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COASTAL federal credit union

May 19, 2014

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

Subject: Comments on Proposed Risk-Based Capital Rule

Dr. Mr. Poliquin:

Thank you for the opportunity to comment on the proposed Risk Based Capital regulation.

In general, Coastal supports a risk based capital regulation that is comparable in approach to that required for other financial institutions. From our perspective, the regulation should appropriately tie the levels of risk that a credit union takes to the capital it is required to maintain. The nature of the share insurance fund is such that credit unions guarantee each others' deposits subject to a government guarantee as a backstop. A well designed risk based capital rule would protect the industry by ensuring that credit unions that chose to take outsized risks are required to protect the fund via an additional capital cushion. Conceptually, this model makes perfect sense to us.

Context and Perspective

It is important to provide some context to our detailed comments on this proposed rule, and provide some perspective on our observations of the proposed rule.

- We fully appreciate that the Dodd-Frank legislation and adoption of Basel III by the international banking regulators has put pressure on all regulators to strengthen capital requirements for banks, many of whom were undercapitalized before the financial crisis began due to inadequate regulatory capital requirements. It would seem that the NCUA feels compelled to <u>increase capital requirements</u> for credit unions as well because of these factors, even though the credit union movement had more than sufficient capital to weather the financial crisis.

- The "financial crisis" was caused by bad practices and actions by the mega-financial institutions around the world. The Dodd-Frank legislation, was in part, intended to deal with those "Too Big To Fail" institutions, and to rein in the risks that they could take. Five (5) years later, those institutions just keep getting bigger and bigger. Unfortunately, the regulatory backlash from banking and credit union regulators, and the CFPB, is creating a new class of community financial institutions that may very well be "Too Small To Succeed." Small community financial institutions (yes, at $2.2 billion in assets, we're still a "small" institution in the financial services world), community banks and credit unions, are in great danger of being unable to serve their communities in the future. This proposed rule will not improve that situation.

- By any measure used, credit unions emerged from the "financial crisis" in much better shape than our banking counterparts. Our historical loan loss ratios, delinquency rates, institutional failure rates, and deposit insurance fund losses (excluding the cost of resolving failed corporate credit unions) are far lower than those same metrics in the banking industry. And aggregate leverage capital ratios, which are over 10%, are relatively unchanged since the beginning of the financial crisis. Our "reward" for this exemplary performance is a proposed rule that is considerably more punitive than Basel III. Chairman Matz has publicly stated that "Basel III is not for credit unions." We naively believed that this meant that the NCUA would propose risk-based capital rules that reflected the relative safety of credit unions compared to our banking counterparts. We certainly did not expect to see a rule that imposed far greater capital requirements on us than that imposed on the financial giants that caused the financial crisis.

- The most extreme risk weightings proposed in this rule appear to be based on a very small handful of credit union failures, that were quite frankly, caused by inept management and weak supervisory oversight by regulators. It would be a grave mistake to penalize an entire sector of community financial institutions for the sins of a small handful of bad actors.

- We support implementation of a "reasonable" risk-based capital rule to replace the current rule, in a way that reflects the unique nature of credit unions and the important role we play in providing loans to consumers, home owners and small businesses. The proposed rule does not meet the "reasonable" test in our view. In fact, we would be better off with having to comply with Basel III. The proposed NCUA rules would place credit unions at a competitive disadvantage to banks that follow Basel III. After studying and reflecting on the proposed rule for several months, we would much prefer to see the Basel III rules adopted for credit unions, instead of the rules proposed by the NCUA.

The Impact on Coastal Federal Credit Union

For Coastal Federal Credit Union, the NCUA website provided an estimated Risk Based Capital ratio of 14.17% as of December 31, 2013. An independent third party consultant has calculated our ratio for the same date under the Basel III requirements that FDIC insured institutions follow. That ratio was 17.63% using the Standard Approach. An analysis of our Risk-Based Capital position is presented below:

Coastal Federal Credit Union Risk-Based Capital Analysis	Coastal 12/31/2013 Actual	Risk Weighted Assets $	Surplus Capital % Above Well Cap	Surplus Capital $ Above Well Cap
Assets	$ 2,232,953,658			
Regulatory Capital	$ 230,129,091			
PCA Net Worth Ratio	10.31%	$ 2,232,953,658	3.31%	$ 73,822,335
RBC Ratio - NCUA Proposed	14.17%	$ 1,601,312,975	2.67%	$ 59,619,863
RBC Ratio - Basel III Standard Approach	17.63%	$ 1,397,300,000	6.13%	$ 136,880,059
Variance to Basel III	**-3.46%**	**$ 204,012,975**	**-3.46%**	**$ (77,260,197)**

Key conclusions from this analysis are:

- Our risk-weighted assets are $204 million greater under the NCUA proposal than under Basel III. Our surplus risk-based capital above the 10.5% requirement is $77 million higher under Basel III than under the NCUA proposal. Each of these poses unnecessary limits to future growth in serving members.

- If unchanged, the NCUA proposal could very well tip the economic scales in favor of converting to a mutual savings bank charter.

Risk Weighting of Investments

The proposed regulation focuses heavily on the interest rate risk embedded in credit union investments. The capital requirement for investments is determined by average life as of the end of each reporting period. Our concerns with the proposed risk weightings for credit union investments are:

- The capital required for investments in each average life "band" is consistent with the unrealized loss that would be realized on a bullet maturity instrument, with an average life in the middle of the band, given an immediate and sustained +300 bp change in rates. Put another way, credit unions would be required to keep enough capital against their investment portfolios to liquidate them given a +300 bp shift in rates. Such a requirement is excessive because it ignores the duration of liabilities, assumes that rate changes are immediate rather than over time, and assumes improperly that credit unions would lack the ability to hold investments given rising rates.

- It presents credit unions with a competitive disadvantage in the financial services marketplace. For example, FDIC insured institutions are typically required to maintain a 20% capital weighting for their investment portfolios that align with federal credit union permissible investments.

- Only the average life as of the end of the reporting period is considered. Some instruments such as companion CMO tranches have significantly more interest rate risk than indicated by their average lives. For example, depending on their structure some tranches have the ability to extend from average lives of a year or two to average lives in excess of 20 years. Such instruments pose a high level of risk yet would be classified the same as instruments with little risk. This is one of several ways that the proposed structure can be "gamed".

- The risk weights are inconsistent with those given to other similar risks that credit unions can take. For example, if a credit union held a 30-year mortgage to a member on its balance sheet, the interest rate risk would be similar to that of a 30-year mortgage backed security (MBS), yet the member loan could have a risk weighting of as little as 50% while the MBS could have a risk weighting of 200%. The unintended adverse consequence is that a credit union could retain its own mortgage production to minimize its capital requirements resulting in increased credit and liquidity risks and similar interest rate risk and be required to have substantially lower capital even with a higher risk profile.

- There are several changes the NCUA could make to overcome the concerns with the disparate treatment of risks, the competitive disadvantage, and the potential adverse consequences. The favored solution is to adopt the 20% risk weight utilized by the FDIC for typical credit union investments. Further, the lack of capital requirements for full faith and credit instruments makes it easy for a credit union to take the risks that the NCUA likely wishes they would avoid. Placing the capital requirements in line with those of the FDIC would eliminate much of the incentive to "game" the capital rules.

- Investments backed by the full faith and credit of the U.S. Governments such as Treasuries, SBAs and GNMAs carry a 0% risk weighting. This compares with risk weightings from 20% to 200% for non-full faith and credit government issued securities. Many credit union investment portfolios are comprised of agency debentures, agency MBS, and collateralized mortgage obligations. A credit union that found itself challenged for capital could construct an investment portfolio with a similar or higher interest rate risk profile and expected returns by utilizing treasuries, GNMA CMOs and MBS and have no capital required, even though the risks are similar to a portfolio that could require substantial capital.

> ***Or put another way, the risk weighting of a 30-year Treasury, with a WAL of 30 years, has a risk weighting of 0%, while securities issued by Government Agencies with a WAL over 5 years carry a risk weight of 150-200%. If the investment weightings are intended to control interest rate risk, this contradiction makes no sense. <u>In our view, the risk weighting of investment instruments should be aligned with Basel III.</u>***

- Under the proposed regulation, overnight deposits with the Federal Reserve Bank require a 20% risk weighting. Does the NCUA really believe that the Federal Reserve Bank is at risk of failing and not honoring it's commitments?

> ***This asset is virtually risk free because of the Federal Reserve's government backing, ability to create cash, and the short term nature of overnight deposits. We recommend that the weighting be changed to 0% consistent with physical cash.***

Risk Weighting of Mortgage Servicing Rights (MSRs)

Mortgage Servicing Assets (MSRs) have proposed capital weights of 250%, in line with those required by the FDIC for banks. However, MSRs have very different risk profiles for credit unions than they do for banks.

While it is true that the FDIC assigned a 250% risk premium to MSRs in its risk-based capital requirements, they did not do so because of the risk of the asset itself. The FDIC was addressing a different risk – the risk of too many MSR assets on the books of too few servicers. They were specifically trying to discourage the mega servicers from accumulating any more servicing.

The four largest servicers in the US -- Wells Fargo, JP Morgan Chase, Bank of America, and Citicorp, -- at the time the FDIC's RBC rules were written, serviced more than 60% of all mortgages outstanding in the US. The FDIC was addressing the risk of this oligopoly when it established its RBC rules. It was strongly discouraging these mega servicers from accumulating any more MSRs, and trying to make it punitive to hold massive amounts of these assets.

The NCUA should be encouraging credit unions to hold the servicing rights to its members' loans, not discouraging it. A mortgage loan is often the most significant financial commitment a credit union member has, and can be the cornerstone of his or her relationship with his or her credit union. A credit union should want to ensure that it controls the member experience related to that asset, and should not be discouraged by its regulator from doing so. For this reason, we strongly encourage the NCUA to consider lowering the risk weighting on MSRs to 100% or less to more accurately reflect the true risk of this asset to credit unions.

Risk Weighting of Loans and Investments in Credit Union Service Organizations (CUSOs)

Coastal has been very active throughout its history in collaborating with other credit unions through CUSOs. Today, Coastal is the sole or majority owner of three (3) CUSOs, and a minority owner of ten (10) other CUSOs.

Coastal has made cash investments in these CUSOs totaling $3,465,000. Today, the book value of those investments is $9.4 million, reflecting a gain of $6 million. And a number of these CUSOs pay annual dividends. For example, Coastal invested $25,000 in CO-OP Financial Services when we moved our debit and ATM processing business to that company. Today, patronage dividends that were paid in additional equity stand at $847,000.

Some of these CUSOs enable Coastal to offer services to its members that it would otherwise not be able to provide. These include investment and insurance services, trust services, title insurance policies and real estate brokerage services.

We participate in other CUSOs with other credit unions to help reduce our operating expenses. These include a shared branch network, an indirect auto lending network, a shared internet search company, and two CUSOs formed strictly to allow us to share research and development expenses. These CUSOs save Coastal hundreds of thousands of dollars each year.

Under the NCUA proposal, Investments in CUSOs have a proposed risk weight of 250%, while loans to a CUSO have a proposed risk weight of 100%. We're unable to discern a logical reason for this disparity. Approval of the proposed risk weights on investments in CUSOs will have a significant and chilling effect to collaboration among credit unions due to the capital charge required. Requiring such a high capital weight would likely decrease innovation, cooperation and increase overall credit union industry costs of doing business.

For these reasons, we recommend that the risk weightings for CUSOs also be held at 100%, in line with other operating assets on a credit union's balance sheet.

Implementation Timeline

The rule proposes an 18 month implementation timeline for credit unions to come into compliance with the proposed RBC rules. While it is true that this provides some opportunity for credit unions to adjust their balance sheets, the sheer size of the increased capital requirements for some credit unions would require a change in business model and/or a dramatic increase in the level of capital via earnings, or conversion to a bank charter. Given the nature of these tasks, 18 months is an unreasonably short time, especially given that the banking regulators have provided substantially longer for their regulated institutions to adapt to new and less onerous capital regulations.

We would propose that the implementation timeline be extended to no less than five (5) years.

Interest Rate Risk

The proposed rule incorporates higher risk weightings for certain longer term investments that have imbedded interest rate risk.

Incorporation of **interest rate risk measures** as proposed are very punitive and one-sided. It penalizes credit unions that may hold longer-term investments, without any offsetting credit for funding or hedging strategies that reduce that risk. The proposed rule is not based at all on the actual levels of interest rate risk in each credit union.

In 1995, the NCUA released a new version of the corporate credit union regulation, Part 704. This regulation clearly defined the amount of interest rate risk that corporate credit unions could take within various levels of operating authority. Whether intentionally or not, many corporate credit unions began to take substantial levels of credit risk and avoided interest rate risk. The result of those decisions left a wound on the credit union industry as several corporates failed and subjected credit unions to the loss of their corporate capital, as well as years of assessments to fund the Temporary Corporate Credit Union Stabilization Fund.

In reading the Material Loss Review documents of large credit unions that failed during the financial crisis, there are many causes of credit union and corporate credit union failure, but none mentions interest rate risk, even though the time frame includes an episode during which some market based interest rates increased by approximately four percentage points in just 24 months. Even given such an event, interest rate risk apparently didn't play a role in the failures of any credit unions.

While we're not opposed to considering a risk-based capital scheme that incorporates interest rate risk, it needs to be done in a way that considers the entire interest rate position of the credit union. This may prove to be impractical, and would place credit unions at a competitive disadvantage to banks.

Designing risk-based capital requirements to account for interest rate risk, while good in theory, will be a complex undertaking to do it right. We would recommend that additional capital requirements related to interest rate risks be addressed in a separate rule focused solely on that matter.

Treatment of NCUSIF Deposit

The NCUSIF deposit is backed out of both assets and Net Worth in performing the Risk Based Capital calculation. The proposal is written such that it only includes assets that would be available to offset losses given conservatorship. Our understanding is that if a credit union goes through a voluntary liquidation, the deposit is remitted to the credit union for the benefit of the credit union's members. Arguably, given a systemic event that wiped out the insurance fund the proceeds from the deposit would not be available. Given a non systemic event that only resulted in the liquidation of one or a manageable number of credit unions the deposit would be available. It is our position that given a non systemic event that did not substantially impair the fund that the asset would be available. Consequently, we also encourage the NCUA to include it in the calculation of Net Worth.

We would propose that the NCUSIF Deposit be risk weighted at 100% and that there be no reduction in capital by the amount of this investment.

Residential Mortgage Loans Guaranteed by FHA or VA

The NCUA rule proposes a risk weighting of 20%, while Basel III uses a 0% risk weighting. Similar to our concerns about the risk weightings of agency-backed government securities, we can find no logical basis for subjecting credit unions to a higher weighting than Basel III.

We would recommend that the risk weighting for residential mortgage loans guaranteed by the FHA or VA be set at 0%.

Treatment of Delinquent Loans

The proposed risk weightings for delinquent loans are consistent with that required for banks under Basel III. We don't object to those weightings.

What we do object to is the differential definition of a delinquent loan. Basel III for banks considers a loan delinquent when it is 90 days past due. The proposed NCUA rule considers a loan delinquent when it is 60 days past due. This will be incredibly punitive to credit unions, that historically have lower delinquency and loan loss rates across all loan categories.

At Coastal, 60+ delinquent loans at 12/31/2013 were $15.2 million while our 90+ delinquent loans were $10.7 million. Under the NCUA proposed rule, we have to hold risk-based capital against an additional $4.5 million in delinquent loans versus the requirement for a bank.

We support the proposed risk weightings for delinquent loans, but propose that the definition of a delinquent loan under the RBC rule be revised to include loans that are delinquent more than 90 days.

Risk Weighting of Member Business Loans

Many credit unions, because of their fields of membership, have business models that are heavily reliant on member business lending. Their members and the communities that they serve rely heavily upon the business loans that these credit unions provide to create jobs, to increase standards of living in their communities, and to contribute to the overall U.S. economy. This was specifically contemplated in the Credit Union Membership Access Act.

As written, the proposal would have a very chilling effect on these credit unions' ability to meet their members' financial needs. Further, it would result in credit unions being required to hold twice the capital levels against some business loans compared to the amount required to be held by banks. For such credit unions, it could result in the credit union charter no longer being viable and would potentially force a change to the inferior bank charter. Clearly, we do not support the high level of capital proposed for member business loans for credit unions that have such a business model.

We recommend that the capital requirement be maintained at levels similar to those required for banks. The statutory cap of 12.25% of assets, which applies to most credit unions makes this a moot point for most credit unions, including Coastal. The inherent risks are covered by other parts of the proposal, including increased requirements for delinquent loans and the overall higher level of capital required by the regulation.

Loans Held for Sale

We cannot understand why a residential mortgage loan held for sale would be risk-weighted at 100%, the same as a delinquent residential mortgage loan. There is no evidence that these loans present more risk to the credit union because of their designation as held for sale.

We would recommend that loans held for sale be risk-weighted at the same level as loans held on the books.

Other Real Estate Loans

These loans, such as home equity loans, have the same risk characteristics as other consumer loans. In the worst scenario, they behave as unsecured loans. There is no rational reason that these loans would be risk weighted at 100-150% when all consumer loans, including all unsecured loans, are risk weighted at 75%. In the commentary, if we hold the first and second lien, the combined lien would be considered a first for purposes of risk weighting – this would require a change to the call report.

We would recommend that Other Residential Real Estate Loans be risk weighted at the same level as consumer loans.

Inclusion of ALLL up to 1.25% of Risk Assets

The rule proposes that up to 1.25% of risk assets from ALLL be included in Risk Based Net Worth, which is consistent with Basel III. We applaud the inclusion of ALLL reserves.

The FASB is in the process of developing a rule that would require loan losses to be accounted for utilizing a Current Expected Credit Loss (CECL) model rather than the current incurred loss model. The pragmatic effect will be that many credit unions will see their ALLL balances grow dramatically as they implement this likely change. The result will be that to keep with the intent of the 1.25% of ALLL in the proposal, after CECL is implemented, that the amount that can be added back to capital will need to increase substantially. If it does not, credit unions will find themselves in a situation where capital will need to increase to cover changes in GAAP as well as changes in Risk Based Capital. Again, we applaud the 1.25% of ALLL inclusion in Net Worth but we must remain vigilant in ensuring that the Risk Based Capital regulation will change in an appropriate manner as GAAP changes.

<u>We would propose that the rule be changed to permit 100% of ALLL reserves to be considered as Net Worth, which would accommodate the changes that FASB is considering.</u> We can think of no logical reason to penalize credit unions that may choose to maintain higher ALLL reserves by "capping" the amount of ALLL that is included in capital. The rule accounts for higher delinquency levels through the loan risk weightings, but does not provide similar accommodation of the higher ALLL balances that would be required by higher delinquency ratios.

Individual Minimum Capital Requirements (702.105)

The proposal would allow examiners to utilize judgment to apply higher capital requirements to individual credit unions based on "judgment." There's no provision for due process or appeal for independent review. Because of the damage that such a requirement could have on a particular credit union, we are wary of this portion of the proposal. There is no way to ensure that an individual credit union's capital requirement would not be arbitrarily and capriciously increased by an examiner. Such uncertainty over capital requirements would unnecessarily add additional operational and regulatory risks to all credit unions subject to the regulation.

Any required increase in risk-based capital requirements for a credit union from the published regulatory requirements should be subject to approval by the Regional Director, with an appeal process to the NCUA Board, and a due process that ensures that the credit union's data and views on the matter are disclosed and considered.

Supplemental Capital

The NCUA has been supportive of credit union efforts to get Supplemental Capital approved by Congress as a tool to meet PCA capital requirements. Certain credit unions are already permitted by the statutes to raise and consider Supplemental Capital in meeting PCA requirements.

This proposed rule presents a unique opportunity for the NCUA to authorize Supplemental Capital as a tool for meeting the proposed risk-based capital rules. We are unable to find a prohibition in the statutes that would prevent this.

We would propose that the NCUA develop companion rules that would authorize credit unions to issue Supplemental Capital instruments to members that would be counted as capital for purposes of meeting the risk-based capital rules.

Opportunity to Bring Back Reg Flex

The proposed rule imposes "requirements" on those with higher risk profiles, but does not provide incentives for credit unions that chose to maintain capital levels meaningfully above those required by the regulation. Examples of potential "carrots" that could be offered to such credit unions include automatic waivers from personal guarantee requirements on Member Business Loans and exemptions from fixed asset limits.

Reliance on Call Report Data

While we applaud the NCUA's desire to not increase reporting requirements for credit unions by basing the Risk-based Capital calculations on **call report data**, that data is insufficient to provide a meaningful and accurate assessment of risk and calculation of risk-based capital adequacy. This simplistic approach does not serve "complex" credit unions well at all. If additional data is needed, we would much prefer to see expanded call report requirements that only apply to "complex" credit unions. This simplistic, one size fits all capital scheme is punitive to the only sector of credit unions that are seeing membership and asset growth – large credit unions.

Combining the Regular Reserve and Undivided Earnings

We do support the proposed change to close out the regular reserve into the undivided earnings account.

Sincerely,

Chuck Purvis

Chuck Purvis
President/CEO