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May 11, 2011

To: Mary Rupp, NCUA Secretary of the Board

From: Gordon Sam, Board Chairman
Eugene Y.T. Chang, President/CEO
Neal S. Takase, VP Operations/Administration

Subject: **Pearl Harbor FCU - Comments on Proposed Rulemaking for Part 741**

The Pearl Harbor Federal Credit Union submits the following comments on the proposed Interest Rate Risk Policy:

While we understand NCUA's reasons for compelling Board of Directors to be more cognizant of their credit union's Asset Liability Management program, we believe that the Proposed Interest Rate Risk Policy (IRR) would have some very negative consequences for the credit union industry. We understand that the ultimate responsibility lies with the Board of Directors, but they should be able to rely on subject matter experts to guide them in their decisions.

<u>Our concerns:</u>

1. The proposed Interest Rate Risk Policy is far too over reaching and if passed in its current form would limit members of Boards to those individuals with extensive financial education and experience. This would dramatically alter the composition of Boards and thus the very nature of credit unions. Natural person credit unions were formed to be managed by the common individual to help his fellow man who could not otherwise receive essential financial services. It is this understanding of the needs of the membership which differentiates the not for profit credit unions from the for profit banks.

   Individuals with the extensive financial backgrounds are not normally like the average member. They don't have the same needs for products and services.

2. The Board of Directors is a policy making group. It provides general direction and goals to the President/CEO or Management Official. The President/CEO or Management Official is responsible to hire staff and obtain the necessary resources to attain the established goals as set by the Board.

   While Board members of small credit unions usually take an active role in managing a credit union, it is usually because they don't have sufficient staff. However, Board members of larger credit unions should not go directly to the staff and bypass the President/CEO or Management Official. If allowed, it would disrupt the chain of command and result in distrust between management and staff.

   "The owners of the plane define their destination. The crew, under the leadership of the pilot, is responsible to chart the course, fly the plane and get to the destination safely and on time."

3. According to the proposed IRR policy, Boards must not substantially rely on third party reviews to determine their adequacy of oversight and governance. While most Board members are normally very intelligent and skilled individuals in their own areas of expertise, they may not have the required financial background to adequately monitor complex investments, accurately project cash flows in an unstable interest rate environment, or determine the proper course of action to correct a policy limit that has been exceeded.

   Third party reviews conducted by competent professionals maintaining an adequate level of independence have become the industry standard in the areas of financial statements, health inspections, accounting firms, etc. Why should credit union Boards be denied using and relying on this practice?

4. The proposed IRR policy potentially imposes the same expectations from a $10 million credit union to a $30 billion credit union yet the level of expertise of most of the smaller credit union's management and boards cannot compare to that of a much larger credit union. Is NCUA attempting to reduce the amount of natural person credit unions to a smaller number but larger in size and more sophisticated group like they are doing to the corporates?

5. It is very difficult to recruit competent individuals in this environment to serve as unpaid volunteer boards and members of the supervisory committee. It would be virtually impossible to recruit anyone to serve if the proposed IRR policy is passed.

Proposed Solution 1:

1. Expand the NCUA 5300 Report to require information that includes pertinent data on long term loans and investments, delinquencies, capital, and allowance for loan losses.

2. Have the NCUA Office of Examinations create intelligent software to determine the level of risk each credit union posses to the Share Insurance Fund.

3. Monitor the credit unions according to their risk level up to and including requiring monthly NCUA 5300 reporting and regularly scheduled visits by their examiners.

4. Have the Management and Board Members of the highest risk credit unions demonstrate their knowledge, measurements and plan to mitigate IRR exposure under different interest rate environments. Have the examiner determine a "Net Risk level for each credit union after considering each credit union's risk level and risk mitigation plans.

5. Assess the Share Insurance Premium according to their Net Risk level.

Proposed Solution 2:

Credit unions with long term fixed yield assets (fixed rate loans over 10 years and fixed rate investments over five years) that exceed 300 percent of their net worth should be required to do the following:

a. Provide NCUA with a monthly 5300 report.

b. Provide NCUA with quarterly fair value and income projections during an immediate 100, 200 and 300 plus and minus Interest Rate change, and projected decay rates in loans, investments and shares.

c. Provide NCUA with semi-annual fair value and income projections for one year, three year and five year horizons.

d. Require annual CPA Opinion Audits of credit unions over $50 million in assets.

CUNA provided Credit Unions a list of suggested questions that they should consider before submitting comments on the proposed policy to NCUA. The following are views on the questions and provides more details on our above comments and proposal:

1. Do you agree credit unions need a new rule on interest rate risk?
   Yes__X__ No____

   Why do you agree or disagree with NCUA? **Too many credit unions used 1st mortgages or long term investments to make their net income positive and risk big problems when interest rates go up. Some credit unions may have used participation loans to improve their ROA without performing adequate due diligence.**

2. Has NCUA provided sufficient rationale for the new rule?
   Yes__X__ No____

3. If this rule is adopted, do you support the triggers for how the written policy requirements would apply?
   Yes____ No_X___

   Please explain your response. **The policy will apply to those credit unions with assets between $10 million and $50 million whose total of 1st mortgages and long term investments exceed 100% of net worth. In Hawaii, 14 of the 39 credit unions in this category will have to comply. Five of the 14 have total assets of less than $20 million and very small staff, some with as little as 2 FTE and 1 part time. It will be very difficult for them to come up with a written policy and they will probably be forced to seek outside assistance at a cost they cannot afford. Most of these credit unions went after 1st mortgages and/or went out long on investments to generate enough revenue to come out with a positive net income. The problem is obvious but what is the corrective action? Should they be forced to sell the 1st mortgages or the long term investments at a loss and go negative on net income, creating a different kind of problem for the regulator? I am sure that this analysis holds true nationwide. Nationwide there are about 2,390 credit unions in this asset range. If we examine their first mortgages alone (not include long term investments) against their net worth, then over 790 must generate a written policy. About 310 of these have assets of less than $20 million. Perhaps we should exclude credit unions below $20 million and raise the threshold to 200% or 300% of Net Worth.**

4. Do you agree with the requirements for the written policy (for those CUs to which these requirements would apply)?
   Yes____ No__X__

Please explain your response. **Presently the policy requires the board to determine the corrective action if limits are exceeded. It would be more appropriate if management determines the corrective action and the board concur or disagree with the proposed action.**

5. NCUA estimates that only 800 credit unions will have regulatory burdens associated with the written policy requirements and the burden for each of them will be 16 hours. Do you agree with that?
   Yes____ No__X__

   What do you think the burden will be for your credit union? **The estimate of 800 credit unions and 16 hours is too low. Credit unions who already have written policies will have to make some adjustments to their policies.**

6. Will your credit union have to create or modify its written policy to conform to the proposal's requirements?
   Yes__X__ No____

   How much time will that take and what other resources of the credit union will be used to comply? **We will have to amend procedures. We will have to hire a third party to validate our ALM policy, assumptions and send board members to get additional training in financial analysis.**

7. Is the guidance on the IRR management program useful?
   Yes____ No__X__

   Please explain your response. **The number of examples listed as inadequate scares us. Currently we use Profit Star to provide us with the tools to conduct our analysis. We will probably have to hire a second firm to assist us in assumptions. I imagine other credit unions our size, $100 million to $500 million will be forced to do the same.**

8. Should compliance with the proposal be a requirement for federal share insurance?
   Yes_X___ No____

   Please explain your response**. If the preservation of the insurance fund is one of the driving factors behind this proposal, then any federally insured credit union should have at least a basic policy. For a small credit union it could be as simple as stating that 1st mortgages plus long term investments will not exceed 300% of net worth. Any credit union can cause a lost to the NCUSIF.**

9. Since the proposed guidance is included as an appendix to the rule, does that create confusion as to what extent credit unions will be required to follow the guidance precisely?

Yes_X___ No____
Please explain your response. **Guidance will create a battle of interpretation between the examiner and the credit union.**

10. The proposal states that IRR policies and management programs must be individualized. Yet, does this proposal and guidance leave sufficient flexibility to credit unions to adopt IRR policies and management programs that reflect this individuals risk profile?
    Yes____ No_X___

    Please explain your response. **The appendix is too detailed and will require most credit unions to comply with everything suggested. Credit unions will have to justify to the examiner why they need not comply with a particular item. For example, a credit union may assume that 90 % of their regular shares are core and not subject to decay rate, and that the remainder is so small that it is immaterial to track. The credit union will still have to track decay rate to prove that their assumption was correct.**

11. Should credit unions be singled out for a new rule in this area when banks have not been? Is the joint guidance that NCUA issued with the other federal financial regulators in January 2010 sufficient?
    Yes____ No__X__

    Please explain your response. **When the FFIEC issued the joint guidance in January 2010, it left it up to the individual regulating agency to implement the guidance. If the FDIC chose not to issue anything more specific, then why should NCUA issue something that so detailed, when the banks are having more problems than the credit unions.**

12. Instead of a new rule for all federally insured credit unions, would it be preferable to address IRR management issues with credit unions that do not have written polices and/or effective IRR management programs?
    Yes__X__ No____
    Please explain your response. **Forcing credit unions to have a written policy is a good way to make them realize that they maybe jeopardizing their future by making their ROA look good through higher returns from long term fixed mortgages and/or long term investments.**

13. Do you agree with the proposal's allocation of responsibilities between a credit union's board and management on IRR management?
    Yes____ No__X__

    Please explain your response. **The management rather than the board should specific corrective action for exceeding limits, the board should concur or reject the proposal. The depth of knowledge required of the board in IRR is equivalent to that of Management. As stated in the policy**

this will require the board to seek professional advice or training. Not all board members will be willing to undergo training in income simulation, net economic value, prepayment drivers, prepayment rates, repricing sensitivity, behavior of instruments with embedded options, such as calls and decay rates on non-maturity shares. This is just another requirement that will drive out the number of volunteers willing or capable of serving in the movement.

14. Do you agree with the proposal's discussion of IRR measurement and monitoring?
    Yes____ No_X___

    Please explain your response. **See our above comments and proposal**

15. Do you agree with the standards for assessing an IRR Policy and Management Program?
    Yes____ No__X__

    Please explain your response. **The standards are too detailed.**