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To: Gerard Poliquin - NCUA	From: Matthew Butler
Fax: 703-518-6319	Pages: 6
Re: RBC Comment Letter	Date: May 21, 2014

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May 20, 2014

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

Re: Comments on Proposed Rule: PCA – Risk-Based Capital

Dear Mr. Poliquin:

I am the founder and managing principal of Elite Capital Management Group, LLC, an SEC-registered investment advisor dedicated exclusively to helping credit unions invest their surplus assets in a safe, secure and productive manner. While Elite Capital Management Group provides a range of investment services to federal and state-chartered credit unions nationwide, our core focus is on "pre-funding," whereby credit unions – relying on the expanded investment authority provided by NCUA Rule 701.19(c) or state parity/other organic legal authority – invest funds not required for member loans in professionally managed, diversified portfolios of publicly-traded domestic and international funds and direct-issuer government and private debt and equity securities. Pre-funding has consistently delivered our clients rates of return substantially above those derived from core operations, and thereby has enabled those credit unions to offset the growing cost of employee benefits. While our returns have been significantly higher than those derived from credit union core operations or traditional investments, our portfolios stress capital preservation and since 2007 no client has ever experienced a net realized loss in any single month in our programs.

Managing a growing pool of credit union capital, currently in excess of $350million, we are concerned that aspects of the NCUA's proposed new capital adequacy rule could inadvertently penalize those credit unions which wish to responsibly invest now to fund their future employee benefit obligations, and instead cause those institutions to opt for an unfunded, pay-as-you-go approach to employee benefits, creating major financial problems down the road.

Although the great majority of credit unions are strongly capitalized, Elite Capital Management Group supports the NCUA's attempt to develop a more refined measure of capital adequacy, one that looks beyond generalized net worth to the actual composition and risk characteristics of each insured credit union's assets. That said, for the reasons noted below, which are specific and limited to credit union non-loan investment programs, we believe the proposed rule fails to achieve its stated objective and should be withdrawn for substantial revision, and then re-issued for further public comment.

Excessively general risk asset categories. Different classes of assets can pose varying degrees of risk, risk being defined as potentially rapid and material decline in asset value related to certain contingencies. Equity securities as a class carry greater risk in the case of issuer insolvency than do debt securities, and within equities common stocks pose greater insolvency risks than preferred stocks. Yet, the proposed PCA risk weightings draw no distinction between preferred and common equities, and bonds with greater than 10-year maturities appear to have been assigned a higher risk weight at 200% than equities in the "other assets" category at 100%. Indeed, within the category of non-loan investments, the only distinction drawn by the draft PCA rule seems to be maturity, a variable tied principally to interest rate risk, while the proposed rule ignores other important risk-related characteristics of investments, including issuer operational and insolvency risk.

Failure to account for issuer-related risk. Within a given class of investment asset, be it corporate bonds, preferred and common stocks, or funds aggregating such assets, there is a wide variation of investment risk, based upon the specific and often unique characteristics of the issuers of the various securities within that class. Elite Capital Management Group assesses these and other risks on an issuer-by-issuer basis when designing and actively managing its client portfolios. But the risk weighting asset categories contained in the proposed PCA rule do not reward credit unions for making informed individualized, issuer-specific risk assessments. Instead, the PCA rule treats all issuers of a broadly-defined security – say, a ten-year corporate bond – the same, whether the issuer is AAA-rated and has been accessing the public capital markets for decades, is an old-line company in terminal decline, or is a highly successful business new to the public capital markets. The same is true for municipal bonds – the proposed PCA rule treats the debt of a shrinking rust belt city the same as the debt of a thriving southern county, when by any objective measure the risks associated with the two are quite different. To be effective, the final PCA rule must take account of issuer-specific investment risk variations.

Policy conflict with Rule 701.19(c) for employee benefit pre-funding. Beyond the failure of the draft PCA rule to draw proper distinctions between and within investment asset classes, there is a policy conflict created by the PCA. Credit unions seeking to "pre-fund" their future employee benefit costs are given broad investment discretion by NCUA Rule 701.19(c), which frees those pre-funding investments from the restrictions which are imposed by the Federal Credit Union Act and Rule 703 on investments made for the credit union's own account, to enhance its earnings. While Rule 701.19(c) reflects a deliberate and longstanding policy judgment by NCUA to permit credit unions to invest more flexibly, when doing so to fund employee benefits, the proposed PCA risk weightings will penalize credit unions which invest in higher-yielding, longer-term investments, by raising the reserves required to carry such investments. Rule 701.19(c) and the proposed new PCA rule thus seem to be at loggerheads, with the likely outcome that some credit unions will reallocate pre-funding investments away from higher-yielding, longer-term securities to much lower-yielding, shorter-term investments that provoke less regulatory scrutiny and cost less to carry in mandated reserves, but that do little to address the need for credit unions to take a more proactive, longer-term approach to funding their rising employee benefit obligations.

To be effective, the final PCA must be more flexible. Beyond legal mandates, there is no question a risk-based capital assessment tool is needed to provide a second look at the basic net worth test applied to all NCUA-insured credit unions. Especially with larger, more complex institutions, the nature and associated investment risk of credit unions assets varies widely, and needs to be more accurately assessed and managed. Unfortunately, the proposed new PCA rule does not provide credit unions or examiners the flexibility needed to make those assessments. The risk weighting categories are too general, lumping together assets with widely varying risks (e.g., all "other assets" being assigned the same 100%, Category 5, risk weighting as delinquent first mortgage loans and repossessed collateral seems dubious), especially when considering risks beyond those tied to interest rate fluctuations. Additional risk weighting categories are needed to properly take account of equity investments, including preferred and common stocks, REIT shares, direct issuer debt instruments (i.e., government and corporate bonds), as well as shares of mutual funds, which at least in pre-funding investment portfolios are increasingly common elements. Further, mechanisms must be developed to take account of the wide variability of investment risks associated with different issuers – there is an obvious if imperfect basis to do this with government, quasi-public and private bonds, based upon credit ratings assigned by third party agencies, while calibrating issuer-based risk weightings for equities issuers obviously is more difficult.

Proposals.

1. There must be additional risk weighting asset categories, and the asset types within them should be more harmonious. Among those new categories should be (i) preferred stock and common stock, each varying by ranges of market capitalization of the issuer and perhaps also by how long the issuer has been a publicly reporting company, (ii) REIT shares as a separate category given the different nature of the underlying asset, and again varying by the market capitalization of the issuer and how long it has been a public company, (iii) debt securities, varying by years to maturity, option adjusted duration (which takes account of risk related to put or call options in the security), debt rating (if any) of issuer, and (iv) mutual funds, varying by the predominant nature of the underlying portfolio as well as duration as a public issuer – with mutual funds, varying risk categories could be created to correspond to observed variations (such as betas above and below 1.0) in the relationship of fund share net asset value to changes in the value of a designated market index, such as the S&P 500, with funds showing greater volatility (higher betas) being assigned to a greater risk weight category.

2. While the "other asset" residual category inevitably must remain, NCUA should in the new draft rule strive to substantially reduce the number of potential credit union investments in it, since by definition it reflects an amalgam of unrelated investments that logically should not have the same risk weightings, and as additional investment classes emerge, they either should be assigned to existing risk categories or new categories created for them.
3. The proposed risk weightings need to be revisited across the board to address anomalies – for instance, a zero risk weighting for any debt instruments, including treasuries, makes no sense, since while US direct and guaranteed obligations may be considered to have no credit risk, they surely have interest rate risk, and that risk seems to be the NCUA's principal focus in risk-weighting all investments. Further, it's not obvious why a 50% weight should apply to both one to three year investments as well as non-guaranteed mortgage loans, which typically will have a much longer maturity and are subject to a variety of interest rate and credit risks not associated with shorter term, highly-rated institutional debt. Additionally, the logic of assigning a 100% weight to delinquent mortgage loans, foreclosed assets and "all other assets" seems arbitrary, especially where those other assets are performing and perhaps represent the obligation of an extremely creditworthy obligor, such as an insurance company issuing a life insurance policy, where the company has substantial capital and is overseen by its own specialized government regulator. Assigning a 150% risk weight to performing debt securities which happen to have a five to ten year maturity seems punitive, and assigning those performing bonds the same weight as applies to delinquent credit card loans seems unjustified. Finally, assigning a 200% risk weight to all investments with more than ten years to maturity, without regard to any other relevant aspects of the investment, is totally unjustified and can be expected to cause many credit unions (especially those on the cusp of a lower capital adequacy rating) to reflexively dump perfectly sound, high-earning investments for the arbitrarily lower reserves required of shorter-term, lower earning securities. Any risk weightings above 100%, which effectively assign a penalty to the affected investment, should be justified by detailed reasons from the NCUA as to why such investments are to be avoided.
4. Once risk weights are more logically assigned among asset classes in a revised draft PCA rule, they should be presumptive only, so that if a credit union can present good reasons why a lower risk weight should be assigned to its investments within a certain category, those lower weights will be applied going forward. Examples include credit unions with assets in a diversified, portfolio under professional management, whether on a discretionary or non-discretionary basis, where the credit union can demonstrate that risks have been effectively measured and managed by asset class, industry and issuer diversification, ongoing, active portfolio management and performance reviews. This process will more accurately assess asset quality and capital adequacy, but will of course entail more interaction between insured credit unions and the NCUA, but the associated administrative demands can be managed by limiting the frequency of risk asset "appeals" by any credit union.
5. $50 million in assets is too low a threshold for applying the expanded PCA rule – in our experience credit unions with less than $150 million in assets tend not to be operationally or financially complex institutions. A more refined measure of complexity, taking into account a combination of gross assets, non-loan investments (excluding short-term/cash equivalent holdings), CUSOs, lower CAMEL ratings and

high concentrations of member business loans would seem better able to identify the kind of operational and asset complexity/risk the new PCA rule is most concerned with.

6. Any discretion for an examiner to require 100% capital reserves for specific investments should require detailed findings by the relevant Regional office that the credit union is materially at risk with regard to the specific investment, by reason of a failure to understand its workings, it being objectively a very high-risk investment and the absence of less burdensome alternative regulatory actions, such as negotiated intermediate reserves, mandated retention of external investment management expertise or disposition of the investment within a defined period.

Elite Capital Management Group brings special perspective and experience to risk-based assessment of non-loan credit union investments, since every day we help client credit unions design and revise their investment portfolios, balancing risk and reward over the long term. We would be happy to discuss this letter and any related questions.

Very truly yours,

Matthew P. Butler