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SENT VIA EMAIL

May 27, 2014

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

Dear Mr. Poliquin:

Thank you for the opportunity to comment on the proposed rulemaking for Prompt Corrective Action – Risk-Based Capital.

Freedom First Federal Credit Union is an adamant proponent of safe and sound financial management and a supporter of aligning capital levels with current and future risks. Though the proposed rule will not have an immediate impact on the Credit Union's capital level and strategic plans, we have the following concerns:

- A regulatory bias is created against long-term risk controls in balance sheet structures and other risk controls.
- An unreasonable economic barrier is created against investment in long-term strategies to create new core earnings.
- A competitive disadvantage for credit unions is created unnecessarily.
- The complexity of the rule results in other notable problems with the proposal, including characteristics that are inconsistent with the recommendations of the BASEL Committee.

Further, we note that NCUA has failed or refused to address the need to eliminate restrictive structures in supplemental capital that close a large part of the secondary capital market to credit unions. This is a regulatory position that is inconsistent with the not-for-profit status of credit unions and particularly relevant to the funding capital requirements of LIC/CDFI credit unions. An evaluation of the noncompetitive characteristics of the proposed regulation weighs even more heavily against the regulation because of unequal access to supplemental capital.

<u>Regulatory Bias Against Long-Term Risk Controls</u>

Why would a capital requirement designed specifically to address risk exclude important risk controls from the calculation?

It is well understood that the success of any risk management program hinges on effectiveness of risk controls. However, the risk weights exclude the presence or absence of risk-controlling structures from a credit union's risk-based capital (RBC) requirement. This creates an economic barrier to installing risk controls in the balance sheet because of the lower yield and higher cost of assets or liabilities. Economic barriers create a bias toward managing the capital ratio instead of managing risk. This is a profound error in the design of the RBC requirement which should be corrected in the final regulation.

Our own Credit Union provides a good example of the importance of controls. Our ratio of net worth to total assets usually is slightly under that of our peer credit unions. However, our shock text results substantially outperform our peers due to controls we have built in our balance sheet. The results of shock tests demonstrate that our capital declines slower, the long-term capital is substantially lower, and the final net worth ratio is higher than our peers' using the same shock test methodology.

Those controls in our balance sheet include a high level of adjustability in asset rates and a substantial level of long-term fixed costs in liabilities. However, those controls are costly. Variable-rate assets have lower yields. Structured liabilities with fixed costs and longer durations are expensive. It is unlikely that we would have invested as extensively in such costly controls if we had foreseen how little those controls were valued under the proposed regulation. That is because our growth would not be limited by net worth at risk. Growth would be limited only by capital.

In publishing the proposed regulation, NCUA has advised credit unions that examiners may adjust a credit union's requirement based on the strength of a credit union's risk management program. However, who can say what surprises may arise when an examiner is asked for relief from a regulatory standard? It is not that NCUA would be expected to be unfair in this practice, but it seems the agency is overestimating its ability to be consistent. How quickly can a consistent method for adjustments be implemented; and while we are waiting for that method to be implemented, what are we to do? Imagine the volume of such requests, triggered by the need to address long-term growth plans.

Furthermore, NCUA is inconsistent in its determination of the risk controlling features of some assets. For example, the agency has published guidance identifying and promulgating the risk mitigating structures of certain derivatives. However, the proposed regulation attaches only a substantial risk weight to such assets. With relation to derivative assets, the agency policymakers seem to be of two minds.

This part of the proposal is rife with uncertainty, reflecting an undefined or weakly defined policy in response to an obvious weakness in the proposed regulation. Consequently, NCUA's current proposal is unsuitable for a well-managed response to the final regulation. To correct this error, the regulation should be amended to include quantified adjustments to the calculation of risk assets based on risk mitigating structures on both sides of the balance sheet. Further, NCUA should establish a well-developed policy for addressing examiners' adjustments and requests for waivers, and publish this policy concurrently with final regulation.

Barrier to Investment in Long-Term Core Strategies

The proposed regulation creates barriers to new core strategies in two ways. First, credit unions would have to maintain excess levels of capital to permit investments in core strategies. Core strategies usually require a building period before returns are earned. During the building period, assets may be acquired long before earnings begin to accumulate, let alone accumulate to the level that the investment in a strategy has had a neutral effect on the RBC ratio. To remain compliant, strategically responsive credit unions would have to maintain excessive capital levels, managing to the ratio rather than to the risks.

Second, management needs a stable regulatory setting before implementing new core strategies. The potential for adjustments by examiners that may increase the RBC requirement raises the risk of unforeseeable capital requirements. This risk is particularly relevant to LIC/CDFI credit unions, whose mission results in business tactics and performance metrics that may not be understood by an examiner.

To ensure that barriers to new core strategies is eliminated, again, we recommend that NCUA establish a well-developed policy controlling examiner adjustments specifically to ensure a stable, knowable capital requirement.

Competitive Disadvantage for Credit Unions

In the evolution of BASEL, the BASEL Committee emphasized the importance of regulatory standards that did not create a competitive disadvantage for one banking segment over another. Yet, the proposed regulation creates competitive disadvantages for credit unions in four ways.

First, proposed risk weights applied to several asset categories held by credit unions are greater than the risk weights applied to the same assets when held by banks. Unequal weights have been identified by several commenters, including weights applied to member business loans and some categories of investments. Unfairly restrictive capital requirements for credit unions raise the cost and restrict growth for those asset classes while the banks are less restricted. In this respect, the proposed regulation flies in the face of the BASEL Committee's guidance and is inconsistent with the actions of other U.S. financial regulators.

Second, credit unions will be given substantially less time to implement the final rule. Following the comment period for its proposed RBC regulation, the FDIC adopted a multi-year, tiered implementation period. In light of the FDIC's experience, it is difficult to connect the proposed credit union implementation period with a rational basis. Even for credit unions with RBC ratios that currently qualify under the proposed weightings, time is needed to evaluate the impact of this complex capital requirement in relation to long-term business plans and stress tests, and to then execute an appropriate governance process over changes in strategic plans, let alone implement them. NCUA should establish a period for implementation that accommodates a comprehensive and controlled process in capital and strategic planning.

Third, liquidity risk weights in the proposed regulation raise the capital requirements for credit unions, while the FDIC has removed this weight from the RBC ratio by establishing a separate standard in the form of a coverage ratio. The BASEL Committee cited the importance of limiting risk-based capital requirements on quantifiable risks only. The Committee identified those risks as credit risk, operational risk and rate risk. The RBC ratio is not well designed to address liquidity risk. It is likely that the proposed rule raised the capital requirement with no assurance the increase is effective and not excessive. The liquidity risk components should be removed from the risk weight; a separate regulatory standard should be developed to address liquidity risk in credit unions.

Fourth, the access to supplemental capital remains unequal for credit unions and banks, with the advantage substantially to the banks, which also have lower RBC requirements. If proposed regulation was implemented without change, NCUA would establish dual disadvantages for credit unions: more restrictive RBC requirements and more restrictive access to capital. A balanced approach would offset more restrictive RBC requirements with easier access to capital. A more reasonable approach would level the playing field for RBC requirements and access to capital.

Though access to secondary capital is not a part of the proposed regulation, that access is controlled by the same regulator. NCUA has not published guidance on the direction the agency is taking toward the restrictions NCUA has placed on secondary capital. Therefore, access to capital forms a very significant part of the context used to evaluate the materiality of competitive disadvantages that would be created by the proposed regulation.

Other Notable Issues

There are several problems created by the attempt to address six kinds of risk with one risk-based standard. For instance the regulation fails to provide clarity. The regulation should bring clarity to the problem of maintaining adequate capital. But, the complexity of the proposed rule does not accomplish that. Instead of clarity, it makes it more difficult for management to determine the level of risk associated with a source or activity and, thus, makes it more difficult to mitigate risks.

The proposed regulation fails to provide assurance. One capital requirement is designed to simply increase capital. The other requirement is designed to align capital levels with risk structure. The regulation encompasses nonquantifiable risks and fails to include risk controls embedded in balance sheets.

The proposed regulation fails to provide understanding across all institutions. However, the proposed regulation contains different risk weightings in attempt to address a broader set of risks. This removes the basis for an understanding of the relationship of risk to capital across institutions.

Sincerely,

Keith A. Rickoff
Executive Vice President/Chief Financial Office