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May 21, 2014

Gerald Poliquin, Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on the Proposed Amendment to Part 702 – Prompt Corrective Action

Dear Mr. Poliquin,

Thank you for the opportunity to be heard. Allegacy Federal Credit Union ("Allegacy") appreciates the notice and comment process of the aforementioned proposed rulemaking. Allegacy understands and supports the National Credit Union Administration's ("NCUA") efforts to modernize NCUA Regulation Part 702 – Prompt Corrective Action ("PCA") to reflect financial services industry changes to a risk-based capital ratio approach, comparable to Basel III. We agree that credit unions should hold capital commensurate with the risks they are taking. Notwithstanding the foregoing, Allegacy does not support the proposed rule in its current form. The proposed rule provides strong evidence in support of the H.L. Mencken quote, "For every complex problem there is an easy solution that is simple, plausible, and wrong." More appropriately, the proposed rule might be described as complex, implausible, and wrong.

Credit unions take the philosophy of people helping people very seriously. The structure and historic performance of credit unions show that generally credit unions are risk adverse. During the recent financial crisis, credit unions fared better than many other financial institutions, because they were committed to making sound business decisions for their members, and not chasing shareholder profits.

The proposed rule would inflict much higher capital requirements than the overall level of risk necessitates, and it ignores the historically solid performance of the existing capital standards. Credit unions' metrics for delinquency rates, loan loss ratios, deposit insurance fund losses, and institutional failure rates are lower than our banking counterparts. Although Allegacy understands the need for PCA changes in light of Basel III, we do not believe the changes in the proposed rule are appropriate.

The Proposed Rule is Fundamentally Flawed

Allegacy submits that the proposed risk-based capital rule has four serious flaws:

1. The proposed rule violates the Federal Credit Union Act.
2. The risk weightings are not properly calibrated for credit unions and would put them in danger of not being able to serve their communities.
3. Part 702.105 provides the NCUA unbridled authority to override the regulatory capital requirements and impose arbitrary and capricious capital requirements.
4. The eighteen month implementation time period is unreasonably short and unduly burdensome on credit unions.

Below, Allegacy will explain our concerns with the proposed rule, and then recommend pragmatic solutions.

1. The proposed rule violates the Federal Credit Union Act.

The Federal Credit Union Act ("FCA Act") requires the NCUA to develop a system of PCA that is comparable to PCA employed by the Other Federal Bank Regulatory Agencies, but that also takes into account the unique nature of credit unions. The FCU Act specifically identifies credits unions as not-for-profit financial cooperatives that "(i) do not issue common stock; (ii) must rely on retained earnings to build net worth; and (iii) have boards of directors that consist primarily of volunteers."[1] One of the most unique characteristics of a credit union is that unlike its banking brethren, it cannot go into the market to raise capital. The proposed rule does not sufficiently take into account the unique nature of credit unions.

Administrative agencies are tasked with implementing legislation passed by democratically elected members of Congress. The FCU Act requires the NCUA to adopt a risk-based net worth plan – but the proposed rule establishes risk-based capital standards, not risk-based net worth standards. The NCUA has stepped outside its scope of authority, replacing its judgment for that of Congress and credit union management. Further, the FCU Act directs the NCUA to "design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."[2] As such, the NCUA should only create a risk-based net worth system at the adequately capitalized level. If a credit union is over the adequately capitalized threshold of 8%, it should have no additional capital requirements. For example, if 8% is the risk-based capital requirement for adequately capitalized credit unions, no more than 8% should be the risk-based capital requirement for well-capitalized credit unions.

<u>Recommendation:</u> Tie any risk-based capital requirement to the adequately capitalized level, consistent with the FCU Act. Do not impose additional capital requirements at the well-capitalized level.

2. The risk weightings are not properly calibrated for credit unions, and would put them in danger of not being able to serve their communities.

Allegacy believes that the risk weightings of the risk-based capital rule will have severe and detrimental unintended consequences on credit unions nationwide. The risk weightings would create strong incentives for credit unions not to make real estate loans, member business loans, longer-term investments, and CUSO investments. The proposed rule's risk weightings would significantly reduce the ability of credit unions to lend to their members and small businesses. With the strap on capital, Allegacy will not be able to provide other important, community oriented services. At Allegacy we run the Center For Smart Financial Choices, operate seven student-run credit unions, and are active with many local charities. Resources would have to be allocated away from the community to address the proposed risk-based capital requirements. Moreover, many of the risk weightings duplicate existing effective regulations, increasing the complexity risk of regulations. Resources will have to be reallocated to handle this regulatory compliance burden as well.

Unlike the Basel system which assigns weights exclusively on the basis of credit risk – NCUA's proposed rule covers credit risk, interest rate risk, concentration risk and other risks. This approach creates considerable duplication of regulation. It also employs a tiered approach, which is a departure from Basel III. The risk weightings that Allegacy is most emphatically opposed to are: real estate related loans and delinquent loans, member business loans, allowance for loan and lease loss, portfolio investments, and CUSO investments.

[1] 12 U.S.C. § 1790d(b)(1)(B).
[2] 12 U.S.C. § 1790d(d)(2).

Real Estate Related Loans and Delinquent Loans

The proposed rule's risk weights for real estate related loans and delinquent loans vary between 50% and 150% depending on the percentage of assets. These risk weights will put credit unions at a distinct and unfair disadvantage to bank competitors, who under Basel III have a 50% (first lien) or 100% (junior lien and delinquent loans) risk weighting for comparable loans. Furthermore, these risk weightings ignore many important factors about the loan. For example, was it a fixed rate loan or an adjustable rate? Where is the property located? A high proportion of the residential real estate problems during the financial crisis were in a handful of states. The makeup of the portfolio should not be overlooked.

The risk weights on outstanding first lien mortgages and junior real estate disregard the prudent underwriting standards that credit unions have used for decades. These prudent underwriting standards were recently codified by the Consumer Financial Protection Bureau through its Ability to Repay and Qualified Mortgage Rule. Lenders must determine that borrowers have the ability to repay the loan before they will extend credit. Compliance with the Ability to Repay and Qualified Mortgage Rule should reduce credit unions' credit risk considerably.

The most detrimental risk weighting scale to Allegacy is junior lien real estate and delinquent real estate, at 100% to 150%. Allegacy has always taken the conservative approach and underwritten junior lien real estate loans like we underwrite first lien mortgages. Again, the Ability to Repay and Qualified Mortgage Rule now requires this for most junior lien real estate loans. Allegacy went one step further and requires this same analysis for lines of credit as well. Junior lien loans and lines of credit are in high demand from Allegacy members. We would have to consider discontinuing these products, or placing a moratorium on them if the proposed rule is left unchanged. This will hurt our members considerably.

Beyond the difference in risk weightings, when comparing the treatment of delinquent loans under the proposed regulation to Basel III, there is a significant difference in the definition of delinquent loans. Basel III defines delinquent as 90 days past due, whereas the NCUA's proposed rule defines delinquent as 60 days past due. Again this disadvantages credit unions, and will cause them to arbitrarily hold more capital than their competitors.

Member Business Loans

The proposed rule's risk weight for member business loans varies between 100% and 200% depending on percentage of assets. Part 723.16 limits a credit union's net member business loan balance to the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets. Part 723.17 provides for three very limited exceptions to this limit. Most credit unions, including Allegacy, would not fit into any of the three exceptions. The proposed risk-based capital rule then assigns higher risk to member business loans if the percentage of total assets is greater than 15%. Since Part 723 already has an aggregate member business loan limit to control this risk, the risk weight in the proposed rule is unnecessary and duplicative.

If the NCUA prefers to deal with member business lending through risk-based capital, it should remove the cap in Part 723 entirely. Alternatively, it could increase the cap to match the risk-based capital rule threshold, and eliminate any risk weight above 100%. Credit unions that engage in member business lending are an important source of competition for banks operating in the same geographic areas – and Part 723, as well as the proposed rule, makes us uncompetitive. The purpose and goal of any amendment should be to put credit unions on a level playing field with banks, so that we can help small businesses.

Allowance for Loan and Lease Loss

Allegacy believes the Allowance for Loan and Lease Loss (ALLL) should not be limited to 1.25% of the total risk-weighted assets. The proposed rule states, "The goal of the proposed risk-based capital ratio numerator is to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses." [3] The purpose of a loss allowance is to provide the initial cushion, ahead of capital, for loan write-downs – and the "Texas Ratio" recognizes this fact by including the total of equity plus ALLL in that ratio calculation. As a result, the entire ALLL balance is properly treated as a buffer, just like capital, which protects the insurance fund from potential losses. The recent Financial Accounting Standards Board ("FASB") proposal may lead to additional reserve requirements which will increase the negative impact of this limitation. Additionally, placing a limit on the ALLL to be counted in the numerator does not support a conservative ALLL policy. We do not understand the need to cap the amount of ALLL that is included in capital, and believe it should be removed.

Investments

The proposed rule's risk weight for investments varies between 20% and 200% depending on the weighted average life ("WAL") of the investment. This is problematic in several ways. First, tiering by tenor is proposed for investments and not for loans. Second, and more importantly the liability/funding side of the balance sheet is ignored. Third, this approach is inconsistent with Basel III which requires no adjustments of weighting by WAL and addresses investments from a credit perspective. For example, the bank rule weight five to ten year WAL investment grade Government Obligation Municipals at 20%, whereas the NCUA's proposed rule weights the same investment at 150%.

The weighting scale works to deter any investment over five years, as five to ten year investments have a risk weight of 150%, and over ten years have a risk weight of 200%. This is a significant and harmful departure from Basel III, which has 20-50% risk weights for investments depending on the type of investment. This approach also clearly creates problems for intelligent portfolio and investment management over the rate cycle. Tiering risk weights by term unwisely works against astute and prevalent use of a bar-bell investment strategy which combines short and long maturities, as opposed to only investing in mid-range bonds (i.e. combining short one and two year bonds with six/seven/eight year bonds rather than investing only in three to four year bullets.) Tiering the investment risk weights by WAL also penalizes the broadly accepted and utilized laddered portfolio strategy which allows investments to reinvest in the longer end of the ladder, "ride the yield curve," and generate regular cash flow.

Allegacy agrees that Interest Rate Risk ("IRR") should be proactively measured and managed, but it is already heavily regulated and examined. NCUA has in place a very complete and up-to-date protocol for guiding and supervising both net interest income ("NII") and net economic value ("NEV"), which serves to protect the insurance fund and reflects the complexity of this task. The proposed rule is a duplication and compounding of regulation, increasing the time required by management and examiners to monitor and assess compliance. Current IRR regulations incorporate years of research and experience by both regulators and practitioners, and recognize the entity-specific complexities of measuring, modeling, managing, and controlling IRR. IRR components of the risk-based capital proposed regulation are inappropriately simplistic relative to the interest rate risk management task.

Natural, constructed, and synthetic balance sheet hedges and funding structures to mitigate asset-driven IRR are completely ignored in the proposal; the rule attempts to partially capture asset tenor risk and ignores the structure of the liability side of the balance sheet. The result creates perverse asset/liability incentives which could unintentionally work against the growth of capital across the entire credit union system and thereby increase exposure to the insurance fund. Liquid investments are penalized according to term while tenor of on-balance-sheet mortgages is ignored. Highly illogical weightings result, such as, first lien 30-year mortgage loans are proposed to be weighted at 50% or 75% or 100% depending on balance sheet concentration while a highly rated, marketable FHLB five to ten year bond would have a 150% weighting.

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[3] 79 F.R. 11193 (February 27, 2014), National Credit Union Administration: "Prompt Corrective Action – Risk Based Capital."

CUSO Investments

The proposed rule's risk weight for CUSO investments is 250%. This functionally acts as a penalty for credit unions who invest in CUSOs, and a deterrent for those considering getting involved. This is illogical and erroneous reasoning. CUSOs act as a hedge for interest rate risk. They provide a diversified income stream, serving as a supplemental form of income that is non-interest income. That supplemental income helps the credit union to build capital, and actually reduces risk to the insurance fund. Generally, such a diversified portfolio is a prudent strategy.

Allegacy is involved with five CUSOs. These investments have provided a significant source of non-interest income to the credit union. Since 2000, our wholly owned CUSOs have provided a $10.2 million increase in capital to the credit union.

The NCUA in its Letter to Credit Unions 13-CU-13 acknowledges the importance of CUSOs: "CUSOs provide significant value to the credit union industry by allowing organizations to collaboratively share risk, manage costs, and deliver services to credit union members. The unique collaborative business model of CUSOs fosters cooperation and shared innovation for credit unions, allowing them to achieve economies of scale, retain expertise, and better serve their members." The 250% risk weight assigned to CUSO investments contradicts this positive perspective.

By penalizing credit unions involved with CUSOs, this will stifle innovation and reduce competition – two extremely harmful effects. CUSOs act as a structure to promote industry efficiency, pooling expertise to better serve credit unions. They complement the cooperative spirit of the credit union movement. They provide targeted credit union support companies, and without them competition with other financial services support companies will be reduced. This will hurt small credit unions with regard to pricing and customer service with third party vendors, who may not be interested in small accounts, or do not understand the unique nature of credit unions.

Additionally, this is another area that from a regulation perspective overlaps and double dips. Part 712 addresses credit union risk and involvement with CUSOs. Effective June 30, the amended CUSO regulation will provide NCUA increased access to CUSOs' accounting and operations. This should sufficiently mitigate the risk, as the NCUA will have increased supervisory access and authority.

<u>Recommendation:</u> Better calibrate the regulatory capital standards, reducing the weights for real estate related and delinquent loans, member business loans, and CUSO investments. Eliminate the ALLL cap of 1.25% of the total risk weighted assets. Remove the tiering of risk weights for investments by WAL. Consider aligning the risk weightings with Basel III. Recognize that existing regulations already mitigate the various business risks, and by layering inflated risk-based capital requirements on top of the existing regulations, the NCUA is creating such regulation complexity that it will be hard for credit unions to survive.

3. Part 702.105 provides the NCUA unbridled authority to override the regulatory capital requirements and impose arbitrary and capricious capital requirements.

The proposed rule's individual minimum capital requirements in Part 702.105 provide the NCUA the ability to ignore the risk-based capital requirements, and impose subjective, increased capital requirements on a case-by-case basis. This carve out is overbroad and not expressly provided for in the FCU Act. It also seems to undermine the entire intent behind the risk-based capital requirements of the proposed rule, if examiners can subjectively disregard and override them at their discretion.

<u>Recommendation:</u> Eliminate part 702.105. Alternatively, add strict qualifiers as to when this authority can be used, and require NCUA Board approval for its use. Create a more robust credit union appeal process when this authority is used. Regulatory requirements must be clear and defined so credit union boards and

management can understand the rules and make sound business decisions. Credit unions need to know the rules of the game in order to have a fair shot at compliance.

4. The eighteen month implementation time period is unreasonably short and unduly burdensome on credit unions.

The proposed risk-based capital rule would go into effect approximately eighteen months after the publication of the final rule in the Federal Register. This is entirely too short. The banking community had approximately nine years to comply with Basel requirements. This multi-year development and implementation approach is much more reasonable, considering the time needed for credit unions to make adjustments to balance sheets, internal systems, and operations.

If the proposed rule were approved as is, many credit unions would need to raise additional capital. Most credit unions do not have access to supplemental forms of capital, and can only raise additional capital through retained earnings – this is a very challenging and slow process. It will take time for credit unions to raise additional capital, and instead they may look to alter their balance sheet composition by repositioning assets in groups with more favorable risk weightings.

For Allegacy, as of March 31, 2014, under the proposed rule our risk-based capital ratio would be 10.70%. The strategic capital buffer that we have enjoyed for some time is functionally erased. We will only have a 20 basis points buffer between being well-capitalized, and falling to adequately capitalized. As a result, we will need time to investigate, analyze, and conduct proper due diligence before making any needed adjustments – this process will take much longer than eighteen months. We will have to consider changes to our balance sheet, internal systems, operations, as well as possible changes to our organizational structure and credit union charter.

Recommendation: Once the final rule is promulgated, extend implementation time to at least five years.

Conclusion

Allegacy makes every business decision with the best interests of our members in mind, and does not take unmitigated risks. Our mission is to help our members make smart financial choices. If the proposed risk-based capital rule were to be adopted in its current state, we would be forced to consider eliminating or rationing products and services, lowering dividend rates, increasing loan rates, and charging more fees. This concept is offensive to the cooperative, member-focused nature of credit unions. These unintended consequences of the proposed rule would hurt credit unions nationwide, and considerably limit our growth.

We respectfully ask you to consider the concerns voiced by credit unions, trade associations, and more than 325 members of Congress. The proposed risk-based capital rule must be changed significantly.

Sincerely,

Cathy J. Pace
Chief Executive Officer

Cosby M. Davis, III
EVP, Chief Financial Officer