KINECTA
FEDERAL CREDIT UNION

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RECEIVED
APR 30 2014
BY:

The Honorable Debbie Matz, Chairman
The Honorable Michael Fryzel, Board Member
The Honorable Richard Metsger, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Proposed NCUA Risk-Based Capital Rule

Dear Chairman Matz, Board Member Fryzel and Board Member Metsger:

Kinecta Federal Credit Union ("Kinecta" or "Credit Union") appreciates this opportunity to comment on the Board's proposed rule that would amend part 702 of NCUA Regulations, Prompt Corrective Action ("PCA"), and replace its current risk-based net worth framework with new risk-based capital standards for all federally-insured natural person credit unions.

Kinecta strongly supports risk-based standards as a component of PCA. Properly designed and implemented, a risk-based approach effectively and equitably addresses capital requirements for the varied risk profiles among credit unions. It also ensures those institutions that may enjoy the potentially higher returns for accepting additional risk also bear the costs of capital necessary to support such activity.

While we agree in principle, we believe there is insufficient evidence to support NCUA's position that the current risk-based framework is inadequate and that a more restrictive one is warranted to ensure the safety and soundness of the credit union system. Furthermore, we see many of the elements proposed in the new framework as either inappropriately generic or redundant. Consequently, the new model fails to provide a more accurate assessment of risk at individual credit unions. While we can appreciate NCUA's objectives, we feel that this attempt to capture the myriad of risks faced by credit unions with a single blunt tool is imprudent and potentially unsafe.

The proposed rule may align NCUA's PCA framework somewhat more closely with the capital standards in place at the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and the Federal Reserve ("Other Federal Banking Regulatory Agencies"); however, the inconsistencies that remain are conspicuous, significant and clearly not mandated by Congress. We offer additional commentary below to support our position as well as to describe the potential adverse impact of this proposal on Kinecta and its members.

Concentration / Interest Rate Risk

As proposed, this rule could seriously restrict Kinecta's ability to serve its members. Because of the proposal's arbitrary caps on mortgage loans, our credit union would go from well-capitalized with approximately 130 basis points of capital cushion to adequately-capitalized with a 100 basis point shortfall. As such, Kinecta's ability to accept members' deposits, meet

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member loan demand and achieve the associated efficiencies of scale is threatened. These are integral to Kinecta's business model and strategic plan.

It is our view that neither we nor the NCUA will have much success if we attempt to dictate the products and services our members demand. If Kinecta is unable or unwilling to meet their needs our members must take their business elsewhere. It is interesting that under the Basel III framework, Kinecta would remain a well-capitalized mutual with its existing balance sheet and business model intact. We do not agree with NCUA that with all things being equal it is far riskier to be a credit union than a mutual savings bank.

Arguably, the biggest threats to credit union capital have traditionally been credit risk, interest rate risk and liquidity risk. All of these are suited to a framework that varies capital requirements based on the risks inherent in specific categories of assets. As such these are already addressed in the existing asset-based frameworks adopted by NCUA and the Other Federal Banking Regulatory Agencies.

Although not stated explicitly in the proposal, the evidence plainly suggests that the changes proposed by NCUA to the existing risk-based net worth framework are principally intended to unreasonably expand regulation of one risk, interest rate risk ("IRR"). Given the current environment, Kinecta acknowledges that IRR is a serious concern for the industry and should be carefully monitored and addressed. However, the proposed rule's attempt to impose a standard IRR model through concentration limits appears a bit unsophisticated, generic and ultimately unnecessary given the existing PCA framework and the current regulatory structure in place for managing and monitoring the unique IRR profiles of individual credit unions.

In contrast, helping credit unions manage IRR by providing tools like basic derivatives is both constructive and appropriate. We appreciate and applaud the NCUA's efforts in this regard. Tools and methodologies like derivatives can be tailored to the unique needs of a particular credit union. On the other hand, blanket implementation of arbitrary and punitive concentration limits is imprecise and indiscriminate. Both methods may ultimately prove effective, but collateral damage is unreasonably and unnecessarily high with the latter approach.

Interestingly "concentration" is not recognized in the risk-based capital frameworks of the Other Federal Banking Regulatory Agencies. Rather, these Agencies correctly conclude that concentration risk is merely the aggregation of credit, interest rate, liquidity and other risks inherent in an asset class. While risk clearly differs among asset classes in their capital framework, these Agencies understand that the riskiness of any individual asset does not increase or decrease in proportion to its percentage of the balance sheet. The NCUA's assertion, that somehow after an arbitrary concentration limit is reached, the risk of the next mortgage loan increases by a factor of 50% or more is illogical. There is simply no rational argument, much less any empirical data, to support it.

Though we do not agree that concentration risk is an appropriate element of a risk-based capital framework, even so the proposed rule appears inconsistent with NCUA's own description of concentration risk. In its August 3, 2011 Supervisory Letter, the NCUA expressed its view that:

> "Avoiding concentrating too much in **any single product or service** is a core tenet of effective risk management and when violated increases the risk of loss to the credit union and to the NCUSIF. Too much reliance on **any single product or service** increases the potential for adverse consequences from "event risk" (i.e. a negative event, such as a housing market crash, that significantly affects the financial condition of the institution). **Every asset, liability, product, service, and third party provider** presents a risk of loss to the credit union under varying conditions or events. Some risks are less likely than others to occur. It is up to **credit union management to identify the risk** in each product or service line, quantify the risk **and set appropriate concentration limits** based on the analysis."

With this perspective in mind, it is difficult to understand why concentration risk as described is inherent only to certain asset classes and not others. It would seem that an over reliance on a single product like auto lending carries concentration risk just like one in mortgage lending, commercial lending, deposit account fees or any other product or service offered by a credit union. Thus far, we have been unable to identify any past period of economic stress, including the most recent, where increased risk of loss was isolated to a single product and not broadly spread across asset categories.

Certainly, event risk is not exclusive to mortgage and commercial loans. For example, a drastic spike in gasoline prices (perhaps due to a conflict in the Middle East) would certainly have an adverse impact on auto portfolios. In a mortgage and auto portfolio of equal size where ten-percent of the balance defaults, identical amounts are initially charged off. The only difference is that after disposition of collateral the loss severity on the auto portfolio is usually higher. In fact, recent analysis of empirical evidence by Callahan & Associates shows that net losses on first mortgage loans actually decrease as their percentage of assets increases.

If we were to assume as NCUA suggests above that concentration risk exists outside asset categories in areas like vendor reliance and geography, it would be applied to virtually every credit union. As community-based institutions with fields of membership, most credit unions are by definition geographically, industry or employer concentrated. This proposal's attempt to impose increased capital standards for the perceived risks of some concentrations and not others is inconsistent and inappropriate.

We believe that the application of concentration limits and higher risk weightings exclusively to long-lived assets clearly suggests that this proposal's purpose is to systemically reduce interest rate risk. In our view, it is inappropriate to pursue this objective through a risk-based capital framework with arbitrary concentration limits indiscriminately applied. Every Federal Banking Regulatory Agency except NCUA agrees. We recommend that the NCUA remove concentration limits from the proposed capital framework and focus instead on enforcement of existing regulatory measures for assessing and monitoring interest rate risk.

Credit Risk

Unmistakably, the biggest problem for both credit unions and banks during the Great Recession was credit risk. Credit unions have historically been much more conservative than banks in underwriting credit due to the nature of their Boards and management and inherent restrictions on their ability to access capital. Not surprisingly the industry fared far better during the crisis. Nevertheless, the NCUA insists that credit union loans are impaired at 60-days past due while bank loans are not impaired until 90-days past due.

It is difficult to understand why a credit union charter makes the same loan riskier. Be that as it may, it is harder still to comprehend why under the proposed rule a performing high quality mortgage loan portfolio may be regarded as far riskier than a sub-prime auto or signature loan portfolio of the same size. Again, we find the proposed framework would not reliably assess capital risk by imposing arbitrary asset caps.

Liquidity Risk

We believe the liquidity rule issued recently by the NCUA Board in October 2013 provides an appropriate framework for managing and evaluating liquidity risk, and therefore no additional measures are needed. It is our view that liquidity risk is influenced much more by the amount, nature and marketability of assets, and by the availability and scope of alternative funding sources, than it is by stated maturities.

We find it ineffective and potentially counter-productive to address liquidity risk by assigning risk weights to investments based on weighted average lives. In fact, investments with relatively longer lives may exhibit low price sensitivity and ready marketability both of which create strong liquidity. The reverse can also be true. Shorter-term investments can be less liquid and comparatively more volatile.

The proposed separate risk weightings for investments in and loans to CUSO's are puzzling. Although the justification offered by NCUA appears largely based on liquidity arguments, this does little to explain why an illiquid investment in a CUSO is so much riskier than an illiquid loan to the same entity. Furthermore, it seems nonsensical that accumulating capital in a successful CUSO through retained earnings should dramatically increase balance sheet risk. NCUA should re-examine CUSO risk weightings and consider using a 100% weighting for both investments and loans.

We believe a liquidity risk framework focused on issuer characteristics and marketability rather than weighted average lives is superior to the capital framework proposed. This approach would be consistent with our position that liquidity risk is more appropriately addressed through adherence to existing liquidity rules with oversight through the periodic examination and monitoring processes rather than through a risk-based capital framework.

Individual Minimum Capital Requirements

The Other Federal Banking Regulatory Agencies have for many years utilized individual minimum capital requirements ("IMCRs") coupled with periodic examination and monitoring to address credit, interest rate, liquidity, and other risks that they deem to be unacceptably high either individually or in the aggregate. We have no objection to establishing authority for individual minimum capital requirements as long as these are applied equitably, consistently, without personal bias and with provision for due process.

Unfortunately, the proposed rule indicates that IMCRs would be imposed by individual examiners. Credit union examinations always involve an element of subjectivity. Therefore, we believe it is unreasonable to expect that any one examiner can be consistent with all others. Past experience supports our position. Each year there are numerous examples cited by credit unions in peer group discussions and at industry events that highlight considerable variation among examiners and examination results. Also, it is perhaps naïve to believe that individual examiners harbor no personal preferences for certain asset classes and lines of business. Of course, this makes IMCR as proposed a very serious concern.

We suggest that both the rationale for imposing IMCR and the credit union's rebuttal (if any) be subject to supervisory review, peer review and due process prior to implementation. Additionally, we feel it would be beneficial to provide more specificity around the rights, authorities, time frames and obligations of each party involved in the IMCR process, especially those of the proposed Ombudsman.

NCUSIF Deposit

We have been unable to determine a sound reason for deducting the NCUSIF deposit from capital under the proposed risk-based capital framework. Clearly, these funds are available to cover credit union losses. Also, it seems the NCUSIF deposit is an asset not unlike the capital deposits that credit unions may hold at their respective FHLB or corporate credit union. When a credit union chooses to leave its FHLB, the deposit is returned. To the best of our knowledge, the NCUSIF deposit works similarly. We would encourage NCUA to provide additional clarification around this issue, or alternatively consider treating the NCUSIF deposit like other illiquid assets instead of contra-equity.

Implementation Period

The proposed implementation period of 18-months is unreasonably short and an unnecessary burden on credit unions. There is no evidence to justify this level of urgency. The industry remains well-capitalized even after the biggest financial crisis since the Great Depression. Additionally, it is wholly inconsistent with the implementation of Basel III in the banking industry. Under that framework, smaller institutions may have as long as nine years to prepare which obviates their need to implement radical and potentially damaging changes to their business models and service levels. NCUA should increase the implementation period to a minimum of three years, or more reasonably to five years.

Summary & Conclusion

We believe the proposed framework is unjustified and would place an unnecessary burden on credit unions. Ours is a closed system where capital is especially dear. Credit unions do not raise capital. We earn it by serving our members well. This proposal limits our ability to do so by making credit unions less competitive with banks.

It is the lack of access to capital that keeps the credit union share of financial assets well under ten-percent. Requiring credit unions to hold unnecessary capital does little more than shrink the small portion of assets we already hold. If NCUA's intent is to improve the long-term viability of the credit union system, a regulatory mandate to reduce our market share would seem a poor choice of strategy. This proposal should be reconsidered.

Thank you again for the opportunity to comment on the proposed rule. We would welcome the opportunity to discuss our concerns with you in greater depth or to respond to any questions you may have regarding this letter.

Keith Sultemeier

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