[Your Name]
Chief Financial Officer
American First Credit Union
700 N Harbor
La Habra, CA 90631

National Credit Union Administration

Re: Proposed Risk-Based Capital Rule

Dear National Credit Union Administration:

It is a difficult job to manage the safety and soundness of the credit union system and effectively balance the permissiveness of risks while keeping the industry safe. The proposed risk-based capital rules do mitigate some risks, but not always in an effective manner, and the rules are too restrictive when addressing acceptable risks. I understand that the proposed requirement "should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk." One of the larger risks currently facing credit unions is interest rate risk and the NCUA is right to focus on this increasing risk. Financial institutions are typically liability sensitive (liabilities repricing faster than assets) because they often lend long (e.g. 30 year loans) and borrow short (deposits and borrowings with an average life of approximately 5 years). This can be a risk if rates might rise. Interest rates will move up. No one knows quite when this will happen, but it is inevitable. Severely liability sensitive credit unions may have a difficult time navigating the rising rate environment when it comes. However, the current rules have minimal effectiveness in addressing interest rate risk and ignore some important tools used to minimize interest rate risk. The proposal is completely absent to the liability side of the balance sheet, which can be used to extend liabilities and effectively manage a rising rate environment.

The proposed rules on assets do not effectively address the risks described above, especially interest rate risk. First, Cash held at the Fed receives a 20% risk weighting while cash held in vaults receives a 0% risk weighting. There is no difference in interest rate risk on where the cash is held. Arguably, credit risk is less with Cash held at the Fed. The other risks are not applicable here. Why is Cash held at the Fed more punitive than Cash on Hand?

The proposal on Investments other than Cash has a component of interest rate risk by "bucketing" off of: Next Reprice date or Weighted Average Life (WAL); however, this broad stroke approach does not adequately capture the interest rate risk within an investment portfolio. For example, a high premium seasoned long bond (e.g. 30 year 6.00% coupon @ 112-00 with 10 years seasoning) can have less interest rate risk than a new issue CMO Floater with a 5.00% cap. With rising rates, the long bond will have slower prepays and a longer term with which to amortize the premium, thereby increasing yield. Additionally, the long bond matures in 20 years. The CMO Floater may have a restricted interest rate for its entire 30 year term. Under the proposed rules, the CMO Floater would likely receive a 20% risk weighting while the high premium seasoned long bond would likely receive 150% risk weighting; this is an extreme difference and penalizing the wrong asset. This is just one example of the bucketing of investment possibly being more punitive to safer assets. Also, WAL is easily manipulated with prepayment speeds. Trying to solve this WAL problem with a prepayment dictum (e.g. use 3 month average PSA) would not be a good solution because some securities follow a peculiar prepayment path (e.g. SBA pools) and using a 3 month PSA history would be grossly misleading.

The other asset class that may be too restricted is loans. Real estate loans quickly become punitive as any real estate loans over 25% of assets have over a 50% risk weight. Member Business Loans (MBLs) over 15% of assets have over a 100% risk weight. The focus of this seems to be on concentration risk, but this is also too broad stroke. Tight credit guidelines and product expertise are not taken into account with the proposed rules. Additionally, banks would have a significant advantage since single family loans almost never have more than a 50% risk weight and MBLs almost never have more than 100% risk weight, and some MBLs are even given a 50% risk weight.

The other asset I would like to address is Mortgage Servicing Rights (MSRs). As stated earlier, most financial institutions are liability sensitive and the majority problem with Interest Rate Risk is rising rates and not declining rates. MSRs are a great protection to rising interest rates. As rates rise, prepayments slow down, servicing assets extend and therefore increase in value and income. Risk weighting these at 250% is a powerful discouragement to any institution holding MSRs. Interest Rate Risk has been a declared focus of the NCUA and penalizing MSRs is going to increase Interest Rate Risk across the industry.

Lastly, using today's balance sheets to say that this rule will not have much of an effect on the industry is both a misnomer and an incomplete analysis. Today's credit unions have abnormally high cash balances, which make many credit unions look unaffected by the proposed risk based rules when, in fact, the rules will be punitive. Additionally, these rules should be used to analyze those institutions that have failed in past to see if the rules would have been effective in protecting the industry. Otherwise, the proposed rules will just be restrictions that do not serve their intended purpose. I strongly urge the NCUA to seriously reconsider the proposed risk-based capital rules before it creates unintended consequences and puts credit unions at a severe competitive disadvantage.

Sincerely,

[Your Name]