Peninsula
CREDIT UNION

April 24, 2014

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

Delivered Electronically

Subject: Comments on Proposed Rule: PCA – Risk Based Capital; RIN 3133-AD77

Dear Mr. Poliquin:
Peninsula Community Federal Credit Union (PCFCU) would like to acknowledge the time and effort that has gone into the NCUA's proposed risk-based capital (RBC) rule. The purpose for this letter is to provide feedback regarding the proposed RBC rule. In short, the rule as proposed is troubling and will have adverse impacts on our credit union's ability to increase market share and live out PCFCU's Community Mission Statement.

First, to be clear there is a need for a risk-based capital regulation. Second, the specifics of any regulation should address prior experiences, the current situation, and future expectations. Third, asking for collaboration from the industry and input into an extremely significant rule is greatly appreciated. Fourth, incorporating that feedback into a new or significantly revised rule will achieve the goal of a better RBC system. Save very significant changes, it is not a rule that is prudent.

PCFCU has a community field of membership that today spans the Olympic Peninsula's five rural Counties of Mason, Kitsap, Jefferson, Clallam and Grays Harbor. We are the oldest federal charter in the State of Washington. Originally in 1935, this Credit Union served the Rayonier Pulp and Paper Mill workers until the closure of Rayonier's Shelton plant in 1958. At that time the Credit Union was granted a "community" charter to all residents of Mason County. Then in 1996, PCFCU's field of membership expanded to include the five counties named above. As a community chartered credit union, PCFCU is committed to financially supporting our members and the economic development of the communities we serve.

The PCFCU Board of Directors in July 2013 adopted the following Community Development Mission Statement:

> *"Peninsula Credit Union is dedicated to promoting community development. Whether low to moderate income or wealthy, unbanked or under banked, by listening to people,*

serving their financial needs with affordable financial services, educating to create a personal development plan, we demonstrate our care to enrich their lives and helping to achieve financial stability...always!"

Several years ago I served as a member of the Northwest Credit Union Association's Credit Union Charter Evolution Taskforce, the need for changes to the risk based capital system was clear. One recommendation of this Evolution Task Force was a risk based capital system that would allow credit unions to obtain supplemental capital to be applied to their net worth. It was clear to the Evolution Taskforce that one without the other would actually add risk to the credit union system. Credit unions only have one way to raise capital, through retained earnings. Appropriate reflection of this reality is imperative.

We are at a historically and protracted low interest rate environment. When contemplating directions such as the proposed risk-based capital rule, all scenarios ought to be contemplated. The current proposal places far too much weight on interest rate risk and concentration risk related to our present interest rate weight environment. These areas of risk have not received the same consideration for similar Basel III risk weighted capital directions for small community banks. Credit unions only have one way to raise capital, though retained earnings. The Federal Credit Union Act requires the NCUA to take this into account.

Statutory changes are necessary so that the NCUA does not add risk to the share insurance fund. The rule as proposed is troubling and will have adverse impacts on PCFCU's ability to increase market share, the financial lives of our members, and the economic growth stronger financial households provide.

Initial Review

After initially reviewing the current proposed RBC rule, there were several questions I began asking. These questions led to larger points of confusion as the proposal was further digested. Some of the initial questions and observations included:

- Why do we need two levels of capital requirements – the existing PCA system and the proposed risk-based capital rule?
  While Section 1790d(b)(1)(a) of the Federal Credit Union Act requires NCUA's Prompt Corrective Action (PCA) to be comparable with those of the other federal banking agencies, it is redundant to place multiple hurdles to accomplish the same objective. A well capitalized credit union must maintain a net worth ratio of at least 7 percent and, additionally, under the proposal a risk-based capital ratio of 10.5 percent or greater. In an already complex regulatory world is there really a benefit in having two sets of rules to protect the safety and soundness of America's credit unions? Rather than creating a second set of requirements for credit union, the NCUA and its examiners to understand. Perhaps a better path forward would be to encourage Congress to make the statutory changes necessary, prior to finalizing the proposed RBC rule.

- How will the proposed rule reduce regulatory burden?
  The new rule allows the NCUA to assume additional authority to impose even higher

capital requirements on individual credit unions that could exceed even well-capitalized levels. Today's regulatory burden is already difficult enough. This proposed rule will make it even more difficult for us to manage due to the potential for moving targets. To be clear, we would rather have additional detail added to the quarterly call report, and removal of any Call Report data that is not utilized by the NCUA or its examiners. This would help avoid the burden of lengthy and cumbersome philosophical discussions during an examination to reach common understanding.

- Why is the National Credit Union Share Insurance Fund's one-percent deposit exists for safety and soundness ignored in the proposed risk-based capital calculation?
  This treatment essentially considers the NCUSIF as if it has been fully expensed by the credit union. Since the NCUSIF is refundable to credit unions, the NCUSIF must be treated as an asset as it is an equity position in the NCUSIF balance sheet. Rather than being excluded, perhaps the NCUSIF should be assigned a risk weight of 100%.

- What rational supports the wide array of risk weightings utilized in the proposed RBC rule?
  A number of risk weightings do not appear to recognize credit unions' positive experience and good business practices and judgment in these areas.

Deeper Dive

Overall, the NCUA does not seem to have justified the need for the proposed rule. The losses and failures suffered by the FDIC were very high, this despite the fact that the number of insured institutions is the same as those under the NCUA's oversight.

In a March 5, 2014, letter to Mr. Bill Cheney, President/CEO, CUNA, and Mr. Dan Berger, President/CEO, NAFCU, Chairman Matz acknowledges the failure of 102 natural-person credit unions during the financial crisis. She concludes that a RBC rule would have mitigated the losses from credit unions that failed, perhaps even saved more credit unions from failing, and saved all credit unions from paying as much as they did to cover those failures. Yet there have only been 7 credit unions that have caused share insurance fund losses in excess of $25 million since 2008.

By far the largest cost to credit unions that did not fail was the corporate credit union collapse, not natural person credit union failures. Corporate credit union capital standards were reactively, relatively, and appropriately increased. What was not explained in this March 2014 letter is how the proposed RBC rule would have prevented any failures. There are already other existing opportunities for regulatory oversight and latitude the NCUA has to curtail such a catastrophic event such as a credit union failure.

Complex Credit Union - The proposed RBC rule defines any credit union above $50 million in deposits as "complex". This definition is curious since the complexity of a credit union can not merely be defined by asset size. The Federal Credit Union Act clearly requires the NCUA to adopt a risk based net worth (RBNW) plan <u>and</u> requires the NCUA to define "complex" credit unions based on the portfolios of assets and liabilities of credit unions. Whether a credit union has a complex balance sheet should be influenced by whether they do real estate lending, member business lending, have risky investments, and many other factors contributing to the composition of a credit union's balance sheet and overall operation. Basing the definition of complex simply upon asset size does not seem sufficient according to the law.

PCFCU very much agrees with Farin & Associates regarding evaluation of what comprises a complex credit union and constitutes an adequate capital plan. As Farin & Associates described during a "CU Capital Planning Xspeak" webinar, a complex credit union is typically expected to have internal processes for assessing capital adequacy that reflects a full understanding of its risk exposure and to ensure that it holds capital corresponding to those risks. The nature of such capital adequacy assessment should be commensurate with the credit union's size, complexity, and risk profile, not simply based on asset size. A capital plan would evaluate whether or not the credit union is planning appropriately to maintain an adequate level of capital given its activities and risk profile. Stress testing of this capital plan would be prudent. The capital plan, a well thought out rationalization by a credit union, is what should be evaluated for adequacy. Such a rationalized plan may differ significantly from conclusions derived from strict risk based capital ratios.

Should asset size be the only way to determine "complex", PCFCU would suggest an asset threshold of $250 million. This is the level that was established in the final liquidity rule to join the Central Liquidity Fund (NCUA Regulation §741.12 Liquidity and Contingency Funding Plans (LCU 13-CU-10)). In justifying this level, the NCUA stated that "credit unions over $250 million have a great degree of interconnectedness with other market entities. When they experience unexpected or severe liquidity constraints, they are more likely to adversely affect the credit union system, public perception, and the NCUSIF. PCFCU believes a $250 million threshold would encourage mid-size credit union growth.

System Comparable to Banks with No Option to Raise Additional Capital – The Dodd-Frank Act required banking regulators to develop capital rules to prevent or mitigate risks to the financial stability of the United States stemming from the material financial distress or failure of large, interconnected financial institutions. This section of Dodd-Frank, does not apply to credit unions or their federal regulator, the NCUA. Lawmakers recognized that credit unions do not pose a systemic risk to the banking system and had the capital to absorb losses during the financial crisis.

Credit unions are very different than banks and should be treated differently. Even the most complex credit unions have a different mix of products and services with far less exposure to high risk activities, such as trading, private equity, and counterparty exposure from derivatives. Banks also have a much greater exposure to commercial real estate and commercial industrial lending than credit unions. Finally, credit unions are not-for-profit financial institutions that invest in their communities and in products and services that their members understand. A strict rule that does not acknowledge the mission to serve that community is detrimental to the community and the credit union.

The NCUA's authority to require risk based net worth originates from the Federal Credit Union (FCU) Act. The FCU Act requires a system of PCA that is "comparable" to bank PCA. To be comparable there needs to be some consideration for the unique nature of credit unions, which the proposed RBC does not do. One primary difference between banks and credit unions is the lack of ability to raise capital stock.

An alternative to raising capital stock would be the option for credit unions to raise supplemental capital. NCUA Chair Matz pledged in a May 2, 2013, letter to Rep. King (R-NY) that should the "Capital Access for Small Business and Job Act (HR 719) be enacted, the agency would promptly propose the necessary rule changes required for implementation. She stated in that letter that the "*legislation would provide credit unions with an additional tool to promote sufficient capital—even under adverse conditions—and ensure that healthy credit unions would no longer be forced to turn away deposits in order to protect their net worth*". By adding RBC to the wagon before the horse power of additional ways to obtain capital to support growth seems to be putting the "cart-before-the horse". The proposed RBC rule, without an option to raise additional capital, would lead to credit unions curtailing growth and turning away deposits.

In April 2010, NCUA Board Member Gigi Hyland announced the release of a Supplemental Capital White Paper. The white paper was an attempt to explore NCUA's current authority to permit federally insured credit unions to offer supplemental capital. There were a couple of critical observations identified in an April 12, 2010, NCUA Media Advisory, that is pertinent to today's proposed RBC rule:

1. Affording credit unions the ability to raise supplemental capital that counts towards PCA "net worth" requirements is an appropriate policy consideration.
2. PCA regulatory reform, including a stronger and more meaningful risk-based capital system, ... should continue to be pursued as a priority. The Reforms combined with supplemental capital could afford credit unions the opportunity to more effectively manage capital levels;

If supplemental capital was worthy of consideration four years ago and PCA regulatory reform would benefit from such capital, why does this proposed RBC rule not recognize the importance of supplemental capital to successful RBC implementation today?

Transition Period – The March 2014 letter to Mssrs. Cheney and Berger from Chairman Matz claims there is sufficient time for the NCUA's proposed rule to go into effect, 18 months after publication in the Federal Register. The FDIC's of risk based rules will not be fully implemented until 2019 versus the proposed 18 months for credit unions. This lengthier time period allowed to institutions with multiple ways to raise capital. Simply stated, more time is necessary for the proposed RBC rule to be phased into reality for credit unions. A 3 to 5 year transition period for an improved version of the proposed RBC rule would seem more appropriate than 18-months.

Capital Categories - The current "risk-based net worth (RBNW) requirement" is replaced with a "risk-based capital (RBC) ratio requirement". The RBNW imposes different capital requirements on different assets (6% for average risk assets, more or less than 6% for low-risk or high-risk assets). The proposed RBC would assign varying weights to different assets, and then calculate the ratio of net worth to total risk-weighted assets. Unlike the FDIC rules, which assigns weights exclusively on the basis of credit risk, NCUAs risk weights by statute include consideration of interest rate risk, concentration risk, credit risk, and other risks. This is disadvantageous to credit unions and like supplemental capital should be address by Congress. There is already separate guidance related for these risks (Letters to Credit Unions: 12-CU-11, Interest rate Risk Policy and Program Frequently Asked Questions; 12-CU-04, Interest Rate Risk Policy and Program Requirements; 10-CU-3, Concentration Risk; Credit Risk as conveyed in 14-CU-02 and 13-CU-01 and NCUA Accounting Bulletin 13-01; and multiple other directions provided through Supervisory Focus points and Supervisory Guidance issued over the past couple of years).

Call Report Data – The proposed risk-based capital ratio uses only existing information contained in the Call Report. In public conversation with representatives from the NCUA, the Agency explained that they did not want to increase the complexity of the call reporting process. PCFCU would gladly add easily obtainable data to the call report towards an effort to refine and support a better designed risk-based capital measurement.

Perhaps as an example for an already acknowledged enhancement to the Call Report, the following verbiage was noted on the calculator pages from the NCUA website: **"Schedule B – Investments, Supplemental Information.** NCUA will revise this schedule to include maturity categories for FDIC-Issued Guaranteed Notes (account 740A) and All Other US Government Obligations (account 741C3). This change will enable NCUA to apply a zero risk-weight to these investments similar to NCUA Guaranteed Notes." The zero risk weight should apply to assets backed by Government Sponsored Enterprises (GSEs) such as Fannie Mae or Freddie Mac. At a minimum, high quality mortgage backed securities should be risk weighted similar to a first mortgage carried in a portfolio.

A deep-dive into the current Call Report may find current data being requested that is rarely if ever used by the NCUA or its examiners. Removing these items would reduce regulatory burden. However, more significantly by supporting and ensuring a strong RBC calculation based on enhanced Call Report data may help to improve communication during examinations. More efficient examinations would definitely help alleviate regulatory burden.

Risk-Weights for the Proposed RBC vs. Basel III Requirements – There are a number of variances between the proposed RBC system and Basel III for small banks. The following are examples that would apply to PCFCU when comparing the risk weighting under the proposed RBC vs. Basel III

- Mortgage Loans – 0-25% of assets (50% risk weighting), 25%-35% of assets (75% risk weighting), and greater than 35% of assets (100% risk weighting) vs. 50% regardless of risk weighting. The only conclusion that may be drawn here is that banks either do a better job of mortgage lending (which would not be supported by experience loss ratios) or additional ways to attain capital results in the risk weighting under Basel III to be less. The risk weighting for Mortgage loans should be the same for credit unions such as PCFCU as it is for small community banks regardless of concentration risk. This is counterintuitive by discouraging the very lending that is critical to any economic recovery. It also results in credit unions not serving our field of membership by being encouraged to restrict concentration risks of real estate lending.

- Investment Portfolio Impact and Loss of Income - Investments Weighted Average Life (WAL): 3 to 5 years WAL (75% risk weighting), 5 to 10 years WAL (150%), and over 10 years WAL (200%) vs. Basel III (20% regardless of maturity).

    - The proposed RBC rule appears to not incentivize an asset-liability approach to roll up the yield curve as interest rates rise.

      Example #1 ("NCUA's risk based capital – Numbers don't tell the story", Gregg Stockdale, 1st Valley Credit Union, April 8, 2014, CU Insight): Consider a long-term investment portfolio is now earning above 2%. The industry has been at or below 1% yield for some time. After 3 years, the long term portfolio has earned 6%. The shorter-term portfolio only 3%. If rates go up next year, the short term portfolio will earn 3%+2% = 5%. The longer-term portfolio will earn 6%+2% = 8%. If rates go up again and the short term portfolio is able to fully re-price, while the long term portfolio has no repricing then the following happens: 5%+3%=8% and the long term portfolio receive 8%+2%=10%. This proves that with a steep investment curve, staying short is not a good investment strategy. This strategy misses the ability for sound investing to roll up the yield curve. To put it another way, a 5-year WAL investment that is earning 3%, then in two years will have a 3-year WAL that is earning 3%. Rates can increase and I'll still have short-term bond further down on the yield curve. During the interim, the income will be booked and the earnings potential has decreased.

    - Any RBC rule should be flexible enough to go work at either low or high interest rate environments. Would it not be prudent to go longer term in an investment portfolio during a high rate environment when the potential exists for rates to begin to fall?

      Example #2: High rate environment: 10 year investment vs 3 year investment This scenario compares two options – placing funds in 10 year investment or a 3 year investment.

When fully evaluating a proposal such as this, we believe it necessary to test an assumption from the perspective of a higher interest rate environment. In this scenario interest rates are much higher and considered to be at the market peak. According to the proposed RBC rule, funds invested in a 10 year WAL investment have a risk weight of 200% whereas 3 year investment has a risk weight of 50%.

- Investing $5 million into a year 10 investment at 8% - PCFCU's RBC initially declines to 10.38% which drops us below the minimum risk-based capital requirement. Earnings over 3 year period are $1.2 million.
- Investing the same $5 million into a 3 year WAL investment at 4% initially reduces PCFCU's RBC to 11.07%. Earnings over 3 year period are $600,000.

Assuming then that interest rates drop over the next 3 years:

- The 10 year WAL investment is still earning us 8% and over the next 3 year earning $1.2 million.
- However, the initial 3-year WAL investment will need to be reinvested in a new lower rate such as 2.5% which decreases earnings over the same next 3 years to $375,000.

The better decisions certainly appears to be to invest and lock funds into a high rate for 10 years rather than going short term and having to re-invest those funds at a lower rate of maturity.

Over the first 6 year time frame in this scenario our 10 year investment brought in $2.4 million of interest income. The other investment option would have earned us $975,000.

The Basel III risk weightings for either investment are 20% (vs. 50% and 200% under the NCUA's proposed RBC). Consequently, either investment decision leads to a significant increase in capital over the first three years. For the 10-year WAL investment, the Basel III capital would increase from 13.18% to 17.39%. For the 3-year WAL investment, the Basel III capital increases from 13.18% to 15.28%.

Conclusions:

a) PCFCU's RBC ratio is significantly and negatively impacted for the 10 year investment but the earnings potential is significantly more!
b) While at peak interest rates, the better investment decision to pursue a longer term investment would be dissuaded under the proposed RBC rule resulting in

lost earnings for our credit union. Presumably rates would be declining due to a deteriorating economic condition. These earnings could be used to supplement net worth and risk based capital for turbulent economic times.

- Additionally, the proposed RBC Rule makes minimal distinction between amortizing and bullet investments or agency backed or private label securities. For instance, a credit union can hold Treasury note with no capital requirement, but a 5-year agency requires 21% capital to be well capitalized. Equally as confusing, the proposal treats a portfolio mortgage with a 50% risk weight (with full credit risk) while the same mortgage in an agency mortgage backed security (with limited credit risk) has 75% or 150% risk weight. The NCUA should modify this part of the proposed rule into multiple options. Credit unions who wish to could continue to use weighted average life for simplicity. Other credit unions who wish to report with more complexity could choose to report additional data including credit quality (full faith and credit, GSE, or private label) and effective duration to more accurately capture the risk characteristics.

- Delinquent Consumer Loans: 150% vs. 100% - This begs the question of why would a delinquent loan at a credit union have 50% more risk than a similar loan at a small bank?

Other variances which could impact PCFCU in the future include considering long term strategic plans for this institution:

- Member Business Lending (proposed RBC risk weight is 100% - 200% depending on percentage of assets vs. Basel III risk weight of 100% regardless of concentration): PCFCU does not currently originate or service business loans. Our current net worth does not support it. The risk weight increasing more than 100% when MBLs would be greater than 15% of assets would likely not impinge be a consideration for awhile. However, down the road the escalation of risk weightings in this area would impact us.

- Investment in CUSOs: (proposed RBC risk weight is 250% vs. Basel III risk weight of 100%): PCFCU is investigating some CUSO investments related to cooperatively pooling health insurance options to obtain economies of scale. This risk weighting is excessive and may adversely impact this thought process to gain efficiency through collaboration. Since CUSO investments operate to supplement credit union services and have low risk of substantial loss, PCFCU would suggest lowering the risk weighting to 100%. Or perhaps to align with the "NCUA Regulations Related to Credit Union Service Organizations" (Letter to Credit Unions 13-CU-13), the risk weighting should be differentiated between those CUSO's determined to be complex versus those that are basic CUSOs.

Other Additional Risk Weights for on-Balance Sheet Assets - The proposed RBC rule decreases the risk weighting for several types of assets: fixed-rate first mortgages, investments up to 5 years, agency backed loans and investments. At the same time, there is a long list of assets that see an increase in risk weighting: investments over 5 years, consumer loans, ARM first-mortgages, "other" mortgages, MBLs, NCUSIF deposits, goodwill, corporate capital, delinquent loans, and CUSO loans and investments. In addition, the proposal has concentration escalators for residential mortgages and member business loans, and investment maturities. A result that both impacts our credit union and does not seem prudent in the current economic environment by creating incentives not to make mortgages or hold long-term investments.

For example, the NCUA has long been sharing the dangers about rates going up. We are not experiencing inflation; unemployment is still at a rate higher than to cause the Fed to make any quick changes to its QE policy and the forecasts for rates to begin to increase has been pushed out to 2016. Despite this information, these disincentives have already begun to influence PCFCU's thought processes around asset-liability management.

Arbitrary Determination of Minimum Capital Requirements – As with the current Part 702, the proposed RBC rule provides minimum standards based on broad generalities related to credit and concentration risk. It is our understanding that the NCUA would be able to require a higher minimum risk-based capital ratio for a variety of circumstances (i.e. risk of a particular investment portfolio, the risk management system, or *other information*). If accurate, perhaps the NCUA could say higher capital was appropriate for a credit union that has a significant exposure to declines in the net economic value (NEV) of its capital due to changes in interest rates. Additionally, other subjective or at best partially objective determinations might be utilized by supervisory attention, expected losses that could impact capital adequacy, degrees of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, etc.

Over the past two years, the objective at PCFCU has been to turn the direction of the organization's financials in a positive way. While well within the Credit Union's guidelines, the concentration risk is being addressed related to real estate backed collateral. However, the proposed RBC rule may mitigate this as a tool to leverage the opportunities for a more solid financial foundation, adversely affect opportunities for growth, and consequently cause a greater concern related to net worth, up to and including regulatory actions.

At the November 2012 NCUA exam, out of perceived concerns regarding interest rate and credit risk a recommendation was made to "shock the balance sheet until it hurt" (the point we began to lose money). Over the ensuing 9 months, we ran this exercise twice to learn that it would take an immediate shock of 700+ basis points (7% +) for PCFCU's balance sheet to reach this point. Had an arbitrary decision made during the examination been reached to require additional capital as a result of this perceived concern, the RBC requirement could have been unnecessarily raised using arbitrary rationale. The proposal is weakened by allowing such flexibility.

During a more recent November 2013 NCUA exam, PCFCU had three very adept and smart examiners. One took the approach to seek common understanding. Another capital market specialist took a global look at our asset liability management, investments and liquidity picture before reaching any conclusions. The third was clearly knowledgeable about risks related to lending. However a comment the third examiner made that the "agency places a great amount of trust in its examiners {which is good} and allows decisions to be made with or without written guidance". The primary basis for findings related to our loan policies was the opinion of this examiner. This third approach would be very unsettling if the thought process was applied to an arbitrary determination of minimum capital requirements.

These are just a couple of examples related to experience with NCUA examinations at our Credit Union. Under the proposal, the NCUA's judgment regarding adequacy of capital can also take into account the urgency of potential problems, overall condition, management strength, the credit union's liquidity, and other indicators of financial stability, or policies and practices. While we believe all of these types of determining or influencing factors to be positive at our institution, the fact that these are items which are largely subjective and above the objective risk-weighting system implicit in the proposed new RBC calculation.

One far stretching example of arbitrary evaluation can be found in the proposed RBC rule related to asset-backed investments. Should an NCUA examiner determine a credit union does not have a "comprehensive understanding" of such investments, a 1250% risk weighting can be applied to the RBC calculation.

The proposal does allow for an appeal process to challenge the requirement for higher capital. When challenging perspective of a black and white regulation, there is a difference of opinion with the hope to reach a mutual understanding. However, when questioning judgment there will almost always be a difference of opinion or the judgment would not be questioned in the first place. Appealing a judgment to a Supervising Examiner or all the way to a Region Director by human nature must be evaluated as to whether this will create an adverse view of the credit union raising such a concern.

Unanswered Observation – The Federal Accounting Standards Board (FASB) has proposed changes as to how allowance accounts are determined. It is unclear whether or not or how the proposed RBC considers these accounting implications. The concern is the NCUA's estimates of the number of credit unions impacted by the proposed RBC may be low.

Impacts on Peninsula Community FCU's Membership and Communities Served

As currently defined in the proposed rule the definition captures 94% of all credit union assets. This was not the intent of the Federal Credit Union Act relating to RBC. Consequently, the proposed rule would have a greater relative and adversely impact on smaller credit unions, up to those with $250 million in assets, which may have to hire staff or expend more resources to determine the complexity of the risk weights incorporated into the proposed RBC rule. To avoid the time and expense of figuring this out, credit unions such as PCFCU, might choose to limit our investments to very simple, plain vanilla offerings. This would have an unintended consequence to the communities we serve. Conversely, credit unions such as ours should be encouraged to grow and contribute to the financial well being of the communities we serve by offering a wide array of financial services.

In addition to the examples provided earlier, we ran a couple of additional scenarios of how the proposed RBC rule would negatively impact PCFCU's and pursuit of our Community Development Mission Statement as described above. These scenarios utilize the previously explained understandings of the NCUA's proposed RBC rule, comparing to the Basel III regulations for small community banks, and looking out three years.

As of December 31, 2013, PCFCU has the following ratios:

Net Worth:	7.91%
Proposed RBC ratio:	11.22%
Basel III ratio:	13.18%

Scenario #1: Investment vs. Auto Loan

This scenario it compares two options – placing funds in investment or in auto loans.

Today a 4 year investment yields approximately 1.30% and average rate for auto loans is 4.49%. Both a 4 year investment and an auto loan have a risk weight in the proposed RBC rule of 75%. So they both have the same impact on our Risk Based Capital – going from 11.22% to 10.95%.

- Investing $5 million in a 4 year investment over the first three years we will earn $150,000.
- Lending $5 million in autos loans will earn over the next 3 years will earn $438,632.

It is clear that the earnings potential for auto loans is almost 3 times greater than the investment, but the proposed RBC rule applies the same risk weighting. Leaving everything else constant, at the end of 3 years our RBC ratio would be at 11.53% (+21bps) with the investment and 12.23% (+101bps) by putting the funds out in auto loans. While the risk weightings are the same, the earning potential is extremely different. It does not make sense for the investment to have the same risk weighting as a loan since the earnings potential is much less and has no credit risk. There is an incentive to simply be a "savings club" for members and invest their funds; a disincentive to be a financial cooperative (a true credit union) and lend money for automobiles to our members.

Basel III uses a 20% risk weighting for (all) investments and a 100% risk weighting for non-delinquent other loans such as auto loans. However, over three years the Basel III ratio improves from 13.18% to 13.75% (+57bps) for the investments and 14.14% (+96bps for auto loans). It is notable that the NCUA's proposed RBC rule recognizes the better loss ratios for credit union auto lending. As credit unions are not for profit financial cooperatives, our incentive is to ensure the ability for our members to afford auto loans and not maximize profits leading to riskier loan decisions.

<u>Conclusion Scenario #1</u>:

a) Investments should have a lower risk weighting in the proposed RBC rule.
b) The proposed RBC rule does a better job recognizing credit union loss history than Basel III.
c) Basel III recognizes this and weights investments all at 20%.
d) Basel III risk weightings still capture risk and the limited complexity from auto lending.

Scenario #2: Mortgage Loan vs. Auto Loan

This scenario it compares two options – placing funds in 15 year fixed-rate mortgages or in auto loans.

Today, an average rate for auto loans is 4.49% and 15 year mortgage is 3.50%. The proposed RBC rule places an equal 75% risk weighting on each option. The impact on our Risk Based Capital is the same – dropping from 11.22% to 10.95%.

- Putting $5 million in auto loans earns us $438,632 during the first 3 years.
- Putting $5 million into 15 year mortgages earns us $379,645 during the first 3 years.

The auto loans earn us a better return and have less interest rate risk than a 15 year mortgage, but yet are weighted the same. Auto loans should be risk weighted less than 75%.

Interestingly, under Basel III the risk weighting for the 15-year fixed-rate mortgages would be 50%, regardless of the concentration in an institutions portfolio. One might presume this is due to the opportunity for the value of a home to increase whereas the value of an automobile begins to decrease as soon as it is driven off the lot. The presumption regarding real estate valuation beginning to rise is easy to reach at this point in history (following valuations that plummeted during the great recession there is only one direction for much real estate to go).

Conclusion Scenario #2: If the NCUA is intent on attempting to factor concentration risk into a RBC rule:

a) Place a 75% risk weight on all first mortgage real estate loans, regardless of concentration of assets, and
b) Decreasing the risk weight for auto loans to 50%.

Summary

Growth is required for survival and requires a strategy related to pricing, channel delivery, and infrastructure investments. While PCFCU is well capitalized under the proposed RBC rule, we believe the rule will have an adverse impact on PCFCU. This impact will impair our opportunity for growth, the way we serve our members, and the economic contributions this makes to the communities we serve.

If the NCUA rethinks the proposed new capital rule's risk weights to a more appropriate parallel to the Basel III risk weightings this would be a good start to improving the rule. By removing arbitrary approaches and adding clarification and further definition the rule would be greatly enhanced. The best approach would be to make statutory changes to PCA. Additionally, HR 719 would help to allow credit unions to access supplemental capital.

One piece of good news relating to an improved risk based capital environment is that the NCUA is not statutorily required to rush to adopt this rule. No specific deadline needs to be met. There is time to encourage appropriate statutory changes. The collective wisdom that exists across the credit unions can only make the safety and soundness of the industry that much more solid.

Sincerely,

James M Morrell

James M Morrell
President/CEO

cc: U.S. Senator Patty Murray (WA)
U.S. Senator Maria Cantwell (WA)
U.S. Congressman Denny Heck (WA-10th)
U.S. Congressman Derek Kilmer (WA - 6th)