~San Mateo~
Credit Union

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May 7, 2014

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

MAY12'14 PM 2:37 BOARD

Re: Response to CUNA's "Questions to Consider Regarding NCUA Risk-Based Capital Proposal"

First, we will address a series of questions as posed by CUNA:

1. Do you agree this new proposal is necessary? Please explain:
No, we do not agree the new proposal is necessary, but could be a positive if done properly. The concept of risk-based capital is sensible given our business revolves around managing risks. The current risk-based capital calculation is flawed, and is essentially reduced to an academic exercise. The proposed methodology has its flaws as well, but it has the potential to actually have some practical implications. The key is to build some sensible parameters so credit unions can continue to do their business and not be hamstrung by regulations seeking risk-aversion versus risk management.

2. How would your credit union be affected by the proposal?
We will retain our classification as a well-capitalized credit union. To this extent, the proposal would not affect us.
In May 2005, our concentration of first mortgage loans and junior liens to total assets was 17.5% and 9.5%, respectively, or an aggregate total real estate loan concentration of about 27.0%. By 12/31/2008, this concentration rose to 32.0% and 11.1%, respectively, or an aggregate total real estate loan concentration of about 43.1%. At that time, we made a conscious decision to reduce our concentration of first mortgage loans. As of 12/31/2013, 5 years later, our concentration of first mortgage loans and junior liens to total assets is 22.5% and 4.6%, respectively, or an aggregate total real estate loan concentration of about 27.1%. It is still our asset-liability management objective to continue to lower our fixed-rate first mortgage loan concentration. The point of the matter is we did not need to use risk-based capital measurements to decide to reduce the concentration level. We looked at our business. We looked at our concentration levels. We looked at our interest rate risk profile. We gather information on financial outlooks. We put it altogether and made the decision.

3. Do you agree NCUA should be able to impose higher capital requirements on credit unions on a case by case basis?
No, NCUA should **NOT** be able to impose higher (risk-based) capital requirements on a case-by-case basis. The specific situations cited in the CUNA Executive Summary on this topic (e.g., inadequate underwriting policies, standards, or procedures; poor liquidity or cash flow; management strength; etc.) should be and probably will be addressed elsewhere such as in the CAMEL ratings for the credit union. It should not be part of the risk-based capital calculation.

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4. Do you agree with the risk weightings for these categories? Please explain

MBLs: We have limited experience upon which to judge, but these risk ratings seem excessive.

- Member Business loans
  - 0% to 15% of Total Assets with risk weight of 100%
  - 15% to 25% of Total Assets with risk weight of 150%
  - > 25% of Total Assets with risk weight of 200%

Mortgage Loans: Yes, except as noted:

- First Lien Real Estate Loans
  - 0% to 25% of Total Assets with a risk weight of 50% **(Yes)**
  - 25% to 35% of Total Assets with a risk weight of 75% **(Yes)**
  - ***> 35% of Total Assets with a risk weight of 100%* (NO) should be expanded to:**
    - 35% to 50% of Total Assets with a risk weight of 100%
    - > 50% of Total Assets with a risk weight of 125%

    This risk weighting and additional tiers recognizes these higher concentrations have more risk exposure.

- Junior Lien Real Estate Loans are too heavy-handed.
  - 0% to 10% of Total Assets **change** from 100% to 75%
  - 10% to 20% of Total Assets **change** from 125% to 100%
  - 20% of Total Assets **change** from 150% to 125%

  This risk weighting recognizes these loans have more risk than first mortgage, but incrementally more.

Longer-term investments: Yes, except as noted:

- Total Investments
  - WAL =< 1-year with risk weight of 20% **(Yes)**
  - WAL > 1-year and =< 3-years with risk weight of 50% **(Yes)**
  - WAL > 3-years and =< 5-years with risk weight of 75% **(Yes)**
  - ***WAL > 5-years and =< 10-years with risk weight of 150%* (NO) should be expanded to:**
    - WAL > 5-years and =< 7-years with risk weight of 100%
    - WAL > 7-years and =< 10-years with risk weight of 125%
  - ***WAL > 10-years with risk weight of 200%* (NO) should be expanded to:**
    - WAL > 10-years and =<15-years with risk weight of 150%
    - WAL > 15-years risk weight of 200%

  There is incrementally higher risk with longer investment duration. The proposal fails to recognize adequately the incremental changes. By expanding and recognizing the incremental investment horizons, we can assign more appropriate risk weights.

  As I understand it, the risk-based capital proposal attempts to capture the credit risk using concentration factors and to capture the interest rate risk component using weighted average life (WAL) factor. Hence, our treasury investments have a credit risk weight of 0%, but our FDIC insured investments and agency investments will have a credit risk weight of 20%. In addition, since our total investment portfolio has a WAL of 33 months, the interest rate risk weight is 50%.

  I think any fully FDIC-insured or NCUSIF-insured deposit should have a risk-weight of 0.0%.

Consumer loans: Yes

- Consumer Loans includes credit cards loans, vehicle loans and leases, and general lines of credit and would have a risk weight of 75% (as it is under the current approach).
- Federally insured Student loans would have a risk weight of -0-
- Non- Federally insured Student loans would have a risk weight of 100%
- Any consumer loan that has been delinquent for 60 days or longer (or is in non-accrual status) would be risk weighted 150%

CUSOs Investments and Loans:

- CUSO Loans would have a risk weight of 100% **(Yes)**
- CUSO Investments would have a risk weight of 250% **(NO)**
  - This risk weight of 250% would imply this investment carries more risk than having a concentration of more than 25% of total assets in Member Business Loan.
  - The primary reason a credit union invests in a CUSO is to help facilitate services for their members. If we invest in a CUSO, it is consistent to making a Member Business Loan (or investing in a member's business) where there is a very close tie-in with the credit union. Accordingly, it may be more appropriate to set the risk weights for CUSO as is proposed for Member Business Loans as follows:
    - 0% to 15% of Total Assets with risk weight of 100%
    - 15 to 25% of Total Assets with risk weight of 150%
    - > 25% of Total Assets with risk weight of 200%

Others (Please identify)

- **Corporate Credit Union perpetual capital** risk weight is too high at 200%. It should be 100%. The NCUA has dramatically reduced the corporate credit union's risk capacity and correspondingly the credit union's capital investment exposure to loss.
- **Mutual Fund investments** risk weight is inappropriate if it is based on the WAL per the mutual fund's average life or duration target. While the bonds held in the fund may have an average life and result in the fund's duration target, the credit union investment is in the shares of the mutual fund. As such, the credit union can get in or get out of the fund within a matter of hours to days not months or years. The risk weight should be more in alignment with cash on deposit or money market funds at 20%.
  - In addition, the current regulations limit Mutual Fund investments to only those funds where 100% of the bonds within the fund are investment grade B or better. Credit risk is minimized.
- **Mortgage servicing assets (Other On-Balance Sheet Assets)** is too high at 250%. It should be 100%. These assets are based on loans the credit union has funded for its members and sold on the secondary market. If we had kept the loans in portfolio and incurred the interest rate risk and had a mortgage loan concentration >35%, the risk weight as proposed is 100%. Risk weight for Mortgage Servicing assets should be no more than 100%.

5. Should the NCUSIF deposit be excluded from the calculation of RBC ratios?

No. NCUA's goal of the proposed numerator is to capture a measure that more accurately reflects the amount of equity and reserves available to cover losses. While we can understand and appreciate the end-of-life perspective of the insurer, it is inconsistent with a going concern of a credit union. This is a real asset and is refundable if the credit union decides to take an alternate route. It is also available to cover losses to the NCUSIF. It should not be excluded from the calculation of RBC ratios.

6. Should goodwill be excluded from the calculation of the RBC numerator?
No. This is an asset usually created to satisfy accounting principles for mergers. If properly applied or created it reflects the value of the merger. In order to complete a merger, NCUA has to bless the union. If the NCUA gave its blessing and hence the creation of the goodwill, it would be inappropriate for NCUA to withdraw this asset from the risk based capital calculation. It is an integral part of the assets of the combined entities. It should not be excluded from the calculation of RBC ratios.

7. Do you agree NCUA should be able to restrict dividend payments as the proposal would provide?
No. We disagree with the proposed restriction on dividend payment to prevent the credit union from dropping below 6.00% (adequately capitalized). However, we agree NCUA should be able to restrict dividend payments if such payments would result in the credit union's net worth classification to fall below 4.00%, or dropping from Undercapitalized to Significantly Undercapitalized.

8. Do you agree with NCUA's implementation time line? If not, how much more time should credit unions be provided?
No, we do not agree with the implementation timeline (i.e., 18-month after the publication of the final rule in the Federal Register). The only way for credit unions to increase capital is through net income. This takes time especially during the current low interest rate environment. Alternatively, but just as time-intensive, is for the credit union to reallocate their assets. In response #2 above, we noted it took about 3 years to increase our real estate concentration to our high limit, and 5 years to recover. (The evil alternative to capital ratio improvement is to shrink the business. This would be contrary to a going business concern principle.)
One suggestion would be to deploy the risk-based capital requirement in incremental phases:

- 24-months after publication of the final rule = 8.50%
- 48-months after publication of the final rule = 9.50%
- 72-months after publication of the final rule = 10.50%

9. Do you have other concerns with the proposal? Please explain.
The inclusion of "off-balance sheet" unused line of credit (HELOC and Credit Cards) is worrisome. This might be an area for further review.

<u>Other Comments</u>
Examiner authority to impose higher capital requirements on a case by case basis is a recipe for disaster. While many examiners have a good business sense, more than a small number simply judge based on spread sheets, peer ratios and personal opinion. When asked what level of capital is needed, the answer is simply "More". And that attitude is reflected in this proposal. What is needed: "More". What is really needed? Scrap this attack and start fresh on a reasonable risk based proposal.
The common ill in the regulatory world is to punish all for the sins of the few. That answer is to create regulations that prevent other credit unions from making the same "mistakes" in the future. The real answer is to use your "supervisory" powers to address these few who insist on undue risk. Don't hide behind flawed regulations addressed to all. Deal with the misbehaving child as you would your own child. But don't punish all the kids, but the one who deserved to be disciplined.

Sincerely,

Barry Jolette
President/CEO