May 28, 2014

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

RE: Proposed Rule on Prompt Corrective Action—Risk-Based Capital
(12 CFR Parts 700, 701, 702, 703, 713, 723, and 747)

Dear Mr. Poliquin,

On behalf of Digital Federal Credit Union, thank you for the opportunity to comment on the National Credit Union Administration's (NCUA) Proposed Rule on Prompt Corrective Action (PCA) — Risk-Based Capital (RBC). As industry responses have indicated, there are many areas in question within the proposed regulation. These include the overall rationale for the approach being taken, and numerous technical questions related to specific details of the proposal.

Overall, we recommend the NCUA review all of the feedback provided as part of the proposal process, and consider this proposed rule an Advanced Notice of Proposed Rulemaking (ANPR). Subsequently, an ANPR (to obtain additional feedback) or Proposed Rule could be issued that addresses many of the concerns, regardless of whether all concerns resulted in changes. Given the improved economic conditions, compared to December 2009, insured shares in troubled credit unions have declined from 5.72% to a current level 1.37%[1].

We do not see the need to expedite changes to PCA regulation and implement a final rule on such an aggressive timetable. In comparison, the derivative regulation process provided for more consideration, feedback and deliberation. The NCUA issued two ANPRs for derivatives before issuing a Proposed Rule. The majority of credit unions do not enter into derivative transactions, yet a two year timeframe took place.

While we understand the need for the NCUA to perform ongoing reviews of all regulations, we do not understand the basis for disregarding the current PCA regulations and adopting a completely different model. Since being finalized, there have not been significant modifications to the model design. This includes the most recent review performed as part of the NCUA's

[1] Share Insurance Fund Quarterly Review – Item 1b April 2014 Board Meeting

rolling three year review of regulations in 2012. This analysis was performed subsequent to the NCUA's December 19, 2011 response, included in the January 4, 2012 United States Government Accountability Office (GAO) Report to Congress.

In late January 2013, the NCUA's Office of General Counsel released the list of regulations being reviewed, indicating "Regulations under review in 2013 include rules governing member business loans, fair credit reporting, privacy of consumer financial information, appraisals and share insurance. ..... Additionally, NCUA will expand its review of federal credit union bylaws, which began in 2012."[2] Based on this release, it would appear the PCA review was completed in 2012, since it was not expanded into 2013.

PCA was written to ensure a credit union has adequate protection from material risks. Congress directed the NCUA to "establish reasonable net worth requirements, including risk-based net worth requirements in the case of complex credit unions."[3] We believe the current model addresses this more accurately than the proposal, which implies that a credit union with assets in excess of $50 million is a material risk regardless of their balance sheet composition. This rational seems inconsistent with the Congressional directive that "For purposes of section 216(d), "complex" refers to credit unions' portfolios of assets and liabilities."[4]

As you know, the GAO's report summarized a study they performed on 85 failed credit unions from the end of 2005 through the beginning of 2011. Many of these failed credit unions had total assets of $50 million or less. We anticipate the NCUA will continue to diligently regulate these smaller credit unions and suggest the same regulatory approach be utilized for credit unions with assets in excess of $50 million.

The proposed rule suggests that the new model is more consistent with RBC regulations from Other Federal Banking Regulatory Agencies (Agencies). Nonetheless, throughout the proposal, the NCUA has varied from a number of risk-weights when compared to the Agencies' model. The NCUA has indicated that Congressional direction for PCA regulation requires a more expansive risk assessment than the Agencies, where the focus is strictly credit risk (i.e. Basel III). The proposed rule indicates the goal is to address credit risks as well as interest rate, concentration, liquidity, operational, and market risks.

The challenge is that in reading the proposal, there is no explanation of which portion of the proposed risk-weight is intended to address each of these risk elements. We do not believe this is consistent with Congress' direction that "design of the risk-based net worth requirement

[2] NCUA Media Release, January 24, 2013 - NCUA Posts 2013 Regulation Review List - Public Comments Invited for Annual Assessment of One-Third of NCUA Rules, ALEXANDRIA, Va. (Jan. 24, 2013)
[3] H. Rept. 105-472 - 105th Congress (1997-1998)
[4] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.)

should reflect a reasoned judgment about the actual risks involved."[5] It is difficult for us to provide valuable comments since the details are not defined. By providing such additional information, we, as well as the rest of the industry, would then be in a better position to provide valuable comments. This in turn would enable the NCUA to carefully reconsider how the risk-weights are calibrated, as well as improve the effectiveness of PCA on capital adequacy.

Should the NCUA decide to disregard our suggestions and feedback provided above, we believe there are a number of technical areas of the proposed rule that require additional attention and re-evaluation. The following are our comments and observations that we believe could improve the RBC regulation as proposed.

Capital Categories

The proposed rule has a scaled RBC measurement approach assigning capital classifications to complex credit unions. To be classified as well-capitalized, a complex credit union must maintain a net worth ratio of 7% or higher, and must also have a RBC ratio of 10.5% or higher. We do not understand the "reasoned judgment" utilized by the NCUA to arrive at a requirement of an RBC ratio of 10.5% or higher for a complex well-capitalized credit union. Such information would allow us to better comment on the overall proposed RBC ratios for each capital classification. Additionally, while the proposal indicates a higher RBC ratio is designed to bolster the resiliency of complex credit unions, the NCUA should reconsider the utilization of the Agencies' capital conservation buffer and its overall design applicable to credit unions.

Effective Date

The proposed amendments would go into effect approximately 18 months after the publication of the final rule in the Federal Register. We believe this timeframe is not sufficient for credit unions to make adjustments to internal systems, their balance sheet structure, their operational processes, and their strategic plans. We believe the NCUA should reconsider the timeframe of the effective date for the final rule and have a phase-in arrangement, similar to the Other Federal Banking Regulatory Agencies.

Individual Minimum Capital Requirements

The proposed rule is extremely vague and confusing in this area. This part of the proposal indicates that "the proposed capital rules would be minimum standards generally based on broad credit risk and concentration considerations."[6] Although, compared to earlier in the proposal, the Board indicates the purpose is to "address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk."[7]

[5] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.)
[6] Federal Register / Vol. 79, No. 39 / February 27, 2014
[7] Federal Register / Vol. 79, No. 39 / February 27, 2014

The Board needs to establish a clear process for increasing the minimum levels for individual credit unions. This should be a required Board approval process, with the impacted credit union having an opportunity to be heard as part of the process.

Allowance for loan and lease loss

The allowance for loan and lease loss (ALLL) limitation of 1.25% of total assets is consistent with Basel III as described in the proposed rule. The proposed rule does not indicate how each risk element (credit, interest rate, concentration, liquidity, operational, and market) is assessed for this proposed limitation. Such indications would allow us to better comment on the ALLL limitation of 1.25% of total assets as proposed.

The proposed rule indicates the 1.25% limitation "would provide an incentive for granting quality loans...[but] should not result in a disincentive to fully fund the ALLL above the 1.25 percent ceiling."[8] Credit unions are known to serve members of modest means and provide financial services in areas that are often underserved by banks. We believe the NCUA should eliminate this limitation.

Real Estate and Commercial Loans

The proposed rule begins the level of risk-weights for real estate and commercial loans at the same percentages as Basel III, and then increases the risk-weights based on the portfolio's percentage of assets. It is unclear what portion of the risk-weights are associated with each risk element. The NCUA should provide "reasoned judgment" of the risk-weights within the proposal.

A credit union's real estate portfolio's adjustable rate loans and/or shorter term loans, such as 10-year fixed rate loans, have far less risks than the portfolios' 30-year fixed rate loans. The NCUA should consider such varying risks within a credit union's real estate portfolio in the final RBC regulation.

The NCUA mentions concentration and market risks in applying a 75% risk-weight on a credit union's "other real estate loans" balance within 25% of assets. We would like to understand how the NCUA derived this risk-weight for all of the risk elements within the proposed rule's goals. This understanding would allow us to better comment on the overall risk-weights of "other real estate loans."

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[8] Federal Register / Vol. 79, No. 39 / February 27, 2014

As indicated above, we have similar concerns on the commercial loan proposed rule risk-weights as we do for the proposed real estate loan risk-weights. The majority of credit unions have statutory caps on their commercial loan portfolio; we believe the proposed risk-weights on such loans appear to add another layer of restrictions to commercial loans for these credit unions.

As mentioned earlier, Congressional directive is to consider a credit unions' portfolio of assets and liabilities. The NCUA should factor into PCA regulation the risk mitigations on the liability side of a credit union's balance sheet. We have entered into borrowings to mitigate long-term interest rate risks on our real estate portfolio, yet no consideration is made under the proposed rule on such mitigating factors on our liability accounts.

Cash and Investments

The risk-weight for "cash on deposit" in the proposed model is 20%. Cash on deposit in the Federal Reserve Bank is not specifically addressed. Under Basel III, the Federal Reserve Bank balance is specifically outlined as a 0% risk-weight; we believe NCUA should include such a definition in the final rule.

In terms of risk-weights on investments, the proposed rule places higher risk-weights on investments with a weighted-average life (WAL) of over 1 year. When the WAL is 5 years or more, these risk-weights differ significantly (20% verses at least 150%). The proposal indicates that in addition to credit risk, the risk-weights consider interest rate risk and liquidity risk. While we believe the proposed risk-weights are excessively high, it is hard to elaborate when the level of consideration given to each type of risk element is not provided.

The proposed rule does not consider the accounting classification of a credit union's investments (trading, available-for-sale, held-to-maturity). The proposed risk-weights are applied to the credit union's recorded balance with no consideration of the fair value of the investment. Because it is unclear which portions of the risk-weights relate to the various risks being considered, it is difficult to assess the importance of the accounting classification.

Additionally, the proposed rule risk-weights corporate credit union perpetual capital at 200%, although provides no basis to this high risk percentage placed on such an asset. Similar to other investment categories, the proposal indicates that in addition to credit risk, this risk-weight considers interest rate risk and liquidity risk. While we believe this proposed risk-weight is excessively high, it is hard to elaborate when the level of consideration given to each type of risk element is not provided. In general, the NCUA has already established thresholds and requirements for corporate credit unions to build and retain their capital, therefore the NCUA should not penalize natural-person credit unions for their cooperative nature in such an investment.

Credit Union Service Organizations

The proposed rule risk-weights an investment in CUSO at 250%. This is well above the 100% level for a bank subsidiary investment (Basel III), as well as loans to CUSO. The proposal provides little basis to support this high risk-weight percentage, indicating "This increase is due to the risk of this unsecured equity investment, which is almost always in a non-publicly traded entity."[9] We believe this indication to the investment is credit related and would be similar for banks. Therefore, we do not understand the justification for a weighting of 1.5 times higher. We recommend a maximum 100% risk weight to an investment in CUSO.

Consumer Loans

In general, the proposed rule's risk-weight for consumer loans is 75% while the Basel III's risk-weight percentage is 100%. We find it encouraging that the NCUA recognizes the difference in risks associated with credit union consumer loans compared to other institutions, although we would like to understand the mitigating factors for this reduction of risk-weight by level of risk element (credit, interest rate, concentration, liquidity, operational, and market). This understanding would allow us to better comment on the overall risk-weights throughout the proposed rule.

NCUSIF Deposit

The proposed rule deducts the NCUSIF deposit from the risk-based capital, or the numerator, and applies a 0% risk-weight for the NCUSIF deposit for calculating the risk assets, or the denominator. As of December 31, 2013, this impact would be about 0.73% of the industry's net worth ratio by simply excluding the NCUSIF deposit from the numerator and denominator. The proposed rule undermines the premise of the NCUSIF deposit and places a $0 value to the deposit. While the proposal indicates otherwise, the accounting industry could interpret this deposit as a $0 value asset based on this regulatory approach.

Mortgage Servicing Assets

The proposed rule's risk-weight for mortgage servicing assets (MSA) is 250%, yet Basel III generally applies a 100% risk-weight to an institution's MSA. Again, the proposal provides little support for the significantly higher risk-weight. While there are brief references made to interest rate risk, market risk, refinance risk and prepayment risk, it remains unclear how distinctive each risk element was measured in determining the risk-weights. Surely, the Basel III analysis would have incorporated some of these under credit risk.

Additionally, the NCUA should consider generally accepted accounting principles for MSA. A credit union is allowed to account for MSA at fair value or at the lower of cost or market. If a credit union accounts for MSA at the lower of cost or market, the impairment can lead to earnings adjustments to reflect any deterioration in value.

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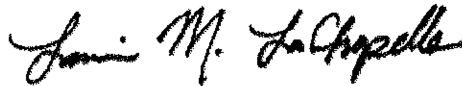
[9] Federal Register / Vol. 79, No. 39 / February 27, 2014

Certain Asset-Backed Investments

The proposed rule assigns a 1,250% risk-weight to an asset-backed investment when a credit union is unable to demonstrate a comprehensive understanding of the features of such an investment that could materially affect its performance. It is unclear to us how a comprehensive understanding would be recognized and consistently applied throughout the NCUA and its regions. We believe the NCUA should provide "reasoned judgment" of this risk-weight as well as its consistent application by examiners.

In closing, we thank you once again for this opportunity to comment on the Proposed Rule on Prompt Corrective Action—Risk-Based Capital. We look forward to additional communication related to improving the effectiveness of PCA on capital adequacy for credit unions.

Sincerely,



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