Directions Credit Union®

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May 23, 2014

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

Dear Mr. Poliquin,

Thank you for the opportunity to provide comment and feedback on the proposed Risk Based Net Worth (RBNW) rule.

I am writing you on behalf of the 70,000 members of Directions Credit Union. Directions is a state chartered, federally insured credit union serving communities in the northern part of Ohio, including Toledo and Mansfield. Due to a concentration of employment in manufacturing, and more specifically the automotive industry, our communities faced many challenges during the recent recession.

Directions Credit Union entered the great recession just after two significant mergers and with a Net Worth Ratio of 8.59%. Five years later, we ended 2012 with a Net Worth Ratio of 8.65% after weathering an extremely challenging economy, along with NCUSIF stabilization expenses. Only once during this period did our Net Worth Ratio dip below 8%; when the initial large NCUSIF premium (later modified) was required in the first quarter of 2009. Clearly, at least in our case, the existing net worth rule along with other regulatory requirements has served us well.

In the end, I think we all want the same thing; a credit union system that is safe and sound and that retains the flexibility to innovate and to change with the evolving needs of our members. A risk based rule should in theory be able to better accomplish that than our current one-size-fits-all rule. However, as currently proposed, I have concerns that the rule will result in less flexibility for credit unions, and quite possibly in *less* safe credit unions because of unintended consequences produced.

The Rule Attempts to Incorporate Too Many Different Types of Risk

The proposed rule seems intended to encompass many different types of risk; credit, interest rate, liquidity, concentration, transaction, even reputational; into one easy- to-apply, check-the-box rule. This is an ambitious and well-intentioned aim, but by attempting to address nearly all varieties of risk in one rule, I fear the new rule will not address many of them as well as rules already in place. At best, including factors for many different sources of risk in this one rule produces over-regulation and confusion. At worst, it confers a false sense of security and may even encourage behavior that is more, not less, risky to the share insurance fund.

Interest Rate Risk

Consider interest rate risk (IRR) for example. Rule 12 CFR Part 741, has clear requirements for a program to measure, manage, and properly authorize the level of interest rate risk taken by a credit union. In compliance with this rule, Directions has a policy and procedures for IRR management and makes use of tools such as Net Economic Value analysis and Income Simulation for various possible interest rate environments. These tools consider both the asset and the liability sides of our balance sheet, as well as our net worth; which is absolutely necessary to properly evaluate the effect of interest rates on us.

The proposed RBNW rule attempts to do the same thing via increased weights for holding assets that are assumed to add more interest rate risk (e.g. higher concentrations of fixed rate mortgages and investment securities with longer weighted average maturities). The proposed rule doesn't consider in *any way* the liability side of the balance sheet, assuming that net worth is the only way to mitigate the IRR that is produced by the structure of the asset side of the balance sheet.

This is potentially dangerous. If increasing net worth and limiting certain classes of assets is the only way to mitigate interest rate risk, what might a credit union be incented to do by this rule? Managing the liability side of the balance sheet to maximize earnings (and therefore build net worth – the only mitigation factor considered by the rule) could be one reaction. Why worry about IRR mitigating funding sources like longer term member certificates and federal home loan bank fixed rate borrowings that cost more? Why not fund entirely with lower cost money market accounts? Wouldn't this build net worth more quickly? Modelling this sort of balance sheet structure against a liability structure that includes longer term funding makes it clear that the way the rule is currently written has incented the credit union to *increase* the amount of IRR it is incurring.

This is just one example. I am certain that many other unintended and potentially dangerous ALM strategies will be the result of this rule as currently written.

Liquidity Risk

Similarly, the weighted average maturity of the investment portfolio is important, but it is not by any means the *only* factor to be considered in managing an institution's liquidity risk. Other characteristics such as marketability and cash flow characteristics of securities in differing rate environments are also important, yet none of these are considered in the proposed rule. Likewise, tools on the liability side of the balance sheet for management of liquidity risk are not considered at all.

The agency adopted a rule specifically for managing liquidity in March of this year that is much more effective than trying to include this risk in the RBNW rule. With rules for the management of IRR and Liquidity risk already in place, why include these components in an incomplete manner in the proposed RBNW rule? An effective and competent corps of examiners and subject matter experts should already have the tools they need to manage these risks.

Delinquent Loans

The proposed rule also has the effect of duplicating accounting and regulatory rules already in place to provide for potential losses from delinquent loans, as it assigns a higher risk weight to different types of delinquent loans and then removes the allowance account from the numerator. With proper policy and procedures in place to fund the credit union's allowance for loan loss account, the potential risk from delinquent loans has already been dealt with from a net worth perspective by removing dollars to provide for future losses (the provision for loan losses) and therefore requiring the credit union to replenish this capital. There would seem to be no need to separately account for delinquency in *this* rule.

All Credit Union Service Organizations (CUSOs) Are Not the Same

Credit unions use CUSOs for many different things, and some of these purposes may warrant a 250% risk weighting as is in the proposed rule. However, not all CUSOs increase the risk of the credit union. In fact, most probably do not.

For example, Directions has partnered with five other credit unions for over 20 years to operate a CUSO (Area Financial Services) that allows us to collaborate, save costs, and more easily afford better technology and skilled talent to manage our data processing system. I would argue that by allowing us to afford better technology and employ more skilled people to manage it, that our investment in AFS *reduces* risk for Directions. Why is it good policy to discourage this sort of investment by weighting it as the most risky thing we do?

The activity of CUSOs should have some bearing on the weight their investments are assigned. There is no reason to weight a credit union's investment in an organization designed to allow the affordability of better tools and risk management as the most risky thing it does. Doing so discourages an activity that improves safety and soundness for everyone.

Individual Minimum Capital Requirements (IMCR)

If this rule has been effectively written and sufficiently validated, and the Agency is confident in the ability and professionalism of its staff, the ability to apply IMCR to credit unions should be unnecessary. Examiners already have many tools at their disposal in the form of existing regulations and supervisory powers to address credit unions operating in an unsafe manner. The agency should be able to trust its professional corps of supervisors and examiners to use these tools to address issues rather than providing what amounts to a way of dealing with problems without actually dealing with them i.e. when in doubt, raise the capital requirement.

In addition it is difficult to see how IMCR could be applied consistently to credit unions. Consistency between examiners, supervisors, and regions is very difficult to maintain, and certainly we and most credit unions have experienced inconsistency in the application of other rules that are better defined than this part of the proposed rule. What guidelines or standards will be used when deciding to apply IMCR, and why can they not be specifically stated in the rule? These must be very well defined, better than they currently are, to have this part of the rule consistently applied.

If a credit union disagrees with the invocation of IMCR by its examiner, is there an effective process to appeal this decision? NCUA's current appeals process calls for appeals to be made to the same chain of authority that made the original decision. It is difficult if not impossible for the best intentioned and most professional of individuals to be impartial in hearing an appeal with this structure.

At the very least, the imposition of an IMCR should not be the decision of an individual examiner, nor even of a supervisor. This type of a decision affects the credit union's strategy and potential opportunities to serve its members every bit as much as the granting of a community charter. Shouldn't it be accorded the same weight and require action by the NCUA board?

Conclusion

NCUA is correct in asserting that credit unions face many different kinds of risk. However, one of two things is responsible for the failure of a credit union in most cases; Fraud, or Credit Risk. It is hard to see how fraud can be addressed using a risk based capital rule, but certainly credit risk can be. Adding other risks such as interest rate, liquidity, etc. to this rule will result in confusion, conflicting guidance, and unintended consequences.

NCUA has promulgated many different rules to address these other risks, especially interest rate, liquidity, and concentration risk. The role of Net Worth in mitigating these risks is already documented in these individual rules. They, along with a competent and professional examination corps should be effective in managing these risks. Attempting to use the RBC rule to manage them is unnecessary, and will not be as effective as these individual rules designed specifically to manage these risks.

Please reconsider this idea of incorporating these many different kinds of risk into this one rule. This rule could certainly be effective in providing adjusted capital requirements to individual credit unions based upon credit risk. Doing so would certainly be effective in improving safety and soundness for us all, and it is my opinion that this is what NCUA should do.

Again, I thank you for the opportunity to provide my comments and thoughts. I would be very happy to answer any questions you have; or, to further explain my thoughts should you find that helpful.

Sincerely yours,

Barry A. Shaner

Barry A. Shaner, President/CEO
Directions Credit Union