May 27, 2014

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

Sent via email to: regcomments@ncua.gov

RE: Comments on Proposed Rule: PCA - Risk-Based Capital; RIN 3133-AD77

Dear Mr. Poliquin,

On behalf of the Board of Directors of Dupaco Community Credit Union, I am writing to provide feedback and express concerns over the National Credit Union Administration's proposed Risk-Based Capital (RBC) rule RIN 3133-AD77. While we don't disagree that some form of risk-based capital provisions may be warranted, the current proposal would weaken Dupaco Community Credit Union's ability to meet members' needs and ignores key risk-mitigating considerations built into our proven business model.

BACKGROUND AND PERSPECTIVE

As a matter of perspective, Dupaco Community Credit Union was chartered in 1948 and:

- Serves residents in 42 counties throughout eastern Iowa, northwest Illinois and southwest Wisconsin;
- Membership totals more than 82,000;
- Assets exceed $1.2 billion;
- Current Regulatory Capital to Asset ratio is 12.71%;
- Earned a 194 basis point Return on Assets (ROA) in 2013;
- Has offered member business loans since 1982;
- Established a full service mortgage lending department in 1989;
- Introduced financial planning services in 1985 and subsequently incorporated a financial services CUSO in 1997;
- Offers a full line of trust products and services through a strategic alliance with First Community Trust, N.A. established in 2000;
- Has offered full service personal and business insurance services through the CUSO, starting in 2006;

Dupaco is a strong community-based lender and one of the area's leading providers of long-term fixed rate mortgage loans sold into the secondary market and serviced locally. In addition, we have provided member business lending since the early 1980s and, as a result of our longstanding success with minimal losses, we were granted a waiver from the 12.25% of assets cap imposed on credit union member business lending as part of the Credit Union Membership Access Act (HR 1151), which was signed into law in 1998.

Over the years, Dupaco has successfully managed a growing investment portfolio comprised predominately of targeted pools of amortizing GSE Securities with the implicit backing of the U.S. Government. This portfolio has provided the credit union tremendous cash flow to help mitigate rising interest rate risk and helped us to earn spread income which has allowed Dupaco to build capital throughout periods of substantial growth all while paying above market rates to our savers.

As part of our vision to be our member's lifetime financial home, Dupaco has also invested in CUSOs which allow us to become a one-stop shop for our members. This has allowed the credit union to deepen relationships by providing access to a full line of investment and insurance services, all while helping generate critical non-interest income. This CUSO strategy has proven attractive to a number of small credit unions from within our charter area as they have opted to merge with Dupaco in order to enhance service to their members in a more expeditious fashion than attempting to add such services over time. These strategic mergers have helped us build scale and further strengthened our financial cooperative despite temporarily diluting capital at the time of the mergers.

When one examines the success of Dupaco's business model in terms of positively impacting member lives, serving communities and operating a strong and viable entity and contrast that with the proposed RBC rule's attempts to mitigate risk in a one-size fits all approach, Dupaco has genuine concerns.

Dupaco feels that should the proposed RBC rule be implemented as is, over time, leadership will be forced to manage the operation much differently, all at the expense of the members we serve and those in the community we seek to lift up through ongoing free financial education, small dollar loans, individual development accounts (IDAs) and more.

Furthermore, by being encouraged to manage away from our proven areas of expertise toward what is perceived by our regulator to be more safe and sound, NCUA will in actuality be moving the credit union away from our model which has proven to be sustainable, scalable and highly profitable for members.

Instead, Dupaco will be forced toward an approach where our ability to generate sufficient earnings to reward members while still allowing us to reinvest in the operation and build capital will be severely limited. This scenario is so troublesome to our Board of Directors that–despite our strong belief and pride in being true blue credit union to our very core–our board and management realize we have the fiduciary responsibility to evaluate all options on how best to serve members. This could include the transition to an alternative financial charter, which will be less severe in forcing change on our proven business model.

SPECIFIC CONCERNS

With this high level overview in mind, our specific concerns with the Risk-Based Capital (RBC) proposal may be best summarized as follows:

- The current proposal is a one size fits all model that does not take into consideration credit union specific risk mitigating factors, such as management, historical performance and financial trends, and current level of safety and soundness. This is particularly relevant as it relates to the longstanding success of our business model in areas where the proposed risk weights are most severe relative to those assessed on banks on the same assets such as member business lending, CUSOs, real estate, and investments.
- Current NCUA regulations such as the interest rate risk rule, concentration risk and the liquidity rule already provide a sufficient regulatory framework. Therefore, these frameworks should not be intermingled with the risk-based capital calculation.
- The proposed 10.5% well-capitalized threshold is the same as banks, yet the banks have the ability to raise secondary capital to help comply whereas credit unions do not.
- With secondary capital not available to credit unions, the proposed 18-month phase in time for implementation for credit unions is far too short. Small community banks have a 9 year phase-in period through 2019 before required to be fully compliant with regulatory capital requirements.
- If unchanged, this proposal would inflict much higher capital requirements on the CU system than the overall level of risk warrants based on historic performance.
- The proposal gives the NCUA examination staff the ability to impose higher capital ratios depending on the risk assets and operations. This is problematic in that the consistent application across all field examination staff will be difficult and can be further exacerbated by rogue examiners who have the latitude to impose additional capital requirements in retaliation for conflicts with credit union boards and/or management.
- Credit unions must know the standard they're managing to in terms of capital. Allowing subjective authority to examiners in the field to arbitrarily establish capital guidelines higher than proposed guidelines eliminates that standard. Including such a provision creates uncertainty and difficulty for our staff and board and prevents us from effectively managing the financial institution on behalf of our members.
- The current proposal does not recognize distinct differences between credit unions and provide regulatory relief to the strongest entities. By our view, credit unions which are adequately collateralized on both net worth and RBC should receive additional regulatory flexibility. Examples could include fixed asset exemptions, member business loan blanket waivers with proven expertise, or an elongated 18 months between exams.

DIRECT IMPLICATIONS

In addition to the aforementioned concerns about the proposal, the direct implications to Dupaco are as follows:

- For a number of years, our Board of Directors has successfully sought to retain our capital to asset ratio in excess of 11%. This gave us a cushion of more than 4% over the current Prompt Corrective Action (PCA) well capitalized ratio of 7%. Currently our regulatory capital ratio stands at 12.71% and we have a 571 basis point cushion on total assets over what is constituted as well capitalized. In the eyes of our board, this substantial cushion allows us the latitude to capitalize on growth opportunities such as mergers as they present themselves and ensure that we are well protected in the event of unexpected losses in member business lending. Under the proposal of 10.5% for well capitalized, Dupaco would see our cushion shrink by a total of $42,294,901 if the proposal were in effect today. In addition, our aforementioned 571 basis point well capitalized cushion on total assets would decline to 234 basis points.
- Stated another way, Dupaco currently has an 84% cushion over the minimum required for well-capitalized under PCA at 7%. To maintain this same level of cushion under the risk based capital proposal, the capital ratio must be at least 19.32%. This equates to $75 million in additional capital to maintain the same cushion as we have today. We lose 62% of the cushion we have established.
- Should the RBC proposal be implemented as drafted, our members will be negatively impacted through modified loan and deposit pricing strategies necessary to further grow our capital to "replenish" the cushion we will lose should the new standards be put into place. In addition, we will likely need to look at increased fees or reduced services in order to boost net income to raise capital.
- The Dupaco Board of Directors firmly believes that full service is what is needed to survive and thrive in the future. Full service includes the offering of mortgage loans, business loans, and CUSO services such as financial planning, insurance, and trust services. If credit unions are not allowed to serve their members but are forced to manage the credit unions to broad brush of the RBC proposal, we run the risk of moving away from full service and more towards only traditional financial products and services. This makes Dupaco less viable as financial services alternatives, less diversified, less valued, and creates an opportunity to marginalize and lessen the perceived sophistication of credit unions as a whole.
- The current proposal is prohibitive to our long-term growth strategies, particularly relating to mergers which would negatively impact our capital to asset ratio.
- The proposal is prohibitive to our interest rate risk and ALM strategies.

RISK WEIGHTINGS

Specifically relating to the proposed risk weightings, Dupaco has the following observations and concerns:

- **CU vs. Bank Weighting:** With the exception of consumer loans and subsidiary investments, the proposal's risk weights are the same as or higher than the risk weights applied to community banks under Basel III. For residential mortgage loans and member business loans – the weights are double the comparable Basel weights. These weightings are exceptionally high considering the fact that credit union losses trend about half the loss rate for community banks. In addition, on risk weighting consumer loans, there is no distinction on whether loans are secured or unsecured.

- **Allowance for Loan and Lease Losses:** The numerator provision of the proposal implements a cap of 1.25% of total risk weighted assets for the Allowance for Loan and Lease Losses (ALLL). This is concerning as the determination for the amounts of the ALLL should be based upon management's current estimation of the credit risk inherent within the credit union's loan portfolio. Dupaco considers all known and relevant quantitative and qualitative factors, both internal and external, which could impact collectability. This proposal penalizes management's ability to appropriately quantify the risk inherent in the portfolio. In addition, there is no credit given within the denominator for the ALLL. Dupaco would suggest that the ALLL should be backed out of the corresponding risk asset categories to more accurately reflect the reserve amounts already established based on the assessment of credit risk within the portfolio.
- **National Credit Union Share Insurance Fund:** The proposed regulation excludes the 1% deposit each credit union makes to the National Credit Union Share Insurance Fund (NCUSIF) within the risk-based capital calculation. This deposit in the NCUSIF is considered an asset under Generally Accepted Accounting Principles (GAAP). This asset is of significant value to the credit union as it represents the presence of federal deposit insurance and safety and soundness to our membership. Excluding this deposit inappropriately lowers the risk-based capital position of the credit union.
- **Federal Reserve Deposits:** The proposed rule is inconsistent as credit union deposits in the Federal Reserve Bank has a 20% risk rating while Treasury Bills and U.S. government obligations have a 0% risk weighting. Dupaco believes that the Federal Reserve Bank deposits risk weighting should be 0%.
- **Investments:** The proposed risk rating for long-term investments only addresses interest rate risk concerns and does not take into consideration the asset liability management strategy of the credit union as the proposal is based solely on maturity. Dupaco's current ALM testing considers the funding of investments using the standard NEV volatility testing to determine if there is a mismatch or excessive risk to the balance sheet as a whole. To risk-weight the investment portfolio for interest rate risk in isolation of the other moving parts of the balance sheets, including consideration given to investment expertise and sophistication, is inconsistent with daily ALM decisions and modeling practices. In addition, the risk weightings imply that funding various loan risk assets on balance sheet is not as risky as funding an investment with an implicit government guarantee. For example, a portfolio of 30-year, first mortgage loans with less than 25% of assets has a risk weighting of 50%. This same asset class alternatively purchased within a GSE security with a weighted average life of five to ten years is risk-weighted at 150%, even though there is no default risk. Furthermore, a member business loan with a seven-year balloon and with member business loans less than 15% of assets is assigned a 100% risk weight. Compare this to a seven year bullet agency security that is assigned a 150% risk weighting, with no credit risk. Dupaco finds these comparisons

between asset class to be problematic and the true risk to the organization is not properly reflected in the proposal.

- **1st Mortgage Real Estate Loans:** Although Dupaco has consciously restricted our concentration and avoided booking first mortgage real estate loans over 10 years. Were our balance sheet strategies to change in the future Dupaco would question the fact that real estate weights are double those required by banks under their Basel III rules.
- **Loans Sold with Recourse:** Dupaco's strategy for serving member mortgage needs has predominately been to work with Fannie Mae and Federal Home Loan Bank (FHLB) to provide our members with long term fixed rate mortgages serviced by the credit union. Under the current proposal, it is our understanding that our MPF serviced loans would fall into the "Loans With Recourse" category due to the credit enhancement (risk sharing) with FHLB. If this were the case, it should be noted that these loans would have two institutions holding capital on the same assets. In addition, while first mortgage loans are reserved at 50%, Loans Sold with Recourse is reserved at a 75% conversion factor with a 50% risk weighting for total reserving of 37.5%. This strikes the credit union as being excessively high.
- **Mortgage Servicing Rights:** Under the proposal, mortgage servicing rights are reserved at a 250% risk weighting which Dupaco again feels is excessively high. Mortgage servicing rights also include no distinction on whether the fair market or amortized valuation method is used despite the fact that the two are substantially different.
- **Member Business Loans:** For nearly four decades, Dupaco has developed extensive expertise in the area of member business lending as part of our strategy to productively put member deposits to support area businesses and enhance the communities in which we operate. The graduated risk weighting of 1.50% based on concentration in excess of 15% and a risk weighting of 2.00% for concentrations in excess of 25% would restrict small business loan growth in communities served by credit unions such as Dupaco with proven expertise in member business lending. As previously mentioned, Dupaco has a high concentration of member business loans due to an exemption from the business loan cap. Management's long-standing expertise in this area, as evidence by strong portfolio performance and historical performance metrics; in addition to underwriting standards, regional specific data and trends, and risk mitigation practices, are not taken into consideration by the calculation. Therefore, Dupaco is penalized and required to hold a larger reserve percentage purely on concentration. The concentration risk framework previously adopted by the credit union adequately addresses concentration risk and therefore should not be duplicated within the risk based capital standards. In addition, Unfunded Business Loan Commitments are also risk weighted at 100% with a 75% conversion factor, despite the absence of advances.
- **Investment in Credit Union Service Organizations:** Credit Union Service Organizations (CUSOs) provide the ability to offer enhanced services to serve members outside of the authorized credit union products and services. The 250% risk weighting for CUSO's would limit CUSO growth opportunities, therefore potentially reducing or eliminating these services altogether for members. CUSOs also offer a diversified source of income and are not only important to our future but given our inability to raise capital they are a critical tool used today to help build

capital, strengthen member relationships, therefore providing protection to the share insurance fund. Setting a blanket risk-weighted percentage of 250% on CUSO s regardless of the following seems problematic. Dupaco feels that it would be more appropriate for NCUA to assign CUSO risk ratings which factored in the following:

- Length of CUSO time in business
- Complexity of CUSO
- Type of services offered by CUSO
- Existing regulations of the CUSO (Financial Planning/ insurance Commissioner)
- Management of the CUSO

Based on the factors noted above, in addition to the collaborative nature of and risk sharing with our CUSOs, we believe a 100% risk-weighting factor applied to CUSO's would be more appropriate as the current regulations are clear that the maximum liability a credit union can incur in a CUSO is limited to the amount of its investment or 100%.

CLOSING

The bottom line is that NCUA's proposed risk-based capital formula would weaken Dupaco Community Credit Union's ability to meet members' needs and place us at a competitive disadvantage with banks. The arbitrary risk weights also ignore key risk-mitigating considerations built into our proven business model which are impossible to address with a one size fits all approach.

For these reasons, the Board of Directors and management of Dupaco Community Credit Union urge NCUA to reconsider the current proposal to ensure that credit unions like Dupaco do not fall victim to unintended consequences which – in the name of further mitigating risk in an already strong industry – negatively impact member service and ultimately weaken the entire credit union movement.

Sincerely,

Joe Hearn
President and CEO