this proposal works contrary to safety and soundness by inserting uncertainty and inconsistency into the net worth and capital calculation formulas that credit unions use to make every strategic decision.

Neither uncertainty in capital expectations nor inconsistency the application of capital standards bring about better management decisions or safer credit unions. Unless it is significantly modified, this proposed rule will not bring about better management decisions or safer credit unions.

Therefore we encourage NCUA to withdraw this proposed rule, or modify it considerably. The resultant impact of not getting the capital system right for credit unions in the next generation could well be the lack of long term viability of credit unions into the next generation.

Finally, we strongly encourage you to consider prescribing a period for when the rule becomes effective that will be sufficient for compliance. It will be essential to give credit unions an opportunity to prepare for the substantial and far-reaching operational and management changes inherent in the creation of this new capital construct. Bank regulators provided for an 18-month period between finalization of their rule and its effective date; an identical, if not longer interval would be appropriate here.

Thank you very much for the opportunity to comment on this proposed regulation. If I can be a source of any further information on this letter or any further matter, please do not hesitate to contact me.

Sincerely,

Kirk Kordeleski
President & CEO
Bethpage Federal Credit Union