May 23, 2014

NCUA Board of Directors
Arlington, VA

Today I am writing to share the thoughts of INOVA Federal Credit Union on the Risk Based Capital proposal. Let me start by saying that we believe that a well-designed Risk Based Capital Rule could be an improvement over the current static capital requirement that is mandated by statute. However, the combination of two capital regimes and, in particular, certain aspects of the Proposed RBCP present real and potentially damaging implications for both our credit union and our industry. I will provide some specific concerns and their impact on our credit union and our members later in my response.

First let me share a bit about INOVA FCU. We were originally chartered in 1942, just a decade after The Great Depression, by employees of Miles Laboratories in Elkhart, IN. Over the years as we grew more sponsor groups were added and regrettably our core sponsor, Miles, sold to Bayer and discontinued operations in our area. This increased the pressure for us to add still more groups to ensure that we were a viable option for the people of modest means in our community. Fast forward to today, Elkhart is a largely manufacturing based economy with a major concentration in Recreational Vehicle manufacturing. This makes us particularly susceptible to swings in the economy and in fact during the "Great Recession" we had the dubious distinction of having the highest unemployment in the United States, over 20% at one point, leading the Wall Street Journal to call Elkhart "the white hot center of the economic meltdown."

It is with great pride that we are able to say that we remained profitable for all but one year during this difficult time and that our capital ratio never went below the "well capitalized level" currently used. This meant that we had to use all of the tools at our disposal to manage our balance sheet and ask our members to bear with us and make sacrifices on the dividends we paid and the fees that we charged. Their confidence in us and our willingness to make the difficult choices is what brought us through the worst economy that most of us have ever seen in the hardest hit area of the country. All the while, banks and credit unions around the country were failing at record rates. We believe that had this capital regime been in place, as currently written, at that time we likely would not have been able to make the decisions that brought us through that recession.

Allow me to share some concerns regarding the proposed risk weights and why they may not be workable:

- Investments as currently weighted will cause specific problems for some credit unions when the next financial crisis arises. As currently constructed the weights seem to assume that long term investments cause more risk than short term investments. While this may be true from an interest rate risk perspective in a rising rate environment, it has not been over the past decade of global recession and extremely low rates. Had a credit union with a 7 to 7.5% net worth ratio in 2006 needed to go longer on the yield curve to increase earnings to bolster their retained

earnings to avoid PCA because the flight to safety had begun causing balance sheets to grow, they would have potentially been unable to do so because the proposed rule would have penalized them on the their Risk Based Capital (RBC) requirements. At that time loan demand was weak, and they would have had few other options to increase earnings.

- As economic conditions improve, as they have been over the past few years, loan growth increases and the proposed loan weighting s will dramatically affect the types of credit that a credit union can offer it membership. The RBC proposal considers loans secured by real estate through a second mortgage to have just as much risk as credit card loans. Clearly this is not the case, especially given the post-recession restrictions on mortgage lending as a whole. Second mortgages should not be weighted any higher than 0.50 unless they are non-performing. There needs to be some recognition that the post-recession mortgage lending environment is dramatically more conservative than what existed prior to 2010 and that type of home value bubble is unlikely to reoccur under the new rules.
- The RBC rules would effectively marginalize CUs ability to provide quality first mortgage loans to their members, one of the most fundamental types of loans that the Federal Credit Union Act implies that CUs should be providing when it states "to provide credit for prudent and provident purposes." This restriction is caused by the confluence of several elements; first, in order to be able to create a quality mortgage loan program in today's highly regulated world, scale is vital. In order to ensure that both high quality mortgage lending staff and top notch software and compliance resources are available, a CU must invest heavily in this area and that can only be done through scale. The RBC would restrict the ability of many credit unions from serving their members because of the escalation of the risk weighting based on this concentration. It is true that too many long term fixed rate mortgages could be damaging in certain rate environments. However, this rule assumes that CU executives and NCUA are not capable of managing interest rate risk through other tools and regulations. The other very troubling area is the weighting for Servicing Rights. This weighting would discourage CUs from selling pools of mortgages and retaining the servicing because of the onerous 2.50 weight for this item. Clearly, this is in direct opposition to the intent of the aforementioned rule regarding concentration risk of mortgage loans, effectively making it "damned if you do and damned if you don't" to hold mortgages. The only remaining options to avoid the RBC penalties is to either not make mortgage loans to your members or sell all loans servicing released and leave your members at the mercy of an unknown entity to collect their payments and mange any problems that arise. Additionally the RBC rule would potentially cause CUs that retain servicing to take great risks by booking servicing assets at higher values at the date of sale because of the need for immediate income to bolster net worth. Let me explain: GAAP requires CUs to book an asset at the time of sale for the servicing rights. There is no specific right answer for this but rather a range of estimated values. So the higher the value that is booked the greater the serving income at the date of sale, but this also increases the possibility of impairment during the life of the asset. So many CUs, like INOVA, choose to take less income at the time of sale and book the asset at a lower and more conservative value. This means that we have reduced the probability of future impairment and that we will collect stronger cash flows in the future. But the new RBC

weighting of 2.50% would force us to harvest as much income up front to build our reserves immediately, a risk we would not otherwise take.

- The CUSO weighting also seems to be a one size fits all solution. For example INOVA has several CUSOs that are not intended to be revenue generating but rather just shells to provide a "corporate veil" and protect the credit union from potential loss. A good example is the fact that we hold some of our real estate and branches in CUSOs in the event that litigation would occur around one of these assets. In this case only the CUSOs assets would be exposed to potential litigation. Under the new rule we would have to move these assets directly onto our books and increase our potential liability needlessly. We also have a CUSO that acts as a pass through for providing tellers for a joint branch shared with another CU. Clearly this is no more risky than running one of own teller lines, however the RBC makes no distinctions. We do operate a CUSO that is a separate business line and may need to be weighted differently, but more thought must be given to how each CUSO should be assessed.
- Our investment in the CLF falls into the All Other Assets category and is given a weight of 1.00, this should be 0%. Why would our CLF investments have to be weighted the same as delinquent real estate loans?
- Our deposits with the Federal Reserve Bank are given a .20 risk rating because they fall in the investments of 0-1 years bucket. It seems to us that if the Federal Reserve fails we have much bigger issues than the RBC rule.
- The penalty for almost all government backed agency investments is so severe at 2.00 that CUs would be discouraged from effectively creating an ALM policy that addresses many interest rate environments.

In summary we feel that the rule as written creates far greater risks to credit unions than it solves. It would literally discourage CUs from providing the services that the Federal Credit Union Act mandates and will greatly impede our ability to fill the needs of our membership both in the areas of loans and deposits because of our inability to manage our balance sheet for the membership. We implore the Agency to reconsider the implementation of this rule. It will be very harmful to CUs and our ability to provide financial services to our members.

Respectfully,

Dallas Bergl
President & Chief Executive Officer
INOVA Federal Credit Union