SAFE CREDIT UNION

May 16, 2014

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

Re: Proposed Risk-Based Capital Rule (RDIN 3133-AD77)

Dear Mr. Poliquin,

Thank you for the opportunity to comment on the NCUA's Proposed Risk-Based Capital Rule. We have reviewed the proposed ruling and have developed a list of comments for your consideration. SAFE is in favor of implementing a risk-based capital structure. Specifically, we agree with the concept of implementing an approach that effectively quantifies the risk associated with each type of an institution's assets and ultimately produces a risk-adjusted capital ratio. However, our comments in this letter are the result of questions and concerns about the proposed rule and its ultimate impact to credit unions if adopted in its current form.

A. <u>General Comments</u>

1. The proposed definition of what constitutes a "complex" credit union (i.e., one that is over $50 million in assets) is somewhat subjective and not reflective of the actual risks an institution may carry. The total amount of assets an institution manages should not be the only consideration for defining complexity. The type and quantity of products and services offered (such as business lending, credit cards, and indirect lending), the presence of goodwill and intangible assets, the use of derivatives, borrowings, or the selling of mortgage loans should also be considerations of whether an institution is considered "complex." It appears that NCUA has determined that credit unions below certain asset sizes are lower risk. We believe this is a fallacy. Smaller credit unions are failing at a higher rate and have a higher incidence of catastrophic failure due to a lack of comprehensive internal management and process controls that can lead to fraud. A credit union charter is a privilege and not a right. We recommend NCUA adopt a policy subjecting all credit unions to the same risk-based capital rules and the same examination standards.

2. Inherent in the risk weightings is too much emphasis on 1) concentration risk and interest rate risk and 2) assigning inconsistent and impractical weightings to MBLs, Investments, and RE loans. We believe NCUA is attributing far too much risk to the "what" rather than to the "how." It appears that NCUA labels all CUSO activity as risky, all business lending as risky, all long term real estate as risky and concentration in anything as risky. We believe that NCUA has drawn the wrong conclusions from the failures at Telesis CU, Arrowhead CU, Nolarco CU, Cal State 9 CU and other recent credit union failures. In each of these failures, NCUA appeared to take the position that the institution's activities determined risk and gave little consideration as to how

the credit union managed its risk, which was the primary cause of the failures. While we welcome a risk-based capital rule that mirrors BASEL III, we believe NCUA's next needed change is to consider better ways to determine management's ability to control and manage risk. Management's ability to manage risk, in our opinion, is a much greater determinant of a credit union's risk, and ultimately financial soundness, than simply assigning risk weightings to specific asset classes based on a dollar amount.

3. There are many variances when comparing the risk weightings under NCUA's proposed rule to those applied to banks (under $15 billion) as prescribed by BASEL III. It is unclear why the NCUA is putting heavier weightings on certain asset categories than what is imposed by the BASEL standards for banks. What is the fundamental difference between a member business loan originated by a credit union and a commercial loan originated by a bank that triggers the need for NCUA to apply a 150% or 200% weighting versus 100% for a bank? We recommend that all of the risk weightings for all asset categories be re-evaluated to more closely resemble the weightings applied to banks.

4. In many cases, risk weightings exceed 100%. We are concerned with all instances of risk weightings exceeding 100%. What is the rationale for a weighting to actually exceed 100% of an asset category when an institution cannot lose more than 100% of the book value (plus unfunded commitments) of an asset? We recommend adjusting all risk-weights to 100% or less, or provide a comprehensive and analytically supported reason for why such weightings should exceed 100%.

5. The proposed rule indicates that the allowance for loan losses would be added to the capital numerator figure, subject to a cap of 1.25% of risk-based assets. Given that credit unions are required to follow generally accepted accounting principles (GAAP), and in many cases the risk weighting is above 100% for delinquent and non-accrual loans, there does not seem to be a reasonable justification for imposing a cap other than to limit the amount of capital going into the risk-based capital ratio. NCUA's policy is that all credit unions must follow GAAP; therefore NCUA's proposed rule-making should be consistent with GAAP accounting. As such, we recommend removing the cap for the allowance for loan losses.

6. The implementation period of only 18 months is a relatively short period of time to comply with the new proposed rules, especially as written today. Balance sheets typically do not re-adjust in 18 months and credit unions cannot simply raise additional capital. We recommend the NCUA extend the effective date to at least three years after the publication of the final rule in order for credit unions to make any necessary strategic, financial, or operational adjustments to their balance sheets in order to comply.

7. We believe defining a well-capitalized institution as one with a 10.5% risk-based capital ratio is reasonable. Our concerns presented in this letter, however, are driven primarily by the NCUA's assumptions of where risk lies within a credit union and the methodology used to determine the risk weightings for each asset category. We recommend that NCUA provide a comprehensive explanation and analysis for determining all proposed risk weighting percentages.

B. Specific Risk-Weighting Concerns

1. Cash – Overnight cash held at the Federal Reserve is proposed to have a 20% risk weighting. In our opinion, this weighting does not make sense. Is there some underlying credit risk that financial institutions should be concerned about with the Federal Reserve? We recommend establishing a 0% weighting for cash held at the Federal Reserve. In addition, cash on deposit in insured financial institutions and cash in transit are also weighted at 20%. We do not believe this is reasonable and recommend the weighting be reduced to 0% for all cash in transit and up to the federally insured limit for cash on deposit at another financial institution.

2. Investments
    a. US Treasury securities are given a 0% weighting while Government-Sponsored Entity (GSE) guaranteed securities are given anywhere from 20 to 200% depending on the weighted average life (WAL). This is inconsistent. Why is interest rate risk being applied (in the form of higher risk weightings for longer-term assets) to GSE guaranteed securities, but not to Treasury securities? In fact, the Federal Government owns the GSEs. We believe these GSE guaranteed securities should carry a fixed weighting across all WALs (similar to Treasuries), but at a nominal weighting to reflect the fact that they are not explicitly guaranteed by the Federal Government. We recommend using a 20% weighting across all WALs for GSE guaranteed securities, which is consistent with Basel III.

    b. The risk weightings are extremely punitive as the WAL increases. For example, an Agency security with a WAL greater than 10 years carries a risk-weighting of 200%. Compare this to a 30-year fixed rate First mortgage loan, which not only carries interest rate risk but also credit risk, with a weighting of 50-100%, depending on the concentration level. In addition, this is another example of assigning a weighting of more than 100% to an asset. These weightings are deeply concerning and will have a significant impact on how a credit union structures its balance sheet. Risk weightings of over 100% are punitive and are a back door attempt to prevent credit union's from holding assets which are allowed by NCUA's investment rule. If NCUA does not want credit unions to own these assets they should propose a change to the rules governing investments (although we would, of course, disagree with such a rule change). We strongly suggest that NCUA revisit the risk-weightings for non-guaranteed, non-agency investments and ensure consistency with the WAL of other assets like real estate loans. As stated above, for GSE guaranteed securities, we recommend a 20% weighting across all WALs.

3. Member Business Loans (MBLs)

    a. The risk weightings increase from 100% to 150% for MBLs above 15% but below 25% of total assets, and increase to 200% if the concentration of MBLs exceeds 25% of total assets. In most cases, credit unions will not exceed 12.5% of total assets as this is the current regulatory cap. However, the risk weightings again are problematic as a weighting of more than 100% of the actual MBL assets on the balance sheet may be assigned. In addition, claiming concentration risk as a reason to assign such a high weighting for an MBL portfolio above 15% of total assets seems illogical in our opinion. For example, assigning a 200% weighting if the category is between 15 and 25% of total assets while real estate loans over 35% of total assets only carry a 100% weighting does not compute and produces a sizeable penalty for those credit unions that specialize in business lending.

b. While MBLs are generally more complex transactions than consumer loans, the risk does not lie as much in the concentration of the asset but rather in the underwriting. If the underwriting is sound, then the risk should be mitigated. We recommend adjusting risk weightings with more emphasis on underwriting practices and potential credit risk rather than concentration risk.

c. One question we believe should be addressed is why all MBL products are being treated with the same risk weightings? Some MBLs are unsecured lines of credit while others are secured by commercial real estate. NCUA has separated out most of the major consumer loan products but has combined all business loan products into a single classification. Obviously, there are different levels of interest rate risk and credit risk embedded within the various types of MBL products. We recommend that loans backed by collateral, such as commercial real estate, be given more consideration in the form of lower risk weightings than unsecured lines of credit.

d. Another example and concern is the current assignment of Non-owner Occupied Residential Mortgage loans into MBLs (per the Call Report) rather than to Residential First Mortgage loans. These loans are not underwritten like a Commercial Real Estate (CRE) loan and should be assigned the same risk weightings as other residential First Mortgage loans (i.e., 50%). We strongly urge NCUA to change the reporting requirement for these Non-owner Occupied Residential loans from an MBL loan to a Residential First Mortgage loan for Call Report purposes. Such a change would create parity with regulatory reporting requirements for banks.

4. First Mortgage Loans

   a. Assigning a 50% risk weighting for First Mortgage loans is reasonable. However increasing the weighting to 75% and 100% as the percentage of this asset class increases is inconsistent with the weightings assigned to comparable loans held by banks. Assigning performing First Mortgage loans that exceed 35% of total assets with a weighting of 100%, which is the same as a delinquent First Mortgage loan, seems inconsistent and appears to ignore the difference in credit risk. Further, it suggests that concentration risk carries just as much weight (or more) as credit risk does for a nonperforming loan.

   b. We strongly believe that concentration risk is again the wrong place for NCUA to gauge risk. We believe that a credit union that focuses on one or two types of lending and masters those types of lending inherently may be of lower risk than another credit union that originates mortgage loans, auto loans, indirect auto loans, business loans, credit card loans and student loans. Each type of lending has its own complexity and requires specialized knowledge. Yet a concentration biased-penalty drives credit unions to be a jack of all trades and potentially a master of none in order to avoid concentration risk. NCUA would be far better advised to consider how well a credit union manages risk through its underwriting and servicing policies. We would argue that specialization and mastery offset concentration risk. We would argue that the more types of lending a credit union manages, the level of assumed risk likely increases. The proposed risk weighting structure assumes a credit union that focuses on real estate loans, for example, with staff who are intimately versed in making those loans and have sound underwriting policies, carries more operational risk than a credit union that makes all types of loans but does only a handful of mortgage loans each month. The logic behind the weighting structure does not appear to be based on documented history or fact-based data. We recommend NCUA re-evaluate and consider lowering the risk weightings for First Mortgage loans when the asset category exceeds 25% of total assets.

5. Other Real Estate Loans

    a. The risk weightings for Other Real Estate loans rise up to a level of 125 - 150% of total assets when the concentration exceeds 10% of total assets. As mentioned previously, we don't believe assigning a weighting in excess of 100% of the book value is reasonable or adequately supported. While it is obvious that concentration risk is the Agency's primary motivation for increasing the weightings, you propose no comparable increase in the weightings for auto loans and credit cards if they exceed certain thresholds of total assets. This inconsistency calls into question the validity of the risk assignment logic.

    b. In addition, Other Real Estate loans assigned higher risk weightings than non-delinquent consumer loans that are either unsecured (credit cards) or are secured by depreciating assets (autos) but are unable to determine the logic for such differences. Further, when Other Real Estate loans are underwritten, they are secured with collateral unlike unsecured consumer loans. This raises further questions about why Other Real Estate Loans carry a higher weighting than unsecured consumer loans. We request re-evaluating and adjusting the risk weightings of Other Real Estate loans to ensure reasonableness compared to other asset types.

6. Loans Held For Sale

    a. Assigning a 100% weighting for Loans Held for Sale seems excessive given that most loans sold by credit unions are First Mortgage loans, and a non-delinquent First Mortgage loan carries a 50% weighting according to the proposed rule. Since these loans are intended to be sold, they do carry market risk and they do not carry the same level of interest rate risk and credit risk inherent in loans intended to be placed on the balance sheet. As a result, we recommend a 50% risk weighting for First Mortgage loans held for sale. In addition, Loans Held for Sale should be separated into major product categories rather than having all loan types combined into one category and one risk weighting.

7. Mortgage Servicing Assets

    a. There is no question that Mortgage Servicing Assets (MSAs) carry fluctuating levels of interest rate, prepayment, and market risk until the assets are committed and sold. But assigning a risk weighting of 250% for a balance less than 15% of capital seems highly excessive. Assigning these assets with a 100% risk weighting would be far more reasonable. A risk weighting above 100% seems punitive and implies that NCUA does not want credit unions to retain servicing assets. Retaining servicing assets is the best way to retain the member relationship and preserve the credit union as an intermediary for the resolution of servicing actions and issues. Credit unions are defined by their ability to maintain and service the member relationship. This risk weighting is completely contrary to the principle that credit unions exist to serve their members. We recommend reducing the risk weighting for MSAs to 100%.

The above areas comprise our major concerns with the proposed rule change and hope that our comments are sufficient to prompt reconsideration of the rules as we have described them. If left intact, the proposed rule changes will expose SAFE Credit Union and others to inconsistent and punitive capital requirements. Such requirements will adversely affect SAFE's ability to grow the organization, meet member needs, and create a false sense of adequately managed risk.

In addition, credit unions are not able to raise secondary capital in the markets. Already a disadvantage, layering on higher risk-based capital requirements than banks will only create further competitive disadvantages for healthy, growing credit unions. We believe a risk-based capital system is an appropriate step for the credit union industry to take. We only ask that the methodology used to implement such a system is built on practical and supportable logic that accurately measures the capital risk embedded in a credit union.

As such, I urge you to consider making structural revisions to the proposed rule as well as offer another 90-day comment period for the public to evaluate and submit feedback to such revisions.

Sincerely,

Chris Harris
SVP/CFO
SAFE Credit Union

cc: Henry Wirz, CEO
SAFE Credit Union