



May 23, 2014

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

Mr. Poliquin,

On behalf of Tropical Financial Credit Union, a \$565 million asset state chartered and federally insured credit union headquartered in Miramar Florida, we appreciate the opportunity to comment on the recently proposed Risk Based Capital rule. We recognize the challenges presented in devising a capital ratio that captures a comprehensive range of risk and commend the agency in their efforts.

We agree with NCUA's perspective that there are several outdated concepts imbedded in the existing rule that will benefit from this modernization effort. The elimination of the Regular Reserve account and the pass/fail aspect of the current risk based capital standard are examples. Our comments however, will be directed toward those areas where we believe improvements can be made to the framework that has been set forth in the proposed rule.

**General Observations:**

In general, we believe the goals set forth; that is, to use the existing Call Report to craft an easy to implement measurement that distills all risk down into one measure of capital adequacy, is admirable but overly ambitious. The financial system has spent decades developing highly specialized techniques to evaluate and control various risks. However, some of the methods used in the proposal, while easy to understand are too simplistic and fail to take advantage of new risk measurement techniques.

For example, risk management practices have migrated away from using a crude *long term asset ratio* as a measure of interest rate risk toward computer modeling for Net Economic Value and Net Interest Income simulations in a  $\pm 400$  basis point shock environment. This technique encompasses all maturity and yield characteristics on both sides of the balance sheet. We fail to see any material interest rate risk component in the proposal. It only considers the maturity structure of investments as a proxy for interest rate risk. We see shortcomings in this approach.

In TFCU's case, we have approximately \$110 million in investments and \$440 in other assets as well as \$550 million in liabilities and Net Worth. The proposed rule considers only 10% of the entire balance sheet for interest rate risk.

Also, using investment maturities as a proxy for interest rate risk creates some risk distortions. As an illustration, TFCU recently purchased a 5 year callable agency step up bond. Under the proposed rule it would be treated as a 150% risk weight despite the fact that it is government guaranteed and that the yield will increase from 0.75% to 4% over its short life. In contrast, a 30 year fixed rate mortgage carries a 50% risk weight.

As written, the rule encourages holding 30 year fixed rate mortgages to a five year Treasury note by a 3:1 ratio. Further, the proposed rule treats all mortgages alike, regardless if they are adjustable or fixed rate, a distinction that is otherwise captured in interest rate shock tests.

We also believe the concentration thresholds are arbitrary. For example, the proposed rule suggests that a first mortgage concentration exists when there are more than 25% of assets in the instrument. However, a concentration for MBLs exists at 15% of assets and a concentration for junior liens exists at 10% of assets. While we agree that diversification among different classes of assets reduces risk, it is hard to establish a universal standard for every credit unions circumstances. A credit union with a concentration in mortgages may also employ a very reliable hedging strategy. More information is required to make the appropriate risk determination.

For these reasons we believe the information collected on the current call report is too simplistic to conduct an adequate evaluation of either interest rate or concentration risk. The call report is better suited to evaluate credit risk. Further, attempts to bring in more sophistication into the call report will make it overly complex. As a practical matter, a credit union would have to load their entire ARIES report into the call report system to gain the level of detail necessary to evaluate all these areas of risk. Enterprise risk management techniques may be a more appropriate approach to achieve comprehensive risk assessment.

One thing that is not clear to us is the outcome NCUA is trying to achieve. More specifically, is the goal of the rule to ensure an institution maintains a level of capital that can withstand the worst case loss scenario and still be viable without affecting the NCUSIF. Or, is the goal to be able to withstand the worst case scenario and never have its regulatory net worth ratio fall below 8% (or its risk based capital drop below 10.5%)? We believe it should be the former, not the latter. (If it's the latter, our competitiveness will be severely undermined.)

We believe the risk based capital rule should be narrowed in its scope to focus on credit risk rather than universal risk, a structure more in alignment with the BASEL III accord. This is consistent with the Congressional mandate to have comparable capital standards across financial sectors. Further, we believe the individual risk measurements techniques should stand independent from each other, (NEV and NII for interest rate risk, Risk Based Capital for credit risk, liquidity rule and Enterprise Risk Management for a consolidated risk view) as opposed to a single capital adequacy ratio. However, if

NCUA does move forward with the proposed framework, we have several suggestions for enhancements.

**Specific Section Comments:**

*702.2 Definitions*

We concur with the definition section of the proposed rule with one exception. We believe that “*Weighted Average Life of Investments*” section should treat the life of callable-step up bonds based on the interest rate reset date not the final maturity date. This would make them more consistent with other variable rate investment which is a better reflection of their interest rate risk.

*702.104(b) Risk Based Capital Ratio Measures - Numerator*

We have several suggestions regarding the calculation of “Capital”. First, the *Allowance For Loan Loss* account should not be limited to 125% of risk assets. These balances are 100% available to absorb credit losses and we do not believe a restriction will create “an incentive for granting quality loans and recording losses in a timely manner”. The appropriate place for a “quality loan” incentive is in the risk weight assigned to the loan category. Further, GAAP will dictate the timeliness if recognizing charge offs. This additional “incentive” is unnecessarily punitive.

With regard to treating the *NCUSIF deposit* as a deduction to both capital and assets, this suggests the asset lacks value and should be written off. We believe it should be excluded as a component of capital and treated as any other risk asset, with a 50% credit risk weight. This is more consistent with the legal and accounting treatment as well.

Finally, we are very concerned about the deduction of “*Goodwill*” from capital. We fail to see how Goodwill would be adversely affected. We believe deducting Goodwill from capital will have a material adverse effect of any merger considerations. If two credit unions merged, each with 15% risk based capital before the merger; the resulting institution may have only 7.5% post-merger risk capital. This could result in a high number of liquidations instead of mergers and create an unnecessarily bad image for credit unions among the public and Congress.

One of the weaknesses of our legal authority is the ability to raise capital. By law we can only generate capital through retained earnings. We believe any additional capital requirements should be paired with additional authority to issue supplemental capital. We recognize this is a legislative issue not regulatory, but we believe we should collectively encourage Congress to act on this shortcoming.

*702.104(c) Total Risk Weighted Assets*

We concur with the proposed rules risk asset classifications. However, we believe there are certain instances where individual risk weights are excessive. In general, we believe the top risk weight should be capped at 100%. How can an institution lose more than 100% of an assets value?

It is not clear to us how the risk weights were calculated. We assume that the concept being applied in the proposed rule is to layer together different risk premiums to calculate a combined risk weight. For example, a mortgage loan has a 50% credit risk premium plus a plus a 25% concentration premium (if in excess of 25% of assets) and a 0% interest rate risk premium for a total risk weight of 75%. Likewise a 5 year government bond has a 20% credit risk premium plus a 130% interest rate risk premium and 0% concentration risk premium for a total of 150% risk weight.

Our concern is that these “risk premiums” are not linked to any economic measure (such as loan loss experience or NEV/NII shock test). Rather they are loosely associated with a perceived risk. This weighting system suggests that the inherent collective risk of a five year treasury bond (150%) is three times greater than a 30 year mortgage (50%). Similarly, a non-perpetual corporate capital investment (100%) is less risky that a five year Treasury (150%). Also, the application of a 1,250% risk premium for asset backed securities on which the purchaser cannot demonstrate a comprehensive understanding appears to be excessive and arbitrary. On what basis would a \$1 million investment require \$1.25 million of capital?

The tables below present our recommended risk weights. In many ways they correspond to the risk weightings’ used by the BASEL III model.

Table 7—Proposed Risk-Weights for Cash and Investments

We believe the longer maturity investments are significantly over weighted as an incentive for credit unions to only make short term investments. We do not see any economic merits for such high risk weightings. Further, deposits held at the Federal Reserve Bank should receive zero risk weight. We would also suggest looking at classifying investments by type issuer so they can be weighted by credit risk characteristics instead of maturity.

Item	Proposed risk-weight (percent)	TFCU Recommended
Cash on hand	0	0
NCUA and FDIC issued Guaranteed Notes	0	0
Direct, unconditional U.S. Government obligations	0	0
Cash on deposit	20	0
Cash equivalents	20	20
Total investments with WAL ≤ 1-year	20	20
Total investments with WAL >1-year and ≤ 3-years	50	20
Total investments with WAL >3-year and ≤ 5-years	75	20

Corporate credit union non-perpetual capital	100	100
Total investments with WAL >5-year and ≤ 10-years	150	35
Total investments with WAL > 10-years	200	50
Corporate credit union perpetual capital	200	100

Table 8—Comparison of Current Regulation and Proposed MBL Component

Current legislation precludes credit unions from holding more than 12.5% of their assets in MBLs.

Total MBLs	Proposed MBL risk-weightings (percent)	TFCU Recommended
0 to 15% of Assets	100	100
>15 to 25% of Assets	150	100
Amount over 25%	200	100

Table 10—Proposed Risk-Weights for First Lien Real Estate Loans

Historically, the underlying credit performance of first mortgage loans has been stronger than any other asset classification. We agree with the 50% risk weighting but believe it should also be applied to higher level levels of concentration.

Threshold	Proposed risk-weight (percent)	TFCU Recommended
0-25% of assets	50	50
>25-35% of assets	75	50
Excess over 35% of assets	100	75

Table 11—Proposed Risk-Weights for Junior Lien Real Estate Loans

Junior liens are more risky than first mortgages but we believe they should not exceed 100%.

Threshold	Proposed risk-weight (percent)	TFCU Recommended
0-10% of assets	100	100
>10-20% of assets	125	100

Table 12—Proposed Risk-Weights for Consumer Loan Types Reported on Call Report

We concur with these risk weightings.

Table 13—Proposed Risk-Weights for Delinquent Consumer Loans

These type loans have a well-established charge off experience ratings. We do not know of any instances where delinquent loans have resulted in a 150% loss.

Consumer loan type—Delinquent more than 60 days	Proposed risk-weight (percent)	TFCU Recommended
Unsecured Credit Card Loan	150	100
All Other Unsecured Loans/Lines of Credit	150	100
Short-Term, Small Amount Loans	150	100
Non-Federally Guaranteed Student Loans	150	100
New Vehicle Loans	150	100
Used Vehicle Loans	150	100
Leased Receivable	150	100
All Other Loans/Lines of Credit	150	100

Table 14—Proposed Risk-Weights for Loans to CUSOs & Investments in CUSOs

CUSOs create operational efficiencies, save money and improve earnings. The 250% capital requirement is arbitrary and we believe will result in adverse consequences. The NCUA already has the ability to examine and influence CUSOs activities to mitigate risk.

	Proposed risk-weight (percent)	TFCU Recommended
Loans to CUSO	100	100
Investment in CUSO	250	100

Table 15—Proposed Risk-Weight for Mortgage Servicing Assets

A 250% capital requirement provides a disincentive for a credit union to retain member relationships, instead selling them to banks. It should be noted that GAAP already requires servicing rights to be recorded at the lower of cost or market. There is no need for additional restrictive capital standards.

	Proposed risk-weight (percent)	TFCU Recommended
MSA	250	100

### *702.105 Individual Minimum Capital Requirements*

This section outlines circumstances under which NCUA could unilaterally impose a capital standard over and above that established in the rule. Although there are general conditions that should be present before the implementation of an individual risk based capital ratio, we believe it is inappropriate for such a rule to be put in place.

There are already two capital standards in regulation which have been screened through the public comment process. The implementation of a third standard which is vague and ambiguous places too much authority in the hands of the regulator without public scrutiny.

In summary, we believe the goals set forth are admirable but unattainable through the proposed rule, and in some cases will create adverse incentives. We do not believe it is appropriate to use a measure of capital adequacy to manage credit, interest rate and liquidity risk. These risks require a level of dynamic technical management not found in a single ratio. Our recommendation is to move closer to an established and recognized risk based system similar to the BASEL III system. Additionally, a credit union's ability to alter their general strategy and restructure their balance sheet will take some time to implement. We suggest the rule should have a longer lead time for compliance. We believe 36 months from the effective date would be more appropriate.

Thank you for the opportunity to comment on this important rule and we look forward to an ongoing dialogue to find a suitable solution to measuring the adequacy of a credit unions capital.

Sincerely,

Richard Helber  
President/CEO