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April 23, 2015

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

Re: Comments on Proposed Revised Risk-Based Capital Rule

Dear Mr. Poliquin,

I appreciate the opportunity to comment on the revised proposed risk-based capital ("RBC") rule, and I thank NCUA for listening to recommendations and making significant changes to the original RBC proposal.

Current Rule Has No Value

I agree with NCUA that the current Risk-Based Net Worth ("RBNW") rule has little if any value and I recommend that it be eliminated whether or not the revised RBC proposal gets adopted. While the RBNW rule may not have affected many credit unions, it did impact ours. In the "Great Recession", our state's economy was hit particularly hard and our net worth ratio declined almost in half to around 6.50%. Loan losses abounded and loan demand was stifled, reducing our earnings ability. Our loan-to-asset ratio dropped into the 45% range, and overnight cash was earning almost nothing.

In these circumstances, we set out to develop an investment strategy that would increase earnings, improve net worth, and protect our net interest income in case of a prolonged low-rate environment, all with a careful eye on liquidity and interest-rate risk. We began implementing our plan and were making good progress until our RBNW ratio started to get a little too close for comfort to our net worth ratio. By rule, had the RBNW ratio exceeded our net worth ratio, it would have caused our Prompt Corrective Action ("PCA") classification to be considered "less than adequate".

The end result was that, due to the rule's inappropriately punitive risk weights on investments, we had to markedly curtail our strategy in order to keep our RBNW ratio from exceeding our net worth ratio. In essence, we had to alter a sound business strategy meant to improve both earnings and capital when we most needed it due to a poorly written rule.

In my response letter to the original RBC proposal last year, I expressed my thoughts that I believed it could be an improvement to the existing RBNW rule if a number of improvements were made. A large part of that belief came from my thoughts that the existing risk-based rule was so poorly written and the negative impact that rule had inappropriately inflicted on our credit union.

Proposed Rule an Imprecise Forward Measure of Credit Risk

Risk-based capital is stated by NCUA to be a forward-looking measure of credit risk. If so, it is a very imprecise measure. There are many factors involved in determining credit risk of any asset. With a loan as an example one could look at: loan to value, debt to income, credit score, migration analysis, national economy, local economy, etc., etc.

However, risk weights in the RBC model are assigned solely based on one simple factor - the class of asset, and the risk weights do not appear to coincide with historical loss data. A fatal flaw is that the model assumes that risk management, including credit underwriting, at all institutions, is equal to each other.

I have always had an issue with what I believe are arbitrary risk weights on different asset classes from when the banking regulators originally adopted the Basel RBC approach. I have never seen any studies to show that the risk weights were developed through an extensive study over time or through a look-back study to validate the risk weights. There are so many variables to measure the risk in any asset that it is impossible to craft a single measure for each class of asset for all institutions. In a relative sense, the model punishes the institutions that have the strongest underwriting and risk management and they elevate the weakest ones in comparison by assigning the same risk weight based solely on the fact that the assets are in the same class.

Model Risk is High in the Proposed Model

NCUA advises, and rightfully so, careful testing of models to eliminate model risk. For example, a model that measures interest rate risk should be tested, back tested, and sometimes cross-tested by another comparable system/provider. I believe the flaws mentioned above are enough to cause serious doubts about the viability of a RBC model. Has NCUA back tested the risk weights compared to actual loss experience? Even if it had done so, the "one size fits all" approach cannot provide an accurate assessment of the varying levels of risk management from institution to institution.

The reality is that the RBC model remains an unproven methodology. Banks have had it in place for around a quarter of a century, yet they failed at a much higher rate in the recent economic downturn than did credit unions. The model has been modified a few times now - it keeps getting more complex but I am not aware of any empirical evidence that it has significantly improved overall failure rates or the ability to predict failures of specific institutions any more accurately than a simple leverage or net worth ratio. In my view, the most impactful change to banking capital guidelines in the most recent round of modifications was to increase the leverage ratio requirement, which is similar to the credit union's net worth ratio.

Over Reliance on an Imprecise Measure

Another major concern with the model is that it is an imprecise measure that regulators and others will immediately jump to as a precise indicator of safety and soundness and it will become over relied upon.

Legal Authority is in Serious Doubt

Even if it were a proven model, the legal authority for two-tiered RBC approach is in serious doubt. The written legal opinion received by NCUA is a weak one at best. The concluding opinion states: "Based on the foregoing facts and a reasoned analysis of Chevron and Section 216 of the FCUA, we are of the opinion that, under current principles of applicable law and existing case law, a court of appropriate jurisdiction, in a litigated matter of proceeding, "could" conclude that the NCUA's statutory authority pursuant to Section 216 of the FCUA permits the NCUA to establish the proposed two-tier RBNW requirement set for in the proposed rule." (Emphasis added to the word could)

"Could" is a weaker conclusion than "more likely than not", and "more likely than not" means a greater than 50% likelihood. Therefore, "could" means an assurance level of less than a 50% likelihood.

If there is any vagueness, original congressional committee members have clarified their position that it was not their intent to allow a two-tiered RBC model.

<u>Negative Unintended Consequences Will Occur</u>

I urge NCUA to consider unintended consequences. With any model like this, there are unforeseen circumstances that lead to unfortunate results. As related earlier in this letter, the current RBNW rule had a definite, negative impact on a well-thought-out strategy to improve earnings and net worth in the exact time when that strategy was most needed. NCUA would not have considered our credit union as "affected" by the rule since our RBNW ratio never exceeded our net worth ratio. However, there is no question our business strategy and our financial results were negatively "affected". The revised, proposed RBC rule, if adopted, will have negative, unintended consequences.

<u>2015: The Year of Regulatory Relief</u>

While I honestly appreciate all of the regulatory relief efforts currently being considered by NCUA, it is extraordinarily ironic that 2015 has been declared by NCUA as the "Year of Regulatory Relief" within weeks of proposing a major regulatory rule that will add significant burden to the industry.

The burden is not only the reporting burden, but the burden of changing the way management makes decisions to conform to a rule rather than making risk/reward decisions. I fully believe that considering the risk/reward relationship of each asset to capital/net worth is appropriate, and I realize that is one the objectives of the RBC rule. However, I believe the risk weights are so imprecise that the rule will burden the industry with decision making that is skewed toward an imprecise measure of risk in the risk/reward decision making.

<u>The Solution</u>

Keep the model, but use it as a tool in the examination process and in the evaluation of the Capital component of the CAMEL rating. This would allow the model to be used in the examination process but defer potentially serious PCA ramifications while the industry continues to evaluate the concept. Save the NCUA and the industry from the effort and cost of potential litigation and the associated additional strain on the relationship between the parties.

Keep the requirement for a comprehensive, written capital plan for complex credit unions. Such a plan is a far better and more sensible approach for managing and regulatory oversight than a RBC model.

If NCUA determines to move forward with the proposal, at a minimum:

1. Eliminate the two-tiered RBC requirement; use the model only for purposes of determining "Adequately Capitalized".
2. Defer the effective date of the rule until meaningful changes have been made to allow supplementary capital in the RBC capital numerator. This would give some true regulatory relief to help those institutions who would need additional capital due to this rule and have no other available sources.

3. Include the NCUSIF deposit in the RBC numerator. To be comparable to banks, it must be included. A perfect example of non-comparability is that a credit union converting to a bank charter would receive its NCUSIF deposit back from NCUA and it would count in their RBC ratio as a bank when it did not as a credit union.
4. Exempt non-complex credit unions from the added reporting burden that this rule would require of complex credit unions.

Interest Rate Risk
NCUA requested comments on ways to standardize interest rate risk ("IRR") measurement and possibly attach it to the RBC model.

It seems as though NCUA would consider Net Economic Value ("NEV") as a possible IRR tool. There is an uncorrectable and fatal flaw with trying to use NEV as a standard IRR tool. Slight changes in input assumptions in the NEV model can cause significant changes to the output. There are definite differences in the characteristics of assets and liabilities from one credit union to another. Creating standard assumptions for all credit unions, will create a significant disadvantage for some credit unions in comparison to others. Using examiner judgment to determine the proper assumptions will also unquestionably eliminate the standard in the standard IRR tool.

Previous guidance issued by NCUA along with sound examiner training is sufficient to govern IRR at credit unions. It would be dangerous and unjustifiable to try to standardize an IRR model amongst complex credit unions, especially one that would be tied to a RBC model with serious PCA ramifications.

Comprehensive, Written Capital Plan
NCUA in its revised proposed RBC rule states that the required ratios are a "minimum standard", and the proposal would mandate a comprehensive, written capital plan to account for other risks. This appears to require the equivalent of a written Enterprise Risk Management plan, which contradicts NCUA's Letter to Credit Unions 13-CU-12. However, having a comprehensive, written capital plan is a far better approach to capital management (and regulatory oversight) than a RBC model.

Submitted by:

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