May 17, 2014

Gerard Poliquin *Delivered Electronically*
Secretary of the Board
National Credit Union Association
1775 Duke Street
Alexandria, VA 22314

RE: Prompt Corrective Action – Risk Based Capital

Dear Mr. Poliquin,

TwinStar Credit Union appreciates the opportunity to offer comments on the National Credit Union Association's (NCUA) proposal to revise Prompt Corrective Action related to Risk-Based Capital. Our credit union is a state chartered, federally insured institution headquartered in Olympia, WA serving over 100,000 members across 24 branches with $900M in assets. We believe that a strong framework for capital standards is necessary for our continued success, and this is an opportune time to consider appropriate credit union capital levels with the recent recession and the introduction of Basel III. Although this proposed rule attempts to provide that structure, we believe that the proposal will negatively impact our ability to deliver on our core mission of providing value to our membership.

Our credit union has survived one of the most challenging times in history through proper risk management practices, expense control, and sound business decisions. All of these were the result of strategic planning centered on how to deliver value to our membership under the current capital standards. This proposed rule has the potential to seriously alter the same business model that allowed us to survive the recession and deliver on our mission, while at the same time growing our capital.

As with any rule as complex as this is, there are well-meaning components that carry unintended consequences. Trying to put one formula in place to measure "all material risks" (as described by NCUA) that can be applied to all credit unions is nearly impossible. Further, it ignores the individual credit union's membership demographics, goals, and local market knowledge; all of which matter in managing a credit union's balance sheet. It is our hope that the NCUA view our comment letter in the spirit for which it is intended: to provide you with the real impact that these rules will have on our ability to deliver on our value proposition to our 100,000+ members.

General Comments:

Our state and federal trade associations will no doubt be submitting their own letters, speaking broadly about:

- The impacts of this rule on the entire credit union industry

- The impacts on Low Income Credit Unions (LICU), Community Development Financial Institutions (CDFI), and Minority Depository Institutions (MDI), which will be disparately impacted by capital rules that discourage lending to the very individuals these credit unions were chartered to serve
- The need for supplemental capital to be considered in conjunction with these proposed rules

We share their concerns and stand in support of their comment letters. Therefore, we will not focus our comments on those areas. Our specific concerns will address what we perceive to be issues within the risk weightings, as well as the unilateral discretion this rule would provide NCUA examiners for modifying a credit union's capital requirement.

Stricter capital requirements than banks will put us at a competitive disadvantage, and as proposed credit unions have much stricter requirements than banks. The overall impact of this inequity is that credit unions will have to price differently than they would otherwise to account for the capital costs of granting a loan or making an investment. This essentially levees a "tax" on capital for the same assets that banks have, which will make it more difficult to compete in an already crowded marketplace.

It's not difficult to see that the true ramification of this rule is not in the present day balance sheet, where most credit unions are considered well-capitalized, but in the future balance sheets and in the strategic plans moving forward. Credit unions don't have access to capital markets and this rule adds systemic risk as it encourages short term assets with low rates of return, leading to lower capital accumulation.

As the mix of our balance sheet changes, the capital ramifications could become significant. With risk weightings that sometimes double from tier to tier, even slight changes in balance sheet mix could trigger enormous changes in capital requirements. These changes will force credit unions to change their business models to comply – and will force credit unions to begin managing to "capital requirements" instead of membership needs. Strategic initiatives will become secondary to the capital requirements, and how our performance is measured will change with it. As an example, the proposed rule will discourage 30 year mortgages and business lending; two areas that are at the very heart of our economic recovery and are part of the lifeblood of our communities! Another example is that credit unions could be forced to sell assets simply to meet the requirements laid out by this regulation, not because they are driven to by market forces or member needs.

Finally, as will be described below, we have several specific concerns with the way the risk weightings are calculated and don't believe that all of the appropriate risks will be measured under this proposal. The NCUA stated that in order to reduce the burden on credit unions this calculation will be done using available data from the current 5300 call report. We believe there are specific areas where obtaining more specific information will improve the risk analysis, and we respectfully suggest that NCUA consider making these adaptations. As a credit union that already has to comply with the difficult task of reporting the 5300 call report correctly, the changes needed to make this proposed rule more effective would be minimal.

RISK WEIGHTINGS:

Two of our biggest concerns with the proposed rule deal with risk weightings. First, these weightings force credit unions to carry more capital than banks for the same assets. This will put credit unions at a competitive disadvantage to banks with respect to the pricing of our loan products. Second, the use of higher risk weightings on long-term assets to account for interest rate risk completely ignores the funding side of the ALM equation. Without taking into account the liability maturities, the proposal inaccurately assigns interest rate risk that may not exist. It also penalizes those credit unions that have been proactive in managing their liability structure while rewarding those that have not managed this risk as effectively.

<u>Credit Risk</u>

Credit risk is one of the main concerns this proposal attempts to mitigate. With 10 different weighting levels and over 50 different variables, we have several concerns with the overall approach to credit risk mitigation though this proposed structure. An example of how this complexity affects the proposed risk weightings is that consumer loans have a *higher* risk weighting than 1st mortgages for the first 25% of assets. By most standards, consumer loans are considered less risky assets than 1st mortgages, regardless of the levels of concentration. That begs the question of how risk weights were developed and if they are based on any historical loss analysis. If so, we'd ask the NCUA to share their data that is driving these risk weightings. As it stands currently, there appears to be an assumption that higher levels of concentration in a particular asset class increases the risk of losses. In fact, studies we've seen show that credit losses for $1B+ credit unions over the last 3 years have actually *fallen* as concentrations have increased. This is not surprising because of the level of expertise that a credit union develops when they work with their membership so closely on a product.

Looking specifically at mortgage weightings, one of the main flaws with the rule is that it completely ignores Loan-to-Value (LTV) considerations. Proper LTV management based on credit risk has a direct effect on reducing overall credit losses. Rather than base a capital requirement solely on the overall concentration percentage, we'd ask NCUA to segment this into LTV categories with lower LTV mortgages requiring a lower capital carrying cost. Further, we'd ask NCUA to consider creating a distinction between Qualified Mortgages and Non-Qualified Mortgages. Qualified Mortgages should have a lower risk weighting, because they inherently carry less risk. These two distinctions of LTV and qualified/non-qualified are integral parts of understanding the credit risk within mortgages and we would like to see them accounted for in the final rule.

<u>Investments</u>

Within the area of investments there are a number of concerns on the proposed risk weightings. As mentioned previously, the investment risk weightings are higher than that of banks putting credit unions at a competitive disadvantage. For example, SBA and Ginnie Mae bonds are treated with 0% risk weighting for banks, but not for credit unions. Furthermore, the structure of the various risk weightings confuses the issues of credit risk and interest rate risk and therefore doesn't accomplish what the NCUA intended. As an example, the treatment of Treasuries and GSEs compared to other types of investments is inconsistent. The proposed rule treats Treasuries and securities guaranteed by the NCUA/FDIC with a 0% risk weighting regardless of the maturity. Other Agency backed securities are risk weighted based on their weighted average maturity, in some cases up to 200% risk weighted. In both cases, the credit risk is assumed to be zero, however the interest rate risk associated with Treasuries and GSEs is not addressed. This is also inconsistent with a statement in the proposed rule that deals with other government products: "While a government guarantee against default mitigates credit risk, it does not affect interest rate risk." The 0% risk on Treasuries is also confusing given that many Mortgage-Backed Securities (MBS) and Collateralized Mortgage Obligations (CMOs) have less interest rate risk when rates rise than a long-term Treasury.

Similarly, there is an inconsistency with weightings as it applies to mortgages and Mortgage-Backed Securities (MBS). The 30 year MBS with weighted average life of 5-10 years has a 150% capital carrying cost, while making the same whole loan only has a 50% capital carrying cost. This is a huge spread in capital requirements for taking on the same interest rate risk and likely a *lower* credit risk.

Another limitation of this entire methodology is that the risk is being measured by weighted average life. Because of this basis, there is minimal distinction between amortizing and bullet investments, or between Agency backed and private label securities. Because of the simplistic nature of the approach, there is a too large of a jump in carrying cost between a bond with a weighted average life under 5 years and one that is over 5 years. Further, there's no distinction between any bond longer than 10 years, except for Treasuries (which we've already seen have a 0% weighting). Using the *current* weighted average life also ignores the interest rate risk that can be caused by extension risk in these types of investments. Credit unions with more complex investments should be able to segment these factors in their investment portfolios to more properly represent the risk.

<u>Deduction of NCUSIF deposit from risk-based capital numerator</u>

The proposed rules don't allow for the NCUSIF deposit to be included in the numerator for calculating risk-based capital. We believe this to be an incorrect treatment of this deposit, for a number of reasons. This deposit is an asset for credit unions and should be counted as such because a credit union could have their deposit returned to them under several circumstances:

- If the credit union converts to a bank or savings institution charter;
- If the credit union elects private insurance instead of NCUA's;
- Upon voluntary liquidation of the credit union.

All of these examples serve to prove that the NCUSIF deposit is an asset for the credit union that should be included in the calculation for risk-based capital.

Allowance for Loan and Lease Losses

We appreciate the NCUA's acknowledgment that ALLL balances should be considered as a part of capital for the equation. This is a different posture than has been taken by our recent NCUA examiners with respect to concentration risk limits, and we believe it is the correct application of ALLL and capital. However, limiting the amount of the ALLL balances that can be included in the calculation doesn't accurately measure the risk mitigation that the ALLL account provides. Creating an arbitrary limit will not incentivize credit unions to add reserves above that level, even though ALLL balances have been the focal point of many recent exams. TwinStar recommends that NCUA revise this provision to allow for all of the ALLL balance to be included, as it buffers against losses to the NCUSIF.

CUSOs

One of the most obvious areas that we believe needs to be revised is the risk weighting of 250% for CUSOs. CUSOs provide a tremendous value in the credit union industry by allowing for economies of scale, buying power, and an extension of services that provide value to our membership. Credit unions already have rules governing maximum allowable investments in CUSOs, and this proposed ruling will only be a further disincentive for credit unions to use CUSOs. Since the very reason credit unions use CUSOs is to reduce operational costs and gain efficiencies, this portion of rule will likely cost credit unions in both their earnings and their overall net worth.

A small number of CUSOs that have failed do not accurately represent the CUSO segment of our industry or the risks that CUSOs bring. Even in recent NCUA rulemaking regarding CUSO's there was an acknowledgement that wholly owned and simple CUSOs are different than multi-owned/complex CUSOs. We believe a 250% risk weighting to be overreaching and recommend reducing it to 100%, or at minimum create a two-tiered weighting system for CUSOs based on whether they are simple or complex.

1250% Risk Weighting and Subjective Capital Buffer Requirements

TwinStar management has serious concerns with sections 702.105(a) and (c), both because we believe it to be an unnecessary authority by the NCUA and because of the subjective nature of how the rule is crafted. In proposed rule 702.105(a) the NCUA examiner will have the authority to unilaterally designate an Individual Minimum Capital Requirement (IMCR) for a credit union. We would suggest that this is unnecessary, and the nature of these proposed capital rule changes speak to that. If the proposed risk-based capital standards are sound, there should be no need for any subjectivity in the process.

As it stands, the IMCR authority is extremely subjective and is allowable based on undefined, vague terms. This naturally leads to questions like "How will hundreds of examiners apply this discretion in a fair and consistent manner? Will there be differences of interpretation and application that will subject credit unions to arbitrary excess capital positions? Can an examiner apply this discretion despite all the other criteria for 'Well-Capitalized' being met?"

In section 702.104(c)(2) an examiner can assign a risk weighting of 1250% for asset classes they have deemed that management does not understand. We find this problematic for a number of reasons. Who does the credit union have to prove this to? Does every member of the management have to demonstrate this knowledge? Does each member of the Board of Directors? Or is it specific positions like the CFO and CEO? Will there be different standards for credit unions from year to year based on different examiner's own level of understanding of those assets? What if our examiners don't understand the risk/reward components of the asset-backed investment as the credit union? It is our belief that examiners don't have the requisite experience to determine what a "Comprehensive Understanding" is as the requirement for asset-backed investments states. We are asking the NCUA to strongly consider removing this unilateral, highly-subjective discretion from the hands of individual examiners and rely on the overarching capital standards that are being built with this proposed rule.

CONCLUSION:

TwinStar believes that having a strong capital framework is important, but that the proposed rule changes don't adequately serve to provide such a structure. The desired outcome was to create a rule that captures "all material risks"; however, the proposed rule does not meet that standard. From arbitrary risk-weightings, inconsistency between the logic being applied, and the subjective nature of both IMCR and the 1250% risk-weighting, this rule has the potential for hurting the industry more than it helps. It will certainly push credit unions toward shorter-term, lower yielding assets which will present systemic risk to the NCUSIF because of overall margin compression. It will cause credit unions like TwinStar to reevaluate our product offerings to our membership, not because of the needs of the member but rather the needs of this regulation. It will put our credit union and every other credit union at a competitive disadvantage within the marketplace, simply because of the extra capital needed as compared to the banking industry.

Thank you for the opportunity to comment on this proposed rule and for considering TwinStar's concerns. Please feel free to contact us with any questions regarding TwinStar's comments on the proposed rule.

Sincerely,

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