Vermont Federal Credit Union Comments on the Proposed Rule For Prompt Corrective Action-Risked Based Capital (RIN 3133-AD77)

Chairman Matz's comments on page 2 of the May 2014 NCUA Report specify that the Federal Credit Union Act (FCUA) requires NCUA to maintain a capital standard comparable to federal banking agencies. Also according to her comments, the NCUA must consider "all material risks" to federally insured credit unions above and beyond the new international capital standards (Basel III) which focuses mainly on credit risk. In order to comply with section 216(d) of the FCUA as per page 35 of the draft proposal, NCUA's capital standard must also account for interest rate risk, concentration risk, market risk and liquidity risk, in addition to credit risk. The following is a list of inconsistencies with the new proposed rules, the Basel III rules, and the antiquated call report reporting methodology that adversely impact this rule:

A) The first inconsistency with being comparable to federal banking agencies deals with the lack of a reasonable phase-in period under proposed 702.102(a)(1) on pages 36 and 37 of the draft propsal. The federal banking agency regulation has a four year phase in period of the 2.50% capital conservation buffer from 2016 to 2019 at 0.625% per year. NCUA's rationale on page 37 of the draft proposal of avoiding the complexity involved in implementing a comparable capital conservation buffer is unjustified, especially in light of the fact that credit unions really do not have the alternative sources of capital available to banks that would allow them the ability to more easily reach these higher thresholds. It is even more unjustified when one factors in that NCUA's new risk based capital approach of factoring in three major risks (i.e. interest rate, concentration, and credit) would be more of a change in a credit union's capital requirements than the Basel III requirements which deal primarily with credit risk. The proposed eighteen month implementation date after the final rule is published in the Federal Register is totally unrealistic and the NCUA should enact a longer implementation period or a capital conservation buffer phase-in period comparable to the Basel III methodology.

B) Page 35 of the draft proposal points out that section 216(d) of the FCUA requires the risk-based capital ratio to include components that require higher capital levels to reflect increased risk due to interest rate risk, concentration risk, credit risk, market risk, and liquidity risk. NCUA appears to use credit risk and concentration risk when looking at loan categories as well as credit risk when looking at cash and U.S. Government obligations, but then uses interest rate risk for most other securities through the use of a weighted average life methodology. Where the bank risk weightings are almost strictly based on credit, the NCUA rules mix in the concept of interest rate risk. Interest rate risk is already a major focus from an asset/liability management standpoint and the NCUA already has tools to require higher capital levels from credit unions with excess interest rate risk. Forcing all credit unions to effectively apply one set of arbitrary risk weight premiums based on average life does not take into account the various asset/liability management positions from one credit union to the next. It makes more sense to keep the asset/liability management process out of the capital rules and instead focus on this in the asset/liability management process as the bank rules do. With that all being said, does it make more sense for the NCUA to factor in credit risk on securities as the bank rules do which reward investments backed by the U.S. Treasury, GNMA, and SBA? Under bank rules, securities issued by Government Sponsored Enterprises ("GSE's" or "Agencies") such as FNMA, FHLMC, and FHLB would carry a 20% risk weight. For these same securities, the NCUA rules would apply risk weights as high as 150% (bonds with a weighted average life of >5 to ≤ 10 years) and 200% (bonds with a weighted average life of greater than 10 years). The strong focus on weighted average life in the proposed capital rules could easily incent credit unions to take actions that are not consistent with their true asset/liability management profile and subject the credit union to additional risk.

C) Table 6-Risk-Weight Categories And Associated Risk-Weights on pages 50-52 of the draft proposal has some inconsistencies in terms of interest rate risk relative to investments and how that is reported on the call report which ultimately rolls up into this table. As pointed out on page 53 of the draft proposal, section 702.105 of the NCUA regulations utilizes the 300 basis point interest rate “shock tests” to corroborate the assigned risk weights in the table. The problem with this rationale is that the callable fixed rate debt obligation (which includes multi-coupon instruments (“step-ups”)) are also reported at the period remaining to maturity on line 5 of page 1 of the call report. This rationale does not factor in the true embedded optionality (i.e. likelihood of call) in these investments which increases as the rates step-up on these types of investments which causes the remaining yield-to-maturity after each rate step-up to increase while the remaining duration on the bond decreases. NCUA’s methodology of using the TRA OAS Shock Analysis (which is not even the default function on Bloomberg and therefore not the industry standard as NCUA keeps insisting that it is) utilizes a blended rate of the step-up rates over the full life of the bond and then evaluates it as a fixed rate callable bond which tends to generally bring it at or close to maturity. This may have been the appropriate methodology to use when step-ups became actively traded in May, 1992 and the analytical tools were not as sophisticated as they are now. FTN Financial conducted an empirical study in January 2012 on step-ups underwritten in the lowest rate portion of 2003 and found that 84% of 15 year issues and 81% of 10 year issues were called before rates plunged due to the financial crisis in 2008 (A copy of this study is available for your review). We conducted our own study of forty-nine (49) callable, step-ups purchased by VFCU since 07/28/09 with forty-one (41) (83.67%) being called by 05/28/14. These types of results over numerous rate cycles only substantiate that utilizing the period remaining to maturity date on callable fixed rate debt obligations (including multi-coupon instruments (“step-ups”)) is a grossly inaccurate and ultra conservative representation of the true weighted average life that we are asked to portray on line 5 of page 1 of the Call Report. Callable step-ups are adjustable rate investments with embedded optionality from its call feature. To assume that this security would go to maturity is totally inconsistent with the rationale used for fixed rate amortizing securities that consider the weighted average life according to industry standard calculations which factors in prepayments. A call on a callable bond is nothing more than a prepayment. If NCUA wants credit unions to use final maturity date on callable fixed rate debt obligations (including multi-coupon instruments (step-ups)), then I question why the NCUA asks credit unions to disclose non-mortgage related securities with embedded options on line 8 on Schedule B-Investments on page 17 of the call report. I would venture to say that it is because NCUA would like to know what bonds have optionality with potential changes in rates which is not what the instructions for these callable fixed rate debt obligations (including multi-coupon instruments (“step-ups”)) on line 5 on page 1 portrays.

The TRA Shock Analysis traditional mode, which is the Bloomberg default and industry standard, factors in both the step up and callable features under different rate shocks and generally does not go to maturity on most callable, step ups at +300 basis points. With the previously mentioned historical experience and empirical studies documentation, we utilize this rate shock screen for pre-purchase analysis and subsequent rate shock monitoring instead of the OAS Shock Analysis recommended by the NCUA which generally goes at or close to maturity and does not factor in the step-up timing. We feel that our rationale meets the rate shock monitoring requirements under NCUA Regulation 703.12 (c) of providing a reasonable and supportable estimate of the potential impact in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points. For these reasons, NCUA change should change the call report instructions on line 5 page 1 of the call report to reflect the true weighted average life on callable fixed rate debt obligations (including multi-coupon instruments ("step-ups")).

In light of the fact that the step ups will not decrease in rate should rates decrease, as would occur on an adjustable rate mortgage backed security, this further increases their call likelihood and decreases their potential to extend to maturity as history has shown to be true. The OAS Shock Analysis and call report instructions on step ups do nothing more than to take an unrealistic, ultra conservative approach on callable, fixed rate debt obligations (including multi-coupon instruments ("step-ups")) which is totally inconsistent with other call report reporting instructions for adjustable rate securities (i.e. period remaining to next rate adjustment date) and fixed rate amortizing debt obligations (i.e. weighted average life according to industry standard calculations) which factors in prepayments (i.e. optionality) similar to a call. An agency's monitoring of a callable debt instrument is much more efficient than a consumer's monitoring of their mortgage rates for refinance purposes. This can be due to the consumer's lack of interest in refinancing even though they should refinance their mortgage or simply because LTV and debt/income ratios do not allow them to refinance. This efficiency increases the likelihood of call on this type of security.

To be more consistent with the rationale of following industry standards which does factor in embedded optionality, the call report instructions for callable fixed-rate debt obligations and deposits which include multi-coupon instruments (step-ups) should not be reported at the period remaining to maturity date as they currently are. A duration or likely call focus should be applied to this instrument which ultimately results in a more accurate reflection of the security's optionality at that point in time. A reasonable approach would be to use the call date at which point the coupon would step above that of a new callable issue with a comparable remaining term. FTN Financial, one of the vendors we utilize, could easily program this option into their call report methodology if NCUA were to change their call report methodology for this type of investment. A ten or fifteen year callable, step-up security has much less extension risk, liquidity risk and credit risk than a low rate, fixed rate mortgage which is given a 50 percent risk weight while the investment will be given a 150 to 200 percent risk weight because the current call report methodology utilizes final maturity date instead of estimated call date as proposed above. If one were to have to consider factoring in the final maturity date instead of the likely call date, the 150 to 200 percent risk weights currently assigned to these securities would be significantly higher than the consumer loan type risk weights which range between 75 and 100 percent yet have more liquidity and credit risk. Utilizing the recommended methodology would result in the majority of these securities being in the >3 year and ≤5 year WAL category which would fall under the 75% risk weight. The additional credit risk and liquidity risk of the consumer loans is no different than the additional amount of extension risk in a rising rate environment on the callable fixed rate debt obligation (including multi-coupon (“step-ups”)). Each product has its own type of risk.

D) On page 64 of the draft proposal, you indicate that loan to CUSOs carry a 100 percent risk weight because they normally have a higher payout priority in the event of a liquidation of a CUSO than an investment in a CUSO which carries a 250 percent risk weight. The 250 percent risk weight on investments in CUSOs seems rather harsh when you consider that delinquent unsecured consumer loans only carry a 150 percent risk weight. An investment in a profitable CUSO is entirely different than an investment in an unprofitable CUSO, both of which may have saleable assets without even having an outstanding loan to the CUSO. This high risk weight will dissuade credit unions from investing in CUSOs that could add to their net worth and make them more competitive. To be consistent with the risk weights on consumer loans which do not differentiate generally between secured and unsecured loans, I feel that it would be more consistent to give a risk-weighting of 75 percent for a loan and an investment in a CUSO. If the CUSO has negative retained earnings, it would be appropriate to use a 150 percent risk weight until the retained earnings become positive at which point it would revert back to a 75 percent risk weight.

E) The Mortgage Servicing Asset (MSA) risk weight of 250 percent on page 65 of the draft proposal appears to also be excessive. I do agree with you that a MSA does have interest rate and market risk that are reflected in its valuation which can decrease when interest rate fall and borrowers refinance or prepay their mortgage loans. We currently have our MSA independently valued twice a year, so I am not so sure that there would be material earnings volatility and erosion of capital, especially when rates eventually increase and refinances and prepayments slow. I would lean more toward utilizing a 150 percent risk weight since there is no credit risk involved in this asset. If NCUA were to choose to stay with the 250 percent risk weight, it should at least phase it in over four years at 40%, 60%, 80%, and 100% of the value similar to the Basel III regulation.

F) Loans held for sale in Table 16 on page 66 of the draft proposal do have short term market risk until they are sold but do not have longer term credit and interest rate risk like portfolioed fixed rate mortgages. For this reason, they should be considered to have a risk weighting on no more than the lowest risk weight on fixed rate mortgages of 50 percent.

G) Proposed rule 702.113(c) on page 174 of the draft proposal recommends that the Statement of Financial Condition when presented to members, to creditors or to the NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter’s absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered. Article VII Section 6 of the NCUA’s standard bylaws give the board of directors the authority to designate the authority and responsibility of the financial officer of the credit union to manage the credit union under the control and direction of the Board to the general manager which is usually the President/Chief Executive Officer. This avoids having to require the treasurer of the credit union to sign the monthly financials posted at the credit union's branches among other things. This rule, coupled with the possibility of the treasurer not being available when the quarterly call report may need to be filed which could subject the credit union to possible fines for a late filing, is unnecessary as long as the board of directors has delegated that authority to the general manager per its bylaws.

I do realize that it is much more difficult and complex to factor in the many risk categories into this proposal than the credit risk concerns primarily addressed in the Basel III regulation. With that being said, I have hopefully provided the NCUA with some suggestions that more accurately will reflect the risk considerations of various balance sheet categories. This will require some needed immaterial modifications to the call report instructions that will more accurately reflect the true risk exposures to the credit union and ultimately to the NCUA. Thank you for your consideration of my comments, and feel free to call me to clarify any of my recommendations further.

Sincerely,

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