State Employees' Credit Union

Accounting Department

May 27, 2014

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

Re: Notice of Proposed Rulemaking – Prompt Corrective Action – Risk-Based Capital

Dear Mr. Poliquin,

We are pleased to have the opportunity to provide comments on the proposed rule of the National Credit Union Administration (NCUA) regarding Prompt Corrective Action – Risk-Based Capital (RBC) for federally insured "natural person" credit unions. State Employees' Credit Union has been providing teachers and state employees of the State of North Carolina and their families with consumer financial services for close to 77 years. With 1.9 million members, SECU provides services through 253 branch offices, 1,100 ATMs, 24/7 Contact Centers, a voice response service and an interactive website.

General Comments

We do not support the rule as proposed. The proposed rule will impose significantly higher capital requirements for most assets and these harsh requirements will have to be borne by our members through higher loan interest rates, lower deposit interest rates and higher fees for services. Other capital conventions vetted over many years and in use by both national and international financial regulatory authorities (Basel and FDIC) are far more balanced in their assignment of risk weights and capital requirements for the same assets.

The higher capital requirements on first mortgage loans will have a direct impact on our ability to assist members in reaching their dreams of owning homes. The proposed rule will limit the duration of investments through harsh RBC requirements which will hamper our ability to invest in safe investments using proven investment strategies to manage capital responsibly. The proposed rule unreasonably requires credit unions to meet the RBC ratio guidelines in 18 months while the Basel/FDIC convention phases in the capital requirement over 7 years.

We recognize the importance of assessing risk as a capital planning tool which will help assure that we remain a safe, sound, well capitalized, not-for-profit financial cooperative. We fully support the efforts to formally incorporate such practices within the credit union industry as other prudential financial institution regulators have done. However, the proposed rule shows no evidence of analysis or data to support the RBC proposals. For years we have included risk-based capital planning into our strategic planning and risk analyses. Our conservative internal application of the bank risk based capital conventions, in fact, reflects that we already meet the 2019 capital requirements under Basel/FDIC requirements.

In reviewing the proposed rule, we understand that NCUA attempts to incorporate in the proposed RBC capital convention a measure of all material risks – credit, interest rate, concentration, liquidity, operational and market. The complex, sometimes contradictory, interaction of the various risks on the balance sheet of a credit union makes it impossible to adequately capture these risks in a single capital measure. The regulatory exam process should continue to evaluate all risks, including interest rate and concentration risks.

By proposing a risk based capital convention while not including the use of supplemental capital the NCUA is missing the opportunity to provide credit unions with a critically important tool which could be used to manage capital and enhance the safety and soundness of the industry.

The remainder of this response will address specific areas of the proposal and our observations and recommendations for changes to the proposed rule.

First Mortgage Real Estate Loans

A single risk-weight category of 50% should be applied to all first mortgage loans.

The proposed NCUA risk weighting category structure for first mortgage loans creates a lending environment that is punitive to credit union members. The result of the higher proposed risk weights will limit the ability of credit unions to serve members who need mortgage loans. The proposed rule will impair the ability of credit unions to serve our members when other financial institutions through Basel/FDIC risk based capital conventions are currently held to a 50% risk weighting standard regardless of first mortgage portfolio size. Without the ability to offer a competitive first mortgage loan product, many credit unions will ultimately be forced to exit the first mortgage market, further reducing the affordable alternatives available to our credit union members.

First mortgage loan portfolios historically represent a lower level of credit losses than other loan products. The risk associated with an additional first mortgage loan does not increase based upon the number of other first mortgage loans the credit union previously originated. The rule gives no consideration to historical and current loan portfolio performance. A high credit quality loan portfolio with a history of low delinquencies and charge-offs is a mitigating factor to a higher balance sheet concentration. Concentration risks can be monitored through the Call Report and the examination process.

A single weighting of 50% for all first mortgage loans should be implemented to align the RBC capital requirements with the Basel/FDIC convention. This approach will allow credit unions the opportunity to continue meeting the housing needs of our members.

First Mortgage Real Estate Loan Definition

The definition of a First Mortgage Real Estate Loan should include a reference to the underwriting regulatory rules pertaining to the borrower's ability to repay that were in

place at the time the mortgages were originated. The proposed rule should not incorporate the requirement to underwrite the loan using "maximum interest rate that may apply in first five years" as part of the definition of a first mortgage real estate loan.

The proposed rule defines a first mortgage real estate loan based on the regulations that are in place today and does not accommodate the first mortgages that were prudently originated based on prior regulations. The proposed rule defines first mortgage loans through three criteria. One criteria to be met states, "*The loan underwriting concluded the borrower is able to repay the exposure using the maximum interest rate that may apply in the first five years, the maximum contract exposure over the life of the mortgage and verified income.*" This requirement, the Qualified Mortgage regulation, was only recently enacted – January 2014. Different requirements for underwriting were in place prior to January 2014. Many high quality, stable and performing mortgage loans are in the portfolio of credit unions which were not originated using the five year convention.

The proposed definition of a first mortgage real estate loan severely penalizes credit unions that followed prudent and accepted underwriting standards in previous periods. The rule is proposing that real estate-secured loans not meeting the definition of first mortgage real estate loans would be classified as ‘‘other real estate loans’’ and assigned a higher risk-weight. Including the specific details of the current underwriting and the ability to repay regulatory standards will require NCUA to update the regulation whenever new mortgage underwriting regulations are enacted. **Therefore, the definition of a First Mortgage Real Estate Loan should include a reference to the regulatory underwriting rules in place at the time the mortgages were originated.**

<u>Federal Reserve Bank Deposits</u>

The rule should explicitly include the risk weight for the Federal Reserve Bank Deposits in the Category 1 – zero percent risk weight.

Cash on deposit with the Federal Reserve Bank should be assigned a 0% risk weight as it is directly and unconditionally guaranteed by the full faith and credit of the U.S. Government. The rule should explicitly include Federal Reserve Deposits in the *Category 1 – zero percent risk weight* description. There is no risk of loss on such funds. There should not be a 20% risk weight assigned to this type of deposit.

<u>Investments – Maturity Based Convention</u>

We recommend that the risk weighting by weighted average life be removed from the proposal. Investments should be categorized based on full government guaranties (0%) and non-government investments. The risk-weighting on Government Sponsored Agency Securities, for example, would be 20% rather than risk-weighting based on maturity proposed in the rule.

There should not be such harsh RBC capital requirements for investments with maturities that are 5 years of higher. This convention requires that all credit unions maintain extremely short investments even if they have the ability to hold a portion of their portfolio in a longer term investment. Government Sponsored Agency Securities carry an implicit guarantee from the U.S. Government against the possibility of credit default. As such, these securities enjoy a highly liquid market and can readily be used as collateral to obtain liquidity, if needed. A risk-weighted tier approach, that doubles, triples, even requires 10 times more capital for holding these low risk securities, penalizes credit union member returns and puts credit unions at a major competitive disadvantage to serve members. The risk weighting for the Basel/FDIC convention assigns a 20% weighting factor to Government Sponsored Agency Securities. The interest rate risk associated with longer duration investments can be mitigated through various means including the ability to use agency notes and mortgage backed securities as collateral for additional funding. The credit union would not be forced to sell investments at a loss to gain liquidity if it had a prudent and strategically positioned portfolio of cash, investments and lines of credit.

<u>Member Business Loans (MBL's)</u>

The RBC requirement for MBL's should be set at 100%.

This would put the risk weight in line with other prudential regulatory regimes and not add an unduly harsh capital requirement for these types of loans.

<u>Delinquency Categories</u>

The loan delinquency categories utilized in the proposal should be adjusted to 30 to 89 Days, 90 Days and Still Accruing, and Non-Accrual. Adjusting the Call Report to these categories will align the delinquency reporting with other prudential financial institution regulatory reporting.

The industry standard for measuring delinquency for banks utilizes the **90 day** delinquency category. Reportable delinquency included on credit union Call Report is defined as **60 day** delinquency. The method of reporting aggregate credit union delinquency levels based on a 60 day convention vs. the bank standard of 90 days puts credit unions at a comparative disadvantage. The different reporting convention gives the membership and the general public the false impression that credit unions are experiencing higher levels of delinquency on our loan portfolios. Financial industry standard practice uses a 90 day delinquency threshold as the point at which a loan is moved to a non-accrual status.

The rule should recognize delinquent loans as 90 days and greater for reporting and assigning the risk-weighting category so that a meaningful and accurate comparison of performance across financial institutions can be achieved.

<u>Other Real Estate Secured Loan</u>

The risk weight for Other Real Estate Secured Loans should be assigned a 100% factor to offer the same advantage to our members allowed under the Basel/FDIC risk based capital rule.

While Other Real Estate loans carry more risk than first mortgages real estate loans, they are secured by collateral and should be risk-weighted similarly. Applying the proposed risk weighting considers the higher credit risk associated with these loans while not penalizing credit union members with an additional capital charge.

Deduction of the NCUSIF Capitalization Deposit from the Risk Based Capital Numerator

The deduction of the NCUSIF Capitalization Deposit from the risk based capital ratio numerator should be removed from the proposed rule.

Under proposed Risk Based Capital rules, credit unions are required to deduct the 1% deposit which funds the National Credit Union Share Insurance Fund (NCUSIF) from the risk based capital ratio numerator. The NCUSIF deposit is an asset of the credit union and should be treated no differently than funds deposited with any other federal government agency. If the NCUA is anticipating that the funds may not be available to return to the credit union in the future, then a better solution is to assign a risk-weight to the NCUSIF capitalization deposit. The risk weight category could be moved out of the Category 1 – zero risk weight to a category similar to an investment in the Federal Home Loan Bank (FHLB). Total capital should not be reduced by the amount of the NCUSIF deposit. It is not appropriate to address concerns about the NCUSIF's balance sheet presentation of equity through this rule. Reducing credit union capital by the amount of the NCUSIF deposit has a severe impact on a credit unions ability to serve its members. The effect is a double capital charge for this refundable asset.

Individual Minimum Capital Requirement

Section 702.105, establishing the Individual Minimum Capital Requirement, should be removed from the proposal. NCUA already has the authority to raise or lower the minimum capital required by setting the risk-weighting for each category of assets at the appropriate level. They can also seek to impose higher or lower capital requirements through the examination process.

Introducing an Individual Minimum Capital Requirement (IMCR), an overriding, subjective determination of minimum capital by an examiner, contradicts the purpose of implementing the proposed approach of risk weighting assets. The idea of the IMCR sends the message that the proposed risk weighting approach is inadequate, ineffective and meaningless.

We strongly disagree with the notion that appropriate minimum capital levels for an individual credit union are better determined based on the subjective judgment and expertise of an examiner. Our experience over four decades is that the capital requirement for a credit union could be changed each year depending upon the whim and whimsy of the current examiner in charge. Allowing the examiners to determine the adequate level of capital each exam does not provide credit unions with consistency of measurement and is no way to adequately manage a financial cooperative.

Allowance for Loan/Lease Losses

The Allowance for Loan/Lease Losses (ALLL) cap of 1.25% should be eliminated from proposal.

The proposed rule should not limit the amount of ALLL that can be used as capital. The ALLL represents a reserve that is available to cover estimated loan losses and as such is a capital buffer. During the recent financial crisis loan charge-offs for all credit unions increased substantially. The average loan charge-off ratio for the peer group of credit unions over $500 million reached 1.18% in March 2010. Credit unions that maintained an ALLL of only 1.25% of risk assets would have had an allowance that was underfunded and not in accordance with Generally Accepted Accounting Principles (GAAP). In contrast, if loan losses do not materialize to the level that was anticipated and the ALLL becomes overfunded, reserves held in the ALLL may be released and returned to capital through income. There is no prudent reason to limit the amount of ALLL that can be counted as capital – the cap of 1.25% should be eliminated from the proposal.

<u>CUSO's</u>

The 250% risk weight for CUSO's is unduly harsh and should be reduced to 100%.

CUSO's serve a valuable function and can be monitored and managed through the regulatory examination process. The unreasonably harsh RBC capital convention puts our members at a disadvantage when such service organizations could be formed to contribute to the benefit of the membership.

<u>Public Disclosure</u>

We recommend public disclosure at the outset of the implementation of the final rule. Full transparency is important—our members have the right to know the results of this capital measurement.

<u>Implementation Time Line</u>

The implementation timeline to meet the new capital requirements should be extended.

The proposal states a time frame of up to 18 months will be available to meet the new standards. Since credit unions can only generate capital through the retained earnings, the effective date of compliance should be longer. If credit unions do not meet the proposed requirements, they will have to adjust business strategies to generate additional capital through earnings; higher loan rates, lower deposit rates, higher fees – all of which are paid for by members. Credit unions do not have access to supplemental funding sources to immediately raise capital. More time is necessary and reasonable in order to transition to a new RBC capital regime. Other institutions have been allowed a seven year time frame for transitioning to an RBC capital convention.

<u>Supplemental Capital</u>

The ability for all credit unions to maintain supplemental capital should be top priority for NCUA.

The NCUA should not miss an opportunity to implement supplemental capital rules in conjunction with an RBC capital regime. An alternative source of capital for credit unions is a huge tool which could assist credit unions in managing capital and risk. This shortcoming needs to be addressed! The time is now!

Conclusion

The Risk Based Capital proposal falls short in many respects. **We do not support the proposed rule as it is currently written.** This proposal will have a major impact on the future of the Credit Union industry and our ability to serve our members. The risk weights are ill-conceived and if implemented as proposed will damage our ability to serve our members. Your serious consideration of all of the comments on the proposal will only serve to improve the final rule. We again thank you for the opportunity to comment on the Risk Based Capital proposal.

Sincerely,

Michael J. Lord
Chief Financial Officer