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CREDIT UNION

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March 31, 2014

The Honorable Debbie Matz, Chairman
The Honorable Michael E. Fryzel, Board Member
The Honorable Rick Metsger, Board Member

Re: Comments on Proposed Rule: PCA-Risked-Based Capital RIN 3133-AD77

Dear Chairman Matz, Board Member Fryzel and Board Member Metsger:

We are writing on behalf of Deseret First Federal Credit Union (DFFCU), which has 53,915 members and $450 million in assets. DFFCU appreciates the opportunity to provide comments to the National Credit Union Administration on its proposed rule, Prompt Corrective Action-Risk Based Capital.

The Board and Management of DFFCU request your review and consideration of the following comments as you contemplate the changes to Risked Based Capital rules, as these changes could be monumental and far reaching in their scope, with unforeseen ramifications.

Overview

DFFCU agrees that credit unions should hold capital that is commensurate to the level of risk entered into on the balance sheet, and is in favor of Risk Based Capital measures; however, there are a number of concerns regarding specifics of the current proposal. In this comment letter, we will share concerns with the direction of the draft as proposed and will make points to limitations of call report data as a measure of risk for complex credit unions, accompanied by recommendations to improve the draft.

For use in these comments, we would define Asset Liability Management (ALM) as the *"process of evaluating balance sheet risk (interest rate and liquidity risk) and making prudent decisions, which enables a credit union to remain financially viable as economic conditions change.[1]"* Enterprise Risk Management (ERM) *"is a comprehensive risk-optimization process that integrates risk management across an organization.[2]"*

Complex Credit Union and Limitations of Call Report Data

In the proposal, a complex credit union is defined as "...if the credit union's quarter-end total assets exceed $50 million". DFFCU believes that the makeup of the balance sheet is what determines the complexity of the institution, not simply the asset size. While a call report supplies NCUA with important data about a credit union, it does not provide all the details necessary to adequately assess risk levels. For example, the investment section does not report details such as options, structures or price. Details such as collateral values, term and credit scores are also missing from the loan information reported. Imposing capital requirements based only on asset size and using data that provides only limited details about the make-up of a balance sheet could result in inadequate or excess capital requirements being imposed on a credit union. Applying a 'one size fits all credit unions' approach simply does not

[1] Chapter 13-Part 1 Overview in NCUA Examiner Guide
[2] Supervisory Letter No.:13-12-Enterprise Risk Management Page 2

work. Rather, DFFCU believes that ERM programs would better measure the risk of a credit union and the capital levels necessary to support such risk.

Components of Risked Based Capital

The draft states, *"The goal of the proposed risk-based capital ratio numerator is to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses.[3]"* The NCUA has identified the main sources of capital; however, it is difficult to follow the logic of deducting the NCUSIF deposit, goodwill and other items that were not included as a source of capital in the proposal.

Exclusion of NCUSIF Deposit

The NCUSIF deposit is a valid asset that should not be deducted from Risk Based Capital. It can be refunded if a credit union were to convert to a bank or savings institution charter, if a credit union elects private insurance, or in the case of a voluntary liquidation. The NCUSIF deposit provides an additional buffer against NCUSIF losses in addition to a credit union's capital if that credit union fails. Although the agency tried to reduce the impact of excluding the NCUSIF deposit from the numerator by also reducing it from the denominator, the scale of Net Capital versus Risked Based Assets is massive. For DFFCU specifically, the NCUSIF is 14.22% of Risked Based Capital (RBC) versus 1.19% of Risked Based Assets (RBA). The difference between 14.22% and 1.19% makes a very material impact on capital and understates the actual capital position of the credit union. **It is strongly recommended that no adjustment be made for the NCUSIF deposit, so that the Risk Based Capital is correctly stated.**

Exclusion of Goodwill

Not including goodwill in the risked based capital total is also a concern. Goodwill allows healthy credit unions to acquire troubled credit unions at no cost to the NCUSIF. Exclusion of goodwill in the capital calculation will become a disincentive to healthy credit unions to help the NCUA by acquiring troubled credit unions. **It is recommended that goodwill be included in Risk Based Capital.**

Components of Risk Based Assets

Compared to banks, the proposed rule requires more capital for credit unions holding the same assets as banks. This places credit unions at a competitive disadvantage as they would be required to hold more capital for the same assets. This will translate to higher product costs or lower returns to members. Additionally, some of the risk weightings assigned to certain assets do not seem logical. Assigning arbitrary risk weightings to assets without considering mitigating factors will force credit unions to adjust the way they do business. They will be forced to focus on the regulator's model rather than member needs.

Investments

There are two concerns with investments; first, using Weighted Average Life (WAL) as the sole measure to determine Interest Rate Risk (IRR) and liquidity risk, and second, classifying all Government Sponsored Entities the same as any other investment.

In the NCUA Examiner's Handbook, **interest rate risk** is defined as "the potential for change in the value of a security when the level of interest rates changes", and **liquidity risk** is defined as *"... the potential loss when a security cannot be sold promptly at or near prevailing market prices. This may be the result of a general market disruption, uncertainty in the market place regarding the value of the security, or a large position relative to market trading volume."*

WAL alone is not a sufficient way to gauge interest rate risk or liquidity risk. The WAL data in the call report does not provide information to accurately determine "value of a security when the level of interest rate changes." In addition, many investments can carry options and structures that help mitigate IRR and liquidity risks. The draft states that those risk weightings are used to

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[3] Page 42 of draft, section 104(b) Risk-Based Capital Ratio Numerator

"maintain continuity and provide a fair measure of the ***interest rate*** *and* ***liquidity risks*** *associated with longer term investments...[4]"*; however, the call report, in its current form, lacks the information of price, optionality and structure of investments that is needed to accurately measure IRR and liquidity risk. Call dates, interest rate changes, cash flows and fixed vs. variable rates are all examples of options and structures that should be considered when accurately measuring IRR and liquidity risk.

An example in the proposal that demonstrates the inadequacy of WAL alone is the risk weighting of agency investments. Per the proposal, an agency investment would receive a risk weighting of 0 percent, no matter the maturity. This is a contradiction to the stated purpose of WAL based risk weightings to *"maintain continuity and provide a fair measure of the interest rate and liquidity risks associated with longer term investments...[5]"* as agency investments have structures and features that could have IRR and liquidity risk. For example, if an investment has a WAL that is greater than five years, it would carry a 150 percent risk weighting. An agency investment with the same WAL carries a risk weighting of 0 percent just because it is an agency. If this agency investment does not have options or structures to mitigate IRR, it could potentially be more risky than a non-agency investment that does have mitigating factors for IRR and liquidity risk. The agency component only addresses credit risk, not IRR or liquidity risk.

Another example in the proposal that demonstrates the inadequacy of WAL alone is the way term categories are used to determine risk. An investment with a 59-month WAL would fall in the three to five year category which carries a risk weighting of 0.75; however, if an investment's WAL extended one month beyond five years, the risk weighting would double to 1.50. WAL alone cannot be a predictor of IRR. **For measuring interest rate risk and liquidity risk on investments, it is recommended that effective ALM processes should be utilized and not rely solely on WAL measurements.**

The draft addresses US government agencies; however, it fails to address Government Sponsored Entities (GSE) and in essence treats GSEs as any other investment, including private label securities. The draft states *"The proposal would lower the risk-weight for direct and unconditional U.S. Government obligations (FDIC issued Guaranteed Notes, and other U.S. Government obligations) from the WAL measure to zero risk-weight assets, and maintain the current zero risk-weight for NCUA Guaranteed Notes.[6]"* GSEs were created by Congress, have an explicit guarantee from the agency and are closely tied to the government. Fannie Mae is evidence of this relationship as the US government aided Fannie Mae with over $116.1 billion during the last economic crisis to avoid failure. **DFFCU recommends that the risk weighting for GSEs be adjusted to fall between a government agency and other private label issuances.**

Allowance for Loan and Lease Losses

In the draft, the Allowance for Loan and Leases Losses (ALLL) is limited to 1.25% of total risk-weighted assets, the explanation being *"By establishing a limit in the amount of ALLL included in the numerator, the proposed rule would provide an incentive for granting quality loans and recording losses in a timely manner.[7]"*

DFFCU agrees that there should be incentive for the granting of quality loans to members; however, requirements for funding the allowance as prescribed by GAAP already creates the incentive. In Allowance discussions in the proposal, there is a comment that is expressed repeatedly: *"...the ALLL is intended to cover estimated, incurred losses as of the balance sheet date, rather than unexpected losses.[8]"* GAAP contradicts that statement. In ASC 310-10-35-27 it states *"...a creditor shall consider all available information reflecting past events and current conditions when developing the estimate of expected future cash flows."* The ALLL experience loss ratio does in fact include losses at origination, unrecognized losses and unexpected losses, because past events included unexpected losses and they are used in the experience loss ratio. As experience loss ratios on loan pools improve, the required allowance funding decreases, which increases earnings. By properly applying GAAP principals, the ALLL accounts for both

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[4] Page 53 of draft, section 104(c) Risk-Weights for On-Balance Sheet Assets
[5] Page 53 of draft, section 104(c) Risk-Weights for On-Balance Sheet Assets
[6] Page 54 of draft, section 104(c) Risk-Weights for On-Balance Sheet Assets
[7] Page 44 of draft, Section 104(b)(1) Capital Elements of the Risked-Based Capital Ratio Numerator
[8] Page 63 of draft, section 104(c) Risk-Weights for On-Balance Sheet Assets

the known and unknown risks in the loan portfolio. For consistence with GAAP and properly recognizing capital levels, the full ALLL balance should be used, not limited.

DFFCU agrees that recognition of losses when they are probable and estimable are vital for compliance with GAAP. It seems that instead of creating another rule or regulation to increase capital, it would be more consistent with GAAP to focus on proper ALLL funding and timely charge offs instead.

DFFCU strongly recommends that to be consistent with GAAP, the complete ALLL balance should be used in the risk based capital amount and not limited to 125% of total risk weighted assets.

Loans

The current proposal evaluates loan risk based on real estate lien position, concentration within the portfolio, or by delinquency. Although those are important factors when evaluating risk in loans, they are not all that should be considered. Additional factors that should be considered when evaluating risk in the loan portfolio include term, collateral, loan to value, variable vs. fixed interest rates and credit score. It is another situation in which more data than is included in the call report is needed and may be more suited to ALM processes to determine risk of the portfolio. **DFFCU recommends that additional factors be used to evaluate the risk in the loan portfolio or leave this measurement to ALM models.**

Member Business Loans

Member business loans have been assigned a higher risk weighting. The draft states *"Supervisory experience has demonstrated that certain MBLs present multiple risks for which credit unions should hold additional capital.[9]"* The fundamental principal that more risk should require more capital is correct; however, loan type alone does not determine risk. GAAP has addressed the higher risk that tends to be associated with MBLs in the ALLL. Member business loans are individually evaluated and reserved as necessary in the ALLL. **DFFCU strongly recommends placing more focus on properly funding the allowance and not limiting it, which would achieve similar results and be consistent with GAAP. Properly funding the ALLL would appropriately state RBC and balance sheet risk.**

Member business loans guaranteed 75% or more by the SBA, U.S. Department of Agriculture, or other U.S. government agency have a 20 percent risk rating. DFFCU has a portion of its MBL portfolio that carries a 50% guarantee by SBA. It seems reasonable that loans with these guarantees should also carry a lower risk weighting. **DFFCU recommends that a lower risk weighting should be established for those loans with guarantees under 75%.**

Consumer Loans

The proposed risk weightings for consumer loans are not consistent with traditional levels of risk. For example, in this proposal, an unsecured credit card has the same risk weighting as a collateralized auto loan. The disconnect continues with the risk factors for delinquent loans, as the risk weight for both the unsecured credit card and the new vehicle is the same even though the risk is less for an auto loan due to the collateral.

The table below is based on call report data for the year ending December 31, 2013, and is provided by CU Data It shows net charge-offs as a percentage of ending balances for credit cards at 1.62% while indirect autos end at 0.01%. It seems the net charge-off ratio should quantify actual impact to capital, and credit cards pose a significantly higher risk to capital than auto loans. Thus, the weightings for autos and credit cards should be different.

[9] Page 55 of draft, section 104(c) Risk-Weights for On-Balance Sheet Assets

(In Millions)	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Net Charge offs							
Credit Cards	$ 29.10	$ 67.80	$ 111.07	$ 117.15	$ 80.64	$ 50.35	$ 37.48
Indirect Auto	$ 79.86	$ 161.92	$ 275.61	$ 185.69	$ 94.33	$ 56.85	$ 54.88
Balances							
Credit Cards	$ 1,807	$ 1,981	$ 2,074	$ 2,082	$ 2,084	$ 2,172	$ 2,317
Indirect Auto	$ 676,555	$ 725,857	$ 723,473	$ 639,026	$ 591,278	$ 615,498	$ 692,518
Net Charge offs as a Percentage of Ending Balances							
Credit Cards	1.61%	3.42%	5.36%	5.63%	3.87%	2.32%	1.62%
Indirect Auto	0.01%	0.02%	0.04%	0.03%	0.02%	0.01%	0.01%

DFFCU proposes that new risk weightings for consumer loans be established to better capture the associated risk by reducing those of lower risk characteristics.

Building, Furniture and Fixtures

The risk rating for buildings, furniture and fixtures is at 100%; however, an unsecured credit card is at 75%. Buildings, furniture and fixtures seem, for the most part, riskless assets, with the exceptions of extreme changes in property values and where the institution needs to sell. In an article in the Detroit Free Press, Paul Tait, Executive Director of the Southeast Michigan Council of Governments said "Regionally, we're down just under a third, about 32%,[10]" Tait said this when referencing the decline in property values since 2007 in the Detroit area, which was one of the hardest hit areas in the nation. With a 32% decline in one of the worst real estate declines in the history of the United States, there is still less risk than the 100% assigned to this asset class. **DFFCU recommends reducing the risk factor weighting for buildings, furniture, and fixtures to a level more commensurate with the level of risk.**

Regulator Discretion

Proposed §702.105(b) and (c) provide regulatory oversight options for credit unions that have become more at-risk; however, there is not enough detail on how it would be implemented and how some of the measures are determined. The proposal leaves this somewhat vague which will cause insecurity in credit unions. There is extreme concern when latitude and subjectivity of this nature is given without sufficent guidelines to implement, and leaves generalities open to interpretation. Limited information on how it would be equitabily immplemented will cause fear with natural person credit unions as there can be inconsistency in the individual examiners across the NCUA examiner pool. This will become troublesome to credit unions if more specifics are not included in the regulations.

- For example, *"A credit union has poor liquidity or cash flow."* What would be considered *"poor"* and how will it be measured?
- Or *"A credit union has inadequate underwriting policies, standards..."* What is the definition of "inadequate"?

DFFCU recommends the elimination of individual minimum capital ratios from the rule. If the individual minimum capital ratios remain, there must be more specific guidelines detailed so that both the regulator and credit union better understand the implementation of this rule.

Implementation Period

The proposal states that credit unions would have 18 months from the date the rule is published in its final form in the Federal Register; however, when a similar measure was introduced to the banking industry in Basel III the implementation period went from January 1, 2013 to 2019, with gradual steps in between. An 18-month implementation period could cause a catastrophic effect on

[10] Article published in the Detroit Free Press titled "After years of decline, metro Detroit housing values making a comeback" by John Wisely and Christina Hall on March 3, 2013

credit unions due to the unique way credit unions raise capital, only through net income. It seems that a longer implementation period would be reasonable for a credit union to be fully in compliance with the new 10.5% risk-based capital ratio; 18 months may prove to be too short of a time period for some credit unions. **DFFCU recommends that the implementation period be changed from 18 months to at least four years.**

Shares and Deposits

Successful risk management in credit unions uses both assets and liabilities (shares and deposits) to manage balance sheet risk such as interest rate risk. For example, a credit union with mortgage loans can leverage longer term share certificates to help reduce re-pricing term variances and more effectively manage interest rate risk. In the current proposal, shares and deposits are not given consideration as a risk management tool employed by credit unions. **DFFCU recommends that shares and deposits be used to help mitigate interest rate risk with loans in the risk based capital calculation.**

Enterprise Risk Management

In a letter to credit unions, numbered 13-CU-12, titled Supervisory Guidance on Enterprise Risk Management, it is stated that *"ERM is not a process to eliminate risk or to enforce risk limits, but rather to encourage organizations to take a broad look at all risk factors, understand the interrelationships among those factors, define an acceptable level of risk, and continuously monitor functional areas to ensure that the defined risk threshold is maintained."* ERM is what the NCUA is attempting to do with limited call report data, statistics and major assumptions that don't apply to all credit unions as they are being used to determine a 'one size fits all' approach to risk based capital. While we applaud the effort, the results are far from what could be accomplished with an effective ERM program that would take all of the various risk components within a credit union and summarize those risks into a comprehensive program to measure and mitigate as necessary.

In the concluding paragraph of letter 13-CU-12 it states *"ERM is a broadly defined and evolving concept that , at its core, presents potential benefits to larger, more complex credit unions."* ERM is a program that is evolving as did ALM in its time and must be given adequate time and focus so that a more complete risk measure can be completed for complex credit unions.

DFFCU suggests that the NCUA better redefine "complex" and require complex credit unions to implement an ERM program and allow less complex credit unions to use modified risk based capital measures based on call report data.

Conclusion

In conclusion, DFFCU recognizes the difficult situation that the NCUA is in, trying to measure balance sheet risk with limited tools; however, the proposed rule misses the mark by trying to apply a 'one size fits all' approach. The rule does not effectively measure risk as it considers only limited factors. The differences between this proposed rule for credit unions and the rule in effect for banks are not comparable and will result in a competitive disadvantage for credit unions and ultimately a cost to members in terms of products and services. It is DFFCU's opinion that an effective ERM and ALM program will better identify balance sheet risks and can reach the detail needed to adequately capitalize for such risk. DFFCU recognizes that adherence to GAAP in the ALLL funding process, timely charge off of loans, and proper underwriting criteria will alleviate most of the concerns that the NCUA has regarding holding adequate capital for the risk in loan portfolios. Finally, not adjusting current capital levels for accounts that should not be deducted will improve the risk management process for credit unions.

DFFCU appreciates your time and consideration of these points as you review the Risk Based Capital proposal.

Sincerely.

James E. Tidwell

Jim Tidwell, Board Chair

Shane C London, President/CEO

Derrick Peterson, EVP/CFO