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May 27, 2014

Mr. Gerard Poliquin
Secretary of 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:

Scott Credit Union (SCU) appreciates the opportunity to comment on the National Credit Union Administration (NCUA) Board's proposed Prompt Corrective Action as it relates to Risk-Based Capital. SCU services seventeen counties in Southern Illinois and St. Louis County in Missouri and currently has over 118,000 members and $955M in assets.

General Comments

SCU understands the need for possible reform of regulations over time, and agrees that there may be a need for modernizing the current capital standards for credit unions, to help identify possible excessive risk within the balance sheet. SCU also appreciates the NCUA for making the calculation less complex than the banks.

The question to consider is how much change is needed, and to what levels, when the credit union industry is already required to carry more capital than the banking community? As this proposal is written today the risk based capital rules will require credit unions to hold more capital than other federally insured financial institutions, with similar risk, which could create a competitive disadvantage for credit unions, as the differences between the NCUA proposal, and Basel III for banks, are mostly unfavorable for credit unions. NCUA has repeatedly stated that 90% of credit unions affected by this proposal would be in compliance with the minimum risk-based capital requirement under this rule. That may be true using a simple calculation of comparing current capital to the new risk-based rule, however, when a deeper look into the calculation is done there is a reduction in the industry in the amount of a capital buffer that the industry has today. Additionally, comparing the balance sheets of today is not the best way to view the risk-based capital and credit unions. As the economy starts to grow credit unions' balance sheets could change and grow and some credit unions may have had conservative balances sheets over the past few years with the crisis that hit, and have been positioning their balance sheets for growth using the current capital requirements, and now may need to alter plans because of a rule that may be too conservative or overstate some risks?

Historical Perspective

The mortgage crisis of 2008 is still recovering six years later and has left an indelible impression on our industry, that is undisputed. As institutions bailing out the corporate credit unions with the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) we have paid a price, lowering earnings and capital. However, when you look at the losses at just the natural person credit unions (see table below), taking the corporate credit unions out of the picture, the natural person credit unions have been strong through questionably the toughest crisis ever, with only two total premiums assessed by the National Credit Union Share Insurance Fund (NCUSIF), and none since 2010.

Year	Estimated Stabilization Fund Assessment	Actual Stabilization Fund Assessment	Estimated Share Insurance Fund Premium	Actual Share Insurance Fund Premium
2009	N/A	4.73 bps	N/A	10.27 bps
2010	5-15 bps	13.4 bps	10-25 bps	12.42 bps
2011	20-25 bps	25.0 bps	0-10 bps	0 bps
2012	8-11 bps	9.5 bps	0-6 bps	0 bps
2013	8-11 bps	8.0 bps	0-5 bps	0 bps
2014	None	TBD	0-5 bps	TBD

When considering all that has happened over the last six years and looking at the chart above, and the performance of the NCUSIF over time, it is evident that credit unions have done a good job with risk mitigation and capital has been strong, and endured, and whatever changes to required capital that may need to be made should be minor at best. Even during the worst point of the crisis the NCUSIF fund only dipped to a 1.23% equity ratio, and is already at 1.30% for the last three years, while the FDIC during that same time period actually had a negative ratio, and still is only close to 2/3 of its peak before the crisis (Source: NCUA, FDIC, CUNA).

Considering all of the above data, there is still an argument to perhaps modify the risk-based capital requirement for credit unions to help be prepared for the appropriate risk, and to be more consistent with the banks and Basel III, but clearly there is not a need to make it more stringent than Basel III, which is what is being proposed.

The NCUA states in the proposed rule that, "The Board believes the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions. Use of a consistent framework for the assigning of risk-weights would promote improved understanding between all types of federally insured financial institutions." This proposal as it stands today does not do this, and in fact puts credit unions at a disadvantage compared to other financial institutions. The proposed rule compared to Basel III penalizes investments too much by seemingly looking strictly at the term of the investments. Concentrations of assets, specifically mortgages are also penalized. These and other potential issues will all be discussed in the subsequent points.

Current, Proposed and Small Bank Basel III System Selected Comparisons

	Current CU System	Proposed CU System			Small Bank Basel III		
Denominator	Current Marginal Required Capital	Weights	Marginal Required Capital: Adequate	Marginal Required Capital: Well	Weights	Marginal Required Capital: Adequate	Marginal Required Capital: Well
Cash on hand	0.00%	0%	0.00%	0.00%	0%	0.00%	0.00%
INVESTMENTS							
Investements: WAL < 1 year	3.00%	20%	1.60%	2.10%	20%	1.60%	2.10%
Investments: WAL 1-3 years	6.00%	50%	4.00%	5.25%	20%	1.60%	2.10%
Investments: WAL 3-5 years	12.00%	75%	6.00%	7.88%	20%	1.60%	2.10%
Investments: WAL 5-10 years	12.00%	150%	12.00%	15.75%	20%	1.60%	2.10%
Investments: WAL > 10 years	20.00%	200%	16.00%	21.00%	20%	1.60%	2.10%
Corporate CU member capital	6.00%	100%	8.00%	10.50%	100%	8.00%	10.50%
PIC/Perpetual Contributed Capital	20.00%	200%	16.00%	21.00%	100%	8.00%	10.50%
LOANS							
Nondelinquent nonfederally GSL	6.00%	100%	8.00%	10.50%	100%	8.00%	10.50%
Nondelinquent other loans	6.00%	75%	6.00%	7.875%	100%	8.00%	10.500%
Reportable delinquent other loans**	6.00%	150%	12.00%	15.75%	100%	8.00%	10.50%
Delinquent 1st mortgage real estate*	N.A.	N.A.	N.A.	N.A.	100%	8.00%	10.50%
Residential mortgages Gty'd by FHA or VA	8.00%	20%	1.60%	2.10%	0%	0.00%	0.00%
Nondelinquent 1st mortgage real estate loans*							
< 25 % of assets	6.00%	50%	4.00%	5.25%	50%	4.00%	5.25%
Excess of 25 - 35% of assets	14.00%	75%	6.00%	7.88%	50%	4.00%	5.25%
Excess of 35% of assets	14.00%	100%	8.00%	10.50%	50%	4.00%	5.25%
Other real estate and delinquent real estate							
< 10% of assets	6.00%	100%	8.00%	10.50%	100%	8.00%	10.50%
Excess of 10% - 20% of assets	6.00%	125%	10.00%	13.125%	100%	8.00%	10.50%
Excess of 20% - 25% of assets	6.00%	150%	12.00%	15.75%	100%	8.00%	10.50%
Excess of 25% of assets	14.00%	150%	12.00%	15.75%	100%	8.00%	10.50%
Small business administration loans	6.00%	-80%	-6.40%	-8.40%	20%	1.60%	2.10%
Member business loans/commercial loans							
< 15% of assets	6.00%	100%	8.00%	10.50%	100%	8.00%	10.50%
Excess 15 - 25% of assets	8.00%	150%	12.00%	15.75%	100%	8.00%	10.50%
Excess of 25% of assets	14.00%	200%	16.00%	21.00%	100%	8.00%	10.50%
* Excludes MBLs secured by real estate.							
OTHER ASSETS							
NCUSIF deposit	6.00%	-100%	-8.00%	-10.50%	N.A.	N.A.	N.A.
Goodwill		-100%	-8.00%	-10.50%			
Identifiable intangible assets		-100%	-8.00%	-10.50%			
Loans to CUSOs	6.00%	250%	20.00%	26.25%	N.A.	N.A.	N.A.
Mortgage servicing assets	6.00%	250%	20.00%	26.25%	Varies	Varies	Varies
All other assets		100%	8.00%	10.50%			100.00%
OFF BALANCE SHEET ITEMS							
Loans sold with recourse	6.00%	75%	6.00%	7.88%	Varies	Varies	Varies
Unfnd commit on business loans (75% conversion)	6.00%	100%	8.00%	10.50%	Varies	Varies	Varies
Unfnd commit on non-business loans (10% conversion)	6.00%	75%	6.00%	7.88%	Varies	Varies	Varies
ABS "comprehensive understanding" penalty	6.00%	1250%	100.00%	131.25%	1250%	100%	131%

****Proposed included delinquent mortgages**

excludes member business loans sec by RE

Above is an overall comparison of the three risk-weighting systems we are comparing including the current regulation, proposed, and BASEL III. The highlighted areas are of more concern in the NCUA risk-based proposal as mentioned above and deviate substantially from BASEL III.

Investments

The risk weighting in this area is far different than those of BASEL III and causes great disparity between like credit unions and banks. Every weighted average life (WAL) over one year is treated differently and credit unions that have used a consistent investment ladder approach strategy and have any kind of longer WAL at all are going to be penalized compared to the BASEL III approach anywhere from 1%-4% of capital depending on their portfolios. This includes certificates of deposit that could be 3-5 years in length but are fully insured, and those are treated the same as any other investment like mortgage back securities which could have more risk.

There are also inconsistencies when it comes to treatment of investments that are essentially backed by the same asset. For instance a 30-year mortgage on the balance sheet, assuming it does not exceed the 25% threshold and is not delinquent, would have a risk-weight of 50%, whereas a similar asset of a pool of mortgage backed products with ostensibly the same WAL of 5-10 years would have a risk-weight of 150%. So the risk weight is triple even though in theory that asset backed security would most likely have the backing, and guarantee of a government sponsored entity (GSE), would have less credit risk then the 30-year mortgage. There are very similar issues with member business loans compared to agencies backed by a GSE, where the business loan has 100% weighted risk and the agency would have 150%, again the business loan has more risk.

You can clearly see when comparing the structure in the current risk-based net worth system, proposed system, and the BASEL III standards are totally different. Regardless, NCUA has taken risk weighting tiers out of this scoring system and dropped them in to a BASEL look-a-like proposed capital regulation. The problem with this is that the risk-weighting tiers are radically different than those used in the BASEL system as well as the international BASEL system. The two systems have very little similarity to each other. It's seems inappropriate for NCUA to adopt the framework of the BASEL system and yet take the most critical parts from a regulation that has absolutely nothing to do with it.

SCU believes the NCUA should consider:

- Have risk-based weighting be more consistent and comparable to other financial institutions.
- Have greater consistency in both loan and asset classes.
- Rely on interest rate risk being monitored through credit union policy and oversight from the regulatory bodies, instead of through capital reform.

Loans

Real Estate Loans-Under the Proposed Rule, no distinction is made on the risk weightings assigned to mortgage loans of various maturity and repricing terms. A 30-year fixed rate mortgage gets the same risk weight as a 1-year adjustable rate mortgage and a fixed rate home equity loan gets the same risk weight as a variable rate home equity line of credit. As opposed to implementing risk-based capital standards that unfairly lump all mortgage loans together there should there be more diversity in the risk weighting.

Under BASEL III, First mortgage loans (1-4 Residential) are given risk weights based on current status (delinquent vs. non-delinquent) and whether the loan was prudently underwritten at 50% or 100%. Why does this proposal vary based on a percentage of assets and 1st or 2nd lien versus delinquency status on the banking side? It seems the NCUA is attempting to control longer term interest rate risk, market, or concentration risk by increasing risk ratings by percentages of mortgage loans on the balance sheet. These controls should already be in place through the institutions ALM policies, credit risk programs, and management. This proposal would limit the ability for Americans to access credit causing a decrease in economic growth and limit the housing recovery. Additionally high risk mortgage products are not as prevalent as before with the adoption of the Dodd-Frank Act and the Consumer Financial Protection Bureau (CFPB). This legislation and the CFPB have changed the way mortgages are underwritten and a repeat of what happened in 2008 is very unlikely.

SCU believes the NCUA should consider:

- That the capital requirement for adjustable rate mortgages and shorter maturity fixed rate mortgage loans should be lowered in the final version of the Rule to fairly take into consideration the reduced risk associated with these adjustable and shorter term mortgage loan products.
- Eliminate the higher risk weights for concentration of 1st mortgage loans. Members will not benefit if credit unions need to increase costs to the members to originate and/or hold these loans.

Small Business Loans-The NCUA Proposed Rule, as currently written, shows that business loans are subject to concentration-based tiered risk weights, whereas consumer loans have a reduced risk of 75%. Traditionally a credit union's member business lending portfolio is one of the more profitable product lines on the balance sheet. If the Proposed Rule was to become final, a credit union may opt to increase production in possible lesser quality secured consumer loans rather than higher quality, more secure member business loans in an effort to preserve capital. History also shows that the loss ratio on business loans actually goes down as the concentration of total assets goes up, so the escalators are really not necessary.

SCU believes the NCUA should:

- Reconsider and remove portions of the Proposed Rule that apply higher risk weights to member business loans based on a percentage of the credit union's assets in that category.

Loans Held for Sale-In the NCUA proposed regulation Loans Held for Sale are risk weighted at 100%, however, under BASEL III in the interim final rule, these are weighted at 0% as long as they are sold in 120 days. These assets are more of a receivable than a loan.

SCU believes NCUA should consider

- A risk weighting similar to the BASEL III risk-weighting of 0% as long as they are sold in 120 days.

Other Concerns

Subtracting the NCUSIF from the Numerator

The National Credit Union Share Insurance Fund (NCUSIF) 1% deposit is being ignored in the risk-based capital calculation. The NCUSIF deposit is a valid asset that can be refunded for various reasons including conversion to a bank or savings institution charter, a credit union electing private insurance instead of NCUA or voluntary liquidation. In addition, the deposit can specifically be attributable to a failed credit union providing an additional buffer against NCUSIF losses in addition to the failed credit union's capital. If a credit union did convert to a bank charter the NCUSIF deposit would immediately be included in the risk based capital numerator.

SCU believes NCUA should consider:

- Not deducting the NCUSIF deposit from the risk-based capital numerator.

Individual Minimum Capital Requirements

The NCUA proposal states, “This proposed rule includes a provision that NCUA may require a higher minimum risk-based capital ratio for an individual credit union in any case where the 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 requirement is appropriate. For example, higher capital may be appropriate for a credit union that has significant exposure to declines in the economic value of its capital due to changes in interest rates. Part 747 would contain procedures for requiring a credit union to maintain a higher minimum capital.”

A predefined calculation gives a credit union the ability to manage their balance sheet appropriately based on predefined limits. This part of the regulation could potentially place a “well-capitalized” institution into any bucket without the ability for the institution to prepare with only a 30 day possible rebuttal process.

SCU believes NCUA should:

- Eliminate this individual determination of the risk based capital regulation and remove it from the proposal. Regulations should be written so both regulators and credit unions have to follow them, not just credit unions.

Investments in CUSOs should be risk weighted at 100% as opposed to 250% under the proposed rule

Involvement with CUSOs can increase the credit union’s profitability by contributing to increased loan production and by helping to reduce operating expenses. Most of credit unions are part owners in the CUSOs and exposure is limited to the credit union’s investment in each of the CUSOs. The NCUA already limits a credit union’s investment in CUSOs, under NCUA Rule 712.4, so it seems to makes little sense to impose a 250% risk weighting on CUSO investments. The inflated risk weighting on CUSO investments may hinder collaboration among credit unions at a time when such collaboration is vital to the future success of the industry. Many credit unions are looking at CUSO

relationships as a way to consolidate functions in an effort to reduce operating expenses and to offset declining net interest income and non-interest income levels.

SCU believes NCUA should:

- Change the CUSO investments risk weight to no more than 100%.

Consideration should be given to increasing the 1.25% allowance limit for adding to the numerator should FASB adopt the Current Expected Credit Loss model.

FASB's proposed new standard on the allowance will most likely increase normal reserves by an estimated 30% to 100% at some credit unions.

SCU believes:

- That more of this required allowance should count towards capital should the higher standard be adopted in the near future, especially as the risk weights are stated at today in the proposal, as credit risk could accounted for twice in effect, by having a higher weight risk and less ALLL added to the numerator.

Mortgage servicing assets (MSAs) should be risk weighted at 100% as opposed to 250% under the Proposed Rule

Rising interest rates and the potential negative impact on credit union earnings, is a major concern to the NCUA. SCU has just begun recently selling fixed rate 15, 20 and 30 year mortgage production and retaining servicing to reduce interest rate risk in the balance sheet. While the value of our portfolio is not material yet, the value of other credit union's servicing portfolio will increase significantly in a rising rate environment as prepayments slow and the average life on the sold mortgages extends. SCU realizes that MSAs become impaired when interest rates fall and borrowers refinance or prepay their mortgages. During the last five years, in this historically low interest rate environment, the negative mark-to-market on MSA's was more than offset by increased gains on the sale of mortgages.

SCU believes:

- That a 250 percent risk weighting on MSAs is excessive and creates less incentive to build the servicing portfolio, which helps protect the credit union's earnings in a rising rate environment.

Conclusion

In summary SCU believes the intentions of the NCUA to try and implement a risk-based capital standard similar to other financial institutions for consistency could help identify risk and would be an improvement over the current Risk Based Net Worth calculation.

However, the NCUA has proposed a regulation that is extremely unfair to the credit union industry. The risk ratings give an unfair advantage to the banking industry especially with regard to mortgage and commercial lending. BASEL III committee has created guidelines that will be used internationally and domestically by FDIC and OCC. Why does NCUA find a need to be more stringent on the capital risk-weighting

requirements, especially when loan losses and investment losses are historically less in the credit union industry versus the bank industry?

As it is proposed now SCU believes the Proposed Risk Based Capital Rule may be too general in assigning risk weightings, focuses on a regulator's model designed to identify concentration and interest rate and not member needs, has the potential to override the Board's and Management's judgments on business strategy and risk. As is, the proposal also leaves the credit union subject to examiner scrutiny by allowing for arbitrary higher minimum capital limits.

SCU would again like to thank the NCUA for the opportunity to comment on such a profound change in our industry.

Sincerely,

Christopher J. Browner
Chief Financial Officer
Scott Credit Union

cc: Frank Padak, President & CEO
SCU Senior Management
SCU Finance Committee