NUMERICA
CREDIT UNION

May 15, 2014

Via Email and Regular Mail

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

Re: Comment on Proposed Rule: PCA-Risk Based Capital

Ladies and Gentlemen:

Numerica Credit Union (Numerica) appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) proposed Risk Based Capital Rule ("Proposed Rule"). Numerica is a $1.3 billion Washington State chartered credit union based in Spokane Valley, Washington and serves over 103,000 members in the State of Washington and Northern Idaho, although our in Washington membership base primarily rests in Central and Eastern Washington.

Numerica respects and encourages NCUA efforts to accurately assess the multitude of risks that credit unions face and the interconnectedness of those risks. After reviewing the Proposed Rule, we do not agree with many of the provisions but thought it best to concentrate our comments on the following:

Section 702.105 Discretion.

Section 702.105 of the Proposed Rule allows the NCUA to arbitrarily increase the minimum capital requirement of a credit union to a special minimum required capital based upon various subjective factors. This gives an incredible amount of subjective authority to a regulator to make an arbitrary determination of the amount of capital a credit union is required to hold. For example, the concept that additional capital will be required if a credit union "may be adversely affected by the activities or conditions of its CUSOs or other person or entities"[1] or "has a high degree of exposure to interest rate risk, prepayment risk, credit risk, certain risks arising from nontraditional activities or similar risks or a high proportion of off-balance sheet risk"[2] are purely subjective. Subjectivity is likely to result in unforeseeable required additions to capital. We recommend that objective factors that are included in the risk based calculation itself be used to require increased capital. In this way credit unions can better manage their business.

[1] Page 85 of the Proposed Rule.
[2] Page 85 of the Proposed Rule.

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At a minimum, Section 702.105 should not apply to credit unions deemed "Well Capitalized" by standard calculations to preserve the integrity of such a designation and the reliance others place on it. Furthermore, applying Section 702.105 to well capitalized credit unions seems to be at odds with the Federal Credit Union Act itself. Section 1790d(d)(2) of the Federal Credit Union Act grants authority for the NCUA to "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." That section does not grant that authority for well capitalized credit unions.

Furthermore, although the FDIC has similar provisions in its capital requirements[3], banks have the ability to raise capital by accessing the capital markets. This option is not available to credit unions. Raising capital is a long, slow process for a credit union as capital accretion occurs through retained earnings. Thus, a credit union that is suddenly deemed under-capitalized may be under onerous restrictions during the long period that it takes to raise capital. The only viable option a credit union in that position may have to improve its capital ratios would be to reduce the size of its balance sheet and the service it provides to its members.

Another concerning aspect of Section 702.105 is that the commentary itself admits the weaknesses of the proposed RBC calculation, but only allows regulators to increase capital levels. The proposed calculation does not take into consideration mitigations to risk, such as hedging, adjustable rate features on loans, or tight credit underwriting. Further, the guidance specifically states that "[i]n practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow."[4] It is unfortunate that this subjective determination to decrease the minimum required capital seems to be beyond the regulators' capability but subjective determinations to increase the minimum required capital can be made. It seems only fair and logical that if Section 702.105 is included in the final rule that a similar process is included to allow credit unions to apply for institution specific *reductions* to capital assessments.

<u>RBC as Proposed Improperly Includes All Risks and is an Onerous Duplication of the Safety and Soundness Exam CAMEL Rating</u>

Section 1790d(d)(2) of the Federal Credit Union Act tasks the NCUA with designing "the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." It does not require that all risks be addressed, only those that are not addressed in the net worth ratio. It cannot be that the net worth requirement does not provide adequate protection for any risk at all. It seems that the Proposed Rule may be trying to address too many risks beyond the permitted scope of the statute.

[3] Appendix A to Part 325 states in pertinent part: "The FDIC also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate."

[4] Page 88 of the Proposed Rule.

Examiners currently, thorough Safety and Soundness exams, assess the nature and interconnectedness of the risks for each institution. The breadth of the Safety and Soundness exam allows examiners to make well informed assessments based on qualitative and quantitative factors. We recognize that the NCUA was tasked with developing a capital metric that takes into account material risks that are not adequately protected by the current net worth ratio requirement. However, the Proposed Rule makes an attempt to assess all risks quantitatively with limited data, including those covered by the net worth requirement. The more it tries to match the rigor of the Safety and Soundness exam, the more onerous and duplicative it becomes. Section 702.105 tries to address this but as noted earlier it only allows institution specific adjustments to increase capital requirement and not decrease capital requirements. This does not make sense.

The limitations of the Proposed Rule reduces the flexibility of credit unions to allocate capital to maximize benefits to the credit union and its members. As we have noted in this letter, the simplistic metrics may have unintended consequences of increasing risk and misallocation of capital. Numerica strongly urges the NCUA to recognize the limitations of any single metric and match the consequences of a low RBC ratio to the limitations and potential inaccuracy of that metric. The current Safety and Soundness exams provide a much more effective means of prudent oversight.

Member Business Loans.

Numerica respectfully requests reconsideration of the risk weighting for Member Business Loans (MBLs). Numerica provides an important service to its members by providing member business loans. Numerica's business lending program includes small business loans, professional loans, SBA loans, commercial real estate loans, and C&I loans. Those loans range in size from $50,000 to $7 million. Providing this service to the Central and Eastern Washington and North Idaho markets is important to the development of the communities of which Numerica is a part. The size of the loans that Numerica originates are generally too small for large commercial banks and the community banks in those regions are unable to fulfill the great need for these loans. Also, many of Numerica's non-MBL members have small businesses that need loans to meet their business needs.

The risk weights of 150% and 200% for MBLs is unwarranted and would have an adverse effect on Numerica's ability to meet its members' needs. Currently Numerica's MBL portfolio is 15.5% of its assets and Numerica's currently anticipates that portfolio to grow another $52.5 million over the next five years. Such growth would result in a decrease in Numerica's risk based capital from an estimated 14.4% as of today to 13.4%, assuming no capital growth, and to 13.8% assuming 3% net earnings on those assets.

Numerica believes that this increased percentage of MBLs remains prudent because (a) the MBL portfolio is diversified by business loan type, by geographic location, and by industry, (b) loans are limited via the loan to one borrower maximum and (c) Numerica's Concentrations Policy limits various aspects of concentration risk by collateral type and other factors. The increase in the risk weight assumes that an increase in MBLs is per se riskier without taking into account the actions taken by a particular credit union to mitigate their risk. This assumption is unfair and unwarranted.

Furthermore, the proposed risk weighting is higher than that which is required for banks. As a result, it is difficult to understand why there is a belief that community banks can manage this risk better than a credit union. Many credit unions have sophisticated personnel capable of managing the risks created by originating and holding MBLs.

The combined effect of the increase in the marginal required capital for MBL and the increase in risk weight percentage has a double negative effect on holding MBLs. The Proposed Rule would inhibit Numerica's MBL and overall growth.

In addition, it limits the amount of operating lines we would grant to businesses. We may have to consider higher loan fees to cover the cost of capital that is required to support unused portions of lines of credit. The capital requirement for MBL commitments is similar to the capital requirement of real "cash out the door" principal to consumer members so we have to choose between making a commitment to loan on an MBL versus actually lending out dollars to consumer members. Unused MBL commitments receive a 75% credit conversion factor and 100% risk weight. It is understandable that a small amount of capital should be kept for unfunded commitments, however, many types of outstanding loans receive a 75% risk-weight and it seems unreasonable to require the same amount of capital for the unfunded amount of all MBL commitments. It is very unlikely that the vast majority of unfunded commitments would be instantly drawn against a credit union at the same time.

ALLL Limitation.

The Proposed Rules limit the amount of ALLL that is added to capital to 1.25% of risk weighted assets. There should be no limit on the amount of ALLL that is added to capital. If a limit is needed, the 1.25% threshold seems low in light of the elevated ALLL levels. Banks are able to reduce risk weighted assets for the entire amount of ALLL. Credit unions should receive the same treatment. The disparate treatment of the "excess" ALLL gives a competitive advantage to banks.

With a pending proposal from FASB to change the method for the ALLL from an "incurred loss" to an "expected loss" model, some are estimating that, if the FASB proposal goes through as proposed, that ALLL could go up for financial institutions 30-50%. To not be able to 'count' a good portion of this could be very detrimental. Numerica does not currently know what the potential impact to Numerica is for the potential FASB change, however, the 30-50% figure statement comes from the OCC. It's difficult to demonstrate/estimate impact because both the Proposed Rule is proposed, not final, and the FASB rule is proposed, not final.

Although most credit unions currently do not have an ALLL above 1.25% this could change with the new FASB rules. As the ALLL is a reserve available to cover losses we do not understand the reason for limiting its inclusion in the numerator of the ratio.

This limit on ALLL coupled with the increase in the minimum required capital for delinquent consumer loans could result in a spiraling decline of a credit union in the event of an increase in delinquency due to unexpected economic conditions similar to the great recession. Although the intent of this change is to "enhance sound capital management and help ensure that credit unions maintain adequate levels of loss-absorbing capital going forward, strengthening the stability of the credit union system and ensuring credit unions serve as a source of credit in times of stress"[5], we believe that an unintended consequence of these two provisions together will result in an increased loss of capital. By our calculations, the effect of these two provisions together as written in the Proposed Rule would reduce the risk based capital of a credit union by more than if the effect of the two provisions were calculated separately and added together. Further, as an example, an increase in delinquency of our non-real estate loans to 1% of the portfolio, coupled with an increase in ALLL of 50%, would result in a decrease in capital of 89 basis points, with the ALLL cap accounting for 62 bps of that reduction.

Also, in order for credit unions to serve all of their members it is necessary to originate loans to sub-prime borrowers. Credit unions currently price those loans accordingly to pay for the associated risk, however, the proposed increase in capital for delinquent loans would result in a significant increase in rates to these borrowers

Definition of First Mortgage Real Estate Loans.

The definition of first mortgage loans and the attendant risk weighting is overly broad and should be revised. It defines first mortgage home equity lines of credit (HELOCs), which may be short term and adjustable, as the same as long term (30 year), fixed rate first mortgage loans. The risks associated with those two products are vastly different and should not be given the same risk weighting.

Also the definition as written may conflict with rules promulgated by the Consumer Financial Protection Bureau (CFPB). As a result, credit unions may be forced to be at a competitive disadvantage as they will not be able to originate mortgage loans that qualify as qualified mortgage loans under the CFPB rules, or are otherwise permissible under those rules, without incurring an additional capital charge.

125% Risk Weightings for Second Lien Mortgage Loans.

Second lien mortgage loans, including HELOCs, have a 125% risk weight while unsecured loans, including credit card debt and unsecured lines of credit, have a 75% risk weight. We request that you reevaluate the higher risk weighting for seconds. Second lien mortgage loans are secured. Although in some instances in a foreclosure there may not be enough value to fully pay off the second, the credit union can take action to be an unsecured creditor for the unpaid balance. From an underwriting perspective, when underwriting a second the ability to repay the loan is always considered. The security of a second causes a lower interest rate, not a reduction in underwriting. The higher risk weighting presumes poor underwriting.

Effective Date.

The amount of risk based capital required by the proposed regulations is based upon the FDIC requirement imposed upon banks that will be effective in 2019.[6] Credit unions, who cannot

[5] Page 41 of the Proposed Rule.

raise capital as easily as banks, are required to meet these capital requirements in 2015 or 2016.[7] The inequity is obvious.

<u>Definition of Limited Recourse.</u>

The definition of limited recourse for loan sales/participations needs to be clarified. From the definition we cannot discern if typical representations and warranties relating to loans given in private sale participation agreements would be considered limited recourse. The proposal as written would have a chilling effect on participations. We are sure this is an unintended consequence of the vagueness of the definition of limited recourse.

In conclusion, we hope that the NCUA carefully considers these comments, as well as those of other credit unions, and thoughtfully revises the Proposed Rule. Thank you for the opportunity to comment.

Sincerely,

Lynn Ciani

Lynn Ciani
EVP – General Counsel
Numerica Credit Union

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[6] Page 36 of the Proposed Rule.
[7] Page 111 of the Proposed Rule.