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May 28, 2014

National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Attention: Mr. Gerard Poliquin, Secretary of the NCUA Board

Re: Comments on the Prompt Corrective Action - Risk-based Capital Rule—RIN 3133-AD77

Thank you for the opportunity to comment on the proposed changes to the NCUA's Prompt Corrective Action (PCA) and Risk-Based Capital (RBC) rules contained in 12 CFR Parts 700, 701, 702, 703, 713, 723, and 747. Overall, I am in agreement that these rules need to be updated and modernized to promote capital adequacy commensurate with risk exposure and risk management. The recent financial crisis clearly illustrates the need for increased levels of capital where higher levels of credit risk are present.

However, I believe that the rule(s), as proposed, may have the unintended effect of encouraging credit unions to take on higher levels of credit risk in favor of other risks, while also marginalizing risk management practices outlined in other NCUA rules. I further believe that aspects of the proposed rule, especially the asset risk weightings, appear inconsistent within the rule, with other NCUA rules, and possibly with the Federal Credit Union Act.

Inconsistent with the Federal Credit Union Act

The Federal Credit Union Act calls for the NCUA's prompt corrective action requirements to be comparable with those of other federal banking agencies. Banking rules for risk-based capital are primarily based on the premise of requiring greater levels of capital for assets with higher credit risk. Given the proposed risk weightings, the rule does not require greater levels of capital for greater levels of credit risk.

- For example, delinquent unsecured consumer loans that carry very high credit risk have the same 150% risk-weighting as five-year U.S. Government insured certificates of deposit that carry no credit risk. Unsecured consumer loans that are not delinquent have a lower risk weighting (75% risk-weighting) under the proposed rule than is required by Basel III (100% risk weighting).
- The proposed rule removes the current rule's consideration of long-term real estate loans and assigns a 50% risk weight for all first mortgages up to 25% of assets, regardless of term. Conversely, real estate based mortgage backed securities (MBS) issued by U.S. Government Sponsored Entities and U.S. Agencies (FNMA, FHLMC, GNMA; collectively referred to as agencies) with a weighted average life of over five years have a risk weight of 150%, or 200% if over 10 years. I believe it is reasonable to assume that real estate loans have the same (or similar) interest rate risk as mortgage backed securities. Agency securities carry virtually no credit risk, but the proposed rule requires as much as four times the risk weighting as the real estate loan that is exposed to credit risk. From a credit risk perspective, all U.S. agency MBSs should carry a lower risk weighting than a comparable real estate loan.
- At a 100% risk weight, delinquent and foreclosed real estate loans that have a high level of credit risk (and again, potentially the same or greater interest rate risk) require as much as half of the risk weighting of a U.S. agency MBS that carries little to no credit risk.
- Credit risk of the investment portfolio is not considered, which could result in credit unions taking on greater credit risk in the investment portfolio to compensate for the highly discouraged interest rate risk.

The Act requires the NCUA's risk-based capital rule to account for all material risks. The proposed rule identifies nine major risk categories in the credit union industry: credit, compliance, concentration, interest rate risk, liquidity, market, operational, reputation, and strategic risks. However, it is unclear how the proposed rule accounts for all of these risk factors across the balance sheet, and to what extent.

- All material risks of each identified asset are not being addressed. For example, the proposal addresses credit risk in loans but not interest rate risk, and conversely, addresses interest rate risk in investments but not credit risk.
- Overall, the proposed rule favors the industry taking on higher levels of credit risk in order to maintain sufficient earnings rather than interest rate or liquidity risks. An unintended consequence of the proposed rule's inconsistent risk weighting between credit risk and interest rate risk may be that instead of instituting appropriate and balanced investment portfolio management practices, credit unions may be motivated to make potentially riskier loans in a reach for yield. This unintended consequence may subject credit unions to credit quality issues (similar to those seen in 2007-08) which will certainly strain liquidity and capital in the event of unanticipated loan losses. Credit risk was the leading cause of the recent crisis overall, and specifically the corporate credit union crisis, and is widely accepted in the banking industry globally as the greatest strain on capital sufficiency.
- The proposal should clarify the definition of market risk, as it is defined in the proposal's referenced footnote document. Because market risk only arises from trading portfolio activities, it seems unlikely that this is a material risk to the industry.

The Act states that a risk-based requirement is based on the portfolio of assets and liabilities, yet the proposal is silent on liabilities.

Inconsistent with existing NCUA rules requiring commensurate risk management

NCUA rules contained in 12 CFR 741 require sound interest rate risk and liquidity risk management processes that are commensurate with the levels of risk being taken. Although the proposed rule addresses these risks, the risks are only considered in the investment portfolio and the proposal is silent regarding the interest rate risk of all other asset categories, as well as the potential for risk mitigation on the liability side of the balance sheet.

- Inconsistently requiring additional levels of capital for the interest rate risk of only certain assets is counter to the comprehensive balance sheet risk management approach that is required under rule 741. The proposal could encourage credit unions to take on potentially higher levels of risk in the portions of the balance sheet that are being exempt from interest rate and liquidity risk capital considerations, which could result in the unintended consequence of even greater levels of overall interest rate and liquidity risks.

NCUA rule 741 calls on credit union boards of directors to be responsible for oversight of their credit union and for approving policy and major strategies, and establishing prudent limits. Furthermore, proper asset/liability risk management practices use the investment portfolio to adjust, manage and mitigate the balance sheet's level of interest rate and liquidity risks.

- I believe the proposed rule discourages strong balance sheet risk management practices by significantly penalizing investment portfolios that are not being positioned for a rising rate scenario. Through the proposed rule, the NCUA has established that the industry's investment portfolio/interest rate risk strategy should be positioned for an increase in interest rates. This is the credit union board's responsibility to decide if this is the appropriate strategy. Interest rates might not rise, or might not rise anytime soon. A regulator's role is to encourage strengthening risk management, instead of prescribing a risk strategy.
- Using the investment portfolio to protect the balance sheet against falling or flat interest rate risk scenarios are highly discouraged by the rule, thus limiting the ability of credit unions to properly manage interest rate risk. Even a simple traditional ladder strategy would be penalized under the proposed rule. Furthermore, the day may eventually come when common concern is that interest rates will fall. Would

the NCUA's RBC rule be revised in that environment to require more capital for very short term portfolios?

The proposal also discourages potential risk reduction strategies. For instance, the proposed rule penalizes the securitization of mortgages to reduce credit risk.

- Under the proposed rule, the risk weighting for U.S. agency mortgage-backed securities is inconsistent with the risk weighting for first mortgage loans. Assuming the first mortgage loans are secondary market eligible, a credit union could swap its first mortgage loans to an agency and get back agency guaranteed MBSs backed by those same first mortgage loans. The credit union's interest rate risk profile is completely unchanged, while all of the credit risk in the loan portfolio has been eliminated. Yet, because of the inconsistency in proposed risk weightings between loans and investments, the risk reduction strategy would result in lower capital. The following is an analysis that illustrates the proposed weaker risk-based capital as a result of a strategy that would reduce risk.

Proposed Risk-based Capital Reg.	Current	Change	What-if
Total Assets	$160,806,620	$0	$160,806,620
Net Worth	$17,332,261	$0	$17,332,261
Consumer Loans	$38,026,813	$0	$38,026,813
1st Mortgage Real Estate Loans	$50,145,367	-$50,145,367	$0
Other Mortgage Loans	$11,237,741	$0	$11,237,741
Member Business Loans	$7,092,426	$0	$7,092,426
Investments 3-5 Yrs	$11,893,606	$0	$11,893,606
Investments 5-10 yrs	$5,934,119	+$45,130,830	$51,064,949
Investments > 10 yrs	$1,102,485	+$5,014,537	$6,117,022
Risk-based Capital Ratio	15.56%	-5.07%	10.49%
Net Worth to Asset Ratio	10.78%		10.78%
NCUA PCA Classification	Well		Adequate

Inconsistent provisions of the proposed rule

Delegation of Authority - The proposed rule has two sections, 701.102 and 702.105, that appear to contradict one another.

- Pursuant to Section 702.102, the NCUA Board has the sole authority to reclassify a well-capitalized credit union and shall not delegate such authority. Yet, pursuant to Section 702.105, NCUA staff, other than the Board, may increase the minimum capital requirement for well-capitalized credit unions under certain circumstances (interest rate risk, concentration risk, liquidity risk, etc.).

Grounds to Raise the Minimum – Although the commentary for the proposed rule defines the material risks to the industry, the commentary lists other risks as being grounds for a higher minimum risk-based capital ratio.

- In the commentary explaining Section 702.105, "prepayment risk" and "significant exposure to declines in the economic value of capital" (NEV) would be potential grounds for a higher minimum risk-based capital minimum to remain well-capitalized. These "risks" should not be a sufficient grounds because neither one is a material risk as defined by the proposed rule.
- Specifically, while NEV measurements are a reliable tool for calculating interest rate risk, the NEV calculation is an assumption-based methodology that can be arbitrarily modified. During an examination, an overly conservative assumption could be prescribed that negatively alters the NEV calculation and provide grounds for a higher minimum risk-based capital ratio. Additionally, overall interest rate risk should be measured both quantitatively and qualitatively, and the NEV calculation alone does not take into account qualitative factors when assessing interest rate risk.

The appeal process established by Section 747.2006 to contest the individual minimum capital ratio, should provide more than 30 days to appeal and should always provide for independent review of the NCUA Board determination by the NCUA Ombudsmen.

Competitive disadvantage with banks and limiting growth of the credit union industry

Proposing higher risk weights than what Basel III prescribes can provide significant disincentives for credit unions to lend to small business and residential homeowners. Member business loan and real estate concentration level RBC increases do not consider portfolio management, underwriting standards, industry experience, or the quality of loans, and the proposed rule could result in reduced overall diversification.

If interest rates don't rise, the credit union industry's investment portfolios will likely earn far less than the banking industry, raising the concern that the proposed rule will put credit unions at a competitive disadvantage to banks.

- The final version of Basel III removed the consideration of unrealized movement in the investment portfolio's value from consideration for regulatory capital in all but the largest institutions. In addition to the overall reduced ability to properly manage balance sheet risks, the impact to credit unions if rates don't rise is that they would not be able to price share and loan rates competitively with banks; and that could result in reduced membership in the industry.

Overall, the rule has the effect of limiting potential growth of the credit union movement. The following analysis estimates the impact of the proposed rule compared to the current rule onto the maximum asset growth potential of the industry, while remaining well-capitalized.

Current PCA Regulation	Actual Dec 2013	Consumer Lns	1st Mortgages	Other Mtg Lns	MBL	3-5yr Inv	5-10yr Inv	>10yr Inv
Max Asset Growth		$580,000,000	$520,000,000	$580,000,000	$580,000,000	$465,000,000	$465,000,000	$279,000,000
Total Assets	$1,075,313,865	$1,655,313,865	$1,595,313,865	$1,655,313,865	$1,655,313,865	$1,540,313,865	$1,540,313,865	$1,354,313,865
Net Worth	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826
Consumer Loans	$301,436,600	$881,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600
1st Mortgage Loans	$237,579,196	$237,579,196	$757,579,196	$237,579,196	$237,579,196	$237,579,196	$237,579,196	$237,579,196
Other Mortgage Loans	$68,521,373	$68,521,373	$68,521,373	$648,521,373	$68,521,373	$68,521,373	$68,521,373	$68,521,373
Member Business Loans	$47,468,991	$47,468,991	$47,468,991	$47,468,991	$627,468,991	$47,468,991	$47,468,991	$47,468,991
Investments 3-5 Yrs	$79,532,546	$79,532,546	$79,532,546	$79,532,546	$79,532,546	$544,532,546	$79,532,546	$79,532,546
Investments 5-10 yrs	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$504,681,453	$39,681,453
Investments > 10 yrs	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$286,372,316
RBNW Requirement Ratio:	5.58%	5.73%	7.26%	5.73%	6.96%	7.52%	7.52%	8.55%
Net Worth to Asset Ratio	10.78%	7.00%	7.27%	7.00%	7.00%	7.52%	7.52%	8.56%
NCUA PCA Classification	Well	Well	Well	Well	Well	Well	Well	Well

Proposed Risk-based Capital Reg.	Actual Dec 2013	Consumer Lns	1st Mtg Loans	Other Mtg Lns	MBL	3-5yr Inv	5-10yr Inv	>10yr Inv
Max Asset Growth		$469,000,000	$467,000,000	$277,000,000	$287,000,000	$469,000,000	$234,500,000	$175,800,000
Total Assets	$1,075,313,865	$1,544,313,865	$1,542,313,865	$1,352,313,865	$1,362,313,865	$1,544,313,865	$1,309,813,865	$1,251,113,865
Net Worth	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826	$115,900,826
Consumer Loans	$301,436,600	$770,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600	$301,436,600
1st Mortgage Loans	$237,579,196	$237,579,196	$704,579,196	$237,579,196	$237,579,196	$237,579,196	$237,579,196	$237,579,196
Other Mortgage Loans	$68,521,373	$68,521,373	$68,521,373	$345,521,373	$68,521,373	$68,521,373	$68,521,373	$68,521,373
Member Business Loans	$47,468,991	$47,468,991	$47,468,991	$47,468,991	$334,468,991	$47,468,991	$47,468,991	$47,468,991
Investments 3-5 Yrs	$79,532,546	$79,532,546	$79,532,546	$79,532,546	$79,532,546	$548,532,546	$79,532,546	$79,532,546
Investments 5-10 yrs	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$39,681,453	$274,181,453	$39,681,453
Investments > 10 yrs	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$7,372,316	$183,172,316
Risk-based Capital Ratio	15.56%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Net Worth to Asset Ratio	10.78%	7.51%	7.51%	8.57%	8.51%	7.51%	8.85%	9.26%
NCUA PCA Classification	Well	Well	Well	Well	Well	Well	Well	Well
Difference in Max Growth		-$111,000,000	-$53,000,000	-$303,000,000	-$293,000,000	$4,000,000	-$230,500,000	-$103,200,000
% Difference in Max Growth		-19.14%	-10.19%	-52.24%	-50.52%	0.86%	-49.57%	-36.99%

Other Observations

For variable rate debt obligations, the definition of weighted average life of investments should be amended to be the lesser of the next adjustment date or the weighted average life according to industry standard calculations (which include the impact of unscheduled payments).

- The current definition does not consider that there are variable rate mortgage backed securities whose industry calculated average life is shorter than its reset date, such as a 10-year ARM.

Section 702.104 (c)(2)(x) Category 10 assigns a 1,250% risk weighting to asset backed investments for which "the credit union is unable to demonstrate, as required by Section 702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance."

- Based on the regulation and its commentary, it is unclear as to which asset-backed securities the NCUA is referring (collateralized debt obligations or private label CMOs, versus U.S. agency MBS, etc.). Clarification as to the definition of asset-backed securities is necessary. Depending on this definition, additional clarification may also be needed on the minimum requirements for documenting the prepurchase analysis demonstrating a "comprehensive understanding." Additionally, the level of authority to make this determination should be stated in the regulation. As it is currently written, the regulation could potentially lead to arbitrary determinations by junior level NCUA staff.

Insufficient implementation time

I am also concerned with the proposed implementation time. In light of Basel III's multi-year and multi-stage implementation that will require full compliance for all banks by 2019, the proposed rule creates undue duress and hardship for the credit union industry when considering the key differences in the respective institutions.

- Credit unions are unable to raise capital in the same manner as banks. Essentially, a credit union must increase its net worth over time through prudent balance sheet strategies. Credit unions cannot issue stock or debt in the same manner as banks. In this rate and lending environment, capital growth takes longer than in years past. As proposed, the NCUA's rule could be implemented years before Basel III is fully phased in for banks.

Conclusion

The proposal should be significantly amended and reissued for comment. It has substantial, relevant inconsistencies that I believe will ultimately harm the credit union industry and will not provide the intended protection.

In closing, I would like to thank the NCUA for the opportunity to submit comments regarding the proposed rule. I am hopeful that the NCUA finds my comments useful and they will be given due consideration. If you have any questions, I can be reached at 1-631-979-0097.

Respectfully Yours,

E. Prescott Ford, CFA
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