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

Via email to: regcomments@ncua.gov

Re: Comments on Proposed Rule: Risk Based Capital - Second Proposal

California Credit Union ("CCU" or "Credit Union") appreciates the opportunity to respond to the National Credit Union Administration Board's second proposed rule (RBC2) to establish risk-based capital requirements for federally insured credit unions. CCU is a state chartered and federally insured credit union based in Glendale, CA with $1.39 billion in assets, thirteen branches and 86,173 members. Our regulatory net worth is 10.57% with a risk-based capital level of 19.33% under the proposed RBC2.

We appreciate the opportunity to comment on the new proposal and provide suggestions we believe will improve the final rule.

GENERAL COMMENTS

CCU supports a strong capital system framework for the long-term safety and soundness of the credit union industry. We believe this framework should include the concept of a well designed risk based capital system for maintaining capital levels commensurate with the varying levels of risk. Given the wide variances of risk in credit union balance sheets, we agree that a risk based methodology that attempts to capture and measure capital at risk is a more analyzed approach rather than relying solely on the PCA net worth ratio.

CCU appreciates the NCUA's acknowledgment of the industry's comments and concerns in the earlier proposal. We are supportive of many of the risk weighting adjustments, extension of the implementation period, and other improvements reflected in the second proposed rule. However, there are significant changes required for a final rule in order to be comparable to other banking agency requirements while taking in consideration the uniqueness of the credit union charter as directed by the Federal Credit Union Act. A business model and capital risk profile which has consistently out performed the banking industry in overall safety and soundness as evidenced by the NCUSIF's significantly lower capital losses compared to the FDIC.

We urge the NCUA to modify the proposed rule with the changes presented. If not modified, the proposal would continue to place credit unions at a competitive disadvantage in the long term.

The areas we recommend modification to the Proposed Rule include:

1. Risk Weightings:
    a. Removal of Concentration thresholds: Tier risk-weighting for first mortgage loans and junior liens should be removed to be consistent with BASEL
    b. Share secured loans and share deposit compensating balances risk weight should have a risk weight of 0%
    c. Investments in Credit Union Service Organizations ("CUSOs") should have similar risk weights as loans to CUSOs at 100%
    d. Mortgage servicing asset risk weighting should have a risk weight not higher than 100%
2. Exclude the Goodwill deduction from numerator of RBC ratio
3. Comprehensive written Capital Strategy (Part 702.101 (b)2)
4. Additional Considerations:
    a. Interest Rate Risk
    b. Legal divergence of statutory authority and cost

In addition to modification of the Proposed Rule, we believe it is absolutely imperative the NCUA, in concert with state regulators, approve the use of Supplemental Capital for Risk-based capital purposes and that regulatory approval be granted before risk-based capital rule implementation.

Supplemental Capital and Risk-based Capital Ratio Requirements

The introduction of a risk based capital system requires more options for all credit unions to raise supplemental capital. Although the risk based capital level was lowered to 10% to be well capitalized, all credit unions should have the ability to meet the 10% RBC requirement with secondary/supplementary (Tier 2) capital as the banks are able to do.

If the intent of RBC2's design is a capital framework aligned with other banking agencies (as the NCUA has stated) then the proposed rule without the option of using supplemental capital creates a restrictive capital requirement which places credit unions at a major disadvantage for years to come unless both RBC and supplementary capital are approved concurrently.

We urge the NCUA to craft regulatory approval for federally insured credit unions to receive payments on uninsured; non-share capital accounts to count towards Risk-based capital requirements. A few general standards to be included in the rulemaking could include:

1. Cooperative nature of the credit union is maintained
2. Uninsured with clear market disclosures
3. Subordinate to all other claims against the credit union, including claims by creditors, shareholders, and the NCUSIF
4. Subject to maturity limits as determined by the NCUA but consistent with the banking industry/ BASEL III
5. Available to be offered by credit unions deemed adequately capitalized by the NCUA and state regulator (if applicable)
6. Would qualify towards meeting risk-based capital standards

In order for the credit union industry to properly transition to the adopted risk-based capital standards for adequate and well capitalization, Supplemental Capital should have regulatory approval for use by credit unions at least one year in advance of the RBC implementation date.

A lead time in advance of a new RBC Rule would only help strengthen the credit union system by help to protect the NCUSIF from losses while providing a period of time to develop a sound secondary market for such non-insured products. Accelerated implementation of supplemental capital ahead of the RBC rule implementation would provide a period of orderly development of the market, price stabilization, and expertise – providing a "capital cushion" ahead of the next potential economic downturn which would place credit unions in a stronger safe and sound position in meeting capital standards.

We therefore urge the NCUA to accelerate the efforts to implement the use of supplemental capital for all credit unions. We believe this is an important tool for providing strategic options in managing to the new risk based capital standards. We believe the NCUA has the authority today to authorize supplemental capital for risk-based capital purposes.

SPECIFIC RECOMMENDATIONS TO PROPOSED RULE

Although the NCUA has made significant improvements to the risk weight categories from the original proposed rule which brought RBC2 closer in alignment to BASEL III, we are concerned that the revised proposed risk weights remain more restrictive than BASEL III requirement for banks for the same asset categories. The areas of concern include:

Removal of Concentration thresholds: Tiered loan risk-weighting for first mortgage loans and junior liens should be removed to be consistent with BASEL

1. Current first real estate loans greater than 35% of assets for credit unions are risk-weighted at 75% compared to bank risk-weighting of 50%.
2. Current junior real estate loans greater than 20% of assets for credit unions are risk-weighted at 150% compared to bank risk-weighting of 100%
3. Non-current junior real estate loans are also assigned a higher risk-weight level of 150% compared to the lower risk-weights for banks under Basel III.

Concentration threshold weightings are a major concern that directly affects our long term ability to meet the credit needs of our members. The proposed uses of asset concentration tiers that escalate capital requirements remain overly restrictive and excessive to BASEL III requirements for banks with higher risk loan portfolios.

As stated in our first comment letter, we are requesting the NCUA to provide evidence-based information and underlying analysis supporting the need of asset concentrations categories and why these levels should be higher than banks. Without a basis for assigning these asset concentration risk-weight categories the approach appears unsupported by the evidence and is of limited value in identifying the types of unsafe concentration risk exposure truly imbedded in portfolios.

Share secured loans and contractual share compensating balances risk weight of 0%

1. Share secured loans for credit unions are risk-weighted at 20% - similar bank deposit secured loans are risk-weighted at 0%.

2. Similar issues exists for contractual deposit compensating balances on other loans, the portion of a commercial loan balance secured by a contractual compensating balance is also assigned a 20% risk-weight for the RBC2 proposal which is inconsistent treatment.

While these areas may appear immaterial to some, if a credit union originates member business loans and loan covenants are in place for contractual compensating deposit balances in order to mitigate credit risk, the capital reserves are higher despite the additional credit risk mitigation.

The higher capital reserve requirement creates a competitive disadvantage for credit unions which is not based upon any research provided to justify the need to hold capital against share deposit secured loan balances.

Government-guaranteed portion of loan balances

Clarity on the definition of Government guarantees for risk weighting treatment is required. US Government guaranteed portions of loan balances are included at a risk-weighting of 20%. What is not clear is if this definition includes types of guarantees from state governments, state government agencies, or municipalities.

Investments in CUSOs

One of the reasons for the creation of a CUSO is to minimize the risks for credit unions by bringing together the necessary collaboration, expertise, and management of a particular business. This is a fundamentally different risk profile compared to the bank risk weighting for private equity investments.

Maintaining an excessive risk weighting would likely only discourage future CUSO formation which would not better serve the credit union system. Given the additional supervisory oversight the NCUA now exercises over CUSOs, and the lack of any evidence of CUSO losses having a material impact to the NCUSIF, we believe the risk weighting for unconsolidated CUSO investments remains excessive and should be the same as the 100% risk weighting for CUSO loans under RBC2.

Mortgage Servicing Rights and Derivative Hedging

Mortgage servicing assets (MSAs) with a risk weight of 250% is excessively out of proportion when evaluating credit union industry. Although the 250% risk weighting is equivalent to the FDIC Risk-weight on banks, it still appears higher than necessary when considering the conservative and cooperative nature of the credit union industry.

We believe consideration should be given to the conservative nature of the credit union charter and business model as allowed by the FCUA when crafting the risk-weighting rules in this area. A credit union following generally accepted accounting principles (GAAP) records mortgage servicing as an asset which requires an annual valuation. If the MSA does not meet the actual valuation it must be written down to the audited value.

The risk typically comes from declining MSA values during a period of falling interest rates. However, GAAP requires credit unions to record MSAs at fair value. Thus, the risk of over-valued MSAs is effectively managed by following GAAP which is validated each year during the audit engagement. There is no record of a credit union suffering a material impact to its capital as a result of declining MSR values.

The general credit union practice is to apply a conservative approach to valuation which has meant mortgage servicing assets are typically not large relative to the balance sheet and are not as volatile as other markets. While this type of risk-weighting is consistent with large banks with large servicing portfolios that have opted into fair market value for mortgage servicing rights, credit union do not have an asset with this same type of volatility and risk.

A concern worth noting is that a high risk weight is penalizing those credit unions for eliminating IRR risk on their balance sheet by selling longer-term fixed-rate real estate loans. For credit unions that have taken a conservative approach to the valuation of MRSs, a proposed weight of 250% may lead to a more aggressive approach. Such an approach could lead to the unintended consequence of discouraging some credit unions from selling their fixed rate mortgage output, thereby taking on more interest rate risk by holding more fixed rate real estate loans.

A 250% risk-weighting would be punitive treatment for a credit union that is acting prudently in the interests of safety and soundness and to the membership by selling a loan asset and retaining servicing. The risk weighting for MSRs should not exceed 100%.

Derivative Hedging: In its current form, the proposal falls short in adequately addressing the risk mitigation benefits of derivative hedging in offsetting risks in the balance sheet including the hedging of the price volatility of Mortgage Serving Rights - currently risk weighted at 250% whether the serving asset is hedged or not.

Hedging instruments would carry a capital requirement based on a conversion factor and applied to the notional amount of the hedge which means credit unions employing derivatives to mitigate risk would be required to carry more capital while not receiving the benefit of hedging the MSR asset or other assets. Coupled with pending NCUA interest rate risk regulatory guidance (rulemaking) – a credit union is essentially penalized for the defensive use of derivatives for mitigating risk.

Goodwill

As currently proposed, Goodwill resulting from a "supervisory merger" would be allowed to be counted as capital until 2025 - after which it would be deducted from capital. While we appreciate that "supervisory merger" is broadly defined to include any regulatory-assisted merger regardless of whether financial assistance is provided, the 2025 sunset date is nevertheless arbitrary. RBC2 requires the opposite treatment of Goodwill arising from mergers not deemed "supervisory" whereby there is an immediate deduction from capital. We believe the disparate treatment and the arbitrary sunset date is problematic.

Use of goodwill allows a well-situated credit union to absorb a struggling credit union which may not yet immediately require "supervisory merger" assistance in a way that does not negatively impact the NCUSIF.

An unintended consequence could be that viable credit unions will be discouraged from taking on less viable credit unions that have not yet reached the "supervisory" assistance level but strategically a merger would be better for their membership. A trend that would lead to the eventual rise in the cost of resolving troubled credit unions which will negatively impact the NCUSIF.

Given the uniqueness of the credit union system when compared to banks, goodwill should not be immediately deducted from the numerator of the risk-based capital ratio. Goodwill arising from both previous and future mergers should continue to be counted without a time limitation, so long as it meets GAAP requirements. GAAP requires companies to subject their Goodwill to rigorous testing for impairment on an annual basis.

We recommend the risk based proposal allow all Goodwill, regardless of whether it results from a supervisory merger or not, to be counted as capital and to eliminate the 2025 sunset date.

Capital Adequacy Plan Requirement

The revised risk-based capital proposal (part 702.101(b)) requires a credit union that is subject to the regulation maintain a "comprehensive written strategy" for maintaining an appropriate level of capital commensurate with the level and nature of risks the credit union is exposed.

We agree with the basic premise of having a capital adequacy plan which would include both PCA and risk-based capital measurements. In our opinion, such a written plan reflects good management and is the best approach to addressing heighten risks from loan concentrations - as opposed to elevated risk-weights for real estate and commercial loans which would arbitrarily create a competitive disadvantage.

The regulation does not at this time describe regulatory expectations for this plan which now has a risk-based capital component. The supervisory authority is not yet defined and is generalized when stating that certain cases will require "specific metrics for necessary reductions in risk levels, increases in capital levels beyond those other wise required under [part 702], and some combination of risk reduction and increased capital." There is a need for the NCUA to clarify how this new section is incorporated in the current supervisory examination process of reviewing adequacy of regulatory net worth and the enforcement authority that it holds.

We believe the NCUA should additionally describe the standards of the new reporting requirement and elaborate on its expectations of credit unions. To ensure a reasonable alignment of the credit union and Agency, clarification in the supervisory guidance is needed in answering the following questions:

- What are the components of a "comprehensive written strategy"?
- What are the possible consequences of an examiner determining that a credit union's comprehensive written strategy does not meet the requirements?

Since the supervisory requirements are not yet defined, our expectation would be for the NCUA to streamline the requirements to minimize the associated regulatory burden and that the effort derives a clear benefit for the supervisory process and the safety and soundness of the credit union industry.

ADDITIONAL CONSIDERATIONS

INTEREST RATE RISK

In response to the Agency's request for comments regarding how the agency might address interest rate risk (IRR) in the future we believe the existing regulatory, supervisory and examination process is appropriate for the credit union's system exposure. Through the examination process, examiners have generally provided effective guidance on interest rate risk as it relates to the individual credit union under examination.

In our view, due to the high number of variable factors and assumptions associated with interest rate risk, a focused ALM examination process remains the most appropriate and effective approach. As cited in our May 15, 2014 comment letter to the RBC1 proposal, "...a better approach to address the NCUA's interest rate risk and concentration concerns is continued effective regulatory safety & soundness examinations with possibly an added "S" (sensitivity to market risk) component in the exam process." This approach would separate interest rate risk from liquidity in the supervisory process and provide a more effective means of specifically addressing those "outlier" institutions having excess IRR exposure.

The option of credit unions ("complex" or not) of providing additional 5300 report data information to include credit and interest rate risk mitigating activities is worth exploring. A reasonable amount of additional call reporting data would better capture the on and off balance sheet risk management (such as derivative hedging to offset price volatility of mortgage loan servicing assets) and could be used to further report the capital at risk exposure and efforts to mitigate such exposure.

DIVERGENCE OF STATUTORY LEGAL OPINONS

We are aware and have been concerned with the divergent opinions regarding the proposed regulation - including the various opinions as to the expressed legality of the NCUA's authority to issue such a rule.

It's apparent that all stakeholders might have been better served if the legal authority issue had been resolved prior to the issuance of new capital standards and that the rule include a provision for Supplemental Capital. While we are not going to debate the attorney legal opinion letters for and against the proposed 2-tier risk weighting system, we do wish to express our concern of the cost and effectiveness of the approach taken to modernize capital standards for credit unions – a need for capital standard modernization that we basically agree is required.

Given the fact that the NCUA board itself is divided on the issue of its statutory authority in creating a 2-tier risk-based capital regime, there remains a serious concern of the cost of implementation, including the potential of litigation incurred by the Agency and the credit union industry.

Some question worth asking:

- What is the NCUA gaining by insisting on the legality of a 2-tiered system?
- Can insistence of a 2-tiered classification be justified in view of continued legal costs and the NCUA's board itself being split on the legality?
- Is this approach worth the estimated millions of dollars if the safety and soundness improvement is "marginal"?
- Does the high cost of implementation justify the expected losses prevented by a risk-based capital rule?
- Could the Agency propose only the RBC "Adequately" capitalization level of 8%, aligned with the banking industry's Tier 1 standard? Particularly if, as Board Member McWatters has commented, the statute's literal language indeed limits the Agency's ability to only establish a level of capital "Adequacy."

We believe that given the lower capital losses experienced by credit unions compared to banks during the great recession, the expectation of a modernization of the credit union capital framework should be more than an attempt to identify the "outlier" institutions. It should benefit all as an approach to measuring and managing safety and soundness. The cost benefit analysis of the effort should be more than identifying a small number of outliers as having capital deficiencies which one would expect would be identified and remedied under regulatory examination scrutiny.

CONCLUSION

As we previously stated, the NCUA's revised proposal to create a risk based capital standard is an improvement over the earlier effort. However, there remains significant areas which place credit unions at a competitive disadvantage and in the long term create a higher cost of doing business in serving our membership. Without further modification, it is our belief there will be unintended consequences as some credit unions who maintain sizable real estate loan portfolios seek a bank charters for a more favorable capital risk-weighted treatment consistent with their business model, field of membership, and market growth opportunity.

We believe our recommendations would improve the Proposed Rule and allow credit unions to safely operate under the new capital standard in a manner which is favorable for the long term relevancy of the credit union industry.

Sincerely,

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