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May 25, 2014

To: Regcomments@NCUA.GOV

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

Re: Proposed Rule – Prompt Corrective Action – Risk-Based Capital – RIN 3133-AD77

Dear Mr. Poliquin:

ALM First Financial Advisors appreciates the opportunity to comment on the above-referenced notice of proposed rulemaking (NPR) published by the National Credit Union Administration (NCUA) in the Federal Register on February 27, 2014. The NCUA has issued this notice of proposed rulemaking on risk-based capital as part of its continued efforts to orchestrate heightened safety and soundness parameters in the credit union industry. In response to Government Accountability Office mandates, the NCUA galvanized an improved scrutiny of systemic capital threats. The proposed risk-based capital (RBC) framework introduced by the NCUA Board on January 23 revises the insufficient, one-size-fits-all capital regulations for federally insured credit unions with more than $50 million in assets. It also attempts to partially correlate with the Basel III capital adequacy standards adopted by the Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC). But the critically important RBC proposal lacks some congruency with the Basel Accords and could lead to a misrepresentation of risk across the credit union spectrum. While the stability of depository systems relies profoundly on capital cushions, it is imperative to measure capital prudently. Doing so will both prevent institutional failures and allow credit unions the flexibility to enhance earnings while strategically managing risk so that they may continue to offer superior products to their members.

The Basel Committee on Banking Supervision (BCBS) rightfully developed the Third Basel Accord in response to the global financial crises of the late 2000s with the intention of reforming bank capital requirements. Specifically, the BCBS suggested that banks increase Tier 1 capital from 4 percent to 6 percent of risk-weighted assets, which the Fed committed to begin adopting in 2011, with the goal of full compliance in 2015. Moreover, the BCBS augmented capital standards with a 2.5 percent mandatory capital conservation buffer and a discretionary counter-cycle buffer that would allow banking regulators to impose an additional 2.5 percent capital obligation during periods of credit expansion. The U.S. banking community intends to gradually phase in the conservation buffer beginning in 2016, with full espousal expected by 2019. Under the current proposal, the NCUA is authorized to necessitate even more capital on a subjective case-by-case basis, which mirrors the motivation behind the counter-cyclical buffer and is consistent with the FDIC's supervisory assessments. Given the prescribed timelines for the U.S. banking arena, affected credit unions should be afforded substantially longer than 18 months to comply, prior to being subject to more punitive capital guidelines.

In order to reallocate balance sheet composition effectively to conform to the new, more stringent capital policies, institutions should have at least twice that amount of time. While the justification is reasonable for requiring covered credit unions to hold more capital than their banking counterparts due to banks' ability to raise secondary capital, the proposed capital computation deductions and risk weightings for credit unions should be calibrated to assess residual, unhedgeable risks. Credit unions with more than $250 million in assets now have the tools with interest rate derivatives to hedge asset types severely punished by the the ruling. Deducting goodwill in the calculation is palatable and in concert with Basel III; however, excluding accumulated-other-comprehensive-income (AOCI) items could be unrealistic. Despite bank regulators allowing a one-time opt out for standard banks to continue excluding AOCI due to the metric's potential volatility, AOCI could reveal exposures like underperforming pensions. With respect to investment risk weights, credit unions are capable of mitigating interest rate risk with both on- and off-balance sheet instruments. Concordantly, risk weights for investments should not be based on remaining terms or weighted average lives which are not only inappropriate in a prompt corrective action (PCA) framework, but also poor measures of interest rate risk. They should instead satisfactorily capture credit exposures congruent with Basel III. For example, agency and supranational debentures should not require more capital than non-agency ABS products of equal term, but revenue-backed municipal debt should require more capital than general obligation municipal debt, given all else is equal. Comparable banking conventions also do not prescribe as many risk-weight classes.

Transitioning from investment to loan risk weightings provides rationale challenges. For example, long-duration mortgage investments have higher risk weightings than similar duration mortgage loans. Furthermore, quantifying residential mortgage and member-business-loan (MBL) exposures largely based on concentration constraints feigns risk to capital and ultimately disincentivizes potentially profitable lending segments. The NCUA's proposal is actually light on delinquent, modified (unless via the U.S. Treasury's Home Affordable Mortgage Program), and non-accrual first-lien residential mortgage loans; a 150 percent capital requirement like Basel III is more appropriate. High-quality, first-lien residential mortgage loans (prime credit, low loan to value (LTV)), however, should not have a risk weighting higher than 50 percent, regardless of concentration, which is consistent with Basel III. Similarly, high-quality MBLs (high debt service coverage ratio (DSCR), low LTV) should not require more than 100 percent risk weighting irrespective of their percent of total assets. Also, multifamily loans, after certain performance criteria are met, should carry the same capital requirements as a high quality single family mortgage. Even though it is paramount to monitor concentration risks, capital penalties should not be assessed that could potentially limit credit unions' ability to pay dividends and offer value-added services to members.

Specific Recommendations:

1. Risk-based capital systems are explicitly designed for credit risk not for **interest rate, concentration or liquidity risks** that are generally managed through diversification, asset selection, or hedged outright either through liability structures or derivative use. The NCUA specifically addresses these risks through its letters to credit unions. **We recommend the NCUA regulate these risks outside of the RBC framework by using Individual Minimum Capital Requirements (IMCR) for institutions taking undue risks in these areas.**

2. For assessments of interest rate risk, it is imperative the NCUA move away from using weighted average life (WAL) as a measuring stick at the asset level. Interest rate risk as measured by economic value of equity (EVE) or net economic value (NEV), which includes funding sources and derivatives, is far superior. Guidance in this area is described in the ***Interagency Advisory on Interest Rate Risk,*** dated January 2010. The interest rate risk profile of a 30-year zero coupon U.S. Treasury security and its coupon paying brother are very different and both have the same WAL. Assuming 30- year interest rates of 6 percent, the coupon paying bond has a duration in the high 13 percent area, while the zero coupon measure is more than twice as high at slightly over 29 percent. WAL is a simple measure of average time until receipt of principal and misses the present value of all coupon payments which can be a significant portion of an asset's market value.

3. ALM First recommends overhauling the current call reporting platform as it represents the data gathering mechanism for the NCUA. The alignment of call report data across all U.S. regulated depositories is a first step toward building a consistent framework for both the assignment of appropriate risk-weights, as well as the comparability of capital adequacy across institutions.

4. ALM First recommends that the NCUA expand its research horizons to include data sourcing outside the natural person credit union space. The NPR contains several examples where "uncertain" conclusions are drawn from insufficient data, or those where research is halted due to the burdensome process of data collection. Often times, these data sources are limited to natural person credit unions, many of which have little exposure to the asset classes in question.

5. Credit union deposits in Federal Reserve Banks should carry a zero risk weighting as should GNMA guaranteed mortgage-backed securities.

6. Credit unions should be afforded substantially longer than 18 months to comply, prior to being subject to more punitive capital guidelines, in order to reallocate balance sheet composition effectively to conform to the new, more stringent capital policies. Credit unions **should have at least double that amount of time.**

7. High-quality, first-lien residential mortgage loans (prime credit, low LTV) should not be have more than a 50 percent risk weighting, regardless of concentration, which is consistent with Basel III.

8. High-quality MBLs (high DSCR, low LTV) should not require more than 100 percent risk weighting irrespective of their percent of total assets, which is consistent with Basel III.

9. After certain performance criteria are met, high-quality multifamily loans should carry the same capital requirements as a high-quality single family mortgage regardless of concentration, which is consistent with Basel III.

ALM First supports the NCUA in their continuing efforts to orchestrate heightened safety and soundness parameters for the credit union industry and believes a more consistent framework across all U.S. regulated depository institutions should be the end goal. Thank you for the opportunity to comment on the proposed rule.

Sincerely,

Robert Perry
Financial Advisor and Co-Head, Investment Strategies Group

Kevin Kirksey
Strategic Solutions Group Manager