May 7, 2014

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

Re: Prompt Correction Action; Risk-Based Capital

Dear Secretary Poliquin:

On behalf of CASE Credit Union, please accept this response as input and feedback to the proposed changes to 12 CFR Parts 700, 701, 702, 703, 713, 723 and 747. Overall, we agree that the current method of determining the risk based net worth (RBNW) ratio should be modified to be more comparable with the methods utilized in the financial institution industry (namely, the Basel III methodology utilized by the banking industry). That being said, there are a number of aspects of the proposed changes that raise concerns from the standpoint of industry comparability and the ability of the Credit Union industry to continue serving our mission of community institutions made up of people helping people.

Risk Mixture

In the proposed changes, it is stated that the proposed measurement of RBNW would have a broad focus on various types of risks that credit unions face, rather than the current RBNW framework which focuses primarily on interest rate risk. While the concept of a comprehensive risk measurement ratio is agreeable, it is our opinion that a number of the measurements proposed for the new RBNW ratio weigh heavily on one risk or another.

For example, investment securities are weighted based on average weighted maturity in the proposed changes, which adequately assesses the interest rate, liquidity and market risks. However, the proposed framework assumes that the investment security portion of the balance sheet is more heavily influenced by those risks mentioned, and does not take into consideration the credit risk that heavily influences an institution's decision-making process. For CASE Credit Union, all such risks are considered when making investment transactions.

Another example is the treatment of residential real estate loans. The proposal would increase the risk weight for residential mortgages that exceed a 25% concentration. While this appropriately addresses concentration risk, it fails to address interest rate or market risks. Meanwhile, the credit risk of the related loan portfolio is accounted for in the Allowance for Loan Loss. The inclusion of multiple risk types in one calculation, such as loans for which credit risk is already addressed elsewhere, unintentionally compounds the results of avenues already affecting net worth and the RBNW ratio.

We believe that these examples serve as evidence that a ratio expected to assess all risks facing an institution will always be unbalanced. Because other regulatory framework and processes are already in place to assess a number of risks (e.g. *Concentration Risk Supervisory Letter 10-CU-3, §741.12 Liquidity and Contingency Funding Plans*, etc), we do not believe it to be prudent to assume that the RBNW ratio could effectively measure risks across the board, as various sections of the balance sheet have primary focuses on different risks in the proposed changes.

Variability and Incomparability

Many of the specific proposed risk weights, or methodologies for measuring risk, vary substantially from other financial industry models. With comparability being one of the main purposes of the proposed regulation, we believe that a closer investigation of weighting methods is vital.

- Investment securities are risk-weighted under Basel III based on credit risk. Under the proposed PCA changes, investment securities would be risk-weighted by credit unions based on average weighted maturity.
- Residential mortgage loans and member business loans are risk-weighted much heavier under the proposed PCA changes than the risk weights for such assets under Basel III.

These differences, among others, will create substantially different results and prevent RBNW ratios from being comparable between a community bank and a small, community based credit union.

Allowance for Loan Losses

The proposed changes suggest a limit to the Allowance for Loan Loss of 1.25% of risk weighted assets. We understand that the proposal is attempting to provide an incentive for granting quality loans and recording loan losses in a timely manner. This limitation of 1.25% presents two unique problems.

- First, the Financial Accounting Standards Board has proposed significant changes to the accounting for receivable credit losses. It is expected that the proposed FASB change could increase many financial institution's Allowance for Loan Losses by approximately 50%. It is important to note that the proposed changes to the FASB's accounting for the ALLL would include a requirement to reserve on off-balance sheet commitments including, but not limited to, unused revolving line of credit balances. This would cause two effects that would negatively impact credit unions: we would be required to reserve on unused lines of credit, which aren't reported as loans on our balance sheets (or figured into risk weighted assets), and our total reserves would increase significantly, making it impractical to maintain the ALLL under 1.25% of risk weighted assets.

- Second, as a designated *Low Income Credit Union* (and soon-to-be a *Community Development Credit Union*), the nature of our lending and member services is geared towards the underserved members of our community. It is our mission to assist these community members with financial services in an attempt to assist them in achieving financial success. This naturally creates a loan portfolio that has the potential to contain a heightened level of credit risk. It is our Board of Directors and Executive Management's responsibility to practically reserve for potential credit risk in the Allowance for Loan Losses in an effort to protect our members' assets. Penalizing a credit union's RBNW ratio for being prudent in estimation of potential credit losses appears to be counter-intuitive.

Additional Discretion for Increased Requirements

While we understand the NCUA's concern regarding credit union's involving themselves in activities that they may not fully understand, we feel very strongly that having arbitrary and subjective determinations of increase RBNW requirements based on the NCUA's assessment of management's inability is not appropriate. We are aware that there exists a large number of activities that are complex and can create long-term tribulations for credit unions (i.e. indirect lending, member business lending, mortgage lending, mortgage backed securities, etc.). We also realize that adequate training and knowledge of these areas is necessary in order to successfully operate such programs.

Even though we recognize the risk to the industry, we do not agree with the subjective nature in which the proposed changes to PCA would apply penalties to an institution's RBNW requirements based on perception of management's knowledge, skills and abilities. We believe that this additional requirement on an institution's RBNW has the potential to cause more harm than good.

Risk Weight Concerns

After a thorough review of the risk-weights assigned to various items from the balance sheet, we have concern with a number of the assigned weights. The most notable concerns are below:

- NCUSIF Deposit – the proposed RBNW calculations remove the NCUSIF Deposit from both the numerator and denominator of the calculation. The true value of these assets has already been called into question by the US Treasury. Removing the value of such deposits from the calculation of RBNW only creates additional doubt regarding the value of the deposit and whether or not credit unions should really expect any of the deposit back, since it is implied that this asset is not available to cover any of our risks or potential losses.

- Business Loans – many would argue that credit unions' commitment to local communities has helped recover from the recent recession greatly. At a time when big banks were unwilling to look at financing small, local businesses, credit unions stepped up to work with the community.

The proposed RBNW calculations would increase the risk-weighting of member business loans once a concentration reaches 15% and 25% of assets. These excessive risk weights make it more and more difficult to revive our local communities through business growth and job creation. The assigned risk-weights also fail to consider quantitative values of the collateral securing such loans. A member business loan with a 60% loan to value (LTV) poses a much lower level of risk as one with an 80% LTV. However, distinction between such risk profiles is not distinguished in the RBNW calculations. With all things remaining consistent, even a mere 5.0% annual growth in our member business loan portfolio would reduce our RBNW ratio by 20 basis points in a matter of only three years. Any growth in excess of this would result in a 15% concentration and would have a much more negative impact on our ability to service small businesses in the community due to additional decreases in the RBNW ratio.

- First Mortgages – the proposed changes would assign a risk weight of 0.50 to the first 25% of assets invested in first mortgage loans (with increasing risk weights as the concentration increases). The assignment of a consistent risk weight to all first mortgage loans (with the exception of Member Business Loans) appears to be unwarranted given the various characteristics of mortgage lending and the related risks. Consideration should be given to various aspects such as loan to value ratios, the Consumer Financial Protection Bureau's regulations regarding ability to pay, and fixed versus variable rates. The risk weights applied look as though they may be excessive given the additional controls in place surrounding mortgage lending. Furthermore, there seems to be a disparity between first mortgage loans and mortgage backed securities. An average mortgage backed security pool has a life of approximately 7 years, which would be assigned a risk weight of 1.50. Even though mortgage backed securities carry less credit risk and less interest rate risk than a 30 year first mortgage loan, they are assigned a higher risk weight.

- Junior Lien Real Estate Loans – for junior real estate loan, a risk weight of 1.0 is assigned to the first 10% of assets invested in such loans. Not only are the risk weights double that of first mortgages, but the concentration points are also significantly less than the concentration points of first mortgage loans. While it is generally agreed in the industry that junior liens carry significantly more risk, the assigned risk weights appear disproportionate. Moreover, additional risk mitigation controls such as limits to loan to value ratios on junior liens are not considered when assigning risk weights to such loans. In a time when the housing market in the United States is slowly making improvements, and members are finally gaining equity in their homes, the proposed changes to RBNW and junior lien risk weights will prevent the credit union industry from assisting these members through home equity and junior lien loans. In the long run, discouraging institutions from granting such loans will contribute greatly to the prolonged housing market slump.

- Mortgage Servicing Rights – the proposed changes would apply a 2.50 risk weight to mortgage servicing rights. With such heavy risk weights assigned to first mortgage loans, many institutions may be looking to sell such loans to remove potential risk from their balance sheet. In the right sale type, the sale of mortgage loans assists an institution's balance sheet by effectively removing a great deal of credit risk, liquidity risk, interest rate risk and market risk. While removing such risk from an institution is a useful risk mitigation tool, most institutions would prefer to retain the servicing on sold mortgage loans. Not only does retained servicing assist the credit union in earning non-interest income in the form of servicing fees, but it also allows the credit union to retain relationships with their members to provide superior service. Properly valued and managed servicing rights pose minimal risk to a credit union, but are risk weighted exceedingly heavy.

- Unfunded Commitments – while unfunded commitments certainly do pose a certain amount of risk to an institution, the conversion rates and risk weights proposed to be assigned appear excessive (75% conversion and a 1.0 risk weight for unfunded business loan commitments and 10% and a 0.75 risk weight for non-business loan commitments). Being a low-income credit union and having a mission to assist members in rebuilding their credit, we rely heavily on small, revolving extensions of credit to help members rebuild their creditworthiness. Applying such risk weights discourages institutions from extending credit to their members. By not making credit available to members on a revolving basis, members are more likely to turn to other financial institutions (i.e. banks) for their credit needs. In essence, by reducing or eliminating members' revolving credit to improve their RBNW ratio, credit unions would be preventing members from preparing for unexpected emergencies, and essentially decreasing the likelihood of financial stability and success.

  Furthermore, applying a 75% conversion rate and a 1.0 risk weight to unfunded business loans incentivize credit unions to decrease or remove businesses' lines of credit, which will ultimately cause financing problems for those businesses in terms of working capital or seasonal needs. Many of our business members do not use their credit lines to the full extent of the credit extended. However, they operate with peace of mind knowing that access is available if unforeseen circumstances arise.

<u>General Concerns</u>

In addition to the specific concerns expressed above, we would also like to convey some general concerns with the proposed PCA changes as a whole.

- The proposed RBNW calculation ignores the liabilities of a credit unions' balance sheet completely. Most institution's Asset Liability Committee works to structure their entire balance sheet in a way to meet the institution's risk tolerance, but also as a way to mitigate certain risks.

By not considering risk mitigating factors (or additional risks) that reside on the liability side of the balance sheet, the RBNW will naturally over-state or under-state total risk to the institution. For example, long-term borrowings locked in at a low interest rate help to mitigate a large portion of interest rate risk that may reside within a residential or business real estate portfolio. Similarly, an institution's mix of deposits (savings, checking, money market, term deposits, etc.) can significantly influence a credit union's risk profile.

- In addition to ignoring the liability side of a credit union's balance sheet, there is also a large void in the lack of consideration for the effectiveness of an institution's management of risk. The Administration assigns a CAMEL rating based on a number of factors, including management effectiveness. While this rating is extremely important, we feel that an institution with a more effective management team can adequately manage an increased level of risk. While there is bound to be inherent risk with each product and service that an institution offers, many risks facing a credit union can be managed with an appropriate management team. By not taking risk management techniques and qualities into account when determining required RBNW, credit unions with strong management effectiveness are essentially limited in how well they can utilize the skills that reside on their team.

- The proposed PCA requirements define a "complex" credit union as any with greater than $50 million in assets. This break-point seems relatively arbitrary. A small credit union has the ability to be very complex based on the products and services they offer to their membership. Conversely, a large credit union greater than $50 million in assets has a very distinct possibility of having a simple balance sheet without complex products or services. We believe that a credit union's product and service mix should determine its complexity, not merely its size.

- The Administration has communicated that timeline of 12-18 months would be used for implementation of the new PCA requirements. This timeline appears extremely aggressive considering the changes that would be required to the Call Report in order for the Administration to collect the necessary data in order to calculate RBNW as proposed. In addition, many credit unions will need time to reposition their balance sheets in order to remain well-capitalized. A credit union with a heavy real estate loan portfolio may need to sell off a portion of their portfolio in order to rebalance their risk profile based on the new requirements. It would be prudent of the Administration to allow ample time for the industry as a whole to rebalance.

We would like to thank the Administration for taking the time to consider our input and concerns. We understand that an overhaul to Prompt Corrective Action and Risk Based Net Worth is necessary and also understand the degree of difficulty in designing a measure that appropriately measures all necessary risks. If you have any questions regarding this feedback, please do not hesitate to contact me directly.

Sincerely,

Jacob F. Darabos
VP of Finance / CFO
CASE Credit Union