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COMMUNITY CREDIT UNION

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Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration 1775 Duke Street
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RIN 3113-AD77

Re: Risk Based Capital Proposal

This letter is written in response to the proposed changes to NCUA regulations regarding risk-based capital requirements for federally insured "natural person" credit unions (Prompt Correction Action — Risk Based Capital). As currently drafted, we understand the Proposed Risk-Based Capital (PRBC) rule has three primary objectives:

1. Establish a risk weighting system that helps credit unions better absorb losses,
2. Replace the Risk Based Net Worth (RBNW) method with one that is more commonly applied to depository institutions worldwide, and
3. Use a framework for assigning risk weights that would promote a more improved understanding and comparison amongst all types of federally insured financial institutions.

While we support the NCUA's efforts to strengthen the current capital management framework, we are concerned that, as presently drafted, the PRBC falls short on meeting these objectives and will have unintended negative consequences for the credit union industry as well as its members and communities served.

The New Rule Remains Inconsistent with the Method Used for Depository Institutions Worldwide

The PRBC rule remains meaningfully inconsistent with the Risk-Based Capital (RBC) measures applied by the FDIC, Federal Reserve, and OCC. In general, the RBC rules employed for banks worldwide determine risk weights based upon the level of credit exposure assumed across an array of broad asset classes and contingent assets/liabilities. While the PRBC necessarily incorporates credit risk as a key element to determining capital adequacy, its proposed methodology and risk weights imply that interest rate risk poses a greater risk to capital than asset quality. For example, the new rules appear to be more punitive for assets with maturities deemed to be long term (e.g. 200% risk weight for 10 year+ government agency debenture) versus assets that present a higher degree of downside credit exposure (e.g. 100% for all delinquent first lien mortgage loans and 150% for all other delinquent unsecured loans).

This proposed approach is especially punitive to our credit union in that we have a material book of business in secured HELOC mortgages and possess sizable positions in bonds issued by government sponsored entities (GSEs). The RBC rule, as proposed, will continue to emphasize interest rate risk, not credit, in assessing capital exposure, which is in direct conflict with the Board's prescribed objectives.

Additionally, applying capital requirements based upon a measure that isolates "interest rate risk" on the asset side, while ignoring the counteracting term structure of a credit union's funding mix, is highly problematic.

While we fully appreciate that net economic value (NEV) risks can possibly lead to reduced capital surplus, it is important to acknowledge the fact that very few credit unions operate with an active trading book. Similarly, and more importantly, they do not and cannot "buy and sell" their balance sheets "at will." Rather, they operate as financial intermediaries that survive on spread income derived by managing the inherent illiquidity of local market lending and deposit gathering activities. In the context of the RBC rule, they are typically only subject to realizing asset gains/losses if liquidations are necessitated or desired. Here, it is important to note that they do not have to monetize losses in order to generate liquidity. For example, many loans and securities with interest rate-effected unrealized losses can be pledged as collateral in various ways.

It is our opinion that institutions with sound operating and contingency liquidity management and interest rate risk management processes rarely experience the "need" to realize unrealized asset losses. In this regard, it is uncommon for interest rate risk to be a catalyst for severe and immediate realized capital degradation.

Conversely, history has shown that capital at risk is highly impacted by an increase in non-performing loans and net charge-offs that result in capital ratios that breach "well-capitalized" minimums. Although operating losses that stem from interest rate sensitivities will cause capital to decline as well, non-credit related operating losses must typically be prolonged over lengthy periods of time before capital ratios are meaningfully impacted and at risk of breaching "well-capitalized" thresholds. In the absence of credit problems, it should be reasonable to expect that credit unions in this position would react and change asset/liability strategy or consider cost cutting methods to strengthen earnings performance levels well before problematic capital degradation would materialize due to interest rate risk.

The New Rule May Actually Reduce the Ability of Credit Unions to Absorb Losses and Compete

Given limited access to the capital markets, the ability of a credit union to absorb losses is directly related to its ability to generate new capital surplus through earnings. This is an increasingly difficult task for many credit unions as margins have been contracting on average for over 10 years while the cost of doing business has escalated upward. As a result, credit unions are contemplating longer-term strategies to scale the business and increase asset size in a manner that achieves a higher core earnings base and, as a result, strengthens the protection of their capital base. This necessitates a meaningful change in culture and strategy since in many cases it requires a greater comfort level with operating at lower yet prudent capital ratios, on average.

The rules for FDIC, OCC, and Fed regulated institutions are focused on a single risk factor — credit. However, the proposed NCUA risk weight methodology commingles credit risk with interest rate risk, concentration risk, liquidity and other risks to determine appropriate capital allocations. While this methodology to assess various risk factors can be argued to have merit, the compounding nature of this proposed risk weight system does make it overly punitive to credit unions. As a result, we believe strongly that the NCUA's proposed method to risk weighting assets will result in considerable contraction between credit union risk-based capital levels and more general net worth ratios. This undermines the objective behind risk based capital principals to distinguish true loss exposure between similarly levered institutions.

Additionally, credit unions will have less flexibility and capacity for growth, which will limit opportunities to increase earnings and capital surplus. **Likely, the credit union industry will operate with higher capital ratios, but present greater potential long-term risk to capital (weaker earnings). Also, the competitive disadvantage that already threatens many credit unions in most areas of lending with the exception of short-term consumer lending (auto) will worsen.** This is of particular importance to the smaller institutions, which characterize the majority of the credit union industry.

We expect a few other unintended consequences may result as well.

- Reduce growth capacity and less support for local market lending activity as the economy strengthens and demand for loans increases, particularly the housing sector.
- Alter the manner in which credit unions hold their liquidity: Larger positions in cash and shorter-term investments will result in increased opportunity costs that lead to lower earnings and less capital replenishment, which further reduce lending capacities.
- Curtail the ability of core earnings growth to outpace continued increases in overhead costs. Accordingly, the industry could expect further labor contraction and/or outward migration of intellectual capital from the industry.

Negative Economic Impact to Credit Unions and Their Members

The RBNW regulation will have a significant and derogatory impact on credit unions and their ability to serve their membership, as they will be forced to curtail member business lending and member home equity lending programs. This in turn will negatively impact the local economy by hindering economic recovery through reduced job growth within the marketplace.

The regulation would also put credit unions at a competitive disadvantage over banks. The cost of this regulation to credit unions to maintain additional capital/net worth is estimated at $7.3B. Credit unions weathered the worst economic recession in the last 80 years, with our federal deposit insurance fund only suffering a total loss of $500M since 2008. While there may be a need for such a regulation, the component weightings within the details of the regulation are misguided and questionable at best, and will have a significant negative impact on credit unions.

Conclusions & Recommendations

The Board's proposed RBC rule for credit unions remains highly inconsistent with those rules applied for banks and other depository institutions in a manner that is significantly more punitive.

As a result, credit unions will be faced with two choices: 1) accept lower capital ratios and, therefore, be forced to restrict loan growth; or 2) maintain a shorter average life for its assets and accept the lower income stream or rate of return on assets, thereby reducing the creation of new capital to support loan growth. In either case, credit unions will be forced to play a reduced role in supporting their membership and communities.

Industry earnings trends suggest that credit unions cannot afford this extra cost of capital, as meaningful loan growth will be necessary to offset contracting net interest margins, higher overhead and a greater cost of doing business.

As prescribed, these rules may very well have the unintended consequence of increasing capital exposure(s) and related risk to the NCUSIF.

We urge the board of the NCUA to either:

1. More closely align the Risk-Based Capital risk weight system with the credit risk centric approach that is applied by the FDIC, FRB, and OCC; or
2. Reassess and reduce risk weight percentages to better fit the proposed methodology in a manner that does not result in unnecessarily punitive and growth constraining required capital levels.

We respectfully ask for your consideration on the points raised in this letter, and appreciate your time and interest.

Sincerely,

Lonny J. Maurer
President/CEO
Belco Community Credit Union