April 18, 2014

Gerard Poliquin, Secretary of the Board
National Credit Union Association
1775 Duke Street
Alexandria, Va. 22314-3428

Re: Comments on Proposed Rule: PCA-Risk Based Capital
RIN 3133-AD77

NCUA Board,

I am writing to comment on the proposed risk-based capital rule. I work for Metrum Community Credit Union, based in Centennial, Colorado. Our membership numbers are nearly 5,000 and we have approximately $58,000,000 in assets with two branches.

In April 1989, I began as the President of this credit union totaling 2,200 members, $5.7 million in assets and a total Capital Ratio of .67%. It was a different era then, as State & Federal Regulators worked with our organization to become a viable entity. Today, it is rare for a small or mid-size credit union that becomes Undercapitalized (<6% Net Worth) to be allowed the time to become viable, before being merged. With this experience, I am concerned when higher levels of Net Worth or Risk-Based Capital (RBC) are being proposed.

<u>General Comments:</u>
I was pleased to hear that the NCUA was taking on capital standards, a long discussed topic in the industry. The topic has the ability to improve a fixed number that was arbitrarily set during the 1998 Membership Act, by Congress. My hopes were based on the notion that credit unions have historically had much lower delinquency and charge off figures than banks, the industry does not participate in a majority of the more risky investment trading and our commercial lending risk is nearly non-existent in comparison. In addition, the industry responded to the recent Mortgage crisis, the greatest financial crisis in approximately 80 years, at a much stronger level than our banking counterparts. Currently, our net worth ratios are set 40% higher than our banking counterparts. I thought, at a minimum, changes would lower our capital to the same levels as our banking counterparts, but more likely place our capital requirements at lower levels due to our stronger performance and less risky cooperative business model.

There are items in the proposal that I am in favor of:

- NCUA's awareness of the burden of collecting additional information and additional reporting requirements.
- Adding back the allowance for loan loss account to capital, although at a limited percentage which doesn't follow GAAP.
- Capturing the risk of off balance sheet items.

The majority of my comments will focus on an overwhelming number of concerns with the development of the proposal, content of individual areas and suggestions for improvements.

<u>Capital Adequacy – Part 702</u>

From my perspective the existing current Risk-Based Net Worth calculation has been overlooked by many credit unions, due to the fact that it has required credit unions to hold Net Worth well below the Well Capitalized level of 7%. As such, the risk-weightings assigned have not been examined thoroughly. As such, a majority of my comparisons will be against the BASEL III for small bank requirements.

Before discussing individual aspects of this section I would like to discuss the need for the development of the proposal. There are several aspects of the material which need addressing, including the need to enhance the current structure as presented, the definition of complex and value to our industry and members that will be forthcoming.

In November 2010, a report was published by the NCUA Office of Inspector General depicting the ten largest losses to the share insurance fund. The report stated, "In all ten of our MLRs, we found <u>management's</u> poor strategic decisions and <u>weak management</u> oversight over lending or investment practices (including one fraud) contributed to the failure. In addition, we had two other MLRs that involved alleged <u>fraud schemes perpetrated by management</u>.' Additionally, when reading the summaries of nine of the ten failures, the report clearly identifies that the <u>Examiners</u> failed to identify weaknesses during the examination process. The common link is all the weaknesses were determined to be the fault of <u>humans</u>.

It is my understanding the banking community has had RBC for nearly 25 years, but the higher levels of capital standards have not eliminated or reduced losses to the FDIC. In fact, just the opposite has occurred. The dollar amount of losses has escalated astronomically from the early 1990's through the most recent crisis. In addition, they are occurring more frequently.

Where is the need to inflict higher levels of capital, by NCUA's estimates, placing another 199 credit unions under the well capitalized level? These organizations not only survived the worst financial crisis since the Great Depression, but in general, credit unions succeeded in being the only financial sector to provide liquidity, increase lending to our members and improve our reputation to the consumers of the United States.

Using the Inspector General's findings and the recent Mortgage crisis knowledge the major reason for these losses were people. The people running these business models were driven in a majority of cases by greed; greed leads to a riskier business model, which normally leads to a liquidity problem, the leading cause of financial institutions being liquidated or bailed out! Can one set of Capital standards for all the different sizes and types of credit unions ensure safety and soundness? Personally, I don't believe that is the solution, but investment in the people (examiners) both from an education and experience standpoint are more likely the problem to the solution. Being from Colorado where two large credit unions were heavily concentrated (over 70%) in condos in Florida and sub-prime auto loans, the issue were the boots on the ground.

In the Federal Register/Volume 63, dated October 29, 1998 the NCUA attempted to define what a 'Complex' credit union was to assist in the development of Prompt Corrective Action; Section 216 required the NCUA Board to define this 'based on the portfolios of assets and liabilities of credit unions.' These words did take into account more than 'credit' risk, but also interest rate risk. Back then, ALM concepts had been in existence for a few years, but software did not allow a strong basis to incorporate the type of modeling and forecasting we have today. In 1998, did the NCUA board place the higher capital requirements, 40% higher than the banks, 7% versus 5%, to compensate for the long-term assets and the liability side of the Balance Sheet?

In the current (Net Worth) and proposed risk-based (Capital) systems the liability side of the Balance Sheet is not taken into account; and now because a credit union reaches another arbitrary figure of $50,000,000 in assets, one has become 'complex'. Has there been a study of losses to the share insurance fund showing that clearly at $50,000,000 in assets your organization is a greater risk to the share insurance fund? How does this definition of complex compare to banks definition of complex?

When comparing the proposed RBC to that of the banking system, BASEL III, the attempt to integrate credit, interest rate, concentration, liquidity, operational and market risk into one set of capital standards, muddies the water. In some areas, the proposal uses extension risk (Insured Certificates of Deposit), but in the same category investments, the length or term of the investment is ignored and only credit risk is used (Direct US Government Obligations). This practice is inconsistent, highlighting the weaknesses of combining multiple risks into one ranking system.

I do not envy having your job of attempting to develop this proposal, but the BASEL system is more consistent as its primary focus is on credit risk; which leads to a more easy to understand methodology and eliminates non-statistical (emotional based) weightings.

In NCUA's summary, the primary mission is to ensure the safety and soundness of insured credit unions. When Congress enacted the Credit Union Membership Access Act (CUMAA) it required the NCUA Board to take into account that credit unions do not issue capital stock, and therefore must rely on retained earnings to build net worth and have boards of directors that consist primarily of volunteers. Throughout the proposal statements are made, over and over, that the RBC will be more consistent with Other Federal Banking Regulatory Agencies. Was that the intent of Congress? Should that be the goal of a Cooperative regulator? Should the NCUA design standards that are different than the for-profit banking world due to the unique nature of credit unions?

My experience in the past few years tells me that the NCUA Board has forgotten the basic principles for which natural person credit unions were formed and given our tax exempt status; which is our fundamental business principle – We're a Cooperative! We were formed to serve our memberships; which have provided a counter cyclical balance to the banking system for over 100 years. Banks are started with one purpose in mind, to make the highest return for their owners. This rub between regulators and stockholders has caused every major financial crisis in our country's history, including the Corporate Credit Union issues due to the AAA package asset backed mortgages. But I digress.

In the Mid-80's I was an auditor for two and a half years and the average capital (use to include the entire balance of the ALLL) was around 3.75% and anyone over 5% was extremely well capitalized. Credit unions have become more complex, at least some of them, higher capital standards put in place and the industry's net worth ratios began the crisis at nearly 11% and ended the crisis at over 10%. This evidence strongly suggests that our system had more than enough capital and now there is a proposal to have more; at who's expense – our members! There is no value to our Cooperative model by having higher RBC levels; in fact there is probably factual data to prove that our business model should have lower capital standards than our banking counterparts.

I am not one of those believers that if it isn't broke don't fix it, but I do believe that you do not make changes unless you can improve the system. The current proposal the NCUA Board is looking to impose provides little value and will hurt our member owned Cooperative System, which has not placed the NCUSIF in jeopardy to be concerned with increasing our capital standards.

Capital Adequacy – Part 702 102(a) Capital Categories

As aforementioned having the higher capital levels, so we can be comparable to Other Federal Banking Regulatory Agencies does not take into account the unique nature Congress intended in setting Prompt Corrective Action capital levels. The proposal mentions the 2.5 percent capital conservation buffer, which is expected to be fully implemented in 2019, is of concern as well, since from day of implementation credit unions are fully expected to exceed that of the Banking Industry. The National Banks deserve to be held to higher capital standards based on their direct responsibility for the Mortgage crisis. Why punish our business model?

Capital Adequacy – Part 702 104(b) Capital Ratio Numerator & Capital Elements of the Risk-Based Capital Ratio Numerator

It is stated that the goal of the proposed RBC ratio numerator is to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses. **The ALLL is then limited to 1.25% of risk assets.** The funds set aside in the ALLL are 'all' specifically set aside based on historical and individual assessments of potential loan losses. Setting a limit is contrary to the position of achieving a measure that reflects a more accurate amount of equity and reserves available to cover losses. The entire balance in the ALLL is there to cover loan losses.

The premise that the rule would provide an incentive for granting quality loans and recording of loan losses in a timely manner is a theory based concept and does not take into account the reality of the economy, as just seen in the recent Mortgage crisis. A majority of the credit unions granted credit to homeowners, knowing at the time of origination that the member had the ability to pay and that the relative value of the home would be stable; 30% to 50% drops are not the norm. The economy determined otherwise, so the limitation is punitive in nature, as if the NCUA board is expecting credit unions to write bad loans, remember, we are member owned.

The other major factor to consider during the recent crisis is examiners determined that ALLL accounts were underfunded forcing a majority of credit unions to increase allowance accounts, one to three times the amounts currently being withheld. The only reason given was it was due to the economy and what may occur; this future forecasting lead to a majority of credit unions not funding a dollar in 2012 and 2013 due to excessive allowance accounts.

The results of this type of cap (1.25%) are the credit union and its member's capital being undervalued potentially limiting the amount of services that can be provided and growth opportunities being taken away.
Our recommendation *is to allow the entire balance of the Allowance for Loan Loss to be included in the capital or numerator.*

The **<u>NCUSIF deposit being deducted from the RBC</u>** does not achieve the stated goal of the proposal that reflects a more accurate amount of equity and reserves available to cover losses. Also, subtracting the NCUSIF deposit from the denominator does not support that the deposit is an asset of the credit union.

The NCUSIF deposit is an investment to be held by and used by the NCUA to earn income to cover losses to natural person credit unions (NPCU) and fund a portion of the operating expenses of the NCUA. The deposit range is 1.20% to 1.30% of the total share accounts in NPCU's, with a premium being accessed if below and a refund or interest payment being made if the cumulative balances exceeds 1.30%. The investment status has been confirmed by numerous CPA firms in their opinion audits of NPCU's. In the proposal it states that the treatment for the risk-based capital standard would not alter the NCUSIF deposit accounting treatment for credit unions.

The subtraction of the NCUSIF deposit from capital changes the entire principle of the classification as an investment by acting as if the loss will occur and by reducing a NPCU's capital ratio. In Generally Accepted Accounting Principles a losses is not recognized unless the probability is certain, the amount can be determined and an expected date in the future is relatively know. In my humble opinion, not one of the three GAAP principles has been met.

In essence, as the proposal is written, the NCUSIF deposit is a loss and reduces our capital, as such. The treatment of the NCUSIF deposit supports the aforementioned theory that the NCUA Board has forgot the basic principles for which natural person credit unions were formed and given our tax exempt status.

<u>Our recommendation</u> *is twofold with the first being to not reduce the numerator or capital by the NCUSIF deposit amount and treat the investment in a similar manner as other investments. The second part of the recommendation is if the proposal is left unchanged, than mail a check back to each credit union and send an annual bill. This method will better match GAAP and keep our capital levels intact.*

The two other deductions, **<u>Goodwill and Other Intangible Assets</u>** are difficult to discuss as I have limited experience with these topics. Based on reading articles in different trade subscriptions it appears that subtracting goodwill from capital may be hinder future merger activity, especially when a NPCU may cause a loss to the share insurance fund and a larger NPCU steps in to remedy the situation.

<u>Our recommendation</u> *would be the NCUA review the stated goal of the proposal that reflects a more accurate amount of equity and reserves available to cover losses. If deducting goodwill does not meet the stated goal, then a reduction to capital should not occur.*

<u>Capital Adequacy – Part 702 104(c) Risk-Weights for On-Balance Sheet Assets</u>

The concept of risk-weighting assets for inclusion in the denominator is an unnatural process, especially when attempting to take into account several different risk categories. As I reviewed the proposed system and the comparison to the BASEL system, it became apparent that there were several inconsistencies even within the same asset classes and several inconsistencies between asset categories. Using a risk-based capital simulator I ran several different scenarios to compare and contrast the effects to the capital ratio, which brought into question the severity of certain balance sheet changes to the capital ratio.

I will highlight the inconsistencies and discuss the simulations ran in the mortgage, business lending, investment, other asset categories and delinquent loan categories.

Capital Adequacy – Part 702 104(c) Risk-Weights for On-Balance Sheet Assets con't

The **Mortgage Loans** section is difficult to follow as the weightings are based on interest, concentration and credit risk; and it appears unfounded assumptions as it relates to second or junior liens. In addition, there are cash flow concepts that were accounted for in the current RBNW system that have been removed in the proposed system.

The determination of how the percentages were set for **first lien risk-weightings** was based on the average, of all credit unions percentage of first mortgage real estate loans to total assets as of June 30, 2013; from this starting point within 10.01% there is great discrepancy in the weights ranging from 50% to 100%. The setting of the percentage to assets does not appear to be based on studies of credit union failures or other more concrete evidence, thus the setting of the weights lacks statistical definition as well.

In the current RBNW calculation, a strength is the recognition of short-term cash flows, as fixed rate mortgages with a maturity date in less than five years reduces the denominator. Although imperfect, as all cash flows from long-term mortgage loans reduce the severity of interest rate risk (IRR), there is no allowance in the new proposal recognizing these IRR reducing principles.

Our ALCO just completed a 'What if' scenario using December 31, 2013 Balance Sheet, testing our fixed rate mortgage policy limit of 50%. The background is our current base case Net Interest Income ranges from year 1 to year 5 from -3.3% to a positive 2.7%; our NEV comes in at 12.19% and our Shocked NEV stands at 11.30%. We would be rated a low interest rate risk credit union, with very strong capital. To reach the 50% of fixed real estate loan limit an additional $12,000,000 in fixed real estate loans were added to our existing balances. Our scenario was ran and the Net Interest Income ranges from year 1 to year 5 were, -6.2 in year one, rises to -15.9% in year two and our recovery begins in year three dropping to -10.07% in year five. Our NEV began at 12.18% and the Shocked NEV ended at 9.16%; showing that our institution could add this large increase in fixed real estate loans. In addition, Net Income in a no rate environment would grow $430,000 per year and in a rising environment Net Income over five years would increase $991,000.

When placing the additional $12,000,000 in the proposed capital system our capital would drop 399 basis points to 17.10% or 18.9% decline. Can the average 14.6% (NCUA's estimate), well capitalized credit union serve their members when lowering their capital 399 basis points? I can't image if it were all in 2nd mortgages how large the decline would have been.

Our recommendation *would be to leave interest rate risks to a strong ALCO and ALM software program and removed the extension risk from the weights being assigned in the first lien programs. Focus on credit risks, similar to the BASEL system which weights all mortgage lending at 50%.*

In the proposal the **second lien position real estate loans** are discussed in relationship to the recent U.S. housing market or mortgage crisis as the reasoning behind the higher risk weightings. The cause for the increase in risk defaults included inadequate underwriting standards, negative amortization, payment shock to the borrowers and unverified or undocumented income loans. This reasoning deserves to be placed where it belongs, the National Banks and Mortgage companies as their reputation risk; not the credit unions! These causes could just as well of been writing in the first lien position loans as well and again belong to the bankers.

Capital Adequacy – Part 702 104(c) Risk-Weights for On-Balance Sheet Assets con't

It is agreed that a second or junior lien position carries slightly more risk than a first lien position, but when second liens are properly written with knowledge of the characteristics of the first lien and other sound underwriting principles the credit risk can be mitigated. The risk lies only in the positioning of lien holders. The interest rate risk reducing benefits are clearly evident in an ALM program, due to the average range of seconds being three to ten years. In addition, HELOC loans have zero interest rate risk. Assuming the basis for the graduated first liens carrying higher weighting is based on interest rate risk there appears to be inconstancy in the same asset classification, as seconds are being downgraded due to increased credit risk.

The variation in the weightings appear to treat second liens as they are substantially more risk. Does the NCUA board believe that a credit union would have 35% or higher in first liens and then be adding on to concentration in the real estate area by having 10% or higher in second liens; compounding the concentration risk? This may or may not be the case; in fact, statistically for many smaller credit unions, only a short few years ago the second lien loans made up a sizable portion of total real estate loans, if not on equal footing. That brings up the point does the Board have data to support that a credit union with a 10% second lien position truly increasing their 'risk' 100% or having a 25% second lien position having a 150% to 200% higher risk?

In the OIG's November 2010 report it clearly identifies commercial lending as the cause for seven of the ten failures. Is there evidence that second lien positions have caused failures, because second liens from 0 to 10% are weighted 100%, the same as commercial loans and then from 10.01% to 14.99% second liens are weighted 125% versus 100% for commercial loans and then second liens from 20.01% to 24.99% are weighted 150% the same as commercial loans. These types of similar weightings when the credit risk is nowhere near the same show the weaknesses within the proposal. One would think the NCUA would prefer that all NPCU's place 25% of our total assets in commercial loans. The unintended consequences of this action would be enormous! Yes, I know that we are all caped to 12.25%, but supposedly so were all seven credit union failures.

Using the RBC simulator, a look back into the industry's past was completed, remember when the average credit union's loan to total asset ratio was 80% and second mortgages were a much larger part of the portfolio mix; and credit union ROA's were outstanding for all asset categories, ah the good old days. The background information is currently we have a 57% loan to total asset ratio, with the following percentage of the loan portfolio being Other Loans 44.92%, First Mortgage 48.43%, and Other Real Estate of 6.59%. We increased our total loans to 80% of total assets by adding $5.75 million in Other Loans and increase Other Real Estate $5.9 million; while leaving First Mortgages at the same balance. The emphasis of placing $5.9 million in seconds being placed in the 100% and 125% weight categories lowered our RBC from 21.09% to 16.99%, a 410 basis point change.

If the additional $5.9 million were placed in longer term fixed first mortgages the risk weightings lower our denominator $2.069 million and improve our RBC ratio from 16.99% to 17.95%. We did not compute an ALM run, but from my experience adding $5.9 million in three to ten year seconds would not show a sizable change to our NII, NEV or Shocked NEV; on the other hand adding $5.9 million to fixed long-term first liens would increase our IRR greatly.

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All things being equal as far as concentration risk and interest rate risk, increasing the second mortgage portfolio is a much stronger asset to hold for various reasons including increased cash flows and turnover of these loans during rising rate environments, HELOC's have zero IRR by repricing either monthly or quarterly. Yet in the proposal, the weightings are 100 percent to 200 percent higher.

Our recommendation *would be to consider all real estate loans at the same weights by eliminating the concentration and maturity levels placed in the proposal. Over the past few years other regulations have been developed requiring analysis of concentration levels and a strong ALM program, by attempting to integrate multiple risks into one measurement the results are uncertain and there will be unintended consequences.*

In the proposals **member business loan area** we have limited experience; as our experience is in rental income properties and not true commercial lending. Based on material read over the years, commercial lending has caused several credit union losses. In Colorado, Norlarco Credit Unions Florida based commercial loans took them and a hand full of other credit unions that purchased participations from them into liquidation or merger. Our comments will be limited to our recommendation to separate rental properties from true commercial lending and the weakness in the CUSO weightings.

Member business loans have a wide range of loan types from everyday mortgage loans (rentals) to speculative condo loan projects, as such, this area is difficult to evaluate. Based on the OIG November 2010 report, seven of the ten losses was due to commercial lending. With this factual data the higher weightings appear on the surface to be appropriate. In reading the details of the OIG's report, in many cases the 1998's Membership Act business concentration limit of 12.25% was exceed, with the NCUA's Regional Directors approving the waivers. So as pointed out earlier in the comment letter measurements are not a replacement for well trained and knowledgeable examiners.

One measure for smaller and midsize credit unions in this area would be through the formation of CUSO, which would allow higher level commercial lender experience than individual credit unions could afford on their own. In addition, the risk of individual loans could be spread throughout several credit union organizations. Later in the proposal there is a deterrent to improving commercial lending capabilities by weighting CUSO investments at 250 percent.

Our recommendation *would be to reclassify mortgage lending (rentals) from the definition of Business Lending. In addition, study and review NPCU's that have strong backgrounds in commercial lending and use their comments for potential improvements.*

In the proposal the **Cash and Investment weights area** states, "the current risk-weights for investments relied on the results of 300 basis point interest rate 'shock tests' to corroborate the assigned risk-weights. The 300 basis point shock test is a widely accepted measure of interest rate risk." And then the next paragraph begins with zero risk-weighting on certain investments categories based on 'credit' risk.

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The most alarming thought in these statements is our industry is going to begin adding capital, to capital that is already 40% higher than banks are expected to retain, based on a 'worst case' scenario (up 300 basis point shock test). Are credit unions expected to manage an on-going business model or one set up to eliminate risk? What does the 7% Net Worth requirement cover today?

The investment area begins with inconsistencies by asset classes as certain insured investments are zero risk weighted and other insured investments may be weighted as high as 200% and ends with inconsistencies when comparing investment choices to lending categories. Insured investments, such as a simple certificate of deposit with a five-year term should not be weighted any differently than a Treasury bill or note with similar terms. It appears the proposal commingles the selection of the proper investment, with interest rate risk, depending on whether the proper choice is made by the credit union.

The semantics of U.S Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government verses a financial institutions insurance disclosure which states, your savings are federally insured to at least $250,000 and backed by the full faith and credit of the U.S. Government means the same to a person or business entity. They are all backed by the U.S. Government and carry no credit risk. Also, a bullet investment is a bullet investment, whether a US Treasury or insured certificate of deposit.

In the example below, a credit union that chooses to invest 10% of their total assets ($50 million asset size CU) or $5,000,000 in a five year U.S. Government obligation has $0 added to their denominator; where a credit union that invests $1,000,000 million, per year, in a three, four, five, six and seven year terms would have $5,250,000 ($3,000,000 * 75% & $2,000,000 * 150%) added to their denominator. While both investments have equal average weighted lives (work with me), 5 years, the laddered insured CD's lowers the average credit union RBC ratio by 185 basis points.
** First set of number assumes <u>CU A invested in five year treasury</u> & the 2nd set CU B assumes the purchase & laddering of <u>CD's</u> with no changes to the Net Worth for comparative purposes:

CU A: Assets $50,000,000 Net Worth 11% ($5,500,000) RBC 14.86% denominator $37,000,000
CU B: Assets $50,000,000 Net Worth 11% ($5,500,000) RBC 13.01% denominator $42,250,000

It is unexplainable how CU B poses a greater risk and would need to hold an additional $778,350 ($42,250,000 * 14.86%) more in capital than CU A, to keep the same RBC ratio. In fact, CU B is strategically investing more soundly than CU A, by laddering their investments, so in either in a rising or falling rate environment CU B is better prepared.

Inconsistencies <u>between investments with zero credit risk and multiple loan types</u> also cause confusion over the different required levels of capital; examples include:

- An insured CD with a weighted average life of five years is weighted at 75% and a 30-year mortgage loan from 0-25% of assets is weighted at 50%. The Insured CD has no credit risk and duration of 5 years versus the mortgage loan having credit risk; with interest cash flows but little principle cash flows in the first five years.
- A FHLB or other Government Security with a weighted average life at origination of seven years being weighted at 150% and a 30-year mortgage loan from 0 to 25% is weighted at

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- 50%. Have similar asset makeup, the Gov. Security has zero credit risk and principle & interest cash flows coming in vs. the mortgage loan having credit risk.
- An insured CD or Government Security with a weighted average life of six years is weighted at 150% and an unsecured signature or credit card loan being weighted at 75%. The Insured CD has no credit risk and the non-collateralized loan has much greater credit risk.
- An insured CD or Government Security with a weighted average life of six years is weighted at 150% vs. an indirect loan at 125% with a term of 72 months being weighted at 75%.

I am sure there are many more examples, similar to this, that show how using one standard of measurement, RBC, when attempting to evaluate multiple risks leads to many unforeseen results. IRR is better left to the ALCO and ALM software.

Finally, I see no mention of derivative trading securities being mentioned in the investment section of the proposal. The main purpose behind derivatives are to hedge against the current interest rate risk held in assets (read too much concentration risk in long-term mortgages), at least this is my understanding. I do not understand the variances between one type of derivative trading and another, so excuse my ignorance, but several banking entities lost billions of dollars in recent years. Is one to assume from the proposal that derivative trading has similar risk attributes to an insured CD?

Our recommendation *would be to follow the* BASEL system which uses a flat 20% risk weighting, no matter how long the term*. But only if the NCUA must assign a risk weighting, as a majority of the instruments have no credit risk and as such will not require any capital to cover principle losses.*

In the proposal there are **several Other Assets** with a wide range of weightings, from 0% to 1,250%. The following will attempt to organize my response by grouping those assets with similar characteristic wherever possible.

In the proposal **consumer loans** covers a wide range of loan types covering current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, and new & used vehicle loans; with the weighting being 75%. The percentage of weighting is difficult to determine, if it is appropriate as each credit union has a different mix of unsecured vs. collateralized loans, under writing plays an important role and variable rate lines of credit while having more credit risk pose little interest rate risk.

Overall, the risk level seems appropriate, but as always the risk is not in the product, but in the lending philosophy and underwriting of each credit union. A $10,000,000 dollar portfolio of 130% loan to value indirect car loans may or may not have the same risk attributes of an internally written auto loan portfolio where no loan is over 100% loan to value. One would assume from the information above that obviously the indirect portfolio would have higher losses, but not at our institution. As one of the methods we use to assist members in need of smaller balance signature loans is to collateralize them with used cars.

This was written to emphasize the importance of other regulations and management tools in place already, such as the concentration risk analysis (CRA). Our CRA has in depth details on each loan portfolio for five years, which when used properly allows for the setting of a fact based concentration limits being set by asset class. The CRA working in conjunction with ALM principles eliminates the need to have additional capital for these areas, added to our current Net Worth balances.
Our recommendation *would be to use the 75% weighting.*

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In the proposal, **<u>non-federal insured student loans</u>** are weighted at 100% versus consumer loans that would be treated at 75%. An unsecured loan is an unsecured loan.

Our recommendation *would be to lower it to 75%.*

<u>In the proposal</u> **<u>delinquent first mortgage loans and all other delinquent consumer loans</u>** have different weightings; 100% and 150% respectively. The starting point for a delinquent loan is inconsistent, as the maximum amount of loss is the principle balance.

In the proposal it states, "Rising levels of delinquent loans are an indicator of increased risk. To reflect the impaired credit quality of past due loans, the proposal would require credit unions to assign a 150% risk-weight to a non-real estate loan if it is 60 days or more past due or in nonaccrual status. NCUA realized that the ALLL is already reflected in the risk-based capital numerator and increased provision expenses decrease retained earnings. However, the ALLL is intended to cover estimated, incurred losses as of the balance sheet date, rather than unexpected losses. The higher risk-weight on past due exposures ensures sufficient regulatory capital for the increased probability of unexpected losses on these exposures."

The assumption that the ALLL is intended to cover estimated, incurred losses as of the balance sheet date, rather than unexpected losses is a partially correct thought. There are two distinct calculations going into the ALLL balance, one using the historical loss ratios and the second reviewing all delinquent loans and any other known loss the credit union is aware of and setting aside a dollar amount. The historical loss ratio, by pool, is based on actual past losses, that are no longer in the balance sheet and is a projection of unexpected losses going forward. So the intent of the proposal is being met in looking forward for probable unexpected losses by setting aside funds based on past losses. Past losses are no indicator of future losses, but we set aside the funds for that purpose.

A concern over the assumption that now credit unions must set aside funds today, for the unexpected losses in the future is an unsound business practice. During the recent crisis examiners forced credit unions to increase their ALLL, based on this same crystal ball approach. The norm was increasing your ALLL by 50% to up to 300% based on the unexpected, unknown losses that were going to occur. Then the future occurred; in 2012 and 2013 many credit unions were so overfunded that many expensed out zero to their provision for loan losses.

The solution to the ALLL is not to have credit unions set aside more capital, due to unforeseen losses in the future, as the recent Corporate system crisis showed the crystal ball estimations to be inaccurate. The issue with the ALLL is during good times there is insufficient build up of the ALLL account and then in the worst of times the expectation is add more and more! In the good old days, a solid three-year historical analysis plus the individual analysis of delinquent and other potential losses was a solid calculation of future losses. When the examiners force credit unions to move to a 12 month historical analysis, the only item captured was the crisis. Now we're all back to placing near to nothing in the ALLL instead of setting aside a reasonable amount for the future!

Capital Adequacy – Part 702 104(c) Risk-Weights for On-Balance Sheet Assets con't

The presentation of the financial statements in conformity with GAAP is management's responsibility. If and only if, proof of additional capital or ALLL is needed by an exam team should the financial statements be adjusted. The recent approach used by exam teams points out the lack of knowledge of a member owned Cooperative, as NCUA management and exam teams tossed us all in the 'banking' pot, immediately assuming we wrote poorly underwritten loans and that were all the same. In certain states this may have been true, but one rule is not the solution for the whole. There is no substitute for highly qualified examiners with experience and strong background.

Our recommendation *would be to weight all delinquent loans at 100%. As the current rule is written, if there is an increase in delinquent loans the ALLL is capped at 1.25% of total risk assets being added into the numerator, so additional capital is already being set aside for future losses by not crediting the Capital numerator for the full balance in the ALLL.*

In the proposal **Corporate perpetual and non-perpetual capital** has weightings of 200% and 100% respectfully. The difference in weightings is inconsistent as both capital accounts are there in case the earning and capital of a Corporate credit union (CCU) would be unable to cover a catastrophic loss. A NPCU has no legal requirement to pay additional funds to a CCU if all the perpetual and non-perpetual is lost, so the doubling to our denominator of an asset on our books is overboard.

The probability of additional losses to the Corporate network is nearly non- existent due to the changes imposed through changes made to regulation 704 and the additional capital their industry has to accumulate. The regulation has nearly eliminated all risk, leaving correspondent services as the only means to earn income; which has caused less value being passed on to NPCU's. This makes our capital investments much stronger; there is less risk in the system.

In addition, the Corporate capital rules takes our capital contributions and eliminates them from use in the calculation of their ratio in 2016 and 2020. This does not follow GAAP accounting and again reduces their capital levels, requiring them to build additional capital that further hinders their ability to serve and provide value to their members.

Our recommendation *would be to weigh the Corporate perpetual capital at the 100% level. The weighting of 200% is a punitive measure to those credit unions that supported the CCU network to recapitalize an organization that provides strong value to NPCU's, especially NPCU's under $250 million in assets.*

In the proposal **loans to CUSO's and investments in CUSO's** has weightings of 100% and 250% respectfully. The starting point is inconsistent, as the maximum amount of loss in either a loan or investment is the principle balance. The proposal states, "This increase is due to the risk of this unsecured equity investment, which is almost always in a non-publicly traded entity. Loans to CUSOs are normally a higher payout priority in the event of liquidation of a CUSO, and thus would be assigned a risk weighting of 100 percent."

Capital Adequacy – Part 702 104(c) Risk-Weights for On-Balance Sheet Assets con't

One difference in the credit union industry is the strength work together and form organizations which are owned by and run for the betterment of the industry; this is show no better shown than through shared branching, which allows a single location credit union to have over 5,000 offices for members to do business.

The formations of these organizations differentiate the credit union industry from the banking sector, as these organizations are run in a Cooperative manner. A profit must be made, but the 30% profit up charge in doing business with a stock owned company does not occur, allowing for improved financial results for credit unions and improved service levels to those we serve.

In the example below a simulation was ran showing the effect of our institution increasing our CUSO investments to 1% of total assets. The credit union currently has $76,420 in CUSO Investments, so the increase is $485,433.
**First set of numbers is our base case & the second set assumes increase to the 1% maximum investment:
Base Case: Assets $56,185,316 Net Worth 12.42% ($6,700,626) RBC 21.09% denominator $31,828,777
Increase: Assets $56,185,316 Net Worth 12.42% ($6,700,626) RBC 20.34% denominator $32,945,273

By increasing our CUSO investments $485,433, our RBC ratio drops 75 basis points and brings our RBC down to 20.34%. Our institution would have to add $247,532 to our capital accounts to bring our RBC level back to 21.09%.

The logic behind reserving for an investment in a CUSO at the 250% level is punitive in nature. This is another example the NCUA Board has forgotten the basic principles for which natural person credit unions were formed and given our tax exempt status; which is our fundamental business principle – We're a Cooperative! A majority of CUSO's across the country make credit unions stronger by their presence and provides valuable services. In addition, a majority of CUSUs fulfill critical roles in areas such as compliance, member services and lending services that strengthen the expertise levels and reduce risk in our organizations.

Our recommendation *would be that Investments in CUSO's be weighted at the 100% level, as you can't lose more than the investment amount.*

Capital Adequacy – Part 702 104(c)(3) Risk-Weights for Off-Balance Sheet Activities

The proposal has several areas in which our organization has limited experience, but the concept to add additional capital to an organization based on **unused line of credit** is difficult to follow; especially when the only objective is the remote possibility of future liquidity risk. Has there ever been a loss to the share insurance fund due to excessive lines of credit moving from an unfunded to funded position?

On the consumer side of the business the conversion factor is at 10%, followed by a weighting of 75%. On the business side, the business line of credit the conversion factor is 75%, followed by a weighting or 100%. I am able to follow some of the logic here, as it must be assumed that consumers are not as apt to access lines of credit as a business may be, but in general having additional capital where credit risk is not taken into account seems unfounded. I was unable to find a clear explanation on how the conversion factors and the weightings assigned.

Our recommendation *would be to have improved understanding of how the conversion factors were developed, along with the weightings.*

Capital Adequacy – Part 702 104(d) Due Diligence Requirements for Asset Back Securities

The proposal has a detailed analysis of the **due diligence requirements for asset-backed securities** in place and appears to have outlined items to include in the review; which is helpful. The risk weighting of 1,250% is excessive and punitive in nature, as the interpretation is left to an examiner who may or may not have the same level of ability as the CFO or CIO that made the investment decision.

It is clear that the NCUA board still feels that the crisis was caused by asset-backed securities due to Corporate Management and board members not understanding the risks, and to some extent that may be true. It is also true, that the organizations (read bankers) that packaged these instruments knew they were selling fraudulent products and the rating agencies were committing fraud by labeling them AAA.

With all that said, ***our recommendation*** *would be to rate these investments at a slightly higher level than insured certificates and Government Insured mortgage products and use other regulatory means to limit an organization investing in such instruments when it is determined, by knowledgeable examiners, that the expertise or due diligence is not at the level required to continue to purchase ABS. The goal of non-compliance, by an examiners opinion, should not place a credit union in an undercapitalized position overnight.*

Capital Adequacy – Part 702.105 Individual Minimum Capital Requirements

The proposal states, "The proposed rule includes a provision that NCUA may require a higher minimum risk-based capital ratio for an individual credit union in any case where the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate."

The subjectivity of this approach to require additional capital based on the findings of an examiner would produce unfair practices within our industry. For several years the agency itself has discussed righting it own ship when it comes to consistency in examinations and has developed new standards for its own teams to follow. Although the past couple of years the consistency of exams has improved the latitude given in this section will have unintended consequences. Each examiner and team has their own strengths and weaknesses, empowering individuals to override regulatory measurements is an unnecessary process in the regulation of NPCU's.

Our recommendation *would be eliminate the Individual Minimum Capital Requirements from the proposal.*

III. Effective Date

The proposal would go into effect 18 months after the publication of the final rule. The proposal states, "this would give credit union lead time to plan for the new risk-based capital ratio requirements and other proposed changes to Part 702."

In my reading, banks were given several years to implement RBC requirements. Credit unions should be given a similar time period as NPCU's may need this length of time to restructure their balance sheet. Additionally, this document mentioned a 2.5% capital conservation buffer that the banks are being given until 2019 to achieve.

<u>Our recommendation</u> *would be to give a NPCU's more time then given to the banks. This would allow NPCUs the time needed to restructure a balances sheet without the need for 'fire' sales of assets. More importantly, to allow for additional capital to be raised thru Net Income accumulation, as NPCU's cannot raise capital in manners similar to banks.*

In closing:
I respect how difficult a project of this magnitude is for the NCUA, but I respectfully request that the NCUA understand and respect the Cooperative nature of the credit union industry. The abuses of the banking industry should not carry over to our industry in any manner, shape or form.

The facts are clear: Our industry has lower loan loss figures, takes substantially less risk in the investment arena, and has never participated in the abuse of our members for the short-term rewards obtained by the bankers in the recent mortgage crisis. We are Cooperative and run under a higher level of standards! We are not driven by profits and returns to stockholders, but by servicing and improving the lives of our members.

I believe that the additional levels of capital are unnecessary, as our industry came through the recent crisis in outstanding financial condition. The additional collection and reporting will burden our industry in spending the necessary time and adding higher expenses for some unforeseen loss going forward.

I hope these changes do not continue to erode our industry in numbers and service to our members, but I don't see that happening. Our banking counterparts have less regulatory restrictions than the credit union charter, carry less capital than our charter and have options not available to credit unions in raising capital.

I will end with a conversation that occurred as I discussed this proposal with our staff. At the conclusion a loan officer said, "When we are successful now in mortgage lending by hitting our limits set by the ALCO, we wait for a new set of limits. So what is going to happen now – are we going to have to run ALM scenarios and then figure out if we have enough capital to close a loan that will make us 4.5% versus the .07% in our Corporate overnight account? Another chimed in, "Does the NCUA not want our business to succeed!"

Respectfully,

Steve E. Kelly
President
Metrum Community Credit Union