From:	Randy Baldwin
To:	_Regulatory Comments
Subject:	Comment on Risk Based Capital proposal - Arizona Federal Credit Union
Date:	Wednesday, May 28, 2014 12:48:30 PM

May 27, 2014

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke St.
Alexandria, VA 22314-3428

Dear Mr. Poliquin,

We applaud the NCUA's efforts to create a risk-based capital structure. It's reasonable and appropriate to apply higher capital standards to those institutions that represent additional risk to the federal credit union system. Our team is also pleased that NCUA appears to be genuinely open to considering well-constructed suggestions from credit unions to ensure the risk based capital structure balances safety and soundness with service to members. However, we are concerned about certain aspects of the proposed risk based capital requirements and methodology.

RISK WEIGHTING

The proposal includes risk weightings that are not reflective of the real risk of certain asset classes or are disproportionate relative to other assets.

Loans

The proposal does not take into consideration the collateral securing loans. For example, a first mortgage with a 60% loan-to-value represents significantly less risk than a first mortgage with a 90% loan-to-value, however, both are given the same risk weighting. Similarly, an auto loan with a 75% loan-to-value represents significantly less risk than an auto loan with a loan-to-value of 150%.

An unsecured credit card is given the same risk weighting as a fully secured auto loan.

There is no consideration for whether a loan has a fixed rate or a variable rate. There is considerably different interest rate risk with these two products. Noting the higher risk weightings for proportionately larger mortgage and commercial portfolios, it appears that some consideration is given to interest rate risk; however, the fixed/variable component is ignored.

There is no consideration for credit risk. While it is assumed that a credit union will consider credit quality in their allowance for loan and lease loss model, credit risk represents one of the greatest risks on a balance sheet and should be given some consideration from an overall risk perspective. A credit union with excessive levels of D/E lending is at considerably greater risk than a credit union with tight underwriting standards. Until high-risk loans reach a delinquent status, no additional reserve is required under the proposed standards.

Page 59 of the proposal mentions the risk embedded in first mortgages with inadequate underwriting, negative amortization, significant payment shock to borrowers, or unverified or undocumented income. These high risk loans are classified in the same category as second mortgage loans, and assign a risk weighting of 100% or more depending on concentration. It is highly questionable whether high risk first mortgage products should be in the same class as well-underwritten, well documented, well-structured second mortgages.

Allowance for loan and lease loss

The allowance for loan and lease loss reserve is included in the numerator for total net worth, but only up to 1.25% of risk assets. For us, this represents only $10.9 million of the $17.2 million we hold in the ALLL reserve. This methodology excludes $6.3 million which should be considered as part of total net worth. The risk based net worth model includes in the denominator a higher reserve requirement for all delinquent loans with no exclusions; however, it does not count all of the ALLL towards net worth. The entire balance of the ALLL should be considered in the numerator for proper determination of capital adequacy.

Investments

Weightings assigned to investments do not consistently represent the risk exposure to the credit union. For example, a US Treasury is assigned a zero risk weighting regardless of maturity, despite the fact that a long-term treasury can experience a significant loss in value if rates increase. These instruments carry a lower weighting than cash on deposit at the Federal Reserve Bank, which carries a 20% risk weighting.

Long-term investments are given higher risk weightings than many loan types. Investments with a weighted average life of >5 to 10 years has a 150% weighting, and those with a weighted average life greater than ten years has a 200% weighting. This is excessive when compared to a 30-year mortgage in portfolio which has a 50% risk weight. Similarly, a 30-year mortgage in a GSE pool with a weighted average life of 5-10 years has a 150% risk weight, while a delinquent first mortgage loan in portfolio has a 100% risk weight. With the protections and implicit guarantee built into a GSE investment, these weightings are incongruous.

CUSOs

The risk weighting for a loan to a CUSO is 100% which is greater than the 75% risk weighting for a credit card loan, and the same as the weighting assigned to a delinquent first mortgage loan or a non-federally insured student loan. There is no consideration to the financial strength or collateral provided by the CUSO. A CUSO loan has a risk weight equal to the highest risk weighting assigned to first mortgage loans in excess of 35% of total assets.

Also, the risk weighting for the investment in a CUSO is 250% which is the highest risk ratings of any asset with the exception of those with an ABS "comprehensive understanding" penalty. This implies that CUSOs are inherently the riskiest of assets despite the fact that, unlike other investments, a credit union may have more influence and control over a CUSO than over other types of investments. This escalated risk weighting may discourage credit unions from investing in CUSOs in the future, which may stifle creativity, growth, and cost savings within the industry.

Goodwill

Goodwill represents real value in compliance with generally accepted accounting principles, and should be included in net worth. The exclusion of goodwill from total net worth in the numerator will play an important role in a credit union's decision to merge another credit union. This may hinder credit unions as well as NCUA, as there are times when the merger of an unhealthy credit union into a healthy credit union might no longer be of mutual benefit.

Asset and Liability Management practices
The proposal does not take into consideration the effectiveness of asset and liability management practices. Longer-term assets are given higher risk weights regardless of the matching of liabilities or the features embedded within the assets. Two credit unions with vastly different ALM practices would both be held to the same capital requirements regardless of how well they have matched liabilities of similar durations or how effectively they have structured those assets and liabilities. There is no consideration given as to whether an asset or liability is fixed or variable, or how penalties are structured to discourage early redemption of liabilities.

COMPARISON TO FDIC STRUCTURE

Ironically, in April 2014 the FDIC, OCC, and Federal Reserve Bank adopted a simple leverage ratio of 6% of total assets to be considered well capitalized. This is a 20% increase from the current 5% leverage ratio and banks will have until 2018 to comply. By comparison, the credit union industry is currently held to a higher 7% ratio which is 16.7% higher than the FDIC level. The proposal will add a second component of 10.5% of risk assets, and will give credit unions only eighteen months to comply. This puts us at a distinct disadvantage over the banking industry.

According to Callahan and Associates, between 2007 and 2013 the FDIC insurance fund sustained losses equivalent to $2.30 per $1,000 of assets, while the credit union industry sustained losses equivalent to $0.26 per $1,000. In other words, the banking system sustained losses 8.8 times higher than the credit union system. Yet the NCUA is proposing increasing the current capital requirement well in excess of the banks' new standard.

Credit unions represent less risk than banks; they outperformed banks during the financial crisis; they do not have access to secondary capital as banks do; and they have tighter restrictions on investment authority than banks. Despite this, the proposal raises capital standards for credit unions to a higher level than banks.

SUBJECTIVE CAPITAL REQUIREMENTS

Among the more troublesome aspects of the proposal is the NCUA's ability to subjectively impose higher capital standards on a credit union for reasons other than those specifically defined by risk weightings. This is referred to as Individual Minimum Capital Requirements (IMCR). This gives excessively broad authority to impose higher capital requirements, without a clearly defined structure. This has the potential to be inconsistently applied between examiners or regions, and could give examiners punitive power that is subject to misuse.

OUR SITUATION

Current financial position
We are a $1.3 billion credit union with a net worth ratio of 11.50% as of March 2014 and 12.11% as of April 2014. For purposes of this comment letter, we will use March 2013 data. We hold net worth totaling $147 million. Adjusting for the NCUSIF deposit, our net worth ratio is 11.78%. We hold only a small first mortgage portfolio totaling 5.1% of total assets and a second mortgage portfolio totaling 9.1% of total assets. We hold business loans totaling 1.5% of assets. Loan credit quality is high, underwriting is sound, and investments are professionally managed with an average life of less than two years. We have in excess of $300 million of available liquidity at any given time. We maintain a strong risk position relative to interest rate

risk, credit risk, and liquidity risk.

Based on our most recent ALM analysis for March 2014, our net economic value would decrease by 4.7% if we were to experience an immediate and sustained 300 basis point increase in interest rates. Our net interest income would decrease by 1.8% under the same shock scenario. By industry standards, we are very well positioned to sustain rate increases.

Our net worth exceeds the 7% well capitalized level by 4.78% of assets or $60 million. This is sufficient to cover all key risk indicators that we have identified in our Enterprise Risk Management evaluation over a five year period of extraordinary losses.

From a credit risk perspective, our delinquency ratio is considerably below our peers at .60% and our net loan loss ratio is -.35% due to recoveries exceeding charge-offs, not because of a reversal of provision expense. Our allowance for loan and lease loss represents 548% of 61-day delinquency and 3.3% of total loans.

Our liquidity position is strong. We typically hold cash and cash equivalents of approximately 4-7% of total assets, our investment WAL is 1.97 years, and we have access to over $300 million through borrowing lines with the FHLB using securities as collateral. We also have access to both the Central Liquidity Facility and the Federal Reserve Bank's discount window. We are in a very strong liquidity position.

Impact of proposal

The proposed capital rule would require us to maintain an additional $3.7 million in capital, which would reduce our excess capital from $60 million to $56 million. This is capital that could be put to work for the benefit of our members to use for future growth or returned to our members in the form of lower loan rates, higher deposit rates, or capital distribution.

The proposed capital structure ignores $6.3 million in our allowance for loan and lease loss, including only $10.9 million of our $17.2 million.

SECONDARY CAPITAL

The banking industry represents a higher risk profile with lending and investment authority we do not enjoy; lower capital requirements; and access to secondary capital. This puts the credit union industry at a disadvantage. This is a perfect opportunity for the NCUA to provide credit unions access to secondary capital. Currently, we can only increase net worth through retained earnings, which creates challenges for credit unions wanting to venture into new product lines or other strategies. Banks can quickly raise capital through other means, giving them a distinct advantage in bringing to market products and services more quickly than we can. Access to secondary capital would allow credit unions to increase capital and strengthen our risk position while meeting the needs of our members. While we are not in need of secondary capital at present, we are advocating for this for the benefit of the industry. We would consider secondary capital if it supported a well-planned opportunity or solution for our members.

IMPACT ON THE INDUSTRY

The proposed risk weightings and capital requirements will no doubt have an impact on strategic planning for the credit union industry. It may result in fewer members being able to get mortgage loans or member business loans.

We currently take into consideration the risks involved with new products or changes to existing products; however, now we must also consider the net worth impact of exceeding thresholds of first mortgages or member business loans as a percent of total assets. This could be a deterrent to serving our members because of arbitrary limits imposed for certain product penetration, without regard to offsetting liabilities that would mitigate risk.

For example, if a credit union reaches the threshold of concentration for first mortgages or business loans, they are now faced with significantly increasing their reserves in order to exceed those limits, regardless of how safe and sound their underwriting, asset liability management practices, and liquidity practices are. They may simply decide not to cross that threshold and to shut off services to their members in order to avoid the reserve requirement.

SUMMARY

The risk based capital proposal as written will have a negative impact on the credit union industry. It carries higher capital standards than the FDIC capital structure. Risk weightings for various asset classes do not adequately represent the relative risk. The proposal, in its current form, fails to properly address risk.

1. It imposes higher standards on the credit union industry despite this industry's stellar performance during the Great Recession, relative to the banking industry.
2. It does not provide options for credit unions to raise secondary capital.
3. Risk weightings must be reviewed to ensure that weightings adequately represent the risk of each asset class. Several of the weightings disproportionately assign risk on a relative basis.
4. There is no consideration of the strength of collateral.
5. There is no consideration of credit risk.
6. There is no consideration of prudent ALM practices such as matching of assets and liabilities or implementing features to influence member behaviors.
7. There is no consideration of fixed vs. variable rate loans and investments.
8. CUSO loans and investments are excessively risk weighted.
9. The NCUA should remove the IMCR component of the proposal.

We appreciate your thoughtful review of the comments and ask that you give them serious consideration before implementing a final rule.

Sincerely,

Randy Baldwin
EVP & Chief Financial Officer

Cc: Ronald E Westad, President/CEO