# DRAFT

[DATE]

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

Dear Mr. Poliquin,

I am writing on behalf of the Board of Directors, Management, and members of Wright-Patt Credit Union, Inc (WPCU). We welcome the opportunity to comment on NCUA's proposed rule for Risk Based Capital.

WPCU is a federally-insured, state-chartered credit union located in Fairborn, Ohio, serving more than 258,000 members. WPCU also holds ownership interests in 9 Credit Union Service Organizations ("CUSOs"), including its wholly-owned subsidiary, my CUmortgage, LLC, which provides mortgage processing and secondary market services for 180 credit unions in 20 states.

**General Comments**
WPCU understands NCUA's intent to adopt new risk-based capital rule for credit unions that considers "all material risk". We note that under the Federal Credit Union Act NCUA is required to adopt a rule that is "similar to that available for the banking industry" but that "takes into consideration the unique structure of credit unions."

While we understand NCUA's intent, we believe the proposed rule fails in a number of respects and thus does not accomplish NCUA's objectives. As a result, America's cooperative credit unions, and the members they serve, do not stand to benefit from this rule in any meaningful way.

In fact, we believe the loss in value to members as a result of this rule may, over the long term, be greater than if credit unions were subject to federal taxation.

NCUA has often commented that the proposed rule has "no impact" on the majority of credit unions. We disagree. Not only is WPCU rated as less well capitalized than it was under the previous rule, we believe the rule will fundamentally change the way WPCU's board and management make future decisions on behalf of members, away from service to members and community, and more towards managing "capital at risk" as if WPCU operated the same as a for-profit banking institution. We believe using the same Basel-style rule for credit unions as that used for banks is a mistake.

Contrary to NCUA's assertions, we believe the impacts of the proposed rule will be real. Members will see less value from their credit unions – higher fees, lower dividend rates, fewer service options, higher lending costs, and less lending to middle Americans still digging out from a severe recession. This will be a natural result of a rule that will force credit unions to hold more capital against routine assets, even as there is no evidence credit union assets have been all that risky in the first place.

NCUA's also believes the rule is necessary because a small number of credit unions had insufficient capital during the recent economic crisis. While NCUA reports 102 credit union failures during the worst economic disruption our country has seen since the 1930's, we note that credit union performance under these worst of circumstances was nonetheless excellent, especially as compared to the banking industry. Losses to the insurance fund were a fraction of those seen in banks and a substantially lower number of CUs failed during or after the crisis.

Indeed, the few credit unions that did fail were more the result of the global financial crisis, and a handful because of mis-management that persisted by a sometimes lax examination process. For the vast majority of credit unions, plenty of capital was on hand to withstand the crisis.

To adopt an RBC rule based on Basel III for banks therefore must imagine that risks between the two types of institutions are similar, when substantial evidence indicates CUs weathered the storm far better than did the banking industry. For this reason we believe there is no compelling reason to adopt this rule, especially given the negative impact on service to members in the future.

**A Better Approach**

Our comments do not mean we don't believe credit unions and NCUA shouldn't seek improved ways of evaluating and managing risk. Given the weaknesses of the rule as proposed, we believe an option is available that offers a better approach: Write the proposed risk-based capital calculation as an examiner model to be used during the supervision process rather than a new rule.

In other words, include a risk-capital model calculation as part of NCUA's examination process, similar to NCUA requirements for other types of modelling such as the model NCUA requires for interest rate risk testing. The results of a risk-based capital model can then be used to identify "potential risk" by examiners and CU boards, instead of prescribing a rule that is assumed to quantify "actual" risk.

We believe this approach cures the most significant weakness in the proposed rule, that regulators are able to assign accurate risk weights to assets with the weight of a one-size-fits-all rule. As we note in our specific comments, we believe it is clear that the risk weights of any Basel-style RBC proposal are inherently flawed and when used in the banking industry have not resulted in lower risk to the financial system.

By establishing RBC as an examiner's model, rather than a rule, examiners will have an effective tool for modelling potential risk and asking boards and managers to substantiate risk mitigation efforts. The following examples show how an RBC model, rather than a rule, can allow for better risk management at credit unions:

- If an RBC model showed an elevated calculation due to a concentration of investments with a weighted average life of 5-10 years, management would have an opportunity to show the investments have floating rates with little actual inherent interest rate risk.

- If an RBC model showed potentially elevated risk due to a concentration of member business loans, Management might document that the MBL portfolio is largely variable rate, with commercial real estate loan-to-values of 60%, and strong personal guarantors.

- If an RBC model showed the need for additional capital and Management is unable to show adequate risk mitigation, examiners could use a number of tools already available to correct the situation, from downgrading the capital component of CAMEL ratios, to issuing documents of resolution, memorandums of understanding, etc.

Indeed, when used as a model, NCUA still receives the benefit of performing the calculation, but allows individual CUs to discuss with examiners the unique characteristics of assets that might mitigate risk without being subjected to an unyielding "one-size fits all" rule. NCUA could document model results and react accordingly, when and where needed. Using an RBC calculation as a model is more flexible than using it as a rule.

We believe this is a much better approach than the proposed rule, and affords NCUA an opportunity to study the effect of different risk weightings on actual risk over a period of time. We thus urge NCUA to consider this alternative approach.

**Specific Comments**

WPCU believes NCUA's proposed risk based capital rule is not the right prescription for credit unions and does not consider the unique differences of America's cooperative credit union system. Our specific comments regarding the rule are attached to this letter for review.

**Conclusion**

In conclusion, WPCU believes NCUA's Basel-based rule does not fit America's cooperative credit unions and will have detrimental impact on credit unions' ability to serve members. We further believe that establishing RBC modelling is a better approach, one that will provide directors, managers, and examiners with a more practical tool for managing risk.

America's credit unions – since their inception - have been the model of risk management in the U.S. financial system. No other class of financial institution has been as resilient to risk as credit unions. Lack of a profit motive, a mission of service, cooperative ownership, and more, are all reasons for this performance. That fewer credit unions have failed throughout their history than any other type of financial institution is no accident.

Credit unions are different. We need a different way of measuring and accounting for risk than the Basel-style methods used by for-profit banks. A method that balances the best interests of members with the safety of the money they entrust to their credit union. A method that recognizes credit unions as unique, cooperative institutions formed to serve members on a not-for-profit basis.

Let examiners calculate RBC as a modelling tool for more effective examination. Let boards and managers use risk-based calculation to better serve their members without it becoming a rule that guides future decision-making. Let credit unions continue to set the example for responsible risk management. We urge NCUA to reconsider this rule.

Respectfully submitted,

Douglas A. Fecher
President/CEO
Wright-Patt Credit Union, Inc.

**Wright-Patt Credit Union, Inc.**
**Specific Comments to NCUA's Proposed Risk Based Capital Rule**
**DATE**

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Please consider the following specific comments to NCUA's Proposed Risk Based Capital Rule:

**WPCU's Capital Position: Well Capitalized Before, Less So After**
As of 12/31/2013, WPCU was considered a "Well Capitalized" CU with a net worth ratio of 11.1%. If the proposed rule were adopted, we would be rated with the addition of a risk-based capital ratio of 15.2%. WPCU would still be considered "Well Capitalized".

Today, WPCU's net worth ratio of 11.1% is 58% higher than required for non-complex CUs to be "well capitalized". Under the proposed rule, WPCU's RBC cushion for being "well capitalized" falls to 44.5%. We do not see reporting as less well capitalized as positive for WPCU, and believe it will harm members without any substantive change to the balance sheet risk WPCU historically has managed. Consider a few examples:

- Given a credit union's only source of capital is retained earnings, CU Boards and Management will feel pressure to retain earnings to build capital. This means paying lower dividend rates, raising fees, and charging higher loan rates in order to maintain a comfortable buffer for "well capitalized). None of these actions are in the interests of members.

- Credit union lending, particularly for mortgage and small business loans, will contract. For example, it would be more difficult for WPCU to serve members who don't qualify for Qualified Mortgages as defined by the CFPB. Selling these loans on the secondary market is increasingly not an option, and so they must be held on the balance sheet if they're made at all. Because of the risk accelerator for mortgage loans, however, it is likely that WPCU will be forced to limit this type of lending, even as we estimate that 30% of our mortgage borrowers fall in the "near-QM" class of lending. The result: Fewer deserving WPCU members will be able to turn to WPCU for a mortgage loan.

- WPCU has historically returned excess earnings to members. Because the proposed rule forces WPCU to retain earnings to maintain desired buffers over "well capitalized", and because additions of certain new assets will require higher capital premiums, future special dividends are likely to be smaller and perhaps not paid at all.

- The need to factor "capital at risk" into every balance sheet decision will cause CUs to minimize other areas of risk, and most likely credit risk. Lending will likely contract further as Boards offset additional risk-based capital requirements by taking less credit risk with members at the margin who historically have needed America's credit unions the most.

**Evidence that CU Risk Performance is Stronger than Bank Risk Performance**
We note NCUA's stated purpose for the new rule is to address losses to the NCUSIF, particularly during the post-crisis era starting in 2008. Yet we find that CU performance during one of the most economically stressed periods in U.S. history was generally excellent, and that CU failures and losses to the NCUFSIF were a fraction of those experienced in the banking industry. Yet, the proposed rule establishes risk weights that are equal to, and in some cases more severe than, those adopted for smaller banking institutions under Basel III.

Consider the difference between CU and bank performance for the period from 2007-2013 as measured by 1) insurance fund losses per $1,000 in insured deposits, and 2) number of financial institution failures:

| | **Losses per $1,000** | | **Institution Failures** | |
|---|---|---|---|---|
| | **NCUSIF** | **FDIC** | **CUs** | **Banks** |
| **2007** | $0.33 | $0.05 | -- | -- |
| **2008** | $0.47 | $4.19 | 22 | 25 |
| **2009** | $0.86 | $6.67 | 28 | 140 |
| **2010** | $0.97 | $3.38 | 37 | 157 |
| **2011** | -$0.67 | $1.26 | 16 | 92 |
| **2012** | -$0.09 | $0.38 | 21 | 51 |
| **2013** | -$0.06 | $0.20 | 17 | 24 |

Source: Credit Union National Association

The data indicates CU performance during the post-crisis period was stronger than bank performance by a wide margin, and that losses to the share insurance fund were significantly lower than losses to the bank insurance fund. The proposed rule, however, assigns risk weights that equate CU risk and bank risk, despite there being little foundation for similar weights between the two types of institution.

**Arbitrary Risk Weights**
Many of the risk weights in the proposal appear to have little observable connection to historical loss experience. Other commenters will likely point out specific instances where risk weights do not correspond to actual risk. For WPCU, some proposed risk weights do not make sense on their face:

- Risk weights for CUSO investments is 250% compared to delinquent consumer loan risk weights of 150%. NCUA believes 250% is reasonable yet offers no loss data on actual losses of CUSO investments to support such a high risk rating. NCUA's seems to be comparing the 250% CUSO weight to a risk weight of 400% for smaller banking institution non-marketable equity investments, thinking that since NCUA oversees CUSOs, the risk may be lower. The useful comparative, however, is actual loss history on CUSO investments experienced over time, and not the banking standard. For WPCU, losses on WPCU consumer loans are routine and a cost of doing business; losses on our CUSO investments have been virtually non-existent over a period of almost 15 years.

- Risk weights for investments with a weighted average life ("WAL") of 5-10 years (and no credit risk in the case of GSE securities) is 150%, compared to a risk weight of 100% for real estate loans with the exact 5-10 year WAL plus the risk of credit loss. WPCU has written off mortgage loans due to credit risk, but never taken a loss on a GSE security.

- Risk weights for longer term assets do not consider the extent to which management has match-funded the investment in its liability structure (By definition managing interest rate risk involves evaluating both assets and liabilities, while the proposed rule penalizes long term assets with higher risk weights without any consideration of liabilities used to fund the assets). If NCUA believes re-pricing risk should be reflected in the proposed rule, then it should also reflect the risk-mitigating effects of liability structure.

Finally, we are troubled by the "catch-all" capital requirement in which NCUA, at its sole discretion, may set a different capital requirement for individual credit unions as a result of the examination process. We see no real process by which NCUA must substantiate its reasons for invoking this provision, and no suitable avenue of appeal.

**Poor Track Record of Basel-Style Risk Based Capital Rules**

WPCU does not believe a Basel-style risk based capital calculation has ever proven to adequately provide for a sufficient capital buffer or result in fewer losses to deposit insurance funds. Such systems rely on the judgment of regulators to assign appropriate risk weights, and history has shown regulators have often been wrong in these judgments.

We are not alone in this belief. Mr. Thomas Hoenig, vice chairman of the Federal Deposit Insurance Corporation, commented recently on this very point, saying "It was the reliance on and manipulation of a risk-based capital framework that allowed risk to build up to a point that nearly brought the global system to collapse". On the other hand, institutions "that entered the financial crisis with relatively higher levels of capital, as indicated by the leverage ratio" were able to maintain "lending levels far more consistently than those with less capital."

This is exactly what we saw during the aftermath of the financial crisis. The use of Basel-style RBC calculations did not reduce risk on bank balance sheets, did not prevent losses, and in the aftermath of the crisis, caused banks to curtail lending (dramatically, in many cases). In fact, if not for our nation's credit unions, the vast majority operating with more than enough capital under NCUA's current, and sensible, risk-based net worth rule, lending in many communities would have dried up completely at a time when our nation desperately needed economic activity.

We believe this is powerful evidence that risk-based capital calculations are ineffective by their very nature, create arbitrary risk judgments that don't necessarily line up with actual risk, and change incentives for managers in ways that don't necessarily reduce risk or benefit members. Even more concerning, however, is that a Basel-style risk-based capital rule will further blur the lines between banks and credit unions without real effect on risk performance.

**Risk Weights for Credit Union vs. Banks**

NCUA is required to adopt a capital rule similar to that in place for the banking industry, and indeed the current proposal uses a Basel-style of risk weighted capital calculation. What is missing, however, is any consideration that the demonstrated riskiness of credit unions has historically been lower than risk in small banking institutions (see credit union versus bank insurance loss data, above).

A comparison of risk weights for smaller banking institutions and risk weights in NCUA's proposed rule shows where bank risk weights are lower than CU risk weights. Given the lower loss history of CUs (much lower, in some cases), we wonder what compelled NCUA to propose risk weights that are equal to or higher than bank risk weights in all but one category (consumer loans – weighted 75% in the proposed rule versus 100% for banks)? We note the following:

- Banks are subject to a 50% risk weight for 1-4 family mortgage loans without accelerator weights. The accelerated risk weights for CUs with first lien mortgages above 25% and 35% of assets, respectively, are 75% and 100%. We believe the accelerated risk weights penalize CUs for trying to meet the mortgage needs of their members, particularly as compared to bank weights, without considering the conditions under which loans were made or how well boards and managers have mitigated risk. If NCUA's intention was to model re-pricing risk via accelerated risk weights, we again point out no risk "credit" is given for how managers may have structured liabilities and funding sources to mitigate re-pricing risk.

- Commercial loans at banks carry a risk weight of 100%. In the proposed rule credit unions have accelerator weights of 150% and 200% for MBLs over 15% and 25% of assets, respectively. We do not believe actual loss data for MBLs justify these accelerated weights and again put credit unions at a disadvantage to smaller banking institutions when financing small businesses in our communities.

- Risk weights for delinquent consumer loans are 100% for banks, versus 150% for credit unions. This difference is not born out in actual loss statistics between the two types of institutions. The result will be a tightening of credit standards at credit unions, most affecting members at the margin who have traditionally turned to credit unions for help.

- Basel III risk weights for investments are not tiered based upon weighted average life (20% regardless of maturity). We believe this is because banking regulators oversee re-pricing risk in bank investments via the supervision/examination process and have not experienced higher investment losses as a result of these investments. We ask NCUA to show how loss experience for longer term investments supports accelerated investment risk weights in the proposed rule.

**CUSO Investment Risk Weights**
We are concerned with a risk weight of 250% for CUSO investments and believe it to be arbitrary and not substantiated by the loss history of most CUSO investments. Further, we believe NCUA's new final CUSO rule provides the agency with improved oversight over CUs with CUSO investments mitigates the risk of CUSO investments to far less than 250%.

We understand certain losses to the NCUSIF occurred at credit unions with significant CUSO exposure. However, a review of NCUA's own OIG Material Loss Reports show the risks were not directly due to the CUSO investment itself, but arose from a variety of factors stemming from mismanagement and inadequate supervisory/examination procedures. Excessive concentration risks, failure to assess a CU's expected profitability independent of its CUSO investments, insider dealing, failure to properly address the ALLL, weak board oversight, among other reasons, were actually responsible for the losses. All of these are subject to the examination process.

Finally, NCUA's new final CUSO rule provides for greater oversight of CUSO investments. The rule has not yet become effective, yet the proposed RBC rule continues to assume CUSO to be among CUs greatest risks.

**Conclusion to Specific Comments**
This concludes our specific comments on NCUA's proposed risk-based capital rule.