CALTECH EMPLOYEES
Federal Credit Union

May 28, 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:

Caltech Employees Federal Credit Union (CEFCU) appreciates the opportunity to comment on the National Credit Union Administration (NCUA) Board's proposal ("Proposal") to revise Prompt Corrective Action related to Risk-Based Capital. CEFCU primarily serves employees of the California Institute of Technology, Jet Propulsion Laboratory and their affiliates as well as immediate family members. CEFCU is a $1.3 billion credit union serving over 31,000 members.

CEFCU generally supports the need to modernize credit union capital standards by the introduction of risk-based capital requirements (RBC), however, the current Proposal will have negative effects not only for CEFCU and our members, but will affect the viability of the entire industry over the long term. Despite the attempt of NCUA to propose a well-intentioned regulation, far too many concerns are present. The proposed 250% risk-weight for investments in CUSO's is arbitrary and excessive. The proposed risk-weights for non-delinquent 1st mortgage real estate loans are too high and penalize too many credit unions. NCUA's proposed risk-weights for MBL's are punitive for credit union's who have performed admirably while carrying out their historically chartered purpose. However, with over 1,000 comment letters having been filed to date, CEFCU will offer some general comments as well as focus on a few of the proposed risk-weightings that would directly impact CEFCU.

With a loan to share ratio of 26%, a net operating expense ratio of .84%, 66 employees and only 3 branches; CEFCU has a unique business model and must rely upon the investment portfolio for the majority of interest income. CEFCU has a large concentration of US government agency mortgage backed securities on the balance sheet. These securities are highly liquid and act as loan surrogates for the credit union. We believe the Proposal, if adopted in the current form, would discourage investments of this type and ultimately result in lower earnings and impact our ability to meet our mission of providing "superior value" to our members in the form of attractive deposit and loan rates as well as providing value-added benefits to our membership. CEFCU currently utilizes a "barbell" strategy to invest on the longer part of the curve to improve earnings, while utilizing floating rate securities tied to the shorter part of the curve as a hedge against rising interest rates.

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GENERAL COMMENTS

CEFCU does not support a rule that requires a credit union to maintain more capital for a specific asset class then a bank. The Proposal arbitrarily burdens the credit union industry by assuming that many types of assets are riskier when held by credit unions rather than by banks. By demanding that credit unions hold far higher reserves to hold the same types of assets, the Proposed Rule would handicap our entire industry, thereby harming credit unions, their members, and the competitive landscape.

CEFCU believes that asset classifications should have the same risk-weight regardless whether the asset is held by a bank or credit union. CEFCU is asking the NCUA to revise the proposed risk-weightings to align the capital requirements significantly closer to the BASEL III standards. CEFCU believes that the NCUA has ample tools to provide oversight on Interest Rate Risk (IRR) and it is overkill to incorporate IRR in the new RBC standards.

CEFCU has survived many different interest rate cycles over the past 60 plus years and has ample liquidity to meet the challenges that lie ahead. We have a large percentage of assets in floating rate securities that will reset should short term interest rate rise. CEFCU has paid a heavy price by holding these low yielding assets over the past 6 years in form of lost revenue that could have helped CEFCU provide more value to our members.

RISK-WEIGHTING COMMENTS

The Proposal assigns higher asset risk-weightings than BASEL III in all but one asset category. In some cases, NCUA places much higher asset risk-weightings than BASEL III. Under the Proposed Rule, credit union risk-weights would be higher than that of banks requiring credit unions to hold more capital than banks for the same assets. This is a major concern to CEFCU, as it would place credit unions at a competitive pricing disadvantage in an already highly competitive marketplace.

In addition, insisting on using higher than BASEL tiered risk-weightings on real estate loan assets in an effort to address concentration and interest rate risk is not reflective of the true interest rate risk and valuation loss exposure by not considering variable rate real estate loans or loan-to-values.

Cash Held at the Federal Reserve

CEFCU maintains a substantial deposit balance at the Federal Reserve as an alternative to short term investments and as a source of liquidity. Under the Proposed Rule, cash balances being held at the Federal Reserve are given a 20% risk-weighting. Given that the Federal Reserve has been designated as a source for emergency liquidity for the entire credit union industry, there appears to be little risk in holding a cash balance at the Federal Reserve. Under Basel III, central bank reserves are deemed to be highly liquid assets and therefore carry a 0% risk-weighting. CEFCU believes cash balances being held at the Federal Reserve should be given a 0% risk-weighting in the final version of the Rule.

<u>Investments</u>

Under the Proposed Rule, investment risk-weightings for credit unions are significantly higher than that of banks. BASEL III assigns asset risk-weightings based on collateral types and the guarantees associated with the securities. On the other hand, NCUA's Proposal assigns asset risk-weightings on investments based on Weighted Average Life of the securities. The NCUA risk-weights appear punitive and somewhat inconsistent when comparing interest rate and credit risks in loan assets and the BASEL standards. The over weighting puts credit unions at a disadvantage which will ultimately lead to a critical reduction in earnings as well as added capital requirements.

The Proposal assigns a 0% risk-weighting to all US Government direct obligations (including US Treasury securities), as well as those securities guaranteed by the NCUA or FDIC, no matter what the final maturity. Other Agency backed securities with no credit risk, such as Fannie Mae and Freddie Mac, are risk-weighted based on weighted average life, which is inconsistent in measuring interest rate and liquidity risk. In theory, CEFCU could own a 30 year US Treasury obligation with no capital requirement. In contrast a US Government agency Mortgage Backed Security (MBS) with a 5 year weighted average life carries a 150% asset risk-weighting. What is the rationale behind such a glaring differentiation?

Investments with weighted average lives greater than 5 years are given punitive risk-weights of 150% for 5 to 10 year average lives and 200% for average lives greater than 10 years. This compares to 20% risk-weightings for similar securities in the banking model. In addition, a 30 year real estate loan mortgage on CEFCU's balance sheet would carry a 50% risk-weighting while securitizing the same loan into a 30 year FNMA security, with enhanced liquidity, would carry a 150% risk-weighting. Clearly, a FNMA 30 year MBS has lower credit risk and is much more liquid than a member loan and therefore should carry a lower risk rating!

CEFCU believes the final version of the Rule should more closely mirror BASEL III risk-weightings for investments (which are market commodities) to correct the Proposal's inconsistency. By adding the additional risk-weightings above the BASEL standards, the proposed asset risk-weightings fail to consider whether interest rate risk is balanced with the credit union's Asset Liability Management as a whole.

In order to be consistent, the Proposal should also include Small Business Administration (SBA) pools, GNMA backed investments, and other US Government direct obligations at 0% risk-weighting – as under BASEL.

Real Estate Loans

The Proposal increases the risk-weightings assigned to 1st Mortgage Loans as their concentrations as a percentages of total assets increases. BASEL III assigns a 50% asset risk-weighting on 1st mortgage loans regardless of their concentrations.

Under the Proposed Rule, no distinction is made on the risk-weightings assigned to mortgage loans of various maturity and re-pricing terms. A 30 year fixed rate mortgage gets the same risk-weight as a one year adjustable rate mortgage and a 20 year fixed rate home equity loan gets the same risk-weight as a variable rate home equity line of credit. This does not make sense. As opposed to implementing risk-based capital standards that unfairly combine all mortgage loans together there should there be more diversity in the risk-weighting if the NCUA is going to insist on tiered risk-weighting levels.

CEFCU's balance sheet is well positioned for a rising rate environment. Mortgage loans that are being held in the balance sheet are diversified in structure and prudent limits have been established for longer term fixed rate mortgage loans as well as limits for all mortgage loan categories. Under the Proposed Rule, there would be no difference between CEFCU's capital requirement for its diverse mortgage portfolio and the capital requirements for a credit union that holds all 30 year mortgages in the balance sheet.

CEFCU believes 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.

The Proposal assigns asset risk-weightings of 100% to 150% for 2nd trust deed loans depending on the concentration of those loans as percentages of total assets. BASEL III assigns only a 50% asset risk-weight on those loans regardless of concentration. The proposed asset risk-weightings seem excessively punitive for credit unions that provide home equity loans to members – in its current form the Proposal suggests that unsecured consumer loans are lower risk than real estate secured seconds. This is not the case when reviewing historical loss ratios.

INDIVIDUAL MINIMUM CAPITAL REQUIREMENT

Under the proposed rule, NCUA would have the ability to require a higher minimum risk-based capital ratio for an individual credit union. This could be in any case where NCUA subjectively determines that the circumstances may require a higher minimum risk-based capital level. In other words, despite regulatory requirements and mandates, NCUA can simply change the rules for an individual credit union. A complex and sophisticated investment portfolio, such as CEFCU's portfolio, could easily be pidgeon-holed into this circumstance despite prudent, thorough, analyzed, and well-managed practices. Having such discretionary authority in the regulation undermines the entire purpose of the rule. This section should be removed from any final rule.

IMPLEMENTATION

The Proposal has an 18-month implementation time frame for credit unions to comply with the new Risk-Based Capital requirement. This does not allow for adequate transition and is well short of the BASEL III five-year implementation period for banks. Once the Proposal is finalized and implemented, credit unions will need time to adjust business models to comply with the new regulatory burden. We believe an 18-month implementation period does not give credit union managements and board members ample time to make sound decisions.

As a result, we believe that NCUA should allow credit unions the same amount of time to fully implement the Risk-Based Capital requirement as our counterparts in the banking industry.

SUMMARY

We believe that this Proposal in its current form will be a detriment to CEFCU and the entire credit union industry. This rule, as proposed, will only serve to accelerate the decline in the number of natural person credit unions. This proposed rule needs to go back to the drawing board and the NCUA should embrace credit union input before the 2nd draft of this rule is released. Although we support the general spirit of the Proposal, we believe there are major modifications needed to allow the credit union industry to stay competitive versus the banking industry.

We urge the NCUA to reconsider the content and parameters of the Proposal. We also urge the NCUA to create a Risk-Based Capital proposal that is more aligned with BASEL standards rather than imposing capital requirements in excess of BASEL.

CEFCU believes that with modifications to the Proposed Rule based on objective criteria, the final version of the Risk-Based Capital Rule could, in fact, be a significant improvement over current Risk-Based Net Worth requirements. The NCUA's efforts to modernize credit union capital standards are certainly well-intentioned. However, much work is left to be done. Thank you for the opportunity to comment on the Proposed Rule.

Sincerely,

Richard L. Harris
President/CEO

John K Meeker
Senior Vice President/ CFO