Great Lakes CREDIT UNION

May 23, 2014

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

Subject: Comments on NCUA's Proposed PCA-Risk-Based Capital Rule

Dear Mr. Poliquin:

On behalf of Great Lakes Credit Union (GLCU), we appreciate the opportunity to comment on the Proposed Rule: PCA-Risk-Based Capital. While we applaud the NCUA for its efforts to revise capital requirements in the credit union industry, we believe there are certain aspects within the proposal that would likely put the industry, and GLCU, at a competitive disadvantage. We also believe that the proposed rule changes would negatively impact our members.

Additionally, in the context of updating the risk-based capital rule, we believe there needs to be a greater effort and emphasis to expand secondary capital opportunities for all credit unions. This should be contemplated in the formulation of these proposed rule changes.
As for the proposed rule, we will address a variety of areas we feel should be amended or changed.

Capitalization:

- Credit unions will have to maintain higher net worth and RBC requirements than the banks' Basel III requirements despite credit unions' regulatory restriction of being able to raise capital in any way other than earnings. The higher requirements serve to exacerbate the difficulty credit unions currently face when competing with banks. We do not understand the need for the aggressively high risk weightings proposed on credit unions given the fact that over the period from 2007 through 2013, the **FDIC incurred over 8 times the deposit insurance losses per $1,000 of insured deposits versus the NCUSIF**.

- The proposal requires a well-capitalized credit union to maintain a 7% net worth ratio (unchanged from the current PCA system) and a new 10.5% risk based capital (RBC) ratio. However an adequately-capitalized credit union (defined as a credit union with a net worth ratio of 6%) requires an 8.0% RBC ratio. In other words, the RBC ratio for well-capitalized credit unions exceeds that for adequately capitalized credit unions. It appears to be illogical that a credit union with a higher net worth is penalized with a higher RBC requirement than a credit union with a lower net worth.

- The proposal suggests that the NCUA may require a higher minimum risk-based capital ratio for an individual credit union on a case-by-case basis where circumstances such as the level of risk of a particular investment portfolio, the risk management systems, or other information indicate that a higher minimum risk-based capital is appropriate. We disagree with the proposal's position of providing for an individual minimum capital requirement. We believe that the authority to require additional capital under individual circumstance already exists through the NCUA's current enforcement processes. Adding an additional layer of potentially arbitrary and capricious constraints on top of existing minimum capital guidelines would create confusion and inconsistency in the application of the agency's standardized framework. Arbitrary examiner subjectivity should not be included in the proposal.

Impact Issues on Credit Unions:

A standardized capital ratio would not be an appropriate and effective measure to mitigate such a broad range of potential risks including credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. The attempt to capture these risks with individual risk-weights could create negative incentives for appropriate risk taking. We believe the proposal oversimplifies the control mechanisms for these risks and creates a framework that increases focus on certain types of risk at the expense of others. For example, the risk-weight categories in particular appear to create incentives for institutions to reduce interest rate risk while substantially increasing credit risk. Those same risk weights also seem to ignore market liquidity factors applicable to investments, and provide incentives for institutions to purchase lower-yielding securities that would reduce earnings significantly over time.

- The proposal clearly focuses on preventing risks, but it is silent on the needs of credit unions to meet member demands. Requiring higher levels of capital and reducing balance sheet risks might mitigate some potential failures, but these requirements could also limit growth opportunities for individual credit unions and weaken the ability of credit unions to adequately serve member needs. The following items are some examples where the RBC proposal would create that impact.

Risk Weights:

While a risk-weighted capital system could be developed to cause minimal impact to credit unions' net worth requirements, the proposed rule will have a very detrimental effect on credit union balance sheets and adversely affect member services.

- The proposal sets higher risk weights and therefore higher capital requirements for credit unions with higher concentrations of assets in real estate loans, member business loans, longer term investments and some other assets. They exceed Basel III risk weights for similar assets and place credit unions at a competitive disadvantage to banks. We believe the NCUA should adopt guidelines that are more consistent with the risk weight guidelines established by Basel III.

- The number of risk weightings, especially for member business loan and mortgage concentrations as well as for CUSO investments, does not appear to be set logically. Using higher risk weights on long term assets to deal with interest-rate risk is short sighted without considering liability maturities.

- All of the non-investment risk categories, with the exception of non-delinquent consumer loans, have the same or significantly greater weights that the standardized risk-weights under Basel III. There is no clear explanation provided as to how these risk weights are derived, nor why they are so different from the corresponding risk weights assigned under Basel III. If the NCUA believes that credit unions should engage in certain types of lending activities, it should suggest those activities through restrictive mechanisms outside of the regulatory capital process. We believe that the capital calculation should be exclusively employed to accurately reflect the inherent risk to the institution's capital base in light of the actual risk that exists within each asset category. Additionally, as proposed, the differences between the Basel III framework and NCUA proposed framework would create significant disparities between the relative capital requirements of the two industries. Based on this disparity issue, we believe that NCUA should adopt guidelines that are more consistent with the risk weight guidelines established by Basel III.

- At best, the proposal assigns risk weights inconsistently and arbitrarily across different investment and other classes. One example is a 0% risk-weight being assigned to investments issued and guaranteed by the U.S. Government, without regard to their weighted average life and therefore ignoring interest rate risk. However a high quality GSE pass-through security with an average life of >5 years and <10 years, receives a 150% risk-weight. Another example is that an individual 30 year mortgage would receive a standard risk weight of 50%. If the loan becomes delinquent, it would then receive a risk-weight of 100%, still below the high quality GSE investment. The implied assumption behind this risk-weight disparity is that the GSE investment represents a much greater risk to capital than the non-guaranteed, single obligor 30 year mortgages. In reality, the GSE has a shorter maturity and is more marketable and liquid than the 30 year mortgage. This appears to be recognized under Basel III guidelines, where the GSE would carry a risk weight of just 20%.

- Deducting the NCUSIF Capitalization Deposit from the risk-based capital calculation suggests that the deposit is worthless and is not consistent with showing that the NCUSIF Capitalization Deposit has value. We believe that the deposit is a real deposit for accounting purposes that can be returned in the event of a merger or conversion. Subtracting the deposit from both the capital and risk-weighted asset totals is equivalent to writing off the deposit. We are concerned that it becomes more difficult to prove the asset has future economic value when it has no value in the regulatory capital ratio calculation

Risk Weighting Recommendation:

- The risk weight for cash on deposit at the Federal Reserve Bank should be 0%. Since the Federal Reserve is one of the NCUA designated sources for emergency liquidity, its safety and soundness should be similar to that of the government agencies. Also, the risk weight of overnight funds (cash) is set at 0%.

- For securities, the 0% risk weight for Treasuries and GNMA MBS, regardless of the weighted-average life, ignores any interest rate risk and is lower than the 20% risk-weight for cash on deposit at the Federal Reserve.

- For securities issued by U.S. Agencies, the risk weights range from 30-170% higher for investments that have weighted average lives >1 year to >10 years respectively than Basel III. Risk weights should be the same as those assigned to securities purchased by banks.

- The 1,250% risk-weight category for an asset-backed investment for which the credit union is unable to demonstrate a comprehensive understanding of the features implies a loss greater than 100% of the principal.

- Share secured loans have a risk weight of 75%, but since we have access to the collateral, these loans should have a risk weight of 0%.

- The CUSO investment risk metric of 250% is excessive especially as compared to other risk ratings. For example, delinquent consumer debt over sixty days as well as delinquent unsecured credit card debt is risk rated at 150% and delinquent first lien mortgage loans are risk rated at 100%. Yet investments in CUSO's that have added millions to the bottom lines of credit unions are arbitrarily deemed riskier. We do not understand this reasoning. The one size fits all CUSO risk rating does not take into consideration (a) what types of services are being provided, (b) whether the investment represents necessary operational expenses that would be otherwise incurred, (c) whether the amount invested is material, (d) whether the CUSO has a history of profitability, or (e) whether the investment amount has been fully recovered by the credit union through savings or income. Even if there is a risk assessment for the initial CUSO investment, there is no reason to continue to have a risk assessment if the amount of the investment has been fully offset by net income or cost savings for the credit union that was generated by the CUSO.

  While there are some CUSOs that are designed to return a profit through dividends, many CUSOs provide a return to the credit union owners by the reduction of operating costs or fees paid directly to the credit unions in the form of networking fees and not dividends. NCUA's choice of equating a CUSO to a bank investing in an illiquid small business, misses the true risk and return factors. For example, when a credit union is deciding whether to pay the expenses for running an operational service through the credit union or its CUSO, money has to be expended by the credit union either way. If multiple credit unions pool their funds in a CUSO to provide an operational service, the money pooled is not an investment in the classical sense and should not be risk rated as such. If the credit unions choose a CUSO to provide an operational service, it is because each credit union will save money, and often receives greater expertise than they could afford on their own. Why must risk capital be reserved by the credit unions in order to save money and generate income?

We have heard that NCUA intends to apply the CUSO capital risk rating to both the cash investment made by the credit union *and upon the appraised value in the CUSO.* We find it hard to fathom that NCUA would penalize the success of a CUSO by requiring that the credit union reach into its pocket and set aside additional capital on the profits earned by the CUSO.

Unlike the banking investment powers, the CUSO risk exposure is limited to an immaterial level. There are only 22 basis points of credit union assets invested in CUSOs industry-wide; less than the aggregate corporate assessments. Each federal credit union may only invest less than 1% of assets in CUSOs. Credit unions could lose all their CUSO investments and the loss would not be material yet the upside potential could be very significant. NCUA would be making a mistake by not recognizing the adverse policy implications of applying the inconsistent BASEL bank investment risk ratings to CUSO investments.

- The risk weights assigned to member business loans (MBL) are to severe, given the restriction on the percentage of MBL's compared to assets. The increase in the MBL reserve based on concentrations of 150-200% when the banking industry is at 100% is excessive. Credit unions are required to have personal guarantees on most of their business loans when this is an option for banks. As with the CUSO comments above, we feel the MBL restrictions could have the unintended consequences of restricting growth in this asset class.

- We believe that the risk-based capital requirements for higher concentrations of residential mortgage loans are too high, and exceed the capital requirements specified for small banks in Basel III. For example, residential mortgage loans that exceed 35% of assets have a risk-weight of 100% in the NCUA proposal versus 50% in Basel III. The most recent financial crisis has plenty of data to support the quality of credit union mortgage lending versus banks. Why is it that we need more in risk-based capital than the banks yet our credit profile is less risky? A number of factors appear to not have been considered such as (type of loan, LTV, debt-to-income, variable versus fixed rate), which would influence the risk of a loan. This broad brush approach to risk weighting seems short sighted.

- Mortgage servicing rights. We feel the risk weighting for mortgage servicing rights is too high because the interest rate risk benefit for rising rates from mortgage servicing rights is not given any credit. When interest rates increase, so does the value of mortgage servicing rights. Interest rate risk on the balance sheet is therefore mitigated. Regardless of the accounting treatment (lower of cost or market vs. market value), the interest rate risk modeling should recognize the change in market value for the mortgage servicing rights. The risk weight should be lowered from 250% to the current 75%.

- Allowance for Loan Loss Limitation. We disagree with the proposed rule limiting the allowance for loan losses in the numerator calculation to no more than 1.25% of risk assets. The ceiling seems arbitrary at best, and given likely accounting rule changes in estimating the allowance, credit unions will be unfairly penalized. Currently, credit unions are appropriately funding the allowance to account for potential losses. The proposal will encourage credit unions to accelerate writing off a loan rather than work with the credit stressed member in order to reduce delinquency, therefore reducing earnings to meet the ceiling.

- Longer Average Life Liabilities Benefit. Although the longer weighted average life of assets gets a higher risk weight, having longer average life liabilities does not get any reduction in the risk based capital calculation. Both sides of the balance sheet need to be appropriately calibrated and accounted for.

- Interest Rate Risk Benefits from Derivatives. For derivatives, only the counterparty risk is used in the risk-based capital calculations but there is no benefit for reducing the corresponding interest rate risk.

- Mergers and Goodwill. The proposed capital levels and weightings will likely hamper merger activity and discourage healthy, well capitalized credit unions from engaging in mergers with undercapitalized credit unions since, for example, the proposal forces credit unions into less profitable asset growth. Additionally, the exclusion of goodwill from risk-based capital creates disincentives regarding merger activity. Merger activity ultimately lowers the risk to the NCUSIF by combining unhealthy credit unions with stronger ones.

- Implementation Timeline. The NCUA has proposed an implementation period of 18 months. Much more time would be needed to implement the sweeping changes and the recovery of the well-capitalized buffer. Bank regulatory agencies have provided small banks with an **8 year implementation period** to completely conform to their Basel risk weighted asset requirement. A similar timeframe would be reasonable.

We appreciate the opportunity to comment on the proposed rule. We hope that NCUA will take these and the many other comments you have received and give them serious consideration before finalizing this proposed rule.

If adopted in its present form, this rule will forever redirect the focus and attention of credit unions away from our cooperative mission of providing affordable products and services into an environment where profitability is paramount simply to meet capital allocations. The industry is at an inflection point and we can't thrive with the current proposal.

Sincerely,

Vikki Kaiser

Vikki Kaiser
President / CEO