SOLARITY
CREDIT UNION

May 28, 2014

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

Delivered Electronically

Subject: Prompt Corrective Action - Risk Based Capital; RIN 3133-AD77

Dear Mr. Poliquin,

Solarity Credit Union[1] is pleased to be able to offer comments on the National Credit Union Administration's (NCUA) Risk Based Net Worth rule (RBNW). Solarity appreciates NCUA board and staff support of a modern regulatory system that allows credit unions to thrive in both present and future market conditions.

We urge the NCUA to exercise their discretionary rulemaking powers to achieve this goal, and believe it is imperative for the Chairwoman to advocate for necessary statutory changes, prior to issuing a final rule to ensure the safety and soundness of our regulatory system.

While we have serious concerns about the rule as proposed, we believe in the leadership of chair Matz and the willingness of the NCUA board to address valid concerns. Solarity supports a Risk Based Net Worth system designed specifically for credit unions and look forward to working to get this right.

Background:

On Thursday, February 27, the NCUA published a notice of proposed rulemaking to revise and replace NCUA's current PCA rules. The proposed rule updates NCUA's current rules, creating a new method for computing how much capital a credit union is required to hold, based on risk weighing a credit union's balance sheet.

We would ask the NCUA to consider the following points:

1. The final FDIC rule is designed to address a problem that does not exist for natural person credit unions. The NCUA board is statutorily required to use the FDIC rule as a template but it should be changed to create a system that works for credit unions.
2. Supplemental capital is a necessary component to ensure a safe and sound risk based capital system that meets the statutory obligations set forth in the Federal Credit Union Act.
3. A number of technical changes should be adopted to make sure that the rule does not add risk to the share insurance fund.

We will elaborate on these issues further in our letter.

[1]Solarity Credit Union is credit union located in Yakima, WA with more than 48,000 members and over $500 million in assets. Membership is open to anyone who lives, works, worships, or attends school within a Washington state school district.

General Comments

The NCUA has taken a positive step by demonstrating a willingness to create a modern Risk Based Capital system for credit unions. A final rule that takes into account the comments and concerns of responding credit unions will be viewed positively by credit union leaders.

However it is important to note that, this is a major rule that impacts all credit unions, not just those credit unions that are no longer considered adequately or well capitalized. Credit unions that are above 10.5% will have to reevaluate their balance sheets, and nearly all credit unions are concerned about the provision that allows NCUA examiners to unilaterally designate them undercapitalized. CUNA estimates that this proposal would require credit unions to raise $7.3 Billion to be in the same capital position that they were in prior to the rule taking effect in current form.

We appreciate the work and thought that the NCUA's Steve Farrar, Tim Segerson, Larry Fazio, and others put into the first draft of this proposal, and commend them for seeking input from state regulators. Solarity was disappointed that the NCUA did not seek industry input through an Advanced Notice of Proposed Rulemaking and has not been willing to extend the comment period. The courtesy of allowing credit unions additional time for review would be a demonstration of goodwill.

Solarity believes that the creation of collaborative industry/regulator workgroups organized by the NCUA has led to an improved rulemaking process, and we strongly encourage the NCUA to continue using this highly effective process.

Credit Union Losses vs. Bank Failures

Banking regulators were required by Dodd-Frank to promulgate capital rules in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, of large, interconnected financial institutions. This section of Dodd-Frank does not apply to credit unions or their federal regulator the NCUA. Lawmakers recognized that credit unions do not pose a systemic risk to the banking system and had the capital to absorb losses during the financial crisis.

Credit unions are very different than banks and should be treated differently. Even the most complex credit unions have a different mix of products and services with far less exposure to high risk activities, such as trading, private equity, & counterparty exposure from derivatives and financing transactions. Furthermore exposure to commercial real estate and commercial industrial lending is minimal in comparison. Finally, credit unions do not have the same ability as banks to raise capital through high-risk channels. Credit unions are not-for-profit financial institutions that invest in their communities and in products and services that their members understand.

Of the federal financial regulators the NCUA stood out amongst its peers, demonstrating that the regulatory system in place for natural person credit unions was sufficient to whether a historic crisis. Programs were created and serious actions were taken but natural person credit unions required relatively little assistance and have seen very few, large failures. The majority of losses suffered by the NCUA were due to the failure of corporate credit unions, which had their capital standards increased appropriately.

By comparison, the losses and failures suffered by the FDIC were staggering. The FDIC insures almost the exact same number of financial institutions as the NCUA. However FDIC insured banks failed at a far greater rate than credit unions have since 2008, and losses from just one mid size bank failure, PFF Bank and Trust, exceeds the losses suffered by all natural person credit unions since 2008.

The NCUA chose to voluntarily make changes to the current Risk Based Capital system that:

> "is more consistent with the risk-based capital measure for corporate credit unions and the risk-based capital measures used by the **Other Federal Banking Regulatory Agencies**" (as stated in the NCUA summary of the proposed rule).

The other federal banking regulatory agencies capital rules were adopted to address the systemic failure of the regulatory system in place for banks, which required historic actions:

- Immediate congressional passage of (H.R. 1424) authorizing $700 Billion to recapitalize banks;
- A direct capital injection of $205 billion to 707 banks, many of which were small and midsized;
- Treasury purchasing $20 billion in preferred bank stock;
- The creation of Maiden Lane 1, 2, & 3, holding companies owned by the New York Fed; and
- The failure of 494 banks that caused total losses to the insurance fund that may well exceed $1 trillion.

Credit unions should not be punished for the inadequacies of the financial system in place for banks with a capital rule that addresses problems that do not exist for natural person credit unions. Only seven credit unions have caused Share Insurance Fund losses since 2008 in excess of $25 million. In each of those cases, the Office of Inspector General's Material Loss Report determined:

> "The NCUA could have prevented or mitigated the loss to the NCUSIF had it taken a more timely and aggressive supervisory approach."

The Northwest Credit Union Association, for which Solarity is a member, and their board of directors has adopted the following position statements regarding systemic risk:

> "The Association recognizes that very large financial institutions may pose systemic risk to the U.S. economy. The Association believes that credit unions do not pose this same systemic risk because of their more restrictive regulatory environment, risk-averse nature, and because of their lack of aggregate size in relation to total U.S. financial institution assets. The Association opposes the application of legislative and regulatory requirements designed to address systemic risk on credit unions."

The 10.5% Risk Based Net Worth requirement is not an equivalent standard. NCUA claims it is based on banks' 8% total risk-based capital ratio plus the 2.5% capital conservation buffer. However, the capital buffer is not part of the PCA buffer and does not affect the rating. The capital buffer also has an extended implementation period.

Credit unions already have pure capital to absorb losses that is far higher than what banks are required to hold, the final risk based capital rule should account for this in the RBC rule by adopting a single risk based calculation requirement for adequately capitalized which we believe should be 8%, and remove all references to well capitalized from the risk based rule.

Having a Risk Based Capital rule is important but it must be written for credit unions, not copied from bank regulations designed to address systemic risk, and then made even stricter. The proposed NCUA rule on Risk Based Capital is in direct opposition to our board position. We cannot support a rule layered over the top of existing regulation and designed to address systemic risk—a problem that does not exist for credit unions.

A modern Risk Based Capital system designed specifically for credit unions would include risk weights that reflect actual portfolio risk as well as access to supplemental capital.

Legal Hurdle

For years credit union leaders have advocated for a Risk Based Capital system, which is viewed as an important step to maintaining a competitive charter. In the Northwest, in the midst of the financial crisis, we pulled together a group of innovative thinkers and emerging leaders to make recommendations that would ensure that the credit union charter would remain competitive in the future. That evolution task force recommended a risk based capital system that would allow credit unions to count supplemental capital toward their net worth, recognizing that one without the other would actually add risk to the credit union system.

The NCUA is fulfilling half of their statutory obligation, ensuring the NCUA's risk based calculation is comparable to other federal regulators and takes into account all material risk, where 6% net worth may not provide adequate protection. The Federal Credit Union Act also requires the NCUA Board to take into account that credit unions do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers.

The NCUA's proposed Risk Based Capital standards discourages real estate loans which will not refinance, re-price, or mature within 5 years, member business loans, or investments with remaining maturities of more than 3 years. Basically the rule discourages the very lending activity that is the bedrock of the recovery, and would cause harm to communities, and credit union members alike.

Without access to supplemental capital, this rule has the potential to add risk to the share insurance fund, rather than protect it. The proposed rule encourages credit unions to purchase short-term assets with lower rates of return. As a result, less capital would be accumulated and portfolios with short durations would cause significant earnings volatility during future interest rate cycles. The proposed rule subjects credit unions to a capital measurement system that fluctuates based upon the Fed's interest rate policy which is not only a disservice but a violation of the NCUA's statutory obligation. Without access to supplemental capital, the rule as proposed does not meet the Federal Credit Union Act requirement.

The NCUA has an obligation to advocate for statutory changes that would allow credit unions to accept supplemental capital that counts towards net worth. This is a necessary component of a safe and sound risk based capital system that meets the statutory obligations set forth in the Federal Credit Union Act. Without this key provision the NCUA would actually be creating risk for credit unions. Fortunately the NCUA is not statutorily required to rush to adopt this rule and has the time to advocate for the appropriate statutory changes.

Alternatively the NCUA has the authority to allow credit unions to use supplemental capital to meet risk- based requirements because the risk based capital rules are regulatory not statutory.

Specific Concerns

Our most commonly shared opinion with other credit unions in the Northwest Credit Union Association is that risk weights do not seem to relate to any sort of historical loss analyses. A number of credit unions that have emerged from PCA have indicated that the risk weights do not correspond to losses that they suffered at the height of the economic crisis. Numerous credit unions have shared that the proposed rule would significantly impact their strategic plans and how they grow, even though they are well capitalized, this is particularly true for credit unions with less than $250 million in assets that need to grow in order to achieve economies of scale.

Definition of complex credit union:

Under current RBNW standard (§702.103) of NCUA's regulations, a credit union is defined as "complex" if "its quarter-end total assets exceed fifty million dollars." This standard should be increased to encourage mid size credit union growth. In the final liquidity rule the NCUA used an asset threshold of $250 million for the requirement to join the Central Liquidity Fund (CLF) or Fed Discount Window. Stating that:

> "credit unions over $250 million have a greater degree of **interconnectedness** with other market entities. When they experience unexpected or severe liquidity constraints, they are more likely to adversely affect the credit union system, public perception, and the **NCUSIF**."

The Federal Credit Union Act requires that the NCUA exempt non-complex credit unions from RBC requirements. As proposed in the rule the definition of a complex credit union captures 94% of all credit union assets. This was not the intent of the act. The proposed rule would adversely impact smaller credit unions, particularly those $50 - $250 million in assets, which may have to hire staff, figure out complex risk weights for residential mortgages, business loans, and other investments. Or alternatively might limit their loan offerings to plain vanilla investments which would have unintended consequences to the communities they serve. These smaller credit unions should be encouraged to grow and contribute to the financial well being of the communities they serve by offering a wide array of financial services.

Low-income-serving institutions are far more likely to be impacted than credit unions in general. In Oregon and Washington, 15% of designated Low Income Credit Unions (LICU) with assets of more than $50 million would drop from their current risk based capital category to a lesser category, and 4% would go from adequately capitalized to under-capitalized. LICUs, Minority Depository Institutions (MDI), and Community Development Financial Institutions (CDFI) are focused on serving higher-risk, underserved members who would be disparately impacted by the proposed capital rules, which discourage lending to the very individuals these institutions serve. Therefore, these institutions should be exempted from the final RBNW rule.

Another group that would be disproportionately impacted are MBL-grandfathered credit unions and their members. Many of these credit unions are located in rural areas and provide agricultural loans to businesses that are the backbone of their local economies. These credit unions maintain higher concentrations in their business loan portfolios and would be penalized because of that concentration, rather than be judged by their expertise and risk-mitigation tools. MBL-grandfathered credit unions should have a 100% risk weight applied to their entire MBL portfolios, with the exception of Construction and Development loans that could be weighted at 150%, due to the inherently higher risk of this specific activity.

Individual Minimum Capital Requirements & 1250% Risk Weight

Two specific aspects of the rule that causes concern for Solarity are the Individual Minimum Capital Requirements and the 1250% Risk Weights. The discretionary elements of these provisions of the rule are highly concerning.

The Individual Minimum Capital Requirements provision giving NCUA the ability to require credit unions to hold additional capital is unnecessary and should be removed. The NCUA currently has the ability to reclassify a credit unions net worth under §702.102b. The current requirement makes it clear that reclassifying a credit union is a board action that requires a hearing, is not delegable, and in the case of state charters requires cooperation with state regulators. The proposed MCR provisions should therefore be removed from the proposed rule as it allows the NCUA to take a significant action with fewer safeguards.

The 1250% risk weight on an asset-backed investment for which an examiner determines a credit union is unable to demonstrate a comprehensive understanding of the features is concerning in that a number of examiners do not have the requisite expertise to make that type of judgment. Only a capital markets specialist should have the ability to make a recommendation reclassifying an investment and should assign a risk weight based on actual risk, that decision should then be reviewed by the regional director.

Allowance for Loan Losses

Allowance for loan losses in their entirety should be included in the capital calculation. Limiting the amount of ALL reserves that can be counted toward capital is a disincentive to making contribution in excess of what counts towards capital, yet the NCUA continues to bring up ALL contributions in nearly one third of credit union exams as an area of concern.

NCUSIF Capitalization Deposit

The treatment of the NCUSIF capitalization deposit should be modified to reduce the negative impact on risk based net worth. Under the proposed rule, net worth is reduced by the amount of the NCUSIF capitalization deposit (which is also removed from assets). This effectively treats the NCUSIF as if it has been fully expensed by the credit union. Recent events have shown that there is significant risk in participating in the NCUSIF for credit unions; however this risk is not consistent with the effective risk weighting for this asset as a result of this treatment. Furthermore, the effective risk weighting does not account for any risk mitigation provided by the proposed rule. The introductory comments indicate this treatment is to address the fact that the NCUSIF deposit is shown as an asset on credit union balance sheets and also as equity in the NCUSIF balance sheet. Since it is refundable to credit unions, it must be an asset and the accounting concern resides on the NCUSIF balance sheet. A more appropriate treatment might be to treat it like perpetual capital and include it in category 8—200% risk weight.

CUSOs

The NCUA's final CUSO rule differentiates between complex CUSOs and basic CUSOs. The RBC rule should therefore assign risk weights that recognize these differences. The risk weight assigned to CUSOs is excessive and should be lowered. Credit union investments in CUSOs are limited by existing rules and most CUSOs operate to supplement credit union services and have low risk of substantial loss. Furthermore, large investments in CUSOs by credit unions are likely to be accounted for under the equity method, which requires recognition of the value of the investment through the income statement. Finally, the NCUA's final CUSO rule issued last year differentiates between complex CUSOs and basic CUSOs. The RBC rule should take these factors into account.

Real Estate

Residential real estate loans should have a lower risk weight for qualifying mortgages. BASEL standards specify a 35% risk weighting for certain residential property secured loans. For example, loans that are owner occupied, below 80% loan to value, fully documented, and not delinquent should receive a lower risk weight than 50%. At the very least, qualifying mortgages should be exempted from the higher risk weights as the percentage of assets increases.

Loans Transferred with Limited Recourse, is pulled from the related Call Report field and is problematic in that it assigns exposure to the credit union equal to the total principal balance of loans transferred, instead of merely recognizing the small percentage for which the credit union has recourse liability. We believe this was an oversight and that it will be addressed prior to finalizing the rule

Life Insurance Contracts

Life insurance contracts (credit union owned life insurance) are not segmented in the proposed rule. Under the BASEL standards life insurance is treated as a corporate claim and is risk weighted based on the rating of the insurer. These are low risk investments with a high level of risk mitigating regulation, a lower risk weight for highly rated insurers would be more appropriate. BASEL standards use a 20% risk weighting for AAA to AA- rated insurers.

Investments

The investment risk weighting criteria should be expanded beyond weighted average life to reflect the actual risk of the investment. The proposal makes minimal distinction between amortizing and bullet investments or agency backed or private label securities. The difference in treatment between Treasury investments and GSE investments does not make sense. (A credit union can hold a 30-year Treasury note with no capital, but a 5-year agency bullet requires 21% capital to be well-capitalized.) The treatment of agency mortgage-backed securities also defies logic. A mortgage in a credit union portfolio has a 50% risk weight (with full credit risk) while the same mortgage in an agency mortgage-backed security (with limited credit risk) has 75% or 150% risk weight. NCUA should modify this part of the proposed rule into multiple options. Basic credit unions that so desire could continue to use weighted average life for simplicity, while complex credit unions with diversified investment portfolios could choose to report additional data including credit quality (full faith and credit, GSE, or private label) and effective duration to more accurately capture the risk characteristics of the investment portfolio.

Conclusion

Credit unions do not operate under the transactional banking model. We provide relationship-based financial services to our members. Not only do credit unions know their members, but are a part of their communities. This is another factor that makes credit unions inherently less risky and is not accounted for in the risk weightings of the proposed rule.

During our recent regulatory advocacy committee meeting it was suggested that **increased data collection beyond what is currently required in the call report would be preferable than being required to hold more capital than is actually necessary.** For example, weighting investments solely by weighted average life fails to properly segregate the risks of various investments. Loans could also be segmented further for risk weighting.

We appreciate that the NCUA assigned a 75% risk weight to credit union consumer loans, while other financial regulators assign a 100% risk weight on consumer loans. In this instance they recognized that credit unions are by design more risk averse because they don't have to satisfy shareholders. This approach to risk weighting should be the norm not the exception.

In conclusion we ask that:

1. The NCUA to revise their methodology for determining the 10.5% risk weight to be well capitalized, remove the well capitalized definition and;
2. Provide credit unions a final rule that includes access to supplemental capital or at a minimum counts supplemental capital for RBC purposes and;
3. Revise the asset threshold for which RBC applies to more accurately reflect complex credit unions, exempt LICUs, MDIs and CDFIs which could be disparately impacted by the rule and;
4. Remove the IMCR provisions since the NCUA already has the authority under §702.102b, with appropriate safeguards to reclassify a credit unions net worth and;
5. Fix technical issues with ALL, SIF deposit, CUSOs, Real Estate, Life Insurance Contracts, Investments and Derivatives Contracts.

We appreciate that the NCUA waited until the FDIC finalized its BASEL III proposal for banks, before proposing their own RBC rule. We support a risk based capital system designed from the ground up for credit unions, not layered over the top of existing regulation.

Once again we believe in the leadership of chair Matz, board member Metsger, board member Fryzel, and their willingness to address valid concerns. Solarity supports a Risk Based Net Worth system designed specifically for credit unions. We hope that our suggestions, comments and concerns, help the board create a RBC system that is tailored for credit unions.

Solarity appreciates the opportunity to submit comments on the proposed stress testing and capital planning rule. We appreciate the NCUA's commitment to improving the regulatory landscape for credit unions. Thank you for the opportunity to comment on this issue. We would be pleased to answer any questions you may have.

Respectfully,

Matthew Russell
Chief Financial Officer
Solarity Credit Union