May 8, 2014

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

Re: Comments on Proposed Prompt Corrective Action—Risk-Based Capital Rule

Dear Mr. Poliquin:

Thank you for the opportunity to respond to the proposed risk-based capital rule. Our comments are based on working with hundreds of financial institutions during various economic conditions. During this time we have performed thousands of simulations of potential risks to earnings and net worth.

Most of the principals of c. myers corporation have been serving the financial services industry since 1985. Specifically, c. myers corporation has been serving the credit union industry since 1991. We've worked with hundreds of credit unions, including 50% of those over $1 billion in assets and 25% of those over $100 million in assets.

This proposed rule is a game changer for the credit union industry. Therefore, our comments are direct, pointed and intentionally repetitive for emphasis.

One of our objectives in writing this response is to point out that prudent risk management is too complex to be reduced to arbitrary risk-weightings applied to the masses.

INTRODUCTION

We agree that each financial institution should maintain adequate net worth to support its strategy and aggregate risks to not pose a threat to the National Credit Union Share Insurance Fund (NCUSIF). Given that each individual credit union has its own unique risk profile and strategy, there is no effective way to standardize risk-weightings to "include all material risks" for nearly all financial institutions (which is one of the stated objectives of the proposed rule), and to ensure that each has adequate capital.

The stakes are very high for the NCUA Board, credit unions and, ultimately, the millions of consumers the industry serves. If the NCUA Board is wrong on their arbitrary risk-weightings, irreparable damage can be done to the industry.

The proposed rule states:

> "This proposed rule would provide a common measure of asset risk and **ensure that credit unions retain levels of capital that are commensurate with their level of risk.** The proposal would also help **NCUA identify**, and **credit unions to avoid, inadequately**

> **capitalized concentrations of asset classes that can lead to a credit union's failure** [emphasis added]."

There is solid evidence that the proposed rule will not do what it states. It will not provide boards, managements or regulators with an appropriate **early warning** with respect to safety and soundness.

Additionally, if implemented as written, risk-based capital ratios can be very volatile, resulting in rapid swings in capitalization classifications. This can surprise credit union boards, managements and regulators, and potentially embarrass the industry – which is unnecessary.

In addition to not achieving its intended objectives, the proposed rule will likely and unnecessarily strategically handcuff well-run credit unions.

The proposed rule describes the new system as "rigorous and disciplined." If a credit union gets a "thumbs up" for **both** net worth and risk-based capital, it would be reasonable to conclude the credit union is safe and sound. If the NCUA Board's assertion of being rigorous and disciplined does not hold up, the industry could be blindsided.

It is clear that the risks intended to be addressed by the proposed rule are inadequately addressed. Additionally, several material risks and risk-mitigating factors are ignored.

We believe the NCUA Board did not provide appropriate rationale to support their arbitrary risk-weightings. Additional rationale and observable data to support the arbitrary risk-weighting for each category should be provided. Before any rule of this nature is passed, the NCUA Board should also identify the specific risk each risk-weighting is intended to address.

The emphasis on risk-weightings is also in direct conflict with the following statement, which is in the final rule for *Capital Planning and Stress Testing*, issued by NCUA and published in the Federal Register on April 30, 2014:

> "The risk exposure of a credit union depends on its marketplace, its individual business model, changes to its business plan, and the management of enterprise-wide risks specific to the credit union's strategies. The adequacy of capital planning must be commensurate with the risks and complexity of each credit union in the context of its own circumstances; these cannot be pre-defined."

Further, the introduction of Individual Minimum Capital Requirements (IMCR) raises two material concerns:

- First, the NCUA Board describes the new risk-based weightings as rigorous and disciplined. If this is true, why is the NCUA Board proposing the introduction of IMCR?
- **Second, the setting of IMCR appears arbitrary. How will the hundreds of examiners across the country determine the necessity and level of an increased IMCR, consistently?**

We recommend that the NCUA Board abandon the entire proposed rule and that the current risk-based net worth requirement structure remain in place, as it is limited in scope and does not strategically handcuff well-run credit unions in a material way.

If the NCUA Board is under external pressure to implement a new risk-based system, at minimum, they should significantly reduce the scope of the rule.

The continuation of rigorous analysis, combined with the NCUA Board focusing their efforts on ensuring that examiners are well-equipped with the right questions to ask when conducting their exams, is far superior to a rule that establishes arbitrary risk-weightings applied to the masses.

Because the proposed rule focuses on "interest rate risk, concentration risk, credit risk, market risk, and liquidity risk," we have focused our comments on several key reasons why the stated objective of the proposed rule will not be met.

INTEREST RATE RISK

Treasuries and NCUA Guaranteed Notes (NGNs)

A simple example of why the risk-weightings do not do an adequate job of capturing interest rate risk is the zero risk-weighting on Treasuries.

It is clear that the NCUA Board is concerned about interest rate risk because they have published much on this topic in recent times. Following are a couple of recent examples:

Excerpt from NCUA's *Strategic Plan 2014-2017*:

> "Interest rate increases have already begun; between April and August 2013, the monthly average of the 10-year Treasury increased nearly 100 basis points. The range of opinions also suggests interest rate volatility is likely to rise going forward. Credit unions should be prepared for interest rates to increase rapidly, but also for rates to swing sharply."

Excerpt from *The NCUA Report (February)*:

> "The concern is that credit unions are reaching for yield in order to supplement earnings," … "It is an understandable response, given the compression of net-interest margins in the low-rate environment. But the nature of the interest-rate environment, along with credit unions reaching for yield, has the potential to create a perfect storm that could have a substantial drag on future earnings, and make some credit unions insolvent."

How is the zero risk-weighting on Treasuries capturing interest rate risk such that credit unions will retain levels of capital that are commensurate with their level of risk? **Is NCUA saying that the lack of credit risk and liquidity risk in a Treasury completely negates the need to consider interest rate risk? If yes, it is quite a bold assumption for a regulator to promulgate in rule making.** In fact, it goes against the following statement in the proposed rule dealing with other government products: "While a government guarantee against default mitigates credit risk, it does not affect interest rate risk."

Additionally, even though Treasuries are highly liquid, the losses a credit union would experience if it had to unload them, should interest rates go up, could have a material negative impact on earnings and net worth. As noted above, the NCUA Board has expressed concern for *interest rates increasing rapidly, or rates swinging sharply*, yet these are ignored in the arbitrary zero risk-weighting for Treasuries.

Consider the example of a 300 basis point (bp) shock referred to in the proposal. In a 300 bp shock, a 10-year Treasury would have a decline in value of approximately 23%. Imagine the confusion of decision-makers if their financials showed a significant unrealized loss on an asset that the NCUA Board said has no risk.

The zero risk-weighting on Treasuries is also confusing given that many mortgage-backed securities (MBS), including collateralized mortgage obligations (CMOs), have less interest rate risk in a rising rate environment than a long-term Treasury.

Fixed-rate NGNs

Fixed-rate NGNs can also have material interest rate risk, yet they are assigned a zero risk-weighting. The same questions we asked regarding Treasuries apply to NGNs.

If credit unions were to load up on long-term Treasuries and NGNs, their level of interest rate risk could be material, yet their risk-based capital calculation would not reflect this risk. Further, if a credit union actually did this, **it is likely that the NCUA would require a higher IMCR.**

This is a simple example of how any rule that is intended to "include all material risks" is flawed and dangerous.

Asset-Backed Investments Including Mortgage-Backed Securities

The proposed rule promotes two options for determining the risk-weightings of asset-backed investments, such as MBS (including CMOs). One uses the current weighted average life for mortgage-backed investments; the other assigns an arbitrary risk-weighting of 1,250%.

Risk-Weightings Based on Weighted Average Life

Using the current weighted average life, especially in today's rate environment, ignores the interest rate risk that can be caused by extension risk in these types of instruments.

If the objective is to "ensure that credit unions retain levels of capital that are commensurate with their level of risk," then ignoring the interest rate risk caused by extension risk is not prudent rule making.

For many MBS (including CMOs), it does not take an extreme increase in interest rates to experience extension risk. When this happens, the risk-based capital ratio can decrease considerably for credit unions with a material portfolio of these types of investments.

As proposed, the rule could result in boards, managements and examiners being surprised by this volatility in risk-based capital, as it is not proactive in providing them with an early warning.

Having modeled thousands of CMOs under a wide range of interest rate environments, we've seen many examples of support tranches that are very short in the current environment, but have significant extension risk if rates go up. The proposed rule could encourage the purchase of this type of investment over a CMO tranche that is a little longer today, but has little extension risk as rates increase. **Encouraging institutions to move from investments with less volatility to investments with more volatility in order to improve their risk-based capital position does not make sense.**

1,250% Risk-Weighting for Asset-Backed Investments
Another arbitrary weighting for asset-backed investments, such as MBS (including CMOs), is the 1,250% risk-weighting. The proposed rule states:

> "Proposed §702.104(c)(2)(x) would require that credit unions assign a 1,250 percent risk-weight (8% * 1,250% = 100%) to an asset-backed investment for which the credit union is unable to demonstrate, as required under §702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance. A 1,250 percent risk-weight is equivalent to holding capital equal to 100 percent of the investment's balance sheet value."

When reference is made to the credit union's ability to demonstrate a comprehensive understanding, is the NCUA Board stating that **each individual member of the board and each individual member of the executive management team** will need to demonstrate a comprehensive understanding of the features?

The judgment as to whether the credit union or the examiner "comprehensively" understands the features of different asset-backed investments, such as MBS (including CMOs), is a material concern.

The scale of the penalty is also hard to defend. There is a huge leap between a CMO with a current average life of four years having a 75% risk-weighting and one with a 1,250% risk-weighting if an examiner does not feel there is a comprehensive understanding.

Again, this seems inconsistent with the NCUA Board's position on Treasuries given that many MBS (including CMOs) have less interest rate risk in a rising rate environment than a long-term Treasury.

Is the 1,250% risk-weight overcorrecting? The proposed rule states that, "A 1,250 percent risk-weight is equivalent to holding capital equal to 100 percent of the investment's balance sheet value." Yet this calculation assumes only an Adequately Capitalized status.

It is hard to imagine a situation in which a credit union holds enough capital to cover 100% of the book value being lost but would only be considered to have "adequate capital." This means that a credit union would need to allocate materially more than 100% of the asset's book value in capital to be Well Capitalized.

Example: A credit union would have to allocate $1.3 million in capital to cover a $1.0 million investment to be Well Capitalized.

Why would the NCUA Board require a credit union to hold more than 100% of an investment's balance sheet value to cover a potential loss in order to be considered Well Capitalized?

	($000s)	
	Investment	$1,000
X	Risk-Weighting	1,250%
=	**Risk-Weight Asset Size**	**$12,500**
X	Well Capitalized Requirement	10.50%
=	**Net Capital $ Required**	**$1,313**

If the proposed rule passes, it can grossly understate or overstate the risk associated with MBS (including CMOs). Doing so directly impacts a credit union's strategy and relevance to its membership.

Which weighting is the NCUA currently applying to calculate the risk-based capital ratios? The NCUA Board has estimated that a limited number of credit unions will be impacted by this proposed rule. If the NCUA Board is using the current weighted average life and later assumes that a material number of credit unions don't have a comprehensive understanding of the MBS (including CMOs) they are holding, it could blindside those in the industry who are relying on the NCUA Board's current estimate of the impact of the proposed risk-based capital requirements.

LIABILITY STRUCTURE

The NCUA Board does not address liability management in the proposed rule. Therefore, it will not "ensure that credit unions retain levels of capital that are commensurate with their level of risk."

It is a fact that liability strategy plays a key role in the level of risk, such as interest rate risk and liquidity risk, of a financial institution.

This proposed rule penalizes credit unions that are proactive in managing their liability structure to help mitigate interest rate risk and liquidity risk. It also rewards those credit unions that are not proactive in managing these risks.

It should be commonly understood that interest rate risk and liquidity risk are greatly influenced by what is happening with the liabilities of the credit union. By ignoring the liability structure, this proposed rule implies that the cost of funds is not an important component in managing interest rate risk. If this is the NCUA Board's assumption, then why would it matter if assets can reprice up if rates increase?

If there is no concern regarding deposits leaving the credit union, why is there concern for managing liquidity risk? The focus only on assets without regard to how the liability structure helps or hurts the credit union's risk profile is imprudent and dangerous rule making.

If one of the requirements of the proposed rule is to address liquidity risk, what rationale and observable data did the NCUA Board use to prove that this can be achieved while ignoring the liability structure?

How would NCUA evaluate a credit union if the credit union ignored the liabilities in its liquidity management process? Ignoring the liabilities fits somewhat with the NCUA Board's fifth requirement of the proposed rule: "Fifth, the requirement should be, given the preceding four goals, as easy as possible to understand and implement."

The problem is that the first three requirements of the proposed rule have not been met.

> "First, the requirement should address weaknesses in the net worth ratio measure. Second, the requirement should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. Third, the requirement should enhance the stability of the credit union system."

Even though the liabilities are a key component of risk, including interest rate risk and liquidity risk, we are not recommending that the NCUA Board simply add liabilities to their weightings. Deposit risk (the risk of deposits leaving and/or repricing rapidly) and risk mitigation capabilities cannot be identified by looking at only the label of a deposit (e.g., a regular share or money market account).

Creating an arbitrary risk-weighting for deposits would be very dangerous for the industry on many levels, from interest rate and liquidity risk management to managing strategic risks.

WHICH RISK IS NCUA AFTER: CREDIT RISK, INTEREST RATE RISK OR LIQUIDITY RISK?

Essentially, the NCUA Board is saying that, regardless of a credit union's internal processes and controls, the following non-delinquent assets carry the same level of risk:

- $25,000 "D" paper unsecured credit card debt at a rate of 1.99%
- $25,000 "A" paper auto loan at 1.99%
- $150,000 30-year fixed-rate mortgage at 1.99% (assuming a 25%-35% concentration in mortgages)

How did the NCUA Board determine that, after factoring in interest rate risk, credit risk and liquidity risk, these assets result in the same risk-weighting?

Another example is to compare home equity loans to unsecured loans. Why would the very first dollar of an 80% LTV home equity loan have a higher risk-weighting (100%) than a "D" paper unsecured loan (75%)? Is the argument that the 80% LTV home equity loan has more credit risk? Or is the argument that it has more interest rate risk? What if the 80% LTV home equity loan reprices quarterly off of Prime?

Further, what is the rationale and the observable data to support assigning the same risk-weightings to an adjustable-rate 1st mortgage (ARM) and a 30-year fixed-rate 1st mortgage? Is the NCUA Board saying that the credit risk from potential "payment shock" in the ARM is equal to the interest rate risk in a 30-year fixed-rate mortgage?

Why do consumer loans have a higher risk-weighting than 1st mortgage loans for the first 25% of assets?

Clearly, each asset class carries a different level of liquidity risk, credit risk and interest rate risk. The level of risk is also influenced by the internal processes and controls of each credit union. We again are asking that the NCUA Board provide more clarity on the specific risks the risk-weightings, for each asset class, are intended to address. Is it interest rate risk, credit risk, market risk and/or liquidity risk?

One of the lessons learned from the recent economic crisis should have been that all loans are not created equal. Business cycles, local market conditions, LTVs, interest rates charged and **internal processes and controls *do* matter.**

While the proposed rule attempts to address credit risk through the delinquency component, it is inadequate. Another lesson learned should have been that, once the delinquencies begin to pile up, it can be too late for, or minimally a very long process of, recovery.

This leads to another question. Typically, a GSE MBS has less credit risk, less liquidity risk, more diversification and about the same interest rate risk as a mortgage loan with similar terms. So, why is the risk-weighting higher for the GSE MBS?

MORTGAGES

Is a 1st Mortgage Really a 1st Mortgage?

Which 1st mortgages are going to be considered low-risk versus high-risk? According to the proposed rule, it does not seem to have anything to do with LTV, credit score, fixed rate versus adjustable rate or final maturity. Rather, it is about the definition below:

> "First mortgage real estate loan means loans and lines of credit fully secured by first liens on real estate (excluding MBLs), where:
>
> (1) The original amortization of the mortgage exposure does not exceed 30 years,
>
> (2) The loan underwriting took into account all the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments, and
>
> (3) The loan underwriting concluded the borrower is able to repay the exposure **using the maximum interest rate that may apply in the first five years**, the maximum contract exposure over the life of the mortgage, and verified income [emphasis added]."

More than 62% of the credit unions that would be subject to this proposed rule have ARMs. That includes 87% with over $500 million in assets. How could these credit unions be affected if many of the 1st mortgages currently on the books needed to be reclassified as "other real estate-secured loans," which start at double the risk-weighting of a 1st mortgage?

Credit unions have varying methods of how the mortgages currently on the books were approved and how ability to pay was verified. For example, when making ARMs in the past, many credit unions did not go through the process of verifying the borrowers' ability to repay **"the maximum interest rate that may apply in the first five years."**

When the NCUA Board studied the effect of the new rule and posted potential risk-based capital ratios for credit unions, was the percentage of 1st mortgage loans that do not fit the descriptions above analyzed?

Again, the NCUA Board has estimated that a limited number of credit unions will be impacted by this proposed rule. If mortgages currently held don't fit the definition above, this could blindside those in the industry, including the NCUA, who are relying on the NCUA Board's current estimate of the impact of the proposed risk-based capital requirements.

THE NCUA BOARD'S RATIONALE FOR WEIGHTINGS

Throughout the proposed rule, the NCUA Board provides essentially two key rationales for their risk-weightings. One rationale is industry averages and the other is banking regulations. How is this type of rationale supported by observable data, as the NCUA Board expects credit unions to provide, when making key modeling assumptions?

To put these types of arbitrary risk-weightings into a rule to be applied for all, we would expect the NCUA Board to have more data to support that the weightings are appropriate when combining "all material risks" such as interest rate risk, liquidity risk and credit risk.

The other rationale, the desire to be like banks, is baffling.

Is it the NCUA Board's view that banks fared materially better through the economic crisis than credit unions? Additionally, how would the earnings and net worth of the natural person credit unions have fared through the crisis if it wasn't for the corporate credit union debacle?

Clearly, the bank regulators did not do a good job supervising many of their financial institutions prior to the economic crisis – even with risk-based capital requirements and other regulations in place.

Why should the credit union industry rely on banking regulations for getting it right this time around?

As we have previously stated, the stakes are high for the NCUA Board in promulgating these types of arbitrary risk-weightings. In just the few points we have outlined above, we have provided evidence that arbitrary risk-weightings used in rule making are dangerous and misleading.

ELIMINATION OF THE RISK MITIGATION CREDIT AND INTRODUCTION OF INDIVIDUAL MINIMUM CAPITAL REQUIREMENTS

The proposed rule states:

> "This proposed rule would eliminate §702.108 regarding the risk mitigation credit. The risk mitigation credit provides a system for reducing a credit union's risk-based capital requirement if it can demonstrate significant mitigation of credit or interest rate risk….
>
> …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** [emphasis added]."

The NCUA Board states that a review of a risk mitigation application requires a substantial commitment from both NCUA and the credit union. **It seems reasonable that a credit union should be able to determine if applying for a risk mitigation credit is worth the time and effort.** Clearly, a credit union will have no choice but to spend time, energy and money if the NCUA determines that the credit union should have a higher IMCR.

Since the approach to risk-based capital is based on arbitrary risk-weightings developed by the NCUA Board, the system should allow for a credit union to continue having the right to apply for a risk mitigation credit.

The statement, "In practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow," raises concern that, no matter how comprehensive the rigorous analysis used by the credit union, the NCUA will not use it. This is very dangerous, as it can:

- Negate the NCUA Board's own efforts at promoting rigorous analysis
- Put the NCUA Board in the position of going on record to state that their "one-size-fits-all" arbitrary risk-weightings are far superior to a credit union conducting rigorous analysis and ensuring that the examiners are positioned to ask the right questions

If it is too difficult and time-consuming for the NCUA to evaluate the validity of a risk mitigation credit, **it only begs the question of how thorough the NCUA will be when determining a higher requirement for an IMCR, as well as considering the credit union's response in the case of a higher requirement.**

The "two thumbs up" approach for **both** net worth and risk-based capital will likely further exacerbate the situation. Because the proposed rule does not meet the stated objectives, there could be more enforcement of IMCR than originally anticipated. This will lead to confusion among boards, managements and examiners.

Imagine being a credit union board member in a scenario in which the credit union is Well Capitalized based on the two requirements outlined by the NCUA Board, yet the examiner starts a discussion about enforcing a higher IMCR because the "credit union has a high degree of exposure to interest rate risk…" – which is the third reason the NCUA Board gave for implementing a higher IMCR.

The board member would have every right to be thoroughly confused, surprised and ready to fight back because the regulator told them that meeting the net worth and risk-based capital requirements would "ensure that credit unions retain levels of capital that are commensurate with their level of risk."

CONCLUSION

Prudent risk management is too complex to be reduced to arbitrary risk-weightings for the masses. The NCUA Board has stated in several documents that a "one-size-fits-all" approach is not prudent. It is a disservice to the credit union industry to apply arbitrary risk-weightings and call it prudent risk management and effective rule making.

Regardless of risk-weightings, this approach will lead to material risks not being identified timely and, equally dangerous, strategically handcuffing well-run credit unions.

Strategically handcuffed organizations can become irrelevant and, in this day and age, irrelevance can happen in the blink of an eye. Either way, enforcing an arbitrary approach is a detriment to the credit union industry and, ultimately, the millions of consumers served by the industry.

We would like the NCUA Board to answer this question: **How can a regulator knowingly write a rule, and ultimately enforce a rule, that does not achieve the intended objectives of the rule?**

We recommend that the NCUA Board abandon the entire proposed rule and that the current risk-based net worth requirement structure remain in place, as it is limited in scope and does not strategically handcuff well-run credit unions in a material way.

If the NCUA Board is under external pressure to implement a new risk-based system, at minimum, they should significantly reduce the scope of the rule.

If you have any questions or would like to discuss this response in further detail, please don't hesitate to contact us at 800.238.7475.

Sincerely,

Sally Myers, CEO/Principal
John Myers, President/Principal
Adam Johnson, EVP/Principal
Rob Johnson, EVP/Principal
Pete Crusius, SVP/Principal