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TECHNOLOGY CREDIT UNION

May 28, 2014

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

RE: Commentary Regarding NCUA Risk-Based Capital Proposal, RIN 3133–AD77

Thank you for the opportunity to comment on proposal RIN 31-33-AD77and share my concerns about the Risk-Based Capital Proposal with you and the honorable members of the NCUA Board. I have spent over 22 years in financial services and have served as CFO, or equivalent, in both banking and finance companies. Most recently I have spent the last seven years as CFO at two different credit unions. I share this information because I believe I have a unique perspective on risk-based capital and how it has been applied to the various sectors within financial services. I believe that this perspective provides valuable insight and warrants serious consideration from the NCUA Board.

First let me state that I support the NCUA's desire to strengthen capital adequacy measurements within the credit union system. Having worked in banking where these concepts are more fully developed and at non-insured finance companies where these concepts are nearly non-existent, I believe a more comprehensive approach to risk-based capital in the credit union sector would be beneficial. However, the current incarnation of RIN 3133-AD77 fails to provide the desired improvement because it attempts to measure and limit too many different types of risk in one single proposal.

Prior to Basel, risk-based capital in banking was centered on credit risk, applying weightings to various asset classes based on collateral type and credit enhancements (payment guarantees) inherent in certain investment structures. In appearance, these banking worksheets were very similar to the worksheets the NCUA has designed for its risk-based capital purposes. However the similarities are visual only. RIN 3133-AD77 is also attempting to incorporate asset concentration limits, and to a limited extent, attempting to include interest rate risk (IRR) management--this is evident by weightings in excess of 100%. It is important to note the attempts to measure and limit concentrations and IRR are in addition to the credit risk measurement and controls traditionally associated with risk-based capital. As a result of such an ambitious goal, in the end, RIN 3133-AD77 performs poorly as a risk control for any of the three types of risk it is attempting to limit.

Allow me to explain further. Risk weightings as historically applied in risk-based capital models provide a generic overview of an institution's inherent credit risk, as it relates to all assets. However, no risk-based capital methodology will be able to take into account a credit union's ALLL methodology, underwriting standards, unique market dynamics, membership demographics, credit risk skill sets, or the experience of management and staff. All of those considerations are critical in determining how much concentration risk an institution can safely manage, and a one-size-fits-all weighting system cannot take those factors into account. This is also why risk weightings should be broad and generic in nature, should be applied consistently regardless of portfolio size, should not step up when concentrations (portfolio sizes) increase, and should never be over 100%. Assigning weights in excess of 100% for portfolios that exceed a certain level set by the NCUA (or a 250% weighting for Credit Union Service Organizations) penalizes credit unions that may have a particular expertise or a favorable market for those products, or that exhibit strength in some or all of the factors described in the second sentence of this paragraph. Those factors are essential to effective credit risk and concentration risk management. Concentration limits and policies are important, but should not be made part of static risk-based capital weightings, which are intended to be used as a generic measure of credit risk. Concentration limits are best treated as separate aspects of credit risk and should take into account the specifics of each credit union's unique circumstance and skill set.

Furthermore, it appears the NCUA is using RIN 3133-AD77 to try to manage interest rate risk, as the concentration penalties are significant for portfolios (asset types) that exhibit a high level of price sensitivity as measured by NEV. This too, is a flawed approach, as it only views IRR from the asset side of the balance sheet and does not take into account mitigating strategies deliberately employed by the credit union on the liability side of the balance sheet, such as deposit mix, strategic borrowings, or hedging powers, nor does it take into account how investment strategies that could counter undesirable IRR traits in the loan portfolio.

Instead of the proposed approach in RIN 3133-AD77, I suggest the NCUA proceed to strengthen the existing capital adequacy rules but stick to what risk–based capital models do best: providing a generic benchmark for credit risk. If the NCUA were to create a risk-based capital model similar to banking's pre-Basel risk-based capital model (schedule RC-R on call reports), that would greatly enhance the level of capital adequacy measurements without diluting or distorting capital adequacy with higher-than-100% weightings and concurrent attempts to manage concentration and IRR risk(s), as RIN 3133-AD77 appears designed to do. These other risk areas are specific to each institution, based on the factors mentioned above, and are best left out of a risk-based capital rule. Regulatory examinations have been very effective at determining the adequacy of a credit union's concentration limits, IRR management and liquidity, and should continue to provide the oversight necessary in these areas.

I caution the NCUA about moving too aggressively towards a Basel methodology, as the risk analysis models required for effective application of Basel also require a large amount of historical data at the product level (with a high degree of data integrity). Credit unions are certainly capable of collecting this data, but since it has not been a requirement in the past, it will take some time for credit unions to capture the data or design systems to capture that data and assemble the required amount of history. The burdens of time, cost and effort to provide adequate data should not be underestimated.

Finally, one of the most problematic areas in RIN 3133-AD77 is the introduction of the Individual Minimum Capital Requirement (IMCR). On a case-by-case basis, the IMCR allows higher minimum capital requirements to be imposed on individual credit unions. The criteria for establishing an IMCR appears to be arbitrary, and credit unions will find it difficult to plan for and anticipate such actions. Additionally, consistent application of IMCR across hundreds of field examiners is unlikely, making the IMCR unworkable. It may, in fact, cause irreparable damage to the desired goal of improving risk-based capital reporting. This concept should be stricken from RIN 3133-AD77.

Respectfully,

Todd Harris

Todd Harris
Chief Financial & Chief Administrative Officer

Ecc:

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Fax cc:
Dianne Feinstein, U.S. Senate
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