JOHNS HOPKINS
FEDERAL CREDIT UNION
Serving the Johns Hopkins community since 1971

Office of the President

May 22, 2014

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

Via e-mail: regcomments@ncua.gov

RE: Comments on Proposed Rule: Prompt Corrective Action – Risk-Based Capital.

Dear Mr. Poliquin:

The Johns Hopkins Federal Credit Union primarily serves employees of the Johns Hopkins University and Johns Hopkins Health System. We currently have over 38,000 members and about $350 million in assets. We appreciate the opportunity to submit comments on the National Credit Union Administration's (NCUA) proposed rule Prompt Corrective Action – Risk-Based Capital (RBC).

We feel strongly that if the proposed rule is adopted as written, it will place an undue burden on credit unions to comply, particularly when examiners are pushing credit unions toward lower earnings and lower capital. This push comes in the form of forcing credit unions to move from more productive, longer investments that take advantage of the yield curve, into investments with maturities less than three years, to reduce interest rate risk. As a reference, the current three year treasury security rate is 0.79%.

From NCUA Letter 14-CU-02: "Interest rate risk is the most significant risk the industry faces right now. As rates have risen above record lows, many credit unions' unrealized gains have swung to unrealized losses. These unrealized losses may foreshadow the actual losses credit unions will face if continuing rate increases eventually result in more compression of net interest margins.

“It is imperative for credit unions to make the necessary adjustments to account for a rising rate environment. Even a slow, gradual increase in rates could have significant consequences for credit unions with high concentrations in certain long-term investments and loans. NCUA will be working to ensure credit unions are mitigating any inordinate exposure. “

NCUA has the enforcement authority to compel credit unions to manipulate their balance sheet in a way that is seen as less of a threat to the National Credit Union Share Insurance Fund (NCUSIF). This means taking on only very low levels of risk, achieving lower returns, and ultimately, lower capital.

NCUA’s current direction to place interest-rate risk over earnings and capital is at odds with the proposed rule which asserts capital as king. NCUA estimates that over 90% of the credit unions with assets over $50 million, under the proposed rule applied today, would meet the minimum risk-based capital requirements. NCUA also estimates that only 200 credit unions would experience a decline in their PCA classification from well capitalized to adequately capitalized if the proposal were in effect now and 10 well-capitalized credit unions would be downgraded to under-capitalized.

However, we assert that a greater number of credit unions would fall from being comfortably well capitalized under the current system to being merely well capitalized under the proposed system, particularly when combined with the current interest rate risk reduction strategy. Credit unions cannot lower their interest rate risk without liquidating longer-term items, and this generally means taking losses. Credit unions can only build capital through net income, or lose it through net losses, there are no alternate means. We have two opposing forces colliding: NCUA’s wish for more capitalization and NCUA’s wish for less interest rate risk. Our credit union is currently in the well-capitalized category, but we are concerned whether we will maintain that position considering the pressure to reduce interest rate risk. We imagine many other credit unions that are slightly less capitalized than us will be caught even more squarely in the crossfire of these opposing goals.

Proposed risk-weights

A number of the risk weights, especially for long-term assets, member business loans, mortgage concentration, mortgage servicing, the NCUSIF deposit, and, CUSO investments do not appear to be properly calibrated for credit unions. They are higher than what is being imposed on banks by the BASEL III changes.

- Using higher risk weights on long-term investments to deal with interest-rate risk is misleading without considering liability maturities and other mitigating factors. We think the important question to be asked is whether an individual investment fits in with a sound ALM strategy. We suggest using average weightings for asset categories, rather than basing the risk weightings on individual investments, to better evaluate overall effectiveness.

- Under the proposed risk weights, if an investment carries a 4.9 year average life, it would be risk weighted at 75%. If the same investment moves with the market to a 5.1 year average life, it would now be risk weighted at 150%, which is the same as for one with an almost 10 year average life. A tiny change in average life should not cause a large change in risk weighting.
- Too much of anything can be bad, but mortgage loans to our own members are the safest loans we can possibly make. We think that a 35% of assets threshold is too low to cause a much higher risk rating for first mortgages, and a 20% of assets threshold is too low for other mortgages. Real estate loans come in many varieties: fixed and variable rates, in terms ranging from 7 to 30 years, and for different geographic areas and neighborhoods. We feel these factors mitigate the concentration and interest rate risks. Pushing credit unions away from mortgages means pushing them toward more risky loans.
- The mortgage loan servicing risk rating seems excessive. There should be a distinction between "with recourse" and "without recourse" loan sales, because loans sold "without recourse" carry far less risk. Often credit unions cannot hold more first mortgages on their balance sheet; but still offer these loans to members and sell them in the secondary market. This process allows a credit union to provide a valued member service, maintain member relationships, maintain a presence in the first mortgage market, and earn a small profit.
- Each CUSO carries a different risk level, and combining them all into the same risk weight assignments for CUSO investments and loans seems oversimplified. We encourage NCUA to implement regulations that promote the use of CUSOs to generate net income and provide services benefitting members; and to remove regulatory impediments to CUSOs and collaboration.
- In regard to category 10 where the risk-weight soars to 1,250%; we certainly agree that credit unions should not invest in instruments they do not understand. However, this weight seems punitive, considering that delinquent first mortgage loans are risk-weighted at 100%. The standard for determining whether a credit union has "a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance" is based on Reg. 701.104(d) but is ultimately a subjective measure, and could cause credit unions to liquidate assets unnecessarily. We suggest that investments falling into this group be moved into category 8 (200% risk rating), where investments with the maximum average lives are classified.
- Ratios throughout are expressed as percentages of assets. We suggest they be expressed in terms of capital. Assets move up and down as member shares move up and down, but capital is the more stable number and more indicative of the true risk to the NCUSIF.

Examiner discretion to change risk ratings

Proposed section 702.105(c) is troubling and unclear in that NCUA would assume additional authority to impose higher capital requirements on individual credit unions that could exceed even well capitalized level requirements. Unlike the existing statutory net worth rules known as Prompt Corrective Action (PCA) regulations, credit unions would no longer have clear rules to avoid prompt corrective action imposed by NCUA if the agency can establish its authority to use "judgment" on a credit union-by-credit union basis to make changes to risk ratings. This section of the proposed rule could open the door to inconsistent and potentially arbitrary application of the intended rules. In addition, this change would significantly diminish the responsibility of boards and management to make critical financial judgments, determine the strategic direction of the credit union, and oversee policy. Our recommendation is to remove section 702.105(c) from the proposed rule entirely.

Implementation Date

We are also recommending that the proposed implementation date of eighteen months after becoming final be extended. This proposed time-frame does not give credit unions sufficient lead time to properly plan for and implement the new risk-based capital ratio requirements and other proposed changes to part 702 and implement them properly. This is particularly important as many credit unions are already restructuring their balance sheets to become less profitable and reduce interest rate risk. We are urging the agency to provide a much longer implementation period, particularly in light of the multi-year development and implementation of Basel III for banks.

Conclusion

We fully understand the importance of capital in a financial institution, but feel this rule needs to be reworked. We are concerned that NCUA's authority is ever-broadening and they are acting in what they believe to be the best interest of the NCUSIF, and not in the spirit of what credit unions were meant to be. There is significant concern that this rule is short-sighted and that its long-term effects could be harmful to our Credit Union and the industry as a whole, which indeed would ultimately hurt the NCUSIF. We would prefer to see NCUA allow more latitude when it comes to well-run credit unions vs. giving examiners extra authority to make changes to risk ranges. Well-run credit unions are going to be what carries the industry forward, and they are best equipped to make decisions for what they need to do to stay well-capitalized.

Up to this point, we have been able to provide our members with advantages that are not offered by our competitors, like more favorable interest rates and lower fees. We will have to lower dividend rates and raise loan rates to comply with this regulation, making us less competitive. As a credit union we have a limited field of membership, are limited as to what we can invest in and can only build up capital through income. If we are required to maintain excessive liquidity, excessive capital, and minimal interest rate risk; we may not be able to provide any advantage to people of moderate means, or any other means, compared to our banking competitors.

In that spirit, we are asking NCUA to carefully weigh the comments received and consider withdrawing this flawed proposal in favor of opening a new productive dialogue with the credit union community regarding warranted and balanced risk-based capital reform.

Thank you for the opportunity to comment on the proposed rule Prompt Corrective Action – Risk-Based Capital. If you should have any questions, please contact me at mmesta@jhfcu.org or 410-534-4500 x262.

Sincerely,

Michael J. Mesta
President & CEO
Johns Hopkins Federal Credit Union

Georgean C. Smith
Board Chair
Johns Hopkins Federal Credit Union

cc:
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