COASTAL
federal credit union

May 20, 2014

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

Subject: Comments on Proposed Risk-Based Capital Rule

Dr. Mr. Poliquin:

Thank you for the opportunity to comment on the proposed Risk Based Capital regulation. We are in agreement that a risk based capital regulation will benefit the industry, but that the current proposal contains flaws that will likely lead to more harm than benefit to credit unions and their members. This comment letter is limited to addressing issues around the capital required to support credit unions' investment portfolios (702.104 Applicability of Risk-Based Capital Measures).

As background, over the past several years the Office of the Inspector General has conducted Material Loss Reviews of failed natural person and corporate credit unions. It is true that there have been significant losses to credit unions and to the insurance fund as a result of a very limited number of credit unions taking excessive risks in their investment portfolios. In each case where a loss to the fund has occurred and the investment portfolio was a factor or contributing factor, it was credit risk and not interest rate risk that led to the losses. Nonetheless, the proposal as written focuses on interest rate risk rather than credit risk.

It is true that credit unions can and at times do take excessive amounts of interest rate risk that could cause or threaten to cause losses to the fund. There are likely cases where excessive interest rate risk has impaired earnings and liquidity to the point where it affected the ability to deliver financial services to members.

A well designed capital regulation would be difficult to take advantage of, would tie the level of risk being assumed to the amount of capital required, and would treat equivalent risk levels in a like manner irrespective of the asset class that resulted in the risk. The proposal as written fails in each of these areas in regards to investments.

Following in bullet point format are the issues that we take with the proposal and guidance as to how the issues can be addressed:

- Overnight funds on deposit with a Federal Reserve Bank carry a 20% risk weighting. For a number of reasons these deposits are typically viewed as riskless. These include the short overnight maturity and the Federal Reserve system's ability to simply create cash to use to pay for any deposits that are withdrawn.

    - *This issue can be resolved by changing the weighting to 0%*

- For non-full faith and credit investments, the risk weighting is determined by various bands of weighted average lives (WAL). In evaluating each WAL band, it became apparent that the weighting was such that the capital requirement would be equivalent to the change in value given an up three percentage point interest rate shock for a bullet maturity investment maturing in the middle of the WAL band. In short, the proposal assumes that there are no mitigating factors such as the duration of deposits and credit unions would lack the ability to retain investments in a rising rate scenario. It is not possible to look at interest rate risk on an instrument-by-instrument basis. Interest rate risk is appropriately measured and managed on an overall balance sheet level.

    - *This issue can be resolved by aligning risk weightings with Basel III utilized by the FDIC and issuing separate regulatory guidance on interest rate risk.*

- The proposal focuses on the WAL of investments presumably at the time of the filing of the 5300 each quarter. Some investments with embedded options can have significant WAL volatility. For example, a companion CMO tranche may have a WAL in the current interest rate environment of a couple of years. However, if the underlying collateral ceases to be refinanceable the WAL may extend dramatically, for some bonds this can be to 20 or more years. Similarly, a bond that is callable in a few months in the current rate environment may see its WAL extend to its maturity given an increase in rates. This makes it possible for a credit union to load up its investment portfolio with interest rate risk in a quest for earnings without an immediate effect on capital requirements. However, if rates rise the amount of capital required as of the next call report date may be substantially higher.

    - *This issue can be resolved by aligning risk weightings with Basel III utilized by the FDIC and issuing separate regulatory guidance on interest rate risk.*

- From the perspective of investment portfolio management, the proposed regulation is highly focused on interest rate risk. However, it would be possible for credit unions to circumvent the capital requirements aimed at interest rate risk. For example, simply holding long dated treasuries rather than long dated agency debentures would result in virtually identical risk profiles but drastically different capital requirements. Similarly, a GNMA CMO tranche with a long WAL or a volatile WAL would have no capital requirement versus a potentially large requirement for a CMO issued by FNMA or FHLMC. This discrepancy makes it easy for credit unions to comply with the letter of the regulation while violating its spirit.

    - *This issue can be resolved by aligning risk weightings with Basel III utilized by the FDIC and issuing separate regulatory guidance on interest rate risk.*

- While it appears that the regulation is focused on interest rate risk for investments, the measure that is used is WAL. However, there's no consideration for coupon type. Floating rate bonds can have significantly lower interest rate risk than those with fixed rates. While options embedded in floating rate investments can offset some of the benefits of their floating rate coupons, they do tend to have less interest rate risk than their fixed rate counterparts. Utilizing WAL is not a useful or appropriate way of determining interest rate risk.

    - *This issue can be resolved by aligning risk weightings with Basel III utilized by the FDIC and issuing separate regulatory guidance on interest rate risk.*

Again, we appreciate the opportunity to comment on the proposed regulation. This letter intentionally deals only with issues relevant to credit union investments.

Regards,

Brad Miller, CFA
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Coastal Federal Credit Union