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April 9, 2015

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

Dear Mr. Poliquin:

This comment letter is sent to address our concerns regarding the proposed Risk Based Capital rule's second draft (RBC2).

Hudson River Community Credit Union is a state chartered community credit union serving 23,511 members in four counties and three cities. Four of our five branches are located in low income census tracts and 44% of our member base is low income according to the regulatory definition. Our net worth ratio as of 12/31/14 is 13.9% under the first proposal RBC1 our risk based net worth ratio would have been 17.8% and now under RBC2 it will be 21.6%. As you can see our comments are not meant to mitigate a capital position instead they are intended to provide insight into our opinion as to whether the rule is necessary and secondarily that it addresses the issue of risk based capital evaluation effectively.

First, I would question the need for the rule at all. The continual flow of rules and regulations takes time and money and inhibits our ability to serve our members. Our members do not need 85 pages (actual count) of disclosures to tell them about their variable rate home equity loan, they do not need to know each year that we continue to protect their privacy which I believe in our business it is a given and we certainly do not need to complicate the measurement of net worth. We have loan officers in our branches that sit with members explaining fully their options, answering all their questions and ensuring that the choices they make are understood and in their best interest. We do not need regulations to tell us to do that. We have ALM models run regularly and financial plans to ensure the credit union is well run and positioned to be financially strong over time.

Being a finance person I understand the level of net worth necessary will vary from credit union to credit union based on the composition of their balance sheet, their strategic plans and the economic forecast both regionally and nationally. I do believe the regulators role is to ensure credit union management is evaluating these components and addressing capital needs, not to devise a calculation to tell them how much they need. Nor should NCUA have the right to second guess a credit union's decisions about how best to allocate resources. But NCUA is insisting that it has the right to impose individual buffer requirements even for credit unions that are in compliance with proposed capital requirements.

I understand that the rule has been written and therefore an unwelcome reality we must contend with. I offer my input to the components of the rule:

- I first would like to applaud the NCUA for recognizing the issues with the first draft and for taking the time to incorporate many changes and release a second draft especially raising the threshold to \$100 million (even though I do not believe asset size is a true indication of complexity), lowering the requirement to 10%, including the entire ALLL account, and delaying compliance to January 1, 2019.
- **Interest Rate Risk**: You have removed IRR from the proposed rule and asked for comments on alternative approaches that could be taken in the future to reasonably account for IRR. Interest rate risk models are very complex and are highly driven by subjective assumptions. It is my opinion they are not anything that could or should be regulated in any way, shape or form. I do believe credit unions need to utilize these models to ensure the credit union is positioned well and I do believe regulators can ensure they are running them and using them to that end.
- **Complex credit union**: Asset size is not a good indication of complexity. Product lines, investment types and product features are better indications of complexity. Things like CMO's, derivatives, Indirect loans, interest only loans, member business loans, embedded options and repurchase transactions are better indicators of complexity.
- **Examiner subjectivity**: Regulations need clarity and specificity in order to be effective. Subjectivity is opinion based, inconsistent and unclear. It will simply create an environment of conflict.
- **RBS Numerator**: need to include supplemental capital as it is at risk as any other capital is and as such should be counted as capital.
- **Risk Weightings**: It does not make sense to weight asset categories more heavily than banks. If anything this needs to be reversed. In Dr. David Smith's & Dr. Stephen Woodbury's research done for the Filene Institute documented in a report entitled "Withstanding a Firestorm: Credit Unions vs Banks" their research concluded that "credit unions are less sensitive to the business cycle than banks. Both certainly suffer when unemployment rises, but the trajectory and magnitude of delinquencies and charge offs at banks – especially during the latest downturn- are much more pronounced." In the study they provide very clear data supporting this statement. I have enclosed a copy of the study for your reference.

I would like to thank you for considering our input to the proposed rule and welcome any requests for further clarification and/or information.

Sincerely yours,



Sue Commanda, CEO

Withstanding a Financial Firestorm: Credit Unions vs. Banks

David M. Smith, PhD

*Associate Professor of Economics and Associate Dean of Academic Affairs
Graziadio School of Business and Management, Pepperdine University*

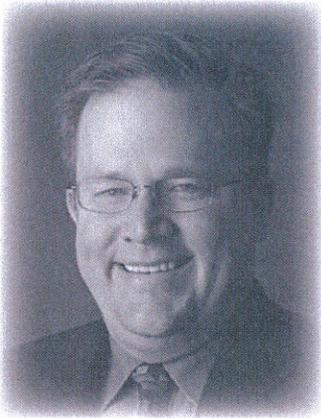
Stephen A. Woodbury, PhD

*Professor of Economics
Michigan State University*

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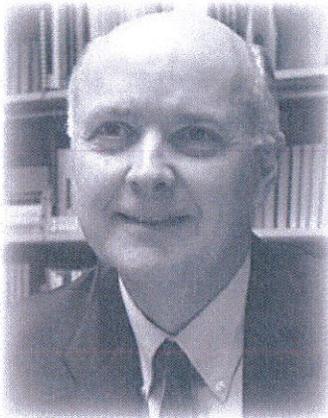


About the Authors



David M. Smith, PhD

Prior to obtaining his PhD in economics at Michigan State University in 1997, David M. Smith worked for seven years as a manager in the insurance industry. Since completing his academic credentials, Smith has consulted for various industries, specializing in the computer, financial services, medical, and nonprofit sectors. His economic expertise includes the areas of labor pay and productivity, forecasting, and analysis of specific labor markets. A labor economist with an applied focus, Smith has published numerous articles in both academic and practitioner journals. His research on credit unions has been used in arguments before the U.S. Supreme Court as well as in state legislative hearings. Smith is frequently quoted by the media, including most recently the *Chicago Tribune*, the *Los Angeles Times*, Fox News, *USA Today*, the *New York Times*, and the *Investor's Business Daily*. Smith is currently an associate professor of economics and associate dean of academic affairs at Pepperdine University's Graziadio School of Business and Management.



Stephen A. Woodbury, PhD

Stephen A. Woodbury is a professor of economics at Michigan State University and a senior economist at the W.E. Upjohn Institute in Kalamazoo, Michigan. He has held faculty appointments at Pennsylvania State University and the University of Stirling (U.K.), was deputy director of the Advisory Council on Unemployment Compensation (U.S. Department of Labor) during 1993–94, and is a past president of the Midwest Economics Association. His research has focused on employee benefits and policies to assist unemployed workers. His books include *Search Theory and Unemployment* (co-edited with Carl Davidson, 2002), *Employee Benefits and Labor Markets in Canada and the United States* (co-edited with William Alpert, 2000), and *The Tax Treatment of Fringe Benefits* (co-authored with Wei-Jang Huang, 1991). He did his undergraduate work at the University of Pennsylvania and Middlebury College, and received his PhD in economics from the University of Wisconsin–Madison in 1981.

Acknowledgments

We thank NCUA and CUNA for making data available for this study.

By Ben Rogers,
Research Director

Keeping up with the Joneses is a familiar North American feeling. When a new car appears next door, you want it. When your daughter's playmate enrolls in private school, you want in. Rightly or wrongly, the sideways glances and scorekeeping come with the culture. And the feelings are not much different in financial services. For the sake of broad comparison, let's call credit unions the Carters and banks the Joneses.

The Great Recession has been excruciating for the Carters and the Joneses alike. The Carters have lost hard-earned savings, have suffered painful pay cuts, and have been forced to stop eating out. But while the Carters didn't make as much as the Joneses in their heyday, they have also lost much less in the downturn. In general terms, the Carters saved up before they bought, while the Joneses acquired their cars with credit and their investments on margin. Today the Carters may have to postpone that new car purchase, but the Joneses are losing their homes.

What Is the Research About?

Professors David Smith, of Pepperdine University, and Stephen Woodbury, of Michigan State University, seek to illuminate the trends that got the Carters and the Joneses to where they are today. Starting from the observation that unemployment coincides closely with loan delinquencies and charge-offs, they aim to describe how the same economic shocks treat the loan portfolios of credit unions and banks.

This report contributes to the regulatory debate by comparing the financial stability of banks and credit unions from 1986 to mid-2009, a period that covers several business cycles and ends during some of the most pronounced effects of the Great Recession. If banks and credit unions show the same delinquency and charge-off behavior through alternating rounds of the business cycle, that would argue for similar regulatory treatment of capital. If delinquency and charge-off ratios of either are more pronounced, then the more volatile group might be expected to hold more capital.

What Did the Researchers Discover?

The researchers match unemployment trends to delinquency and charge-off behavior as reported to the FDIC and NCUA. The resulting data show that credit unions are not immune but are much less susceptible to the business cycle than banks. Their lending growth moves gradually with cyclical unemployment trends, but it

1. Introduction

After a financial crisis that has contributed to a severe recession, there is a widespread consensus that our regulatory system failed us and there is a need for reregulation of our financial system. Some are calling for a simpler system, one that may lead to a single regulator model for financial services (Hofheimer 2009). In light of this possibility, it is useful to consider the extent to which credit unions should be regulated differently than banks. Issues that have been debated in the past include whether credit unions should have a separate share insurance fund and whether the capital requirements of credit unions should differ from those of banks.

This report contributes to the debate on regulating credit unions by comparing the financial stability of banks and credit unions from 1986 to 2009, a period that covers more than two business cycles: from the mid-1980s economic recovery from the 1982 recession, through the 1991–92 recession, to the 2001–2 economic downturn, and concluding with the recession that began in December 2007. We compare the loan performance of banks and credit unions over this time period, with the objective of comparing the resiliency of banks and credit unions to economic stress.

We focus on two key dependent variables—loan delinquencies and net charge-offs—and examine the sensitivity of these variables to a key business cycle indicator, the unemployment rate. We use these data to examine whether the loan delinquencies and charge-offs of credit unions are less sensitive to business cycle downturns than the loan delinquencies and charge-offs of banks. Similar observed performance of the delinquencies and charge-offs of banks and credit unions over the business cycle would support similar regulatory treatment of the two types of financial institutions, whereas differential performance would suggest the opposite. The report proceeds as follows: Section 2 reviews prior work that has compared differences in loan portfolios between banks and credit unions. Section 3 reveals

Credit unions and banks have fundamentally different governance structures, which in turn generate different incentives to assume risk.

some data on delinquencies and charge-offs from banks and credit unions over the past 23 years. Section 4 looks at loan growth rates over the business cycle, and Section 5 presents the statistical analysis and key

results. Section 6 delves into some data on loan growth rates and also looks at state-specific factors. Section 7 concludes with implications for regulating credit unions.

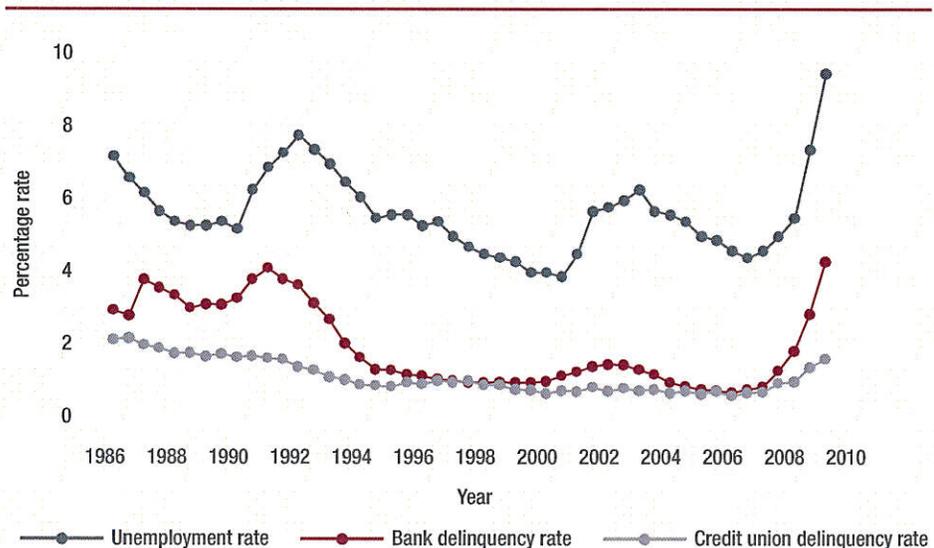
controlled banks from 1979 to 1982. The present study extends this research by studying credit unions and banks.

3. The Business Cycle, Delinquencies, and Charge-offs

A recession is defined as two or more quarters of declining GDP. One useful measure of the health of the economy is the unemployment rate, since it is inversely correlated with GDP.² Figure 1 displays a time series of the U.S. unemployment rate, captured in June and December, from 1986 to 2009. The figure illustrates more than two full business cycles, starting in the middle of the 1980s recovery from the 1981–82 recession and ending in mid-2009, during a time of particular economic turmoil. The 1991–92 recession led to a peak-to-trough GDP loss of 1.4%, corresponding to an approximately 2% trough-to-peak increase in the unemployment rate. Though not fully captured in these data, the 2007–9 recession led to a peak-to-trough GDP loss of 3.9% and a more than 5% trough-to-peak increase in the unemployment rate. As we study loan performance under economic stress, using the unemployment rate has an intuitive appeal, since job loss at the individual level can often lead to one becoming delinquent in meeting financial obligations, including loans.

Figure 1 also plots semiannual data on the delinquency rates of banks and credit unions from 1986 to 2009.³ A bank loan is considered delinquent when it is 90 or more days past due, and a credit union

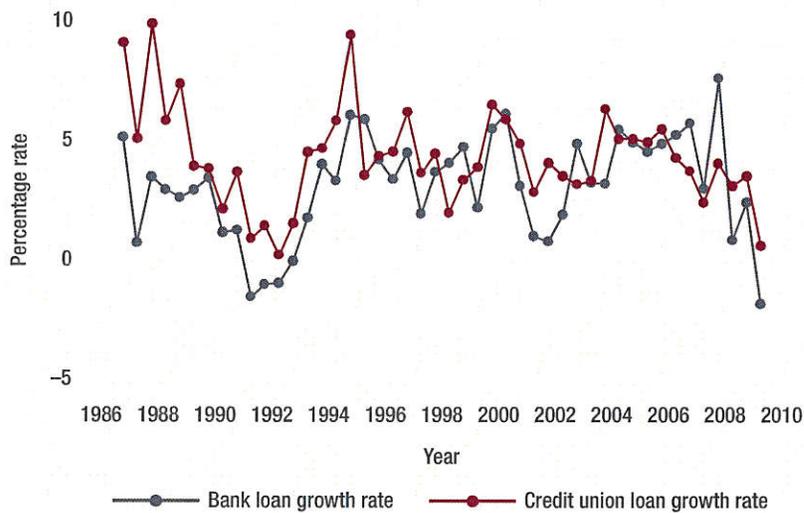
Figure 1: Unemployment and Delinquency Rates



Sources: Federal Reserve Bank, 1986–2009, Commercial Bank and Bank Holding Company Database; Credit Union National Association, 1986–2009, Madison, WI; U.S. Department of Labor, Bureau of Labor Statistics, 1986–2009, Washington, DC.

from 1986 to 2009. If banks are more responsive to economic conditions, we would expect that banks would have lower periods of

Figure 3: Loan Growth Rates: 1986–2009



Sources: Federal Reserve Bank, 1986–2009, Commercial Bank and Bank Holding Company Database; Credit Union National Association, 1986–2009, Madison, WI.

growth rates during economic downturns, relative to credit unions. Figure 3 presents the data on loan growth from 1986 to 2009. The data reveal that loan growth rates dip lower for banks during recessions, even turning negative in the early 1990s recession. Credit unions seem to follow a similar pattern, but an econometric analysis discussed in the next section reveals a difference between the sensitivity of loan growth rates for banks and the sensitivity of loan growth rates for credit unions to the business cycle. From a public policy standpoint, economists

recognize that investment spending (and hence lending) plays a key role in economic recoveries; thus the availability of credit during an economic downturn can play a key stabilizing role in the economy.

5. Comparing Resiliency between Banks and Credit Unions

Although the figures presented thus far suggest a difference between bank and credit union loan performance in economic downturns, an econometric analysis is necessary to confirm and quantify the differences. Call report data are available on a state-level basis, and the unemployment rate is as well, which allow for a unique panel data set to be constructed that includes 2,397 observations (51 states over 47 time periods). This panel data set offers some unique advantages when conducting this sort of analysis. Using an econometric estimator called “fixed effect,” we are able to control for the state-specific and time period factors, thereby isolating the impact of the variable of interest, the unemployment rate.

First, we are interested in measuring the approximate percentage change in bank and credit union delinquencies resulting from a one percentage point increase in the unemployment rate.⁵ We will refer to this measure as β , and this is the parameter that is of central interest, as it offers an estimate of the degree to which delinquencies

time periods—both in the contemporaneous six-month period under consideration (t) and in one future period ($t + 1$).⁶

Row 1 of Figure 4 reports the results of the estimating β for delinquency rates. The estimates suggest that a one percentage point increase in the unemployment rate leads to a 21.3% increase in the level of delinquencies for banks and an 11.2% increase in the level of delinquencies for credit unions. This difference between banks and credit unions in sensitivity to economic conditions (21.3% vs. 11.2%) is statistically significant, suggesting that banks are approximately twice as sensitive as credit unions to changes in the unemployment rate.

Figure 4: Quantifying Resiliency to Economic Downturns

β	Banks	Credit unions
Delinquency rate	21.3%	11.2%
Charge-off rate	20.9%	16.2%

Row 2 of Figure 4 reports the results of the estimating β for charge-offs. The estimates suggest that a one percentage point increase in the unemployment rate leads to a 20.9% increase in the level of charge-offs for banks and a 16.2% increase in the level of charge-offs for credit unions. Once again, this difference between

banks and credit unions in sensitivity to economic conditions (20.9% vs. 16.2%) is statistically significant, suggesting that credit unions are about 75% as sensitive to the business cycle as banks.

This result could have important implications for differential capital requirements for banks and credit unions. For example, if banks are required by statute to hold 8% capital to be adequately capitalized, credit unions should hold 6% to be comparably shielded from economic shocks and downturns. Requiring both credit unions and banks to meet the *same* capital requirements does not seem to reflect the underlying risks.

Banks and credit unions have different loan portfolios and differ in their resilience to business conditions for the same reason—they differ in the degree to which they are willing to accept risk.

A potential weakness of the above analysis is that the type and mix of loans differ from credit unions to banks, and one

could argue that these differences should be controlled for in the empirical analysis. However, because the reporting requirements in the call reports differ for banks and credit unions, and because these requirements have changed over the period covered in this study, a consistent set of controls is not available. Even if such controls were available, it may not be desirable to include them. Banks and credit unions have different loan portfolios and differ in their resilience to business conditions for the same reason—they differ in the degree to which they seek out and are willing to accept risk. Thus it would not be proper to try to explain the same thing—or one variable that serves as a proxy for another—in an econometric analysis.

Figure 5: State Effects for Credit Unions: Charge-off Rates

Relatively low-sensitivity states (β : 8.6%–16.1%)	Relatively moderate-sensitivity states (β : 16.2%–20.9%)	Relatively high-sensitivity states (β : 21.0%–31.7%)
WI	CA	NJ
VT	MS	MO
MN	WA	WY
DC	OH	UT
NC	NY	GA
ME	TX	CT
WV	AK	IN
OR	AR	OK
MI	KY	ND
RI	KS	FL
NM	PA	CO
TN	LA	HI
IL	ID	NV
MA	IA	MD
MT	AL	AZ
	SC	SD
		NE
		VA
		DE
		NH

The state effect could reflect something unique to the credit unions within a state or, more likely, something unique to the state. Indeed, in most of the high-sensitivity states, corresponding results for banks reflect a sensitivity that is *greater* than the estimate for the credit unions in those states. This suggests a state effect that negatively impacts both types of financial institutions within the state, and in most cases, banks still have a greater sensitivity to the business cycle than credit unions. Six states serve as an exception: Colorado, Connecticut, Florida, Maryland, Hawaii, and Wyoming. In these states, credit unions appear to be more sensitive to the business cycle than banks over the period of consideration.⁷

7. Summary and Implications

This report used data on U.S. banks and credit unions from 1986 to 2009 to examine the differential impact of changes in business conditions on the solvency of banks and credit unions. We collected semiannual call report data on loan delinquencies and net charge-off rates for all banks and credit unions in the United States and aggregated the data to the state level. Descriptive data suggest that credit unions are less sensitive to the business cycle than banks. Using the most

Capital requirements imposed on credit unions to cover macroeconomic shocks should be roughly three-fourths the capital requirements imposed on banks.

1. Karels and McClatchey (1999) found that risk taking among credit unions is unaffected by the availability of deposit insurance.
2. This relationship is referred to as Okun's law after the economist Arthur Okun, who proposed the relationship in 1962.
3. Although call report data are collected and reported on a quarterly basis for banks and credit unions, this is not the case for all credit unions over the entire time period studied. Thus, to be consistent, we use only semiannual data (June and December) for banks and credit unions.
4. There is another difference in how delinquency rates for banks and credit unions are usually reported. For banks, delinquencies are generally reported as a percentage of all *gross* loans, but for credit unions they are reported as a percentage of all *net* loans. To provide a more consistent comparison, we calculated the bank delinquency rate as a percentage of *net* loans.
5. To achieve this elasticity measure, we use the natural log of delinquencies and charge-offs.
6. When a greater number of time periods were considered, the econometric results revealed problems, likely reflecting collinearity in the data.
7. These results should be read with some caution, as disaggregated data will not yield results that are as reliable as the panel data studied earlier.

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