April 18, 2000

Ms. Becky Baker
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Ms. Baker:

The Credit Union National Association appreciates the opportunity to comment on NCUA's proposed rule to implement provisions of the Credit Union Membership Access Act regarding risk-based net worth requirements for "complex" credit unions. CUNA represents more than 90% of the nation's approximately 10,500 state and federal credit unions. CUNA's comments were developed under the direction of CUNA's Examination and Supervision Subcommittee, chaired by Alabama League President Gary Wolter, with substantial input from CUNA's Board, Governmental Affairs Committee, Leagues and a wide range of other credit union officials.

Summary of CUNA's Position

CUNA finds the proposal to be a reasonable approach to the implementation of the risk-based requirements for complex credit unions under prompt corrective action. More specifically, we believe that for the vast majority of cases, the proposal presents a robust design for identifying potentially complex credit unions and determining the amount of net worth they should hold to be adequately capitalized.

However, we do have some significant recommendations we believe will improve the efficiency of the rule and help mitigate credit union concerns about its application, without compromising the statutory objectives of PCA. These recommendations, which are listed in the order they appear in our letter, are:

- **Replace the term, "complex."** A number of credit unions view this term as pejorative, and we recommend NCUA replace it with more neutral terms. CUNA suggests the main rule and credit unions that are only required to comply with it be referred to as "Net Worth Basic" or "Net Worth Level I" and that the rule addressing risk based requirements and credit unions that must follow it be referred to as "Net Worth Plus" or "Net Worth Level II."

- **Redefine the standards for "complex."** We urge the Board to amend the test for determining whether a credit union is complex. We recommend that a "complex" credit union be one that reaches one or more of the thresholds **and** has a calculated risk based net worth (RBNW) requirement of more than 6%.

- **Clarify and contain the consequences of being "complex."** We urge the Board to state in the final rule or accompanying supplementary information that being "complex" (or Net Worth Plus or Net Worth Level II) will not subject a credit union to additional scrutiny from NCUA and that such credit unions are not more complicated than other credit unions or nontraditional.

- **Exempt credit unions with assets below $20 million or less from the rule.** Such credit unions pose little risk to the National Credit Union Share Insurance Fund. They hold only 10.3% of all federally insured credit unions' savings and only 3.1% of the insured savings in "complex" credit unions.

- **Permit Qualified RBNW Adjustments.** Credit unions that mitigate risk through proper risk management should be allowed to reduce their RBNW requirement by up to 300 basis points upon approval by NCUA (in consultation with state regulators, as applicable.)

- **Revise the Call Report.** CUNA urges NCUA to make necessary changes to the Call Report to accommodate our recommendations and develop optional, supplementary schedules for credit unions that need to report more detailed information.

- **Allow credit unions to use one of the four definitions of assets in calculating their net worth ratios.** Once the RBNW requirement percentage is determined, CUNA recommends that credit unions be permitted to use one of the four definitions of assets in calculating their net worth ratio for comparison with the RBNW requirement.

- **Announce a one-year review.** This regulation is one of the most important regulations NCUA will ever adopt. The agency should plan a one-year review of the regulation and announce the review to credit unions when the final rule is adopted.

- **Improve the risk assessment of long-term mortgage loans.** While CUNA supports NCUA's basic approach to the inclusion of long-term real estate loans as one of the risk portfolios, we have several changes to improve its application.

    - **Exclude closed-end, fixed-rate home equity loans with remaining maturities of seven years or less.**

    - **Exclude mortgages with terms of up to five years from the definition of "long-term."**

    - **Include anticipated prepayments in defining mortgages that are below the maturity threshold.**

- **Allow a reduction in fixed-rate long-term real estate loans based on similarly long-term, fixed rate borrowings from a corporate credit union or Federal Home Loan Bank.**

- **Use a single factor of 12% for all long-term, fixed rate mortgages above the threshold.**

- **Improve the risk-assessment of member business loans.** While CUNA agrees that MBLs should be one of the risk categories, we urge the Board to make significant changes in the treatment of MBLs and unused commitments as a risk portfolio.

  - **Include long-term, fixed-rate member business mortgage loans with the long-term real estate risk portfolio.**

  - **Increase the 12.25% threshold to 25%, consistent with the threshold for mortgage loans.**

  - **Lower the RBNW factor from 14% to 9% generally and to 7.5% for MBLs with an LTV ratio of less than 60%.**

  - **Lower the RBNW factor to 4.5% for unused commitments.**

  - **Exclude the portion of MBLs guaranteed by a unit of government from the risk portfolio.**

  - **Exclude a portion of credit-enhanced MBLs from the risk portfolio.**

- **Improve the risk-assessment of long-term investments.** CUNA supports NCUA's general approach to long-term investments in the proposal but has a number of suggestions for improvement.

  - **Raise the threshold for determination of potential complexity from 15% to 25% of assets.**

  - **Exclude investments with terms of up to four years from the definition of "long-term."**

  - **Determine the maturity of investments in mutual funds based on the prospectus**.

- **Improve the Risk-Assessment for Loans Sold with Recourse**. CUNA agrees with the treatment of loans sold with recourse, but believes the proposal should be improved in three key ways.

  - **Eliminate the RBNW factor for the first 5% of assets in loans sold with recourse.**

- **Exclude from the risk portfolio certain loans sold with recourse.**

- **Exclude the portion of a loan that is sold with recourse**.

- **Modify Risk-Based Net Worth Factors for Assets Not in the Risk Portfolios.** NCUA should make a number of changes in this area to reflect that certain assets not included in the risk portfolios may be used to reduce a credit union's risk exposure.

  - **The NCUSIF 1% deposit should have an RBNW factor of 0%.**

  - **Cash and cash equivalents should have an RBNW factor of 0%.**

  - **Other short-term investments should have an RBNW factor of 3%.**

  - **The limit on allowance for loan losses should be eliminated.**

CUNA's Recommendations

CUNA applauds the NCUA and the state supervisors who worked with the agency for the general approach to defining a "complex" credit union and the RBNW requirements. We believe the four "risk portfolios" identified in the proposal correctly identify the major sources of material risks against which a 6% net worth ratio may not provide adequate protection as defined in the Credit Union Membership Access Act. The proposed method of calculating the risk based net worth requirement also has considerable merit.

However, we have a number of recommendations to refine and improve the application of the general approach. Our comment letter presents our suggestions in three sections: I. Suggested changes to the overall structure of the proposal; II. Suggested changes to the treatment of the four risk portfolios; and III. Suggested changes to the treatment of assets not included in the four risk proposals.

Before presenting our recommendations, we would like to point out CUNA's three major areas of concern about the proposed rule.

First, the proposal identifies a much larger number of credit unions as complex than we believe should be the case. Complex credit unions should be those who present a material increased risk to the share insurance fund. For reasons we will develop in more detail below, we do not believe that almost 15% of credit unions present a material level of risk above that which is covered by the 6% net worth standard for capital adequacy. Credit unions are concerned about the possible "stigma" of being labeled "complex." A number of our suggestions below address this concern. However, an overall solution to this concern is to identify as "complex" only those credit unions that clearly present risks to the Share Insurance Fund that require more than 6% net worth.

Second, we are specifically concerned about the large number of small credit unions identified as complex under the proposal. These credit unions, because of their lack of economies of scale, face greater relative burdens from compliance with existing rules and the requirements of general business operations. We believe that the burden placed on them by compliance with the complex portion of the PCA rule far outweighs the minor additional protection for the Share Insurance Fund.

Third, we believe that for the vast majority of cases, the proposal presents a robust approach to identifying potentially complex credit unions and determining the amount of net worth they should hold to be adequately capitalized. However, for a relatively small number of credit unions that are actively engaged in some of the "risk-portfolios," the approach may not be effective. The proposal does not adequately capture the extent to which a credit union might appropriately manage the risks associated with the risk portfolios.

I. The Overall Structure of the Proposal.

A. Use of the Term "Complex." Many credit unions have expressed their concern about the term, "complex," and the fact that negative connotations may attach to credit unions labeled as such. They worry that detractors will add to the confusion by attempting to mischaracterize credit unions defined as "complex" as institutions that engage in nontraditional activities that are inconsistent with credit unions' history, purpose, and philosophy.

While we realize that the statute uses the term "complex," we do not believe it requires NCUA to adhere strictly to that terminology, as long as the substance of the Act's provisions is faithfully implemented. We believe the NCUA Board has the authority to utilize other terms that subsume the definition of "complex," as long as the objectives of the statute are met.

Thus, we recommend NCUA change the nomenclature to avoid the word "complex." This can be accomplished in several ways. For example, the main PCA rule and credit unions that only have to comply with its requirements could be distinguished as "Net Worth Basic" or "Net Worth Level I." The risk-based net worth regulation and credit unions under its scope could be designated as "Net Worth Plus" or Net Worth Level II."

We urge NCUA not to dismiss the concerns credit unions have raised about the "complex" categorization and to adopt terminology that is more neutral in the eyes of credit union officials. We believe this change would enhance compliance with the regulation by removing the potential that credit unions determined to be "complex" would be needlessly stigmatized.

Because we do not believe that it is necessary for NCUA to retain the term "complex" in the regulation in order to meet the agency's legal requirements, we request NCUA

change the term, as we have suggested. These changes would in no way harm or detract from the agency's ability to achieve the purpose of the statute which is to ensure credit unions with more risk in their portfolios meet higher risk based net worth standards.

B. Definition of "Complex." The proposal would define as complex a credit union that crosses one or more of four thresholds. We suggest the definition be amended to identify as complex a credit union that crosses one or more of the four thresholds, **and** has a calculated RBNW requirement of more than 6%.

The purpose of identifying complex credit unions is to subject those credit unions that are exposed to material risks against which the 6% net worth ratio may not provide adequate protection to appropriately higher net worth requirements. In that sense, the four thresholds are "screens" or "pre-tests" to determine whether the RBNW should be above 6%. As the proposal is constructed, a credit union that crosses one of the four thresholds but has a calculated RBNW requirement of less than 6% does not need additional protection. Under our suggested change, a credit union crossing one or more of the four thresholds would not yet be classified as complex, but it would be required to calculate its RBNW. Only if its RBNW requirement exceeded 6% would it then be classified as complex. This change would reduce the number of credit unions classified as "complex," without reducing in any way the protection to the Share Insurance Fund provided by the rule.

C. The Limited Consequences of Being Classified as Complex. The final rule should contain an explicit statement that being "complex" has no application other than a risk-based net worth requirement that is greater than 6%. The rule should specify that being "complex" will not generate additional supervisory scrutiny or action, and that "complex" does not mean complicated or non-traditional. Being "complex" simply means a credit union has certain balance sheet risk exposures for which a 6% net worth ratio does not provide adequate protection.

D. Exclusion of Small Credit Unions. The complex section of the regulation should not cover small credit unions. A number of small credit unions would be classified as complex under the proposed regulation, but they are much less likely to be so classified than larger credit unions. Also, smaller credit unions hold only a small portion of insured savings, i.e., they pose a relatively small risk to the Share Insurance Fund. Using the specifications of the proposed rule as of December 1999, all credit unions with less than $20 million in assets held 10.3% of all federally insured credit union savings, but complex credit unions in this size group held only 3.1% of the insured savings in all complex credit unions. Credit unions with assets below $10 million had 5.1% of total insured savings, but only 1.1% of the insured savings in complex credit unions. Therefore, exempting credit unions with assets under $20 million would nevertheless retain almost 97% of the insured savings of potentially complex credit unions under the requirement to calculate an RBNW. Exempting credit unions with assets under $10 million would require those credit unions with

almost 99% of insured savings in potentially complex credit unions to calculate a RBNW.

CUNA believes that the burden placed on smaller credit unions of having to comply with the complex portion of the PCA rule far outweighs any additional protection to the Share Insurance Fund. Further, we believe that such an exemption is consistent with the CUMAA in that the stated purpose of the PCA section of the Act is to minimize long-term losses to the fund, and the standard for design of the RBNW requirement is to cover cases in which a 6% net worth ratio does not provide adequate protection. Construing "protection" as applying to the Fund the *de minimus* amount of insured savings in small "complex" credit unions suggests that a 6% net worth requirement for all small credit unions provides adequate protection to the Fund. These small credit unions should not be subjected to the burden of compliance with the complex portion of the rule.

While that Act does not expressly exempt small credit unions from the RBNW provisions, we believe that NCUA has the legal authority to limit their compliance to the requirements of the PCA basic regulation only. Because these institutions account for just over 3% of insured savings, excluding them from the purview of the complex PCA provisions will not diminish in any substantive way NCUA's ability to ensure that credit unions posing additional risk to the Share Insurance Fund meet applicable RBNW standards.

The agency's authority to exempt small credit unions from complex PCA is contained in two provisions in the Act. Under one of the relevant provisions, the statute directs NCUA to develop a system of prompt corrective action that takes "into account that credit unions are not-for profit cooperatives that –(i) do not issue capital stock;" (ii) must rely on retained earnings to build net worth; and (iii) have volunteer boards of directors that consist primarily of volunteers" (12 USC 1790d(b)(1)(B)). Smaller credit unions often have greater difficulties than larger ones in building net worth and compliance with complex PCA would certainly be disproportionately burdensome for the volunteer boards of smaller credit unions. Another key provision states: "The Board shall design the risk-based net worth requirements to take account any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection" (12 USC 1790d(2)). As stated above, smaller credit unions pose virtually no material risk to the Share Insurance Fund. We believe that these provisions clearly support our view that NCUA has flexibility to design a PCA program that exempts smaller credit unions from complex PCA.

CUNA therefore recommends that credit unions with assets below $20 million be excluded from the scope of the rule. This exemption from the burden of having to determine potential complexity and calculate RBNWs would in no way exempt these small credit unions from basic PCA, and from all of the supervisory and other powers available to the agency and state supervisory authorities in examining and supervising smaller credit unions.

E. Trade-off Between a Complicated and Simple Rule. CUNA generally believes that regulations should be as simple as possible to facilitate compliance. However, in the context of the complex PCA rule, CUNA is concerned that an overly simple rule might be inadequate to capture the variety of ways that credit unions manage risks in their balance sheets. CUNA believes that the agency has struck a reasonable balance between the advantages of a simple and complicated rule. Some of CUNA's suggestions will serve to complicate the rule further. We believe this is appropriate so long as the basic determination of the threshold remains fairly simple. It should be simple for a credit union that is not complex to determine that fact. Simplicity is less crucial in determining the amount of the risk-based net worth requirement. In other words, the rule should be fairly simple so far as determination of whether or not a RBNW needs to be calculated, but should allow for considerable complexity in determining the RBNW.

F. Qualified RBNW Adjustments. The proposed system is a reasonable approach for the vast majority of credit unions, especially if the only information available is Call Report data plus a few alternate measures. However, for some credit unions that are actively engaged in some of the "risk-portfolios," the proposal does not adequately capture the extent to which a credit union might appropriately manage those risks. As proposed, the only option for a credit union with "apparently" above normal risks is to hold additional net worth. In practice such a credit union may mitigate those risks through appropriate risk management. A credit union with a high exposure to one of the risk portfolios (especially mortgage loans or member business loans) should have the opportunity to demonstrate that its risk management policies and procedures qualify it for some reduction in the RBNW that would otherwise be indicated by the simple application of the RBNW calculations. These Qualified RBNW Adjustments should not be taken lightly. They should require substantial and rigorous demonstration based on history, policies, practices and risk-management techniques. Qualified RBNW Adjustments would need to be revalidated regularly, such as once a year.

CUNA recommends that complex federal credit unions be permitted to apply for Qualified RBNW Adjustments of up 300 basis points from NCUA. CUNA recommends that complex state chartered federally insured credit unions also be permitted to apply for such Qualified RBNW Adjustments from state supervisors in consultation with the NCUA Board.

G. Revisions to Call Report. Some of CUNA's suggestions for changes to the rule will require credit unions to report data that is not currently collected on the 5300 Call Report. Some of the new data requirements can simply be met with minor modifications to the standard Call Report, for example, changing the maturity classifications reported for investments and mortgage loans. Other changes might require that more detailed information be provided, such as information on the nature of loans sold with recourse, loan-to-value ratios on member business loans, etc. Only a relatively small number of credit unions is likely to need to report this more detailed

information. CUNA therefore recommends that in addition to making necessary changes to the Call Report for all credit unions, the agency also develop optional, supplementary data schedules to the Call Report for those credit unions that need to report more detailed information for purposes of compliance with the complex PCA rule. Credit unions would only be required to report this more detailed information if they choose to on the basis of providing additional information for purposes of compliance with the complex portion of the PCA rule.

H. Asset Base for Calculation of Net Worth Ratio. In the basic PCA rule, credit unions are permitted to use one of four definitions of assets to calculate their net worth ratios. In the complex portion of the rule, quarter-end assets are used to measure the four thresholds and to calculate the RBNW requirement. CUNA agrees that this use of quarter-end assets is appropriate. However, once the RBNW requirement percentage is determined, CUNA recommends that credit unions be permitted to use one of the four definitions of assets in calculating its net worth ratio for comparison with the RBNW requirement. If this recommendation is accepted, credit unions will be able to use the same calculation of the net worth ratio for comparison to either the 6% and 7% standards, or to the RBNW requirement. This should avoid confusion in application of the rule.

I. One-Year Review of the Entire Rule. The complex portion of the PCA rule constitutes a new and far-reaching approach to credit union regulation and supervision. CUNA requests that the Board, in adopting a final rule, stipulate that it will review the entire regulation one-year after implementation to ensure that it is operating in accordance with legislative intent and without undue, unintended negative consequences.

II. The Four Risk Portfolios.

A. Long-Term Real Estate Loans. CUNA agrees with the proposal's general approach to the treatment of long-term mortgage loans, but offers the following suggestions for improvement.

1. Exclude closed-end, fixed-rate equity loans with remaining maturities of seven years or less. Credit unions grant fixed-rate auto loans of up to seven years in maturity. Such loans are appropriately not included in any of the risk portfolios. Some credit union members prefer to secure these loans with the equity in their homes instead of the automobile to take advantage of the tax deductibility of mortgage interest. That member choice does not add to the risk exposure of the credit union. In fact, it may lessen it because, as the balance of the loan is paid down, the value of the "collateral" usually increases, unlike the case with a typical auto loan. Therefore, such loans should not be included in the definition of long-term real estate loans. This change, in addition to excluding new equity loans with maturities of seven years or less, would also remove from the definition a small amount of very seasoned fixed rate mortgages that may have had original maturities of 15 or 30 years. However, since these loans would all amortize to final payoffs within seven years, the interest rate

risk is substantially reduced. This suggested change does not envision excluding from the definition of long-term real estate loans those that might reprice within seven years but that amortize over longer periods (balloons, or adjustable rate loans with long adjustment periods.) It would only apply to loans that fully amortize within seven years.

The interest rate risk implicit in a new, seven-year amortizing loan would reasonably be covered by the 6% net worth standard. A seven-year loan with an 8% interest rate would lose 6% of its value if rates were to rise by 200 basis points. Further, a balanced portfolio of such loans, with an average remaining maturity of roughly 3 and a half years, has an interest rate risk exposure that is very well covered by the 6% standard. Such a portfolio would suffer only a 3.5% reduction in net economic value at a 200 bp rate shock, or a 5% reduction at a 300 bp rate shock.

2. Change from three years to five years the term below which mortgages are not considered long-term. If the cut-off point for long-term mortgages were five years, the most interest-sensitive mortgage to fall under the limit would likely be a brand new, five-year adjustable rate loan amortized over 30 years. Such an asset would have a duration of 3.5 years, (8% coupon, 6% prepay rate.) For a 200 basis point increase in interest rates, the economic value of such a mortgage would fall by 7%. However, the average duration of the pool of mortgages that would mature or reprice within five years would of course be considerably less than that. It would include adjustable-rate loans with repricing times of anywhere between one and 60 months, and scheduled repayments and expected prepayments on the rest of the pool or mortgages in the portfolio. CUNA believes that the duration of a portfolio of mortgages that will mature, prepay, or reprice within five years is unlikely to exceed by much the duration of a portfolio of auto loans with initial maturities of up to six or seven years. We also note that in Section 700.1, a five-year cut-off is used to determine "risk assets."

3. Include reasonable prepayments with contractual payments for defining mortgages that fall below the maturity threshold. Section 702.103 defines long-term real estate loans as "exclusive of those outstanding that will contractually refinance, reprice or mature within three years." Credit unions should have the opportunity to include anticipated prepayments within three years (or five years based on the above recommendation). This would be consistent with the use of the weighted average life concept for investments which allows expected principal payments that are reasonable and supportable estimates. The same standard of reasonableness should apply to anticipated prepayments on mortgages.

4. Permit long-term sources of funds to reduce the amount of long-term real estate loans for calculation against the threshold, and for calculation of the RBNW. A credit union can be vulnerable to reductions in the net economic value of its balance sheet if rising interest rates cause the net economic value some of its assets to fall. However, if the same increase in interest rates causes a similar reduction in the net economic value of some of the credit unions sources of funds, the effect on the net economic

value of the balance sheet is mitigated. One way that some credit unions manage the increased interest-rate risks associated with holding fixed-rate, longer-term mortgages is to secure long-term, fixed-rate sources of funds. Such matching sources of funds could include longer-term fixed-rate certificates from members, and also long-term fixed-rate borrowing from other sources such as a corporate credit union or a Federal Home Loan Bank.

CUNA does not recommend allowing for a reduction in fixed-rate long-term real estate loans based on matching funds from share certificates. That would not be justified because members have a fairly low-cost option to call certificates prior to maturity should rates rise substantially. This is because prepayment penalties are fairly low compared to the potential gains of acquiring new certificates at higher rates. However, granters of term, fixed-rate loans have no such options. These sources of funds do indeed provide protection to the credit union's net economic value in the event of rising interest rates. Therefore, CUNA recommends that long-term, fixed- rate borrowings by credit unions for terms longer than the term at which a real-estate loan is considered long term should be netted against the balances of such loans before making the complexity and RBNW calculations.

5. Modify the RBNW factors for long-term real estate loans. First, the dual factor system (14% for loans between 25% and 40% of assets, and 16% for loans above 40% of assets) does not appear to be justified. A loan in the 41st percentile does not suffer any more of a loss in economic value in response to a given rise in interest rates than does one in the 26th percentile. Therefore, CUNA recommends that a single factor be used for all long-term, fixed-rate mortgages above the threshold.

   Second, CUNA believes that the risk-weight factor for mortgages at 14% is higher than necessary. We believe that the reduction in economic value of the typical portfolio of mortgages that would be included in the above five year repricing category is close to 12% for a 300 basis point rate shock. This is based on the average mix of such mortgages held by credit unions. Historical evidence suggests that the credit risk of household mortgages is nominal. Since 1992, the net charge-off rate on credit union real estate loans has averaged 10 basis points. Therefore, CUNA recommends that a single factor of 12% be applied to all long-term real estate loans above the threshold. We further point out that in the system of risk-based capital applied to banks, loans secured by real estate have are assigned a risk factor that is one half the factor assigned to consumer loans. Applying a 12% risk factor to mortgage loans above the cap would in effect be crediting them with twice the risk associated with consumer loans. Admittedly, the bank risk-based capital standards do not adequately account for interest rate risk, but the low risk-weight assigned to real estate loans by the bank system suggests minimal additional risk premium is necessary for credit risk on mortgage loans.

B. Combined Member Business Loans (MBLs) and Unused Commitments. CUNA agrees that member business loans should be one of the risk portfolios, but has

several substantial suggestions for changing the way that this portfolio is treated under the proposed rule.

1. Include long-term, fixed-rate member business mortgage loans with the long-term real estate risk portfolio. As presented in the proposal, the long-term real estate and investment risk portfolios are dealt with primarily on the basis of their interest rate risk. The treatment of MBLs in the proposal is at times confusing because, unlike the other two major risk portfolios, it deals with both credit risk and interest rate risk. Because not all MBLs are long-term and fixed-rate, this can result in excessive RBNW factors for MBLs. Comparing two fixed-rate, real estate loans of equal maturity, one might argue that the RBNW factor for the MBL should be higher than that for the owner-occupied residential mortgage because of greater exposure to credit risk. But, a short-term business loan does not warrant that high an RBNW factor. Having only a single 14% RBNW factor for all MBLs, which is designed to capture both credit and interest rate risk, leads to a higher than necessary factor for many of these shorter-term member business loans.

   CUNA therefore recommends that long-term, fixed-rate MBLs be included as part of the long-term real estate portfolio for both determination of crossing a threshold and calculation of the RBNW. We recommend they be included with long-term real estate loans on a dollar-for-dollar basis for purposes of measuring against the threshold. Then, if a credit union crosses one of the four thresholds, long-term fixed rate MBLs should be assigned an RBNW that is somewhat higher than that for non-business long-term real estate loans. CUNA recommends an additional 100 basis point premium for member business long-term, fixed-rate loans. For example, if the agency accepts our suggestion that long-term real estate loans be assigned an RBNW factor of 12%, then long-term fixed rate MBLs should have an RBNW factor of 13%. Notwithstanding this recommendation, CUNA believes that any MBL with a loan-to-value ratio of less than 60% should not be assigned a premium over non-business long-term real estate loans.

The remainder of our comments on the MBL risk portfolio applies to the resulting redefinition of MBLs consistent with the preceding recommendation. This includes all MBLs backed by real estate that reprice or mature in less than the number of years defining a long-term real estate loan (three years in the proposal, five years as recommended by CUNA) plus all non-real estate MBLs.

2. Raise the 12.25% threshold to 25%. The CUMAA requires the agency to define complex credit unions based on the risks carried on the credit union's balance sheet. The rationale for the proposed threshold for MBLs of 12.25% is the limit on MBLs in the CUMAA for credit unions without an MBL exemption. Although that is indeed the limit on MBLs, Congress did not base that limit on risk considerations. The 12.25% limit is derived by multiplying net worth by 1.75, but only to a limit of 7% of net worth. Had this been a risk-based limit, the level of net worth to multiply by 1.75 would not have been capped at 7%. The 12.25% level is instead the result of a

political compromise among members of the Senate Banking Committee in an attempt to balance the desires of credit unions and the banking industry.

Instead of the arbitrary limit of 12.25%, the threshold should be set at a level that indicates a significant exposure on the balance sheet. CUNA believes that the 25% threshold for mortgage loans would also be appropriate for MBLs.

3. Lower the RBNW factor for MBLs. Credit union MBLs may indeed carry a greater risk of loss than consumer loans and other assets. However, CUNA does not believe that MBLs present two-and-a-third times the risk of other credit union assets, as the proposed RBNW factor of 14% suggests. This is especially true if the interest rate risk in MBLs has been accounted for by including them with long-term real estate loans as suggested above. In the eight years ending 1999, the average annual net charge-off rate on credit union MBLs was 57 basis points. (Each year's average was calculated as the unweighted average of individual credit union ratios.) That is considerably less than the 75 basis point average for non-real estate consumer loans. Since MBL charge-offs also exhibit greater variance, it is appropriate to apply a higher RBNW factor. CUNA recommends a factor of 9%, suggesting a 50% increase in risk exposure. All MBLs below the threshold should be assigned the RBNW factor of 6%. In addition, CUNA recommends that MBLs with a loan-to-value ratio of less than 60% should have an RBNW factor of 7.5%.

4. Modify the treatment of unused commitments. Because unused commitments to fund MBLs are an off-balance sheet risk, it is appropriate to include them in some way in the MBL risk portfolio. However, there are two ways they are overstated. First, since unused commitments are extremely unlikely to all be called on at once, it is unnecessary to include all of them with MBLs in measuring against the threshold. CUNA recommends that the value of the MBL risk portfolio to measure against the threshold include 50% of unused commitments in addition to all MBLs outstanding.

   Second, for similar reasons, and consistent with our suggestion that the RBNW factor for MBLs be set at 9%, we recommend that the RBNW factor for unused commitments be set at half that level, or 4.5%.

5. Allow partial exclusion of loans partially backed by the government. A loan for business purposes, "the repayment of which is fully insured or fully guaranteed by, or where there is an advance commitment to purchase in full by, any agency of the Federal Government or of a State, or any political subdivision thereof" is not included in the definition of MBLs. In the case of loans that are partially guaranteed in a similar manner by the same governmental agencies, the portion that is guaranteed should be excluded from the amount included in the risk portfolio. Examples of such partial government guarantees may be found in some agricultural loans.

6. Allow partial exclusion for loans with credit enhancements. If a credit union secures an on-governmental credit enhancement for an MBL, some level of reduction in the amount of the credit enhanced balance for application against the threshold or

calculation of the RBNW should be permitted. For example, credit enhancements backed by a federally insured financial institution may qualify for a 75% reduction in the balance to count as part of the risk portfolio.

C. Long-Term Investments. CUNA concurs in the general approach to the treatment of long-term investments, but offers the following suggestions for improvement.

1. Raise the threshold for determination of potential complexity from 15% to 25% of assets. A portfolio of long-term investments will typically have an interest rate risk exposure no greater than that found in a portfolio of long-term real estate loans. In addition, given restrictions on the types of investments credit unions can buy, there is likely to be even less credit risk in a credit union's investment portfolio than in its mortgage portfolio. This suggests that the complexity threshold for long-term investments need be no lower than that for long-term real estate loans. CUNA recommends that, subject to the exception below, the threshold for long-term investments be set at 25% of assets. The RBNW factor of 6% should be applied to all investments below the threshold.

   There is a possibility that, under current investment rules, a credit union could expose itself to substantially more interest rate risk in its investment portfolio than might be found in a typical long-term real estate portfolio. That could be the case if the credit union held a substantial portion of its assets in fixed-rate, bullet securities with maturities of over 10 years. This practice is rare. At the end of 1999, only 2.4% of total credit union investments (about 0.8% of assets) were in investments of any kind with remaining maturities of over 10 years. Only 171 credit unions held more than 5% of their assets in investments with maturities of over 10 years.

   To deal with this potential for additional interest-rate risk exposure, CUNA recommends one of two alternatives. One option would be to modify CUNA's suggested threshold for long-term investments from 25% of assets to 15% in the case where investments with over 10 years remaining maturity comprise more than 5% of assets. The second option would be to create a fifth risk portfolio (investments with remaining maturities greater than 10 years) with a 5% threshold, and a high RBNW for investments over the threshold, say 16%.

2. Change from three years to four years the term below which investments are not considered long-term. If the cut-off point for defining long-term investments were four years, the most interest sensitive investment to fall under the limit would likely be a bullet security with four years of remaining maturity. Such an asset would have a duration of 3.5 years, (6% coupon.). That is the same duration as is implied for the longest mortgage loan with a five-year threshold. A 200 basis point rate increase would lower the economic value of such a security by 7%. However, the average duration of the pool of investments with maximum maturities or weighted average lives of four years would of course be considerably less than that. Considering the issue in the context of weighted-average life, a pool of securities with a WAL of 4 years would experience about a 5% reduction of value in the event of a 200 bp

increase in interest rates. This example was constructed using year-end 1999 data. Based on these observations, we recommend that the maximum maturity for an investment to be excluded from the long-term investment risk portfolio be four years instead of three. We also note that would be shorter than the five-year cut-off used to determine "risk assets" in Section 700.1.

3. Determine the maturity of investments in mutual funds based on the prospectus. The proposed rule justifies categorizing investments in registered investment companies and collective investment funds as having a WAL of between 5 years and 7 years "because their weighted-average lives are generally not disclosed." This may well be appropriate for funds for which the prospectus is indeed silent as to maturity, duration or weighted average life. However, CUNA recommends that where a prospectus is explicit about limitations on the maximum maturity of any security the fund will purchase, or about limitations on the fund's duration or weighted average life, those limitations should be determinative for a credit union to report the maturity bucket for the fund.

D. Loans Sold with Recourse. CUNA concurs in the general approach to the treatment of loans sold with recourse, but offers the following suggestions for improvement.

1. Eliminate the RBNW factor for the first 5% of assets in loans sold with recourse. For the other three risk portfolios, assets below the threshold are assigned the standard RBNW factor of 6%. Assets in excess of the threshold are assigned higher RBNW factors. The proposed RBNW factor for all loans sold with recourse is 6%, regardless of whether they exceed the 5% threshold. To be consistent in the treatment of other risk-portfolio assets below the threshold, CUNA recommends that the first 5% of assets in loans sold with recourse be assigned a RBNW factor of 0%. This is especially the case for credit unions with loans sold with recourse below the 5% threshold that might cross one of the other three thresholds. Their exposure to losses from loans sold with recourse is *de minimus.*

2. Exclude from the risk portfolio certain loans sold with recourse. In some cases, credit unions that sell loans with recourse generate allowances for those loans through provisioning loan loss expenses. In these cases, potential losses from these portfolios have already been accounted for in the balance sheet, as a reduction in net worth. Applying an RBNW factor to these loans is thus "double counting" for the risk. CUNA recommends that the "loans sold with recourse" risk portfolio exclude those loans or loan portfolios for which allowance for loan losses have been provided according to GAAP.

2. Exclude portions of a loan that are sold with recourse. In some cases, credit unions may sell loans with partial recourse. In such cases, only the portion of the loan sold with recourse should be included in this risk portfolio. This exclusion should only apply to loans where any loss might be shared on a pro-rata basis between the credit union and the purchaser. For example, consider the case of a loan sold with recourse

with the credit union liable for the first given percent of loss. Unless that percentage is small compared to likely losses for that type of loan, the entire loan should be included in the risk portfolio. However, if a loan is sold under the condition that losses would be shared on a pro-rata basis between the credit union and the purchaser, the credit union's proportionate share of any loss should be used to determine the proportion of the balance to include in the risk portfolio.

III. Risk-Based Net Worth Factors for Assets Not in the Risk Portfolios.

1. The NCUSIF 1% Deposit. The 6% net worth ratio for a credit union to be considered "adequately capitalized" is greater than the 4% net worth ratio required for commercial banks. There are two reasons the CUMAA's drafters included this 200 basis point differential. One hundred basis points is for the fact that credit unions, as cooperatives, cannot acquire capital as rapidly as can stock-owned banks. The drafters believed that by holding additional capital, credit unions would not be as imperiled by dropping below the adequate level given the limits on capital acquisition. The second 1% was to lay to rest once and for all any question as to the accounting of credit unions' 1% Share Insurance Fund deposits as assets. As a result, the 1% Share Insurance Fund deposit is already accounted for as a net worth requirement. It has essentially been assigned a 100% RBNW factor in that the credit union's overall net worth requirement has been increased by that amount. (Actually, it's even more than that because savings typically are only about 90% of assets, the deposit is 1% of savings, and the additional net worth requirement is applied to all assets.)

   Because the 1% NCUSIF deposit has already been built into the 6% net worth standard, CUNA believes that it is double counting to also apply a 6% RBNW factor to the deposit. Accordingly, CUNA recommends the 1% deposit be assigned a RBNW of zero percent.

2. Cash and Cash Equivalents. The determination of a credit union's risk-based net worth requirement should not only accurately reflect areas of greater risk in the balance sheet, but also appropriately account for the effects of lower-risk assets. Indeed, one function of the RBNW factors should be to create incentives for credit unions to hold less of certain higher-risk assets and more of other, lower-risk assets. Credit unions thus appropriately have the choice of managing their overall risk exposure by selecting the combination of asset redistribution strategies and net worth levels that they feel best meets their particular circumstances.

   Considering that one of the chief risks identified in the risk portfolio is interest rate risk, the proposal does not adequately reflect the extent to which credit unions can mitigate this risk through balance sheet management. The proposal deals with this issue in part by assigning an RBNW of 3% to cash and cash equivalents. CUNA believes this RBNW does not sufficiently reflect the power of cash and cash equivalents to balance against the interest rate risks of holding long-term, fixed-rate assets. Thus, it also does not sufficiently incent credit unions that hold long-term

fixed rate assets to maximize their holdings of cash and cash equivalents. CUNA recommends that the RBNW factor for cash and cash equivalents be set at 0%. The credit risk of such investments to credit unions is close to zero, and a balanced portfolio with average maturity of six weeks (cash and cash equivalents can have maturities up to 3 months) would fall in value by only 25 basis points in response to a 200 basis point increase in interest rates. Under the bank risk based capital standards, cash is assigned a risk weight of 0%. Cash equivalents have risk weights of 0% or 20%.

3. Other Short-Term Investments. Short-term investments maturing in less than one year can also be a significant tool in lowering the overall interest rate sensitivity of the assets of a credit union. A pool of investments with an average maturity of 7.5 months (the average for investments with maturities between 3 months and a year) would only fall in value by 1.2% in response to a 200 basis point rate increase. CUNA recommends that the RBNW factor for short-term investments (maturities between 3 months and one year) be set at 3%.

4. The Limit on Allowance for Loan Losses. CUNA can see no reason for limiting the amount of the allowance for loan losses than can be used to determine the risk-based net worth requirement, and therefore recommends that credit unions be permitted to use it for that purpose without limit.

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In conclusion, we commend the NCUA Board and staff as well as state regulators who worked together to develop the proposed PCA "complex" rule. While we believe NCUA's approach is for the most part well-crafted to achieve the agency's statutory directives, we have a number of recommendations we urge the Board to adopt that will improve the operation of the rule, address issues of concern to credit unions, and facilitate compliance. If you have any questions about our comments, please feel free to call CUNA's Chief Economist Bill Hampel, General Counsel Eric Richard, or Associate General Counsel Mary Dunn at 202-682-4200.

Sincerely,

Daniel A. Mica
CUNA President and CEO