April 9, 2014

Gerard Poliquin - Secretary of the Board
National Credit Union Administration
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Comments on Proposed Rule: PCA – Risk Based Capital

Per the instructions listed in your proposed rulemaking, I have organized these comments by section or by "General Comments".

<u>General Comments</u>

I am generally in favor of reasonable capital regulation as it can provide for a basic level of certainty in financial institutions' strategies for managing risk; however it is beginning to feel that you want to regulate all risk out of credit union balance sheets and our relationships with members. I fear this regulatory creep is going to begin to stop smaller credit unions from serving their members based on relationships and managing risk using tools other than arbitrary figures.

I did find this proposal somewhat interesting in that the reasons given for these proposed changes were due to NCUSIF losses resulting "from individual credit unions holding inadequate levels of capital relative to risks". NCUA has consistently been increasing its examination and oversight budget over the past several years to apparently accomplish the same goal of eliminating risk to the NCUSIF. This proposal does not address the costs to credit union members of both of these initiatives together.

I am becoming fearful that in your efforts to protect the fund <u>at all costs</u>, you just might succeed. The cost to members in the form of excessive supervision and lost earnings due to potential over capitalization may themselves begin to pose risk to the NCUSIF, especially in the current interest rate environment.

This proposed rule also mentions Basel III and FDIC rules numerous times in the summary and analysis section. It seems that you rely too much on their guidance for a risk based capital rule for Credit Unions. Our capital structures, loss histories and risk profiles are significantly different than "too big to fail" or systemically important banks as only NCUA would know, however this is not reflected in this proposal. Why not?

<u>Comments by Section</u>

<u>702.102 Capital Classifications</u>
In the proposed capital classifications, you propose a risk based capital ratio of 10.5% simply as it is comparable to other Federal Banking agencies ratios of 8% PLUS a 2.5% capital conservation buffer (CCB) which won't be fully implemented until 2019 per the FDIC. This CCB is discussed in the FDIC's interim final rule as a means to keep banks from paying dividends to shareholders and "substantial discretionary

bonuses" to management which occurred even as banks financial conditions weakened during the last crisis.

To my knowledge, this has not been an issue with failed credit unions in the past and was not addressed in any of the OIG material loss reviews that I read; therefore it seems that adding this "buffer" into the risk based capital proposal seems arbitrary. If 10.5% is truly a prudent amount, I believe NCUA should provide more information specific to credit unions and background as to how this figure is appropriate. Absent this information or the ability to generate capital through means other than retained earnings, a risk based ratio of 10.5% appears excessive based on your other risk weightings.

702.104(b)

In your discussion of the ALLL and the limitation of 1.25% included in the numerator, several statements were made that I feel are inappropriate. The proposal analysis states: *"By establishing a limit in the amount of ALLL included in the numerator, the proposed rule would provide an incentive for granting quality loans and recording losses in a timely manner."* **Does NCUA believe this proposal is the only incentive credit unions have to make quality loans?!**

It goes on to state *"The proposed 1.25% limit should not result in a disincentive to fully fund the ALLL above the 1.25% ceiling because complex credit unions are bound by GAAP in maintaining the ALLL."* Since we are already bound by GAAP to fund the allowance at appropriate levels (regardless of the 1.25% limit), this arbitrary limit (based on Basel III) can't possibly be a disincentive! What if a credit union made higher credit risk loans due to their field of membership, realized higher loan yields as a result but needs to fund the ALLL at higher levels? This arbitrary limit will certainly begin to limit their ability to serve their membership through a requirement of higher capital levels translating into ever higher interest rates on loans for their members.

702.104(c)(2)

MBL – Your rationale for adjusting the minimum risk weight for these to 100% and 150/200% for over 15% concentrations is unusual. First, you footnote the justification for increasing the base risk weight to 100% based on the FDIC proposal which maintains a 100% base and includes a 150% level for high volatility CRE which they ultimately define as development lending. Second, you then justify increasing the concentration risks (over 15%) higher since the few credit unions this affects have concentrations in one type of MBL's but you state it would be a burden to those credit unions to give you information that could help alleviate the concerns about the concentrations. For credit unions who predominantly originate MBL's, this proposal effectively makes it difficult to continue in business. To justify originating MBL's with a 200% risk weight will require credit unions to price loans at such a high interest rate that it would start to make me nervous about the types of borrowers who might accept those terms. Maybe that is the "intended" consequence.

CUSO Investments – A 250% risk weighting for CUSO investments is much too high and does not provide any ability to differentiate between various CUSO's which can have drastically different balance sheet and risk structures. This oversized risk weight will most definitely force credit unions to rethink any

investment in a CUSO regardless of any potential expense savings or member service benefits they may provide.

The remainder of your risk weight scheme for various loan types is overly broad and arbitrary and I don't believe it takes into account the individual underwriting, terms, pricing and risk management of individual credit unions. I believe the past several years have proven those issues to be more important in managing risk vs. looking at concentration risks only.

702.104(c)(3)

Off Balance Sheet loans sold with Recourse – We currently sell conforming first mortgages through FHLB MPF program where we retain a limited "contractual" portion of the credit risk. Your effective risk weight of 37.5% is much too high for these loans. Since we do not retain any interest income on these loans, we must generate enough net earnings at origination to offset your risk based capital requirement. This would equate to almost a 4% gain. If you factor expenses of origination into this, we would need to generate a gain of at least 4.5%. To generate this much income would require us to price these loans at the maximum level which puts them into the High Priced Mortgage Loan ballpark and where we would never get a loan as members would go elsewhere due to the high interest rates.

Our risk for these loans is dependent on individual loan risks aggregated for each master commitment amount. Your proposed capital requirement would mean we must hold enough capital to satisfy the maximum entire credit risk for our pool of loans. If this proposal were finalized, we would have to seriously consider whether we could continue to originate first mortgages with this program.

702.105 Individual Minimum Capital Requirements

There are several comments made in your discussion section that are troubling. First, you state that "a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of a credit union's regulatory capital ratios." If this statement is true, why bother with these guidelines at all and just have examiners assign required capital levels to each credit union?

Second, you state that "a complex credit union is generally expected to operate with capital positions above the minimum risk-based capital measures." Since this proposal applies to only credit unions over $50 million and you define those as complex, aren't you saying that the REAL requirement is even higher than 10.5%?

Finally, you state that NCUA may require higher minimum capital ratios "for a credit union that has significant exposures to declines in the economic value of its capital due to changes in interest rates." The fact that you don't define "significant" is worrisome. What if a credit union has a larger decline in NEV than its peers but still holds adequate capital?

Is NCUA concerned with the NCUSIF portfolio which has increased its exposure to interest rate risks just as it tells credit unions to do the opposite? If there is truly a "significant" exposure for credit unions to rising rates, shouldn't our insurance fund operate somewhat counter cyclically and not stretch for yield

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with longer-term securities and begin preparing itself for higher rates? The decline in the economic value of the fund over the past year is a staggering $350,000,000! Reaching for yield has cost credit unions significantly already at the hands of their insurer.

<u>702.105(b) "Appropriate Considerations for Establishing Minimum Capital Requirements</u>

It is difficult to even get into the details of this section as your comments are so broad that they could be easily be interpreted to include virtually every "complex" credit union. Is this your intention? A few questions that I believe need answered in this section are:

- What exactly does "high degree of exposure to "fill in the blank" risk mean?
- How does NCUA define "poor liquidity or cash flow"? Do you have specific numbers or guidelines?
- What is the specific credit union growth rate percentage that "creates supervisory problems that are not adequately addressed by other NCUA regulations or guidance"?
- Doesn't almost every credit union have "loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms"? If so, then all credit unions will be subject to these individual minimum capital requirements.

<u>Summary Comments</u>

Overall, this proposal doesn't seem to provide enough justification for the capital levels or risk weights chosen and doesn't provide specific details for credit unions to manage their risks. It seems as if it just attempts to mimic the FDIC proposal somewhat but give NCUA all the leeway to do whatever is necessary to "protect the fund".

How will these changes help lower our oversight and supervision costs? Paraphrasing your comments, "this will solidify the credit union movement"… so I would assume that examination expenses should begin to decrease as credit unions meeting the new risk-based capital requirements should need far fewer contacts.

Credit Unions are NOT banks. Will NCUA recognize our differences and structure a capital rule to reflect this? As we are only able to generate the risk based capital required for this regulation through retained earnings, it will be very difficult to do that if a credit union finds itself below the requirement. The only choice will likely be to shrink the balance sheet by the very assets that would likely bring the necessary profitability to the credit union.

Thank you for the opportunity to comment.

Regards,

Greg Hill
President/CEO