Redwood Credit Union

April 30, 2014

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

Re: Comments on Proposed Rule: Prompt Corrective Action – Risk-Based Capital

Dear Mr. Poliquin:

Redwood Credit Union (RCU) appreciates the opportunity to comment on NCUA's proposal relating to risk-based capital. RCU is a federally insured California-chartered credit union with $2.3 billion in assets and 230,000 members. Our Net Worth and Risk-Based Capital (proposal) ratios are 10.34% and 16.58%, respectively, as of December 31, 2013.

RCU supports the concept of risk-based capital and believes credit unions should maintain levels of capital that are commensurate with their level of risk. However, we are deeply concerned that the current proposed rule will not achieve this objective and may actually cause more harm than good. We believe there are serious flaws with the proposed risk-based capital regulation that could have negative consequences on credit unions' risk management and ability to stay relevant to members. These flaws are in the form of inconsistent and arbitrary treatment of interest rate risk, credit risk, and liquidity risk on asset risk weightings, as well as no recognition of liability management and issues related to the treatment of the Allowance for Loan Losses, Investments in CUSOs, Goodwill, and NCUSIF.

Confusion and Inconsistency with Interest Rate Risk, Credit Risk, and Liquidity Risk

The proposed regulation is inconsistent and arbitrary in the risk-weightings related to interest rate risk, credit risk and liquidity risk.

- Investments with longer lives are assigned higher risk weights reflecting greater interest rate risk and liquidity risk, yet U.S. Government obligations and NCUA guaranteed notes (NGN) securities are assigned a zero risk weight apparently due to their lack of credit risk. It's hard to understand why a 30-year Treasury bond would be considered less risky than a two-year agency security or overnight federal funds. Does NCUA really believe the lack of credit risk in Treasury and NGN securities somehow nullifies interest rate risk? It appears a credit union could load up its balance sheet with long-term fixed rate Treasury securities and enjoy a positive impact on risk-based capital relative to holding the same amount in overnight funds.
- Mortgage-backed securities (MBS) and collateralized mortgage obligations (CMOs) are risk-weighted based on their current weighted average life. For many MBS and CMOs it does not

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take much of an increase in interest rates to extend the life of a security, thereby possibly moving it to a higher risk weighted investment classification. Accordingly, MBS and CMOs will likely contribute volatility to risk-based capital under the proposed regulation.

- Real estate loans at greater concentration levels receive higher risk weightings up to 100%. However, it is not clear whether this is being driven by concern over interest rate risk, credit risk, or liquidity risk (or all three risks). To the extent that it is interest rate risk, we believe it would make more sense to differentiate real estate loan risk weightings based on fixed vs. adjustable rates, in lieu of portfolio size as a percent of assets. A further refinement related to credit risk would also be to differentiate real estate loan risk weightings based on current loan-to-value ranges.
- Member business loans (MBLs) at greater concentration levels receive higher risk weightings up to 200%. Since most MBLs have adjustable rates, the relatively high risk weightings must be indicative of credit risk. We believe it would be an improvement to breakout MBLs into commercial real estate (CRE), Small Business Administration (SBA), and commercial and industrial (C&I) types and assign risk weightings that are more appropriate to the risk profile for each MBL type.
- Consumer loans are assigned a higher risk weighting than real estate. This is confusing since consumer loans carry lower interest rate risk, liquidity risk, and varying credit risk levels depending on borrower credit worthiness and underwriting practices. It would make more sense to differentiate consumer loan risk weighting based on credit score ranges (e.g., 720 and over = 50%, 680-720 = 75%, 600-680=100%, 600 and below = 125%).
- Mortgage servicing rights (MSRs) being assigned the second highest risk weight possible of 250% is out of proportion with the risk. The risk comes from declining MSR values during a period of falling interest rates. We are not aware of any credit union that has suffered a material impact to its capital as a result of declining MSR values. Further, the high risk weight may have the unintended consequence of discouraging some credit unions from selling their fixed rate mortgage output, thereby taking on more interest rate risk by holding more fixed rate real estate loans. The risk weighting for MSRs should not exceed 100%.

Overall, we encourage you to provide transparency, rationality, and consistency in how assets are weighted for the various applicable risks.

No Recognition of Liability Management

The proposed rule does not address the liability side of the balance sheet. This is troubling since the liability strategy plays a key role in a credit union's management of interest rate risk and liquidity risk. In essence, the proposed rule penalizes credit unions that mitigate their interest rate risk and liquidity risk by proactively managing their liability structure (e.g., maximizing core deposits, matching FHLB borrowings to real estate loans, etc.) and effectively rewards credit unions that have no liability strategy.

Allowance for Loan and Lease Losses (ALLL)

The ALLL is an element of capital in the proposed regulation. However, it is limited to 1.25% of risk assets in how much can be included in the capital calculation. This limitation will become problematic and reduce most credit unions' capital once the Financial Accounting Standards Board's current expected credit losses (CECL) accounting requirement goes into effect. Current estimates are that most financial institutions will need to raise their ALLL by at least 50% when they adopt the CECL accounting methodology. The 1.25% of risk assets limitation will mean that a significant portion of the ALLL will be excluded from capital for many credit unions. We encourage you to eliminate any limitation on the amount of the ALLL that can be counted as capital.

Investments in CUSOs

The proposed regulation assigns a risk weighting of 250% to Investments in CUSOs, regardless of whether a CUSO is a wholly-owned subsidiary or an outside entity in which the investment is only an incremental portion of the CUSO's equity. It makes no sense to us to treat these two CUSO types in the same manner. In the case of a CUSO that is a wholly-owned subsidiary of the credit union, there is no need to assign any risk weighting to the unconsolidated Investment in CUSO amount. Rather, the CUSO assets that remain after consolidation should be appropriately subject to risk weighting. Accordingly, the proposed regulation should be changed so that only consolidated-basis Investments in CUSOs should be subject to risk weighting. This would mean there would be no Investment in CUSO amount for a wholly-owned subsidiary.

Further, the 250% risk weighting for Investment in CUSO is out of proportion with the risk. We are not aware of any CUSO losses that have had a material impact on any credit union or the National Credit Union Share Insurance Fund. Accordingly, we believe the risk weighting should not exceed 100%. If there are in fact CUSO types that have a track record of losses, we encourage you to differentiate the risk weightings for higher-risk CUSO types.

Another problem with the 250% risk weighting is the unintended consequence of discouraging shared resource CUSOs. These are CUSOs that are formed for the purpose of providing a shared resource (e.g., IT, compliance) for multiple credit unions. The goal of a shared resource CUSO is not to generate dividends so much as to promote operational efficiencies and specialized competency. We believe strongly the credit union system would be better served by having more, not fewer, shared resource CUSOs, and that NCUA should be encouraging, and not discouraging, their formation.

Goodwill

Goodwill is treated as a deduction from capital in the proposed regulation. This is a tacit recognition that there is no real value in Goodwill. We believe there are two problems with this treatment. One problem is that generally accepted accounting principles (GAAP) require companies to subject their Goodwill to rigorous testing for impairment on an annual basis. Accordingly, the proposed regulation's treatment of Goodwill effectively contradicts GAAP. The second problem is the likely chilling effect on mergers, particularly when one is a troubled credit union. Healthy credit unions will be discouraged from taking on a troubled credit union in a merger due to the negative impact it will have on their capital. It is not hard to fathom that this will also raise the cost of resolving troubled credit unions which will negatively impact the whole credit union system. We encourage you to not treat Goodwill as a deduction from capital.

NCUSIF Capitalization Deposit

NCUSIF Capitalization Deposit is also treated as a deduction from capital in the proposed regulation. This is another tacit recognition that there is no real value in the NCUSIF Capitalization Deposit. Not only does this treatment fly in the face of GAAP, but it forces the issue that NCUA is trying to have it both ways when it comes to allowing credit unions to record the deposit as an asset while not counting it as capital. It should either be an asset and not deducted from capital or it should not be considered an asset at all.

We are submitting our comments with the expectation that it is in the common interest of all parties – credit unions, credit union members, NCUA, and NCUSIF – to have a rational risk-based capital regulation that is consistent with and encourages sound risk management practices and aligns well with business strategies for maintaining or increasing relevance to our members and communities.

Sincerely,

Wade Painter, EVP/CFO
Redwood Credit Union
Santa Rosa, CA