Midwest Business Solutions

Commercial and Agricultural Lending

2700 N. Plaza Dr. / Rapid City, SD 57702 / Phone: 605-718-5455 / Fax: 605-716-0655
E-Mail: phil.love@mwb-s.com / Web: www.mwb-s.com

May 25, 2014

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

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

Dear Mr. Polquin and Members of the NCUA Board:

I am writing this in response to the NCUA's request for comments on the proposed rule regarding risk-based capital (RBC) changes. Midwest Business Solutions is a credit union service organization that provides commercial and agricultural loan underwriting and servicing to credit unions in the upper Midwest. The primary group of credit unions we serve are headquartered in three states and have trade territories that extend into another four. The primary area we operate in is characterized by strong, diversified economies, low unemployment, fewer regulatory requirements, and a favorable business climate. Consequently, the credit unions in this area of the country do see strong opportunities to add good earning assets to their balance sheets through business and agricultural lending.

A well-structured risk based capital program can be an important tool for helping to ensure the long term viability of credit unions. However, the proposal, as set forth by the NCUA is fraught with flawed logic and incorrect assumptions. The short time for comments and also the speed of proposed implementation also points to a hasty attempt to push new regulations without concern as to the overall impact of the credit union industry health going forward.

Risk Rating of Member Business Loans

The risk rating of Member Business Loans (MBLs) is much more severe compared to our counterparts in the banking industry with their use of Basel. So why should banks and credit unions be judged with different standards when the loans being assessed for risk are the same? Also the last I checked, it was banks that received a bailout from the government en masse, as opposed to credit unions which were not given the same consideration. The current risk rating by the FDIC for Commercial and CRE loans is at 100%. The proposed risk ratings under RBC calls for a tiered rating from 100-200% based solely on the institutions amount of assets it has in business loans without any consideration given to the actual credit quality behind those loans.

A look at the net charge offs as a percent of outstanding loans shows that over the past 12 years, credit unions' business losses have tracked closely to credit unions' mortgage

2700 N. Plaza Dr. / Rapid City, SD 57702 / Phone: 605-718-5455 / Fax: 605-716-0655
E-Mail: phil.love@mwb-s.com / Web: www.mwb-s.com

losses, which both ended slightly over 0.5% in 2012. A look at bank losses during that same period is constantly substantially higher than those in the credit union industry. In the immediate period following the crash, these losses reached over 2%. On the basis of charge offs, it would seem that CUs have consistently managed their portfolios better than banks. So why should CUs be judged more severe than banks in this area?

Another flawed logic here is that the more business loans that a CU has, the more risk there is inside the institution. More business loans mean a different type of risk, but not necessarily more risk. A credit union with a strong concentration of consumer and mortgage loans to one community or one particular company will find its portfolio stressed if a severe economic downturn hits said area or company. This risk can be much greater than a well-managed business loan portfolio diversified across several geographic areas and industries.

The proposed RBC amounts penalize a well-managed, non-delinquent, and performing business portfolio from a CU that has a larger percent of their assets in business loans as compared to delinquent consumer and mortgage debt, which is risk rated at 150% and 100%, respectively. It would appear in this case, that the NCUA dislikes MBLs of any kind with the exceptions of those that represent a very small percentage of a CU's assets.

The long term viability of an institution is in its ability to continue to generate a steady stream of earnings sufficient to satisfy its operational expenses and return earnings in excess of expenses back to said firm and its owners. Curtailing well-managed business loans that tend to earn more money than a lower earning consumer loan, just because you think the consumer loan has less risk, hampers the industry's ability for future earnings.

The business lending restrictions will slow down the economy as economic growth requires a free flow of capital and credit to grow. This will hurt CUs' ability to serve its business clients, which may drive some of them to other alternatives, effectively shrinking the size of the institution. Also as companies find it harder to borrow to expand, they will stop growing and employing more people. With more unemployment, more individuals will face a tougher time to meet their obligations, resulting in more stress on a CUs' consumer and residential assets. Thus, these RBC rules tend to favor large companies that are stockpiling cash instead of smaller ones that need capital to grow.

A more sensible approach in this area would be to follow the FDIC example and weigh MBL loans and construction and development loans (C&D) that have perm financing in place and are not dependent upon the sale of the asset for repayment, at 100% and speculative or horizontal C&D loans at a higher amount, say 125%. This could place a greater limitation on the riskier loans while not placing CUs at a competitive disadvantage to banks. Also, it is important here to weigh loans on the underlying risk in that loan instead of judging the entire portfolio as a whole.

2700 N. Plaza Dr. / Rapid City, SD 57702 / Phone: 605-718-5455 / Fax: 605-716-0655
E-Mail: phil.love@mwb-s.com / Web: www.mwb-s.com

Change of Risk Rating By Examiner Discretion

Another problematic portion of the RBC is in Section 702.105(c). This section changes the clear rules CUs have to run their shop and instead, moves to rules that can be switched at any time based upon an examiner's wishes. This invites inconsistency and an arbitrary application of rules. A clear view of capital and net worth requirements are mandatory for top CU leadership to make strategic decisions on how to meet those needs. Thus, in my view, this entire section must be deleted.

Inconsistent and Poorly Structured Risk Rating in Other Areas

RBC has other flaws in its proposals to rate other CU assets. Examples of this are where an investment in a 30 year US Treasury is a 0% risk, yet overnight money deposited at the Federal Reserve Bank is risk rated 20%. Apparently, in this case, no concern for duration risk is needed. This section also conflicts with the proposed weighting of securities and investments in government sponsored enterprises (GSEs) according to weighted average life where all of the sudden, duration risk is important. A GSE guarantee from the US Government indicates that the government will not allow such institutions to fail. This is another case where the RBC has flawed logic in its attempt to push higher capital requirements.

A solution in this case would be to rate any overnight money placed on deposit with the Federal Reserve at 0%. Following the Basel model for the GSE investments at a 20% weight no matter of the duration is a more prudent approach to these investments.

Risk Weighting of Investment in CUSOs

The 250% risk weighting for investments in CUSOs is also arbitrary, especially in light when delinquent consumer loans and 100% for delinquent mortgage loans. So is an investment in a CUSO over 2/3 riskier than a delinquent consumer loan?

The regulation seems to suggest that unless a CUSO pays a cash dividend to its CU owners, there has not been a return on investment and therefore the investment is at risk. This approach, takes a very small view of the value a CUSO plays to the overall profitability to a CU with either cost savings, revenue generating, or service expansion opportunities. In our case, we have not paid a direct cash dividend to our shareholders, yet half of our CU equity partners made at least 25% of their investment amount in the form of fees and interest we paid them on loans they participated in. We also have two that made more than their investment back in one year. This seems to show a substantial return on their investment.

We have other CUs that we have operated as their back office credit department and have seen countless poorly structured or risky deals that we have encouraged the CU to avoid. So, these CUs all obtain value through us and are able to have better quality assets on their books in spite of us not having paid them a dividend. We have provided cost savings and have allowed that CU to benefit from lower staff expenses by utilizing our expertise. When you look at the entire benefit provided by CUOSs, many CUs receive revenue or save costs from the first day of the investment.

Again, all CUSOs are not alike and there is no differentiation here to analyze the type of services that are provided, if the benefit given to the CU has actually saved operational expenses that the CU would have had to incur on its own if not for the CUSO, it real income was generated to the CU from the CUSO that would have not otherwise been available, whether the amount invested is material (there are only 22 bps invested in CUSOs industry wide now), and whether the institution has earned more money than its original investment amount.

Also, why would investments in a CUSO be taxed at any amount higher than the original investment if there is no way that the actions of the CUSO can impact the CU at an amount greater than its investment in said CUSO. In each case, attorney opinion is necessary to make sure there remains a separation between the CU and the CUSO. Given that, a more appropriate risk rating for a CUSO investment would be 100%, the same as other assets.

Urgency in Comment and Implementation Period

Although the NCUA is asking for comments, repeated requests to extend the comment period has been met with denials from the regulators. Also the rapid 18 month implementation pales in comparison to the 9 years given to banks to comply with Basel requirements. It seems the banking regulators recognized that time is required for institutions to restructure balance sheets in order to meet the requirements. It seems like an appropriate 9 year period to match the Basel requirements provided to banks is appropriate.

I think you for allowing comments to be made regarding the proposed regulations. I hope you make the correct decisions for the overall health and viability of the credit union industry.

Regards,

Phillip Love, President and CEO
Midwest Business Solutions