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March 12, 2014

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

Re: Comments on Proposed Rule: PCA – Risk-Based Capital
RIN 3133-AD77

Dear NCUA Board,

I am writing to comment on the proposed risk-based capital rule. I work for First Credit Union, based in Chandler, Arizona. We have 42,000 members, \$402,000,000 in assets, and 8 branches.

General Comments:

I commend the NCUA for what I feel is a positive step toward a risk-based capital standard. The proposal has potential to become an improvement over the existing risk-based net worth standard.

There are a number of things I like in the proposed standard:

- a. Keeping the calculation less complex than the banking risk-based capital calculation.
- b. NCUA's awareness of regulatory burden on credit unions relating to reporting requirements.
- c. Attempting to measure capital in a more consistent manner with the other financial regulators in the United States.
- d. Separating loans by delinquent/non-delinquent and assigning different risk weights.
- e. Adding back a limited amount of allowance for loan losses to regulatory capital.
- f. Capturing risk of off balance sheet items.

The remainder of my comments relate to areas I feel need to be revised in the final rule. In summary, my concerns relate to:

1. The risk weights for some investments are excessively punitive and need to be changed to match the risk weights used in the Basel/bank method.
2. The NCUSIF deposit should not be a deduction from the risk-based capital numerator.
3. Individual minimum capital ratios should be eliminated from the final rule.
4. The concentration risk penalty for 1st residential mortgage loans should be eliminated or the thresholds should be raised.
5. The effective date should be extended with shorter, periodic step requirements.

6. The sections related to “comprehensive understanding” of “asset-backed investments”, including the 1250% risk weight, should be eliminated or revised.
7. NCUA should be prepared to increase the amount of ALLL permitted in the risk-based capital numerator if FASB issues a final rule that requires higher levels of ALLL.
8. There needs to be a technical correction to the wording for the “Undercapitalized” classification in the proposal.
9. In comparison to the risk-based capital rules of other federally insured financial institutions, the overall impact of the proposed rule, as it currently stands, will require credit unions to hold more capital than other federally insured financial institutions with similar risk profiles and therefore will be at a competitive disadvantage in the marketplace. Where there are differences in the methodology between the proposed rule and the methodology used by banks, the vast majority are less favorable to credit unions when compared to banks.

NCUA’s assessment is that 90 percent of credit unions affected by this proposal would be in compliance with the minimum risk-based capital requirement under the rule. However, if the final rule is issued without some needed modifications, there will be significant negative consequences for many affected credit unions and without these needed changes to the proposed rule, the issuance of this rule will be a step backward rather than a step forward.

Let’s work together to get this right and avoid substantial unintended and negative consequences. One of the primary negative consequences is that this rule, as proposed, would cause many credit unions, including First Credit Union, to unnecessarily hold more capital than what is rightfully needed. Opportunities for growth would be reduced. Returns to members would be diminished. Following are suggestions for improving the proposed rule.

Proposed Section 702.104(c)(2) Risk-Weights for On-Balance Sheet Assets:

Investments:

The proposed risk weights for investments is a troublesome piece of this proposal. The measurement is based on the wrong type of risk, has multiple substantial inconsistencies, provides real incentive to carry more risky assets on the balance sheet, places credit unions at a competitive disadvantage compared to other types of federally insured financial institutions, and fails to meet the stated goals of the proposal.

According to the NCUA proposed rule: “The Board believes the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions. Use of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions.” The proposal, as currently drafted, fails to meet this stated goal.

An area of major concern is the highly punitive nature of the risk weights applied to investments in the proposed rule. For our credit union, our risk-based capital ratio for December 31, 2013, according to the NCUA’s online calculator, came to 11.68%. Using NCUA’s proposed rule, but substituting the calculation related just to investment securities and certificate of deposit

investments with the risk weights used by all of the U.S. banking regulators, our risk-based capital ratio would be 14.51%. That is a 2.83% disparity stemming from differences in just the investment area (the difference would be 3.17% if not for the fact that our ALLL reserves exceed the 1.25% limit of risk-weighted assets).

It is difficult to argue that there is comparability between all types of federally insured financial institutions with this large of a difference. While one might argue that both ratios would be considered “well capitalized” and therefore the credit union is not negatively impacted; this argument is not true.

A lower risk-based capital ratio would limit growth and merger opportunities, alter sound investment strategies meant to properly manage interest rate risk, cause us to raise additional, unnecessary capital, and reduce returns to members along with reducing the value of a credit union charter. Examiners, board members, creditors, and other third parties will come to rely on the risk-based capital ratio as a risk-measuring standard, with serious negative impact to First Credit Union if this rule is adopted as proposed.

The methodology for risk-weighting most asset categories in NCUA’s proposal is primarily based on credit risk, including the loan portfolio, which is typically the largest asset class of credit unions. The adjustments for concentration risk in the loan portfolio are, in reality, a subcomponent of credit risk, as it only attempts to recognize additional credit risk in the loan portion of the balance sheet created by concentrations of certain types of loans. While NCUA purports to have given consideration to other types of risk in its proposed rule (“consideration was given to credit risk, concentration risk, market risk, interest rate risk, operational risk, and liquidity risk”), there is little evidence of measuring any risks other than credit risk for any significant classes of assets with the exception of certain investments.

Within the investment area, the approach is a mix of credit risk and interest rate risk. Credit risk is the driver for investments in corporate credit union capital and CUSO capital, as well as for certain U.S. agency securities such as Treasury securities and securities guaranteed by NCUA or FDIC. The risk weights for other types of investments appear to be based primarily on the perceived interest rate risk. This not only creates an inconsistency within the overall methodology, it also causes this proposal to fail to meet the NCUA’s previously stated goals of comparability of risk-adjusted capital levels across financial institutions and a consistent framework. The fact that our credit union’s risk-based capital ratio would be negatively impacted by 283 basis points in just a portion of this one area is compelling example of this lack of comparability.

The risk-based capital methodology that came out of the Basel accords is based almost exclusively on credit risk both of assets and off balance sheet items. This is the standard throughout the rest of the U.S. financial institution industry, as well as throughout the many developed countries in the world that have adopted Basel. This is reasonable and appropriate since the vast majority of failures result from credit risk.

NCUA states in the proposed rule: “The design of the [RBNW] requirement should reflect a reasoned judgment about the actual risks involved.” How many natural person credit unions failed in the recent economic downturn due to interest rate risk? How many natural person credit unions failed in rising

rate environments in the last 30 years due to interest rate risk? I doubt very many in either of these situations, especially when compared to credit unions that failed due to credit risk.

According to the proposal, “The current risk-weights for investments relied on the results of 300 basis point interest rate “shock tests” to corroborate the assigned risk-weights. The 300 basis point shock test is a widely accepted measure of interest rate risk.” While interest rate risk is a critical area of risk to assess, it is impossible to measure interest rate risk by looking at only a small portion of the balance sheet. In fact, if credit union management were to try to measure interest rate risk in this manner, they would be severely chastised by their examiners, and rightly so. Therefore, any attempts to limit interest rate risk (with the teeth of prompt corrective action through a critical capital ratio) through a portion of the investment portfolio without regard to the overall interest rate risk of the entity is inappropriate and will cause serious, negative, unintended consequences.

A credit union’s interest rate risk profile might indicate the need for some fixed-rate, longer-term securities. One of the largest concerns in the more recent environment is for continued net interest margin compression if rates were to stay low for an extended period. This is a real risk, and even the more recent increase in longer-term market rates has not alleviated the possibility. In many cases, an extended period of low interest rates would have a more negative impact on income and net worth than rising rates, yet this proposal would punish those credit unions that rightfully are protecting against a viable risk by holding an appropriate amount of longer-term, fixed-rate investments within their established interest rate risk and liquidity guidelines.

The main disparity between the calculation under NCUA’s proposal and the other financial regulators’ method is NCUA’s risk-weighting of investments due to its high emphasis on potential unrealized losses to the portfolio in rising rate scenarios in developing these risk weights. This is another inconsistency within the proposal that fails to meet the stated goals. The following is from the proposal:

“The proposed risk-based capital numerator would not include the following Call Report equity items:

- Accumulated unrealized gains (losses) on available for sale securities;
- Accumulated unrealized losses for OTTI on debt securities;
- Accumulated unrealized net gains (losses) on cash flow hedges; and
- Other comprehensive income.

NCUA recognizes the items listed above reflect a credit union’s actual loss absorption capacity at a specific point in time, but includes gains or losses that may or may not be realized. NCUA also recognizes that including these items in the risk-based numerator could lead to volatility in the risk-based capital measure, difficulty in capital planning and asset-management and other unintended consequences. Accordingly, NCUA chose to exclude these items from the proposed risk-based capital numerator.”

While the proposed rule appropriately leaves unrealized gains and losses on available for sale securities out of the risk-based capital numerator and explains NCUA’s good reasoning behind that position, the punitive risk weights applied to investments almost completely offset this in our case, and likely for many other credit unions. In fact, based on December 31, 2013 numbers, NCUA’s proposed investment risk weights effectively reduce our current risk-based capital ratio versus the banking methodology as if we had already realized in our risk-based capital numerator the vast majority of what the expected

change in unrealized losses in our investment portfolio would be in an instantaneous rates up 300 rate-shock scenario. In other words, the punitive investment risk weights reduce our risk-based capital ratio today as if we had already sold almost our entire portfolio at the loss in market values we would expect in an unrealized, instantaneous up 300 basis points rate-shock scenario.

To help show this, our credit union's risk-based capital ratio, as discussed earlier, would be 14.51% using the NCUA's methodology except for substituting the banking risk weights for investment securities and certificate of deposit investments. Taking this same calculation, but reducing our risk-based capital numerator by the expected unrealized loss in value of our investment portfolio in an instantaneous rate shock of up 300 basis points, our ratio would be 10.66%. Our risk-based capital ratio based on NCUA's calculation comes to 11.68%.

As of December 31, our investment securities and certificate of deposit investments totaled \$99.4 million. Our risk-weighted asset denominator for these assets would total \$13.1 million under FDIC's risk weights and \$75.3 million under NCUA's proposed rule. That equates to an average risk weight in the investment portfolio of 13% per FDIC and 76% under NCUA. The impact to the total risk-weighted asset denominator is 27%, and the impact to the risk-weighted capital ratio is a massive 24%. These calculations are shown in "Exhibit A".

Credit unions with lower loan-to-share ratios are likely to receive the most negative impact of the proposed risk weights on investments due to the likelihood that they will have a higher portion of their assets in investments. In many instances, the average life of a credit union's earning assets will shorten when the loan-to-share ratio decreases, and there is a need not only to improve earnings but also to maintain the duration of its assets to balance interest rate risk. The proposed rule hinders these efforts.

Other issues with the proposed investment risk weights are major inconsistencies not only when compared with risk weights of other assets, such as loans, but also when compared with different investment classes. Some examples of this include:

- a. A 30-year 1st residential mortgage on the books, assuming it is not delinquent and does not exceed the 25% of assets threshold as defined in the proposal, would receive a 50% risk weight. However, a pool of the same type of loans in a mortgage-backed security, assuming an average life between 5-10 years, would be risk weighted at 150%, even though the credit risk is less due to the guarantee of a government agency or a government sponsored enterprises ("GSE"). In other words, the same type of asset with a similar average life but with less credit risk has three times the risk weight.
- b. A member business loan with a 7-year balloon maturity, assuming MBLs make up less than 15% of assets, would carry a 100% risk weight. A 7-year bullet agency security would carry a 150% risk weight (if not specifically designated with a 0% risk weight). The credit risk is greater on the member business loan than on the bullet agency, but the interest rate risk would be similar. Again, the asset with significantly less risk would carry a much higher risk weight.
- c. A nondelinquent unsecured credit card loan would have a risk weight of 75%, while a 5.5-year security guaranteed by a GSE would require twice as much capital with a 150% risk weight.
- d. A nondelinquent 84-month indirect auto loan with a 130% loan-to-value ratio would carry a 75% risk weight compared to a 150% risk weight for GSE security with a 5.5-year life.
- e. U.S. Treasury debt securities, and debt instruments unconditionally guaranteed by the NCUA (such as NCUA Guaranteed Notes or "NGNs") or the FDIC receive a 0% risk weight, no matter the

average lives – even up to 30-year maturities. The proposal is not clear on whether securities guaranteed by GNMA or other agencies also backed by the full faith and credit of the U.S. Government will be included in the 0% risk weight. If not, then a U.S. Treasury debt instrument with a 30-year average life would have a 0% risk weight and a debt instrument with a much shorter 5.5-year average life issued by another agency (other than NCUA or FDIC) such as GNMA, also backed by the full faith and credit of the U.S. Government, would have a 150% risk weight.

- f. Other GSE securities, such as those issued by FNMA and FHLMC, have no historical losses to purchasers of investments backed by these issuers, and whose implicit U.S. government backing was proven in the recent economic downturn, are given a less-than-favorable risk weight compared to either loans with similar average lives (of over 5 years) or U.S. Treasury debt securities of far longer maturity.
- g. General obligation municipal bonds, for which defaults of AA or AAA-rated bonds have been less than one-hundredth of one percent (0.01%) over the past 30+ years, similarly are given less-favorable risk weights compared to loans with similar average lives or U.S. Treasury debt securities of far longer maturity.
- h. Private-label asset-backed securities, which have greater credit risk and higher complexity, receive the same risk weights under this proposal as other securities backed by GSE guarantees as long as their weighted-average lives are similar when, in reality, government-guaranteed securities should carry a lower risk weight than these more risky alternatives.

The proposal seems to suggest the NCUA believes that longer-term, fixed-rate investments are bad no matter what the scenario, and these require more capital than other, more risky assets. Assuming a normally-sloped (positive) yield curve, and that a credit union is properly managing its liquidity and interest rate risk, the “shorter is better” mentality is generally only true in a rising rate scenario; the opposite is typically true in a rates down or unchanged scenarios. In fact, an interest rate risk profile might need longer-term, fixed-rate investments to be neutral, but a credit union is punished in its risk-based capital ratio for having these in its portfolio. Or, a credit union may have liabilities with similar durations offsetting those investments or interest rate swaps mitigating the interest rate risk exposure of the investments, but the proposed rule would throw the baby out without checking the bath water.

Another negative impact of using weighted-average lives as the determining factor for investment risk weights is that this method will cause volatility in risk-based capital ratios. Many credit unions invest a sizable portion of their investment dollars in government-backed mortgage products such as mortgage-backed securities and collateralized mortgage obligations, which have many positive characteristics when properly balanced within the rest of the investment portfolio and the balance sheet as a whole. Premium mortgage securities can be an effective tool against rising interest rates when properly balanced with interest rate risk, extension risk, and liquidity risk considerations. However, since the average lives of these different types of mortgage instruments lengthen in rising rates, many of them will move into higher risk-weight categories under the proposed method, creating volatility in this critical risk-based capital ratio.

Attempts to limit interest rate risk primarily through a portion of the investment portfolio as proposed in the risk-based capital rule will not work effectively, creates inconsistent treatment between different types of investments, creates inconsistent treatment between investments and loans, creates volatility

in the risk-based capital ratio, provides real incentive to carry assets with more risk, places credit unions at a competitive disadvantage to banks, and fails to meet the stated goals of the proposal.

Recommendation:

Adopt the risk weights for investments and deposits in federally insured financial institutions consistent with the risk weights in use by all other financial institutions in the United States. Allow regulatory governance of interest rate risk through existing, more comprehensive NCUA guidance rather than attempting to regulate interest rate risk by looking at only one small portion of the balance sheet.

Benefits would be:

1. Risk-based capital measurements more consistent and comparable with other financial institutions.
2. Consistent methodology between loan and investment classes.
3. More appropriate and less punitive risk weights for investments.
4. Avoid negative and unintended consequences to credit unions.
5. Less volatility in risk-based capital ratios.
6. Avoid unnecessarily requiring too much capital for credit unions.
7. Leaves credit unions on a more level playing field with other financial institutions.

While adopting investment risk weights consistent with the other banking regulators will require additional reporting in the quarterly call reports, this is a small issue for some and a non-event for others. A vast majority of credit unions that would be affected by this proposal either use systems developed by, or outsource their investment accounting and reporting to, firms who are already providing the required information to banks, and it would require little relative effort to modify the reports provided to credit unions to be able to report this information in the call reports.

Given that the Federal Credit Union Act requires the consideration of all material risk, NCUA should consider the fact that its existing standards for core capital measurement already exceed the capital levels required for banks.

Credit unions are required to maintain a 6% net worth ratio to be considered "adequately capitalized", a full 2% above the banks' comparable leverage ratio which requires a 4% level. To be considered "well capitalized", credit unions are required to maintain a net worth ratio of 7% compared to the 5% leverage ratio required for "well capitalized" banks. NCUA should base its asset risk weights (including investments) on credit risk and consider the higher required core capital ratio as a buffer to account for those risks other than credit risk. Note that a higher core capital ratio will also project to a higher risk-based capital ratio assuming a similar risk-weighted measurement structure and asset makeup.

Nondelinquent 1st Mortgage Real-Estate Loans (Excluding MBLs Secured by Real Estate):

First residential loans have historically been a low credit risk and an important part of a credit union's presence and mission in their communities. While significant losses occurred in this type of loan in the recent economic downturn, major progress has been made in underwriting of these loans subsequent to the recession. High-risk mortgage products are not nearly as prevailing a concern today as they were in the past, and regulation coming out of the Dodd-Frank Act and the Consumer Financial Protection

Bureau have changed the landscape and almost eliminated the likelihood of a repeat of these high-risk mortgages and the circumstances that caused the extensive losses from 1st mortgage real-estate loans during the recent market turmoil.

However, a negative concern is that the new regulations regarding qualified mortgages has increased the costs of a residential mortgage and may reduce credit availability in this important sector for consumers. This proposal, by requiring higher levels of capital for 1st mortgage loans above the concentration thresholds, increases those costs to credit unions and their borrowers. In addition, the capital cost to credit unions again puts them at a competitive disadvantage in comparison to other financial institutions which do not have higher risk weights for concentrations of loans.

Recommendation:

Eliminate the higher risk weights for concentrations of residential 1st mortgage loans. Credit unions and their members will benefit by not increasing their costs to fund these loans, and credit unions will not be at a competitive disadvantage to other financial institutions.

If NCUA feels it must include concentration risk as a subcomponent of credit risk in the 1st mortgage loan portfolio, increase the thresholds within each proposed risk weight to a more reasonable level. The proposal to increase risk weights starting at a 25% concentration is right on top of what NCUA states is the average percent (24.9%) of 1st mortgages to total assets currently held by credit unions affected by this proposal, which is very restrictive. My recommendation remains to eliminate the higher risk weights for concentrations of these types of loans, but if that does not occur, please consider the following:

<u>Proposed Rule Thresholds</u>	<u>Recommended Thresholds</u>	<u>Proposed Rule Risk Weight</u>
Up to 25%	Up to 35%	50%
Over 25% to 35%	Over 35% to 50%	75%
Over 35%	Over 50%	100%

702.104(b)(2) Risk-Based Capital Numerator Deductions:

The proposed rule eliminates the NCUSIF capitalization from the risk-based capital numerator. From the proposal: "The proposed rule would address concerns about the NCUSIF deposit reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. In the proposed rule, the NCUSIF deposit is subtracted from both the numerator and denominator of the risk-based capital ratio. This treatment for the risk-based regulatory capital standard would not alter the NCUSIF deposit accounting treatment for credit unions."

It appears NCUA is either considering the NCUSIF deposit similar to goodwill and other intangible assets or trying to make the risk-based capital numerator comparable to that of banks, who expense their insurance premiums as paid. However, there is a major difference. Banks do not pay an insurance deposit reserve to FDIC, they pay and expense their premiums for each period due and cannot get those funds back. Federally insured credit unions, on the other hand, not only pay an up-front deposit of 1% of insured shares and record that as an asset, but, in addition, pay for and immediately expense periodic assessments from NCUA needed to bolster its insurance fund. The deposit is adjusted twice per year to account for increases or decreases in insured shares to ensure a 1% level is maintained.

Another distinct difference, and one that cannot be ignored, is the fact that a federally insured credit union can have its deposit returned if, for example, it converts to a bank or savings association charter, elects to go with private insurance rather than NCUA coverage, or if it elects to do a voluntary liquidation. This is truthfully an asset as recognized by generally accepted accounting principles and to eliminate it would suggest otherwise. The NCUSIF deposit does not rightly fit in the same category as an intangible asset; the deposit is tangible, it is easily measured, and it can be refunded.

While the approach to insuring shares/deposits of credit unions and banks differs, the end result is similar. One might argue that a bank's capital has been diminished by its ongoing expensing of quarterly deposit insurance premiums, and this would be justification of needing to reduce a credit union's risk-based capital numerator to be comparable to a bank's. Although it is true that the bank's deposit insurance premiums have reduced its capital, a credit union's capital has been reduced in real terms by the lost income it would have earned had it placed the funds in an earning asset rather than in a non-interest bearing deposit to NCUSIF. Assuming a normal earnings rate of 6% on the deposit, which is 1% of insurable shares, this equates to an "unrecorded" or "opportunity" cost of six basis points per year on insurable shares and to approximately six basis points annual reduction in ROA - a significant annual cost.

Recommendation:

The NCUSIF deposit should not be deducted from the risk-based capital numerator nor from the risk-based asset denominator.

While it is true that the deposit would be an asset lost by a credit union that fails and in effect would reduce its capital, that same deposit is held in the NCUSIF for that exact purpose and it can be specifically attributed to the failed credit union. This deposit truly is a buffer against losses to the remainder of the NCUSIF not specifically attributable to the failed credit union, it is under NCUA's control, and it is supplementary to the capital available on a credit union's books in case of a failure. Therefore, it should remain part of the risk-based capital numerator.

The 10.5% risk-based capital requirement is the proper level to be considered "Well Capitalized" even without deducting the NCUSIF deposit (i.e. - if NCUA follows this recommendation, it should not increase the risk-based capital ratio requirement above the proposed 10.5% required level).

The risk of loss of this asset is small, since it is under NCUA's control, and the related risk weight should be zero percent.

Proposed Section 702.105 Individual Minimum Capital Ratios:

From the proposal: "This proposed rule includes a provision that NCUA may require a higher minimum risk-based capital ratio for an individual credit union in any case where the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. For example, higher capital may be appropriate for a credit union that has significant exposure to declines in the economic value of its capital due to changes in interest rates. Part 747 would contain procedures for requiring a credit union to maintain a higher minimum capital."

I have grave concerns about having a subjective approach to required capital levels and NCUA's ability to determine higher minimum risk-based capital at its own discretion in a fair and consistent manner. Seemingly minor changes in assumptions used in calculating economic value of capital, for example, can cause wide variations in results. And using the same assumptions for each credit union is not appropriate. My concern again would be the strong likelihood of unfair and inconsistent methodology across the agency. Even NCUA seems to argue how difficult this is in practice a little later in the proposal.

In explaining its reasoning for eliminating current Section 702.108 Risk Mitigation Credit, NCUA writes: "The review of a credit union's application for a risk mitigation credit requires a substantial commitment of NCUA and credit union resources. In practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow."

If it is so difficult to determine how much credit to allow, it would seem just as difficult to determine fairly and consistently how much extra capital a credit union should hold in its risk-based capital ratio in determining individual minimum capital ratios.

Recommendation:

Eliminate Individual Minimum Capital Ratios from this proposal. Stay with a constant standard applied to all credit unions to maintain consistency and fairness.

III. Effective Date:

The proposed effective date of approximately 18 months after publication of a final rule in the Federal Register is far too short of a time frame for many credit unions that will need to adjust their asset mix and reconsider strategic direction that has been previously determined and for which action plans are being carried out. These changes will take time, and credit unions are at a sizable disadvantage as it relates to options for raising additional capital that may be required by this proposed rule.

Recommendation:

Give a four-year transition period after publication of a final rule to allow credit unions time to transition their asset mix and/or give them time to earn additional income to support the new capital requirement. The transition period could include periodic steps for compliance. For example, after the first year of the transition period there could be a 9.00% risk-based capital ratio requirement to be "Well Capitalized", the ratio could move to 9.50% after year two, 10.00% after year three and 10.50% after year four.

My comments are combined for the following two related sections.

Proposed Section 702.104(d)(1):

From the proposal: "Proposed §702.104(d)(1) would provide that if a credit union is unable to demonstrate a comprehensive understanding, as required under proposed §702.104(d)(2), of the features of an asset-backed investment exposure that would materially affect the performance of

the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The proposed rule would also require that the credit union's analysis be commensurate with the complexity of the asset-backed investment and the materiality of the position in relation to regulatory capital according to this part."

Proposed Section 702.104(d)(2):

"Proposed §702.104(d)(2) would provide that a credit union must demonstrate its comprehensive understanding of each asset-backed investment exposure under §702.104(d)(1) by:

- Conducting an analysis of the risk characteristics of an investment's exposure prior to acquiring the investment and documenting such analysis within three business days after acquiring the exposure, considering:
 - Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;
 - Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);
 - Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and
 - For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and
 - On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure."

I agree wholeheartedly with the notion that a credit union should have a comprehensive understanding of any investment it purchases. My first concern with this proposed rule is whether there will be fair and consistent application across the agency of such an overwhelmingly punitive 1250% risk weight.

My second concern is that there is no definition within the proposal of "asset-backed investment". This could lead to wide interpretation (more cause for inconsistent application) both of the 1250% risk weight as well as potential examiner expectation of the initial and ongoing depth of the review, analysis, and documentation of "asset-backed investments".

These requirements may be necessary for certain types of investments, but I would be concerned about examiners enforcing this depth of a review for instance of a government agency guaranteed mortgage-backed security and potentially enforcing a 1250% risk weight or requiring excessive and unnecessary analysis and documentation. While more understanding of the investment certainly improves the likelihood of a wise investment, the lack of inherent credit risk in the government agency security should reduce the concern of a large credit loss on the investment and therefore should reduce the depth of the review and analysis.

Recommendation:

Eliminate these two sections from the proposal. They are unclear, are likely to be enforced unfairly and inconsistently, and their result will be devastating risk weights applied to investments at a significant capital cost. Examiners will assuredly misinterpret the review, analysis, and documentation directives and create heavy burdens regarding these unnecessarily in too many instances.

If NCUA feels it can provide clear definition of the types of investments it intends to consider under these guidelines, provide a method for fair and consistent application of these sections, and include reasonable expectations regarding all of these, then revised language needs to be re-proposed with each detail laid out and a comment period allowed so we can work together to get this right.

Proposed Section 702.104(b)(1) Capital Elements of the Risk-Based Capital Numerator:

The proposal allows inclusion in the risk-based capital numerator of ALLL, limited to 1.25% of risk assets. Both the inclusion of the ALLL in the risk-based capital numerator and the 1.25% limit are appropriate based on the current environment.

When a credit union adds to the ALLL, it does so through the provision for loan losses, which decreases retained earnings (capital) but increases ALLL. The effect of which to the proposed risk-based capital numerator would be neutral, since these two items offset each other.

The limit would suggest that ALLL reserves greater than the 1.25% level are higher than “normal” and likely a predictor of higher charge-off losses in the future, which will reduce the ALLL and therefore the risk-based capital numerator. The limit recognizes excess ALLL as if already charged off in the risk-based capital ratio, and in my opinion, this makes sense.

However, the Financial Accounting Standards Board (“FASB”) most recent proposal on ALLL (the Current Expected Credit Loss model), issued in December 2012, if put into place, has potential to significantly increase the “normal” ALLL reserves. Some estimates are that ALLL reserves may increase by 20-50% under FASB’s draft proposal.

Recommendation:

If FASB changes accounting standards that cause more than inconsequential increases to the normal levels of ALLL, NCUA should increase the limit of ALLL to be included in the risk-based capital numerator comparable to the additional levels of normal ALLL.

Section 702.102 – Capital Categories:

The wording in the table is not clear for the “Undercapitalized” classification. The table states that a credit union “Must pass both net worth ratio and risk-based capital ratio”. The net worth ratio requirement for “Undercapitalized” is “4% to 5.99%” and the risk-based capital requirement states “Less than 8%”. This leaves in question the capital classification of a credit union with a 5.90% net worth ratio and an 8.10% risk-based capital ratio.

Recommendation:

Revise the wording to be clear. Possibly substitute “N/A” for “Less than 8%” in the risk-based capital ratio column for “Undercapitalized”. Make corrections in all places in the proposal where this is addressed.

In Closing:

As stated earlier, NCUA’s proposed rule to move “complex” credit unions to a risk-based capital standard is a step in the right direction. Left as is, this proposed rule will be a step in the wrong direction with significant, negative, and unintended consequences. I believe the recommendations in this comment letter, for the reasons outlined, will make the proposal workable for credit unions and NCUA and an improvement in capital standards for federally insured credit unions.

Submitted by:



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Exhibit A

First Credit Union
Risk-Based Capital
Risk-Weighted Investments vs. Bank Method
12/31/2013

	Amount at 12/31/13	Risk Weight	Risk Weighted Assets
<u>FDIC Method:</u>			
AFS Securities:			
- Government Agency Guaranty	33,839,931	0%	-
- GSE Guaranty	50,682,979	20%	10,136,596
- General Obligation Municipals	7,512,712	20%	1,502,542
Certificates of Deposit	<u>7,396,640</u>	20%	<u>1,479,328</u>
Total	<u>99,432,262</u>		<u>13,118,466</u>
Average Risk Weight			13%
<u>NCUA Method:</u>			
0-1 Year	18,634,161	20%	3,726,832
1-3 Years	19,359,180	50%	9,679,590
3-5 Years	40,280,472	75%	30,210,354
5-10 Years	21,158,449	150%	31,737,674
Over 10 Years	-	200%	-
Total	<u>99,432,262</u>		<u>75,354,450</u>
Average Risk Weight			76%
Difference in Risk-Weighted Assets	-		62,235,984
<u>NCUA Method</u>			
Risk-Based Capital Numerator			34,111,623
NCUA Method Denominator			<u>291,948,525</u>
NCUA Risk-Based Capital Ratio			11.68%
<u>NCUA Method Adjusted for FDIC Investment Risk Weights</u>			
Risk-Based Capital Numerator			34,111,623
Adjustment to ALLL Due to Limit of 1.25% of Risk Assets/Denominator			<u>(777,950)</u>
Adjusted Risk-Based Capital Numerator			33,333,673
NCUA Method Denominator Adjusted for FDIC Method for Securities and Certificates of Deposit			<u>229,712,541</u>
NCUA Risk-Based Capital Ratio Substituting FDIC Investment Risk Weights			14.51%
<u>NCUA Method Adjusted for FDIC Investment Risk Weights Assuming Realized Investment Losses in Up 300 Rate Shock</u>			
Risk-Based Capital Numerator			33,333,673
Estimated Loss on Investments in Instantaneous Up 300 Rate Shock			<u>(8,835,420)</u>
Adjusted Risk-Based Capital Numerator			24,498,253
NCUA Method Denominator Adjusted for FDIC Method for Securities and Certificates of Deposit			<u>229,712,541</u>
NCUA Risk-Based Capital Ratio Substituting FDIC Investment Risk Weights and Assuming Realized Investment Losses in Capital in Up 300 Basis Points Rate Shock			10.66%