ROYAL CREDIT UNION

April 25, 2014

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

Royal Credit Union
Charter: 66834

Dear Mr. Gerard Poliquin:

The purpose of this letter is to express my comments on the recently released NCUA Proposed Risk-Based Capital rule.

I am writing on behalf of Royal Credit Union (RCU). RCU is a $1.4 billion community chartered credit union serving 152,000 Members with 26 traditional branches and 26 school site branches. The following is a very brief overview of RCU:

- We have a 97% loan-to-deposit ratio.
- Following is our loan penetration:
    - 34% Consumer Loans
    - 26% Real Estate Loans
    - 40% Member Business Loans
- Our net worth ratio is over 11%.
- Our net charge-off ratio is less than NCUA peers.
- We have been a Member business loan lender for the past 34 years. Given the size of our portfolio and the length of time successfully being a Member business loan lender, we are a resource for the credit union community.
- In 2013, we bucked the "fee income" trend that is being experienced in the financial industry and actually decreased our punitive fee income by 47%, which represents a $1.5 million benefit for our Members. Our 2014 budget includes an additional $800,000 decrease in fee income.
- The bulk of our membership has a moderate, at best, level of income. Per NCUA's September 2013 financial performance results (FPR), our Members have an average deposit balance of $7,775 compared to our NCUA peers at $11,759. Our Members carry an average loan balance of $10,977 as compared to our NCUA peers at $16,035.

There are many good points to the proposed rules; but, overall, I feel the rule is overkill. The credit union industry weathered the worst financial crisis in 80 years, and it appears this proposed rule is an attempt to prepare for a worse event.

Our biggest concern with the proposed rule concerns the weighting of Member business loan concentrations. As the percent of Member business loans to assets increase, so does the risk weighting.

In the next few paragraphs, I will lay out my rationale as to why the added concentration is not a risk and, in some ways, could be looked at as a lower risk due to the high level of expertise and policy limitations/parameters that are needed to monitor a large concentration. Said another way, the "real life" expertise needed to oversee a portfolio with a 40% concentration is much higher than what is needed for a portfolio less than 15%.

- The Member business loans risk weightings in the proposed rule are much more punitive than Basel III due to NCUA's approach to increase the risk weighting based on concentration levels. The definition of concentration is the lack of diversification. I would argue that we have a lot of diversification in our Member business loan portfolio. Our Member business loan portfolio is comprised of many different "types" of loans each carrying their own risk levels.
    - By board policy, we limit the total amount of Member business loans as a percent of total loans and as a percent of net worth.
    - By board policy, we limit the amount of Member business loans by NAICS codes. NAICS codes identify the type of business such as restaurant, lessors of residential real estate, entertainment, wholesale, etc. We would be happy to help NCUA develop such a matrix.
    - By board policy, we further limit the concentration of NAICS codes as a percent of net worth. Policy allows for a greater concentration (as a percentage of net worth) of historically very low risk loans than industry types that carry a higher historical loss ratio even though these higher loss ratio loans are priced accordingly.
    - By board policy, we limit the concentration of NAICS codes as a percent of total Member business loans.
- The rule puts the same risk weight on all Member business loans. As mentioned above, all Member business loans do NOT carry the same amount of risk.
    - A Member business loan secured by a 4-family rental property with a good risk rating and a low loan-to-value (LTV) is weighted the same as a higher NAICS risk loan with an average risk rating with an 80% LTV.
    - Rather than place a blanket weight on the entire portfolio, a weight should be based on national historical loss ratios by NAICS codes. Our history along with industry averages indicate certain NAICS codes are less risky than a vehicle loan (the proposed rule has a risk weighting of 75% for vehicle loans). To properly assess Member business loan risk, the call report must be expanded to report the correct information.
- The proposed rule, by increasing the risk weighting over and above the Basel III levels, seems to indicate that NCUA feels Member business loans carry a greater risk. I contend this is factually inaccurate.
    - We have a long history as a Member business loan lender, and we have the expertise to make business loans. Prior to 2003, our GROSS MEMBER BUSINESS LOANS CHARGE-OFF ratio was close to 0%. From 2003 to 2013, our Member business loans gross charge-off ratio averaged 70 basis points per year. Excluding losses generated by the great recession (2011 and 2012), our gross charge-offs since 2003 would have been 15 basis points. According to a Federal Reserve historical charge-off report (http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm), from 2003 to 2013, the approximate C&I (business loans) charge-off ratio was 84 basis points year. The

same spread sheet indicates the average "other consumer loan" (non-credit card) charge-off ratio was over 150 basis points. The FED report shows our historical Member business loan charge-off ratio is less than national peers and less than consumer losses.

- We agree that we have historically had a much larger concentration of Member business loans than our peers; but, as mentioned above, a larger concentration of Member business loans does not equate larger losses. Using NCUA's FPR reports, RCU's average 10-year NET CHARGE-OFF ratio ending December 2013 is **exactly** the same as our peers at 70 basis points. I find it very compelling that even with losses due to the worst economic downturn in 80 years, our balance sheet and its concentration of Member business loans is no more risky than the average credit union. But, the proposed rule risks weights Member business loans up to three times more than that of a consumer loan.

We currently have a 400 basis point net worth cushion over well-capitalized. Under the proposed rule, we would fall 17 basis points under well-capitalized due mainly to our Member business loan concentration. Quite frankly, RCU is not an adequately capitalized credit union…we are a vibrant, well run, and well-capitalized credit union. The following bullets address our remaining major concerns to the proposed rule.

- The proposed rule would negatively impact the current net worth cushion most credit unions currently enjoy.
    - We currently have a 400 basis point cushion over the well capitalized 7% requirement. If the proposed rule is enacted as written, we would fall to 17 basis points below the 10.50% risk-based well-capitalized requirement.
    - According to CUNA, 1,643 of 2,504 credit unions will see their cushion above well-capitalized decrease.
    - Net interest margin compression will likely continue; so to replenish this net worth cushion, credit unions would most likely look to fee income. Fee income is not only bad for the Members, but it is also bad for the credit union industry in the long run.
    - RCU feels to be competitive for the long run, we need to reduce our reliance on fee income. This is being achieved by expense reduction and aggressive balance sheet management.
- The proposed rule will negatively impact Members because credit unions will be forced to raise capital faster than normal or reduce their size.
    - Credit unions can only raise capital through net income. To increase net income, credit unions need to increase interest income, reduce interest expense, or increase fee income - of which all are on the backs of our Members/owners.
    - As mentioned earlier, we have already started the process of reducing punitive fee income; but had we NOT reduced fees, our risk-based capital would be approximately 10.58%!
- The proposed rule has a 12- to 18-month transition period, which is much shorter than the Basel III 5-year transition.
    - Credit unions do not have the ability to raise capital similar to banks. As such, the proposed rule should have a longer transition period than banks.

The proposed rule has also been reviewed by firms outside the industry, and they understand this may require credit unions to look at their business model. We already have been contacted by a firm specializing in charter changes. Royal Credit Union is very proud of what we do for our Members and the value we place on their relationships. In fact, we are recognized often in industry publications regarding the good things we do. By restricting our historically successful business model, we would be forced to look at our options. Our healthy and successful Member business loan program has generated the cash flow to support our large number of retail and school site branches, to support our deep community involvement, etc. If we needed to curtail our Member business loan program, we would be a different and less successful credit union.

In summary, I would encourage you to ponder the following two statements:

1. Member business loans, in and of themselves, do not carry a greater inherent risk than other lending products. Our experience clearly and objectively proves this statement. This rule must be rewritten to place the appropriate amount of risk on this product.
2. The proposed rule is more restrictive to the credit union community than the Basell III rules are to the banking community. NCUA needs to explain and quantify why they feel the credit union rule must be more restrictive.

I am available for questions at 715-833-8135 or jonh@rcu.org.

Thank you for taking the time to read my letter.

Sincerely,

Jon Hehli
EVP - CFO