From:	Marv.Elenbaas@dfcufinancial.com
To:	_Regulatory Comments
Subject:	DFCU Financial/Marvin J. Elenbaas, EVP&CFO - Comments on Proposed Rule: PCA – Risk-Based Capital
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Thank you for the opportunity to comment on the Proposed Rule on Risk-Based Capital. DFCU Financial is a $3.5 billion asset state-chartered, federally insured credit union headquartered in Michigan.
We support the NCUA's effort to develop a risk-based capital ratio that arrives at the required level of capital based on the unique risks of each credit union. We believe it is appropriate to have a combination of a risk-based capital ratio and a one size fits all minimum leverage ratio (e.g., the net worth ratio) at its current level.

However, we have some serious concerns with the proposal. It includes many inconsistencies and weaknesses, including but not limited to: inconsistency with bank risk-based capital, treatment of interest risk, treatment of concentration risk, capital volatility inherent in the proposal (with no ability to manage it), disadvantaged loan pricing and likely lost market share resulting from risk factors significantly above those of banks, treatment of goodwill and other purchased intangibles, ability to require capital in excess of minimum requirements, and the transition period.

Inconsistency With Bank Risk-based Capital. The NCUA risk weighting for certain assets differs from bank risk weightings. The higher risk weightings for credit unions mostly result from the leveraged concentration ratios in first mortgages, other real estate loans and member business loans. To achieve the same return on regulatory capital, and to cover the volatility described below, credit unions will need to price these loans at rates uncompetitive with banks, thereby ceding market share. Likewise, credit unions may be able to claim market share with lower rates when risk factors are unduly favorable. We do not believe risk-based capital should decide inter-industry pricing. These risk weightings also create an inconsistency in the framework, treating the loan/investment principal at a higher risk weighting than related interest receivable.

Interest Risk. The NCUA's incorporation of interest risk into risk-based capital is ill-advised, illogical, and inaccurately assesses interest risk. Interest risk derives from mismatches between rates on interest earnings assets and interest bearing liabilities caused by a changing rate environment. The added (and punitive) levels of capital in the proposal double-counts interest risk and credit risk. We believe that interest risk is best regulated outside of risk-based capital, as it is done in banking.

The proposal is illogical in that it assigns interest risk to mortgage-backed investment securities with increasing durations, but requires no capital for interest risk to U.S. Treasures or first mortgages with long durations. A mortgage-backed pass-through investment security, with underlying collateral of 30 year mortgages, has the same interest risk as a portfolio of 30 year first mortgage loans on the balance sheet, yet one requires three times the capital for interest risk. Even more illogical is that a 30 year U.S. Treasury, with even more duration, requires no interest risk capital. Also, the selective use of interest rate risk weights could lead to some credit unions managing to regulations by shifting asset allocations into riskier assets that do not have interest rate risk weights.

The proposal only assigns risk to interest bearing assets, without including the offsetting impact of interest bearing liabilities. This is not a true measure of net interest risk, and therefore is inaccurate.

We believe interest risk is best managed and monitored by regulators separately from risk-based capital, as is done by the other banking regulators. That allows for a full balance sheet view of net interest risk.

However, if the NCUA insists on including interest risk in risk-based capital, even though it creates an unequal playing field with banks, then we believe it should be based on the impact of a 300 basis point change in interest rates applied to the all assets, liabilities and off-balance sheet instruments. Credit unions would self-report this number in the call report. Examiners would validate the self-reporting during annual examinations. The self-reported interest risk should be assigned a risk weighting of no more than 250 basis points. This change would then assign a 20 percent risk weight to agency backed investments regardless of term (same as banks). We believe that, with an appropriate implementation timeframe, credit unions will be able to generate this self-reported information by the new filing dates of the call report (we can do it today). We also suggest that our proposal be elective, allowing less complex credit unions to choose the more punitive (but simpler) option currently proposed by the NCUA.

Concentration Risk. As with interest risk, we believe concentration risk is best managed, examined and regulated outside of risk-based capital. Concentrations are unique to each credit union's balance sheet, sometimes in areas other than those incorporated in the proposal (e.g., indirect loans), and concentrations risks usually differ in various economic cycles (e.g., the last cycle was focused on real estate). Also, the basis for the proposal's concentration initial threshold is the average for credit unions, not the level where concentrations become problematic for that particular credit union. And finally, as with interest risk, we believe the proposed levels of capital (10.5 percent risk-based and 7.0 percent net worth) adequately cover concentration risk. If the NCUA insists that concentrations risk be explicitly included in risk-based capital, even though it creates an unequal playing field with banks, we suggest that the highest risk weighting should be no more than 25 basis points above the standard factor.

Capital Volatility. Using both the NCUA proposal (based on the risk-based calculator) and FDIC risk-based rule, we noted that our risk-based capital ratios under the NCUA proposal are much more volatile than under the FDIC – in fact, nearly twice as volatile. Under the NCUA proposal, within the last five quarters we saw +100 basis point and -200 basis point changes in capital ratios in a single quarter, often in the opposite direction of bank ratios. Much of our volatility came from interest rate changes affecting prepayment speeds on our investment portfolio, whereas volatility may also come from other interest and concentration risks. Sometimes, these interest rate changes occurred in the latter part of a quarter, allowing no ability to react. Credit unions cannot strategically operate with such volatility. If adopted, our suggestions above would eliminate the unnecessary volatility.

Goodwill. Currently, intangibles resulting from a credit union merger are not included in the numerator of the net worth ratio. This causes a reduction in the net worth ratio for non-goodwill intangibles which (a) are not included in the numerator (only undivided earnings are allowed) and (b) are deducted from the numerator when amortized. So, while we agree with the proposed treatment of goodwill and intangibles for risk-based capital, it is predicated on a balanced treatment. In other words, we only deduct those items initially included, and only deduct to the extent of the current (net) asset.

Other Risk Weightings. We believe certain other risk weighting are unnecessarily punitive. Two of these are Investments in CUSOs and Mortgage Servicing Rights. In each case, we believe that the 250 percent risk weighting is only appropriate if there is a concentration. If, for instance, these assets are less than one percent of total assets, the risk weighting should be 100 percent, like all ‘other’ assets.

Minimum Capital Requirements. If interest and concentration risk are left in the final rule, the 10.5 percent minimum ratio is too high. The ratio was set, as stated in the proposal, to be comparable with banks, which would be logical if the NCUA proposal focused only on credit risk as does the bank ratio. If the NCUA insists on inclusion of interest and concentration risk , we recommend a minimum ratio of 8.0 percent.

Excess Minimum Capital Requirements. We believe the NCUA should contain risk through the examination process, rather than through requiring excess capital. If the NCUA determines a credit union is taking excessive risks, regulation of those excessive risks should be dealt with in the examination cycle, via progressively stronger exam findings.

Transition. We believe that credit unions should be given the same elongated transition period as banks – until 2019. It will take time for those credit unions penalized by the new risk-based capital rules to adjust balance sheets or accumulate additional capital. While some would argue that credit unions deserve an even longer transition period as our only source of capital is retained earnings, we believe the bank timeline is satisfactory since we can accumulate capital on a pre-tax basis (i.e., faster pace than banks).

NCUSIF Deposit. The proposed rules require the NCUSIF deposit to be deducted from both risk assets and capital (i.e., both the numerator and denominator). Inherent in this treatment is the implication that the deposit is not an asset of a credit union and should be expensed. Since the NCUA continues to maintain that the deposit is a valid credit union asset, we believe the capital treatment should be consistent with that view (i.e., no risk asset or capital deduction).

Thank you for listening to our concerns.

Marvin J. Elenbaas
Executive Vice President, Chief Financial Officer
DFCU Financial
313-322-8693