April 22, 2015

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 (RBC2)

Thank you for the opportunity to comment on the most recent iteration of RIN 3133-AD77 (hereafter RBC2). I would also like to thank the NCUA Board and staff for taking into consideration the comment letters on the first iteration of RIN 3133-AD77 (hereafter RBC1) and for the significant improvements presented in RBC2. I feel my comments provide a somewhat unique perspective in that I have spent over 23 years in financial services, eleven of which were as CFO in credit unions, banks and finance companies. As a result, I am very familiar with the FDIC's PCA capital ratio standards and the first two iterations of Basel. I believe that this perspective provides valuable insight that can be leveraged by the NCUA Board, if the Board chooses to do so.

I have comments on RBC2 in four major areas: the NCUA's legal authority to implement RBC; the remaining components of concentration risk in RBC2; the positive changes made to commercial loan classifications; and finally, I will take the NCUA up on their request (on page 62 of RIN 3133-AD77) and comment on the future direction of IRR.

Legal Authority: There have been many comments questioning the NCUA's legal authority to implement a risk-based capital standard. I note on pages 77-79 of RBC2 that the NCUA Board presents unambiguously a rationale and basis as to why it believes it has authority to implement such a standard. However, the vote to proceed with RBC2 was a 2-1 vote, and there is no explanation, acknowledgement or discussion about the source and reason for the dissent. In the interest of transparency and full disclosure to all stakeholders, I suggest Board Member McWatters be given the opportunity to fully explain his rationale, and why he believes the NCUA does have the legal authority to impose a risk-based capital standard. The dissenting opinion should be included in the final version of RIN 3133-AD77. As an example of how the NCUA could accomplish this, they need only look at the Financial Accounting and Standards Board (FASB) process to address dissenting and concurring votes. If a proposed accounting standards codification (ASC) topic does not receive unanimous support, the dissenting voters are able to explain their rationale and logic as to why they did not support the proposal or why they believed it should not advance. Concurring votes are provided the same opportunity to explain that, while they may have voted with the majority, they did so for a different reason not explained by the majority opinion. The dissenting and concurring rationales immediately follow or are incorporated into the majority opinion rationale. I suggest the NCUA use this approach and give Board Member McWatters the opportunity to explain his position and rationale for his dissent and that it be incorporated into the prologue of the final rule or as part of an RBC3 proposal, if there is to be a third iteration. Doing so would serve the cause of transparency and better inform the credit union, government and public stakeholders on this important issue.

Remaining Concentration Risk Elements: The risk weighting matrix was significantly improved with the removal of the IRR components. However, some concerns remain with the residual elements

related to concentration risk. Risk-based capital models are intended to provide a generic overview of an institution's inherent credit risk, as it relates to asset classes. And, as the NCUA has acknowledged, 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 management skill sets, or the specific experience or expertise of a management team. 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 important factors into account.

A concentration, in and of itself does not necessarily constitute elevated risk. One could argue a 40% asset concentration in a mortgage portfolio with an average LTV of 65% is less risky than a 20% asset concentration in a mortgage portfolio with an average LTV of 85%. Many credit unions, including ours, serve large areas that only experienced a small (0%-5%) decline in residential values (in certain markets) during the most severe parts of the real estate crisis ('08-'09 timeframe). In addition, all credit unions are facing increased competition from FinTech companies that are moving fast, with large marketing budgets and aggressive credit structures, and are competing effectively with credit unions in the consumer space for both secured and unsecured product. As credit unions react to this, there will be a natural shift in product mix, either because a credit union will pivot towards a certain product it believes it has an advantage in, or it will be effectively driven out of the marketplace for certain products. It is for these reasons, and the others mentioned in the previous paragraph, that simply putting a demarcation line to discourage asset concentrations is problematic at best and could actually threaten a credit union's ability to remain a going concern if concentration risk thresholds are set too low.

I understand the NCUA's desire to set concentration limits that are portfolio invariant.[1] However, I note the examples the NCUA provides to prove this point do not acknowledge the fact that mortgage and HELOC underwriting standards have tightened, and credit unions in general have divested away from residential real estate, and they fail to anticipate where credit union asset mix will likely migrate in the future. Given the preceding, I suggest even the newly improved concentration risk thresholds may not prudently attain the desired goal of portfolio invariance and may, in fact, threaten the long term viability of many credit unions, given market trends.

Given this dilemma the NCUA may opt to take one of three options:

1. Do away with the concentration penalty altogether.
2. Use current demarcation points as a trigger for expanded reporting in the call reports, thus allowing the NCUA to assess if there is in fact additional risk.
3. Increase the current threshold levels that call for increased weighting, for example, by moving the mortgage threshold to 50% to match the commercial loan threshold, and increasing the residential junior lien threshold from 20% to 25%

In the RBC2 document, the NCUA made it a point that the proposed residential real estate thresholds were intended to capture just the outliers. However, as pointed out above, economic and competitive pressure will push credit unions toward residential real estate, and, also as pointed out above, the presence of a concentration does not necessarily equate to elevated 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.

Commercial Loan Classifications: RBC2 made positive progress in excluding, for risk-based capital purposes, loans to CUSOs and non-owner occupied 1-4 family residential real estate loans from the

[1] Page 240-242 in RBC2.

definition of commercial loans. In the case of 1-4 family residences, the NCUA recognized it is the nature of the collateral, not the purpose of the loan, that is the primary driver of the credit risk profile, and since risk-based capital is primarily used as a an indication of credit risk, this change has a high degree of merit. I encourage the NCUA Board to continue this train of thought and to also remove loans secured by non-owner occupied 1-4 family residences from the MBL classification altogether. The statutory MBL restriction, as antiquated as it is, was put in place as a proxy to limit credit risk. Surely the Board will agree, as was the case for RBC2, the credit risk profile of 1-4 family residences is driven by the collateral and not the purpose of the loan, and that removal of loans secured by non-owner occupied 1-4 family residences from the MBL classification is both proper and prudent. The NCUA would have a strong rationale if it were to change the definition of a MBL to match exactly the definition that is used for defining commercial loans[2] for RBC purposes

How to measure IRR in the future: On page 62 of RBC2 the NCUA Board specifically asked for comment on alternative approaches to measure IRR in the future. Effective management of IRR is a critical factor in not only gauging an individual institution's long-term sustainability, but also the credit union system's overall health and long-term viability. This being the case, I am grateful for the chance to share my thoughts and our practices as they pertain to IRR management. The NCUA approach to IRR is primarily driven by NEV and, in fact, exhibits a strong bias for NEV at the expense of other equally important IRR measures. I agree that NEV is important for assessing a credit union's IRR position, but there are two other important measures as well. I suggest the NCUA Board consider emphasizing three measures treated equally, and used in combination to include: NEV, Cash Flow and Earnings (NII simulations) to evaluate a comprehensive IRR position, as opposed to the current bias towards NEV.

NEV is a solid tool for evaluating the price sensitivity of a credit union's balance sheet and can provide a basic understanding of the economic consequences of price miss-matches between assets and liabilities under various instantaneous and parallel yield curve shifts, but that is the limit of its usefulness--no more, no less. The three percent instant and parallel yield curve shift is the rarest of events in the real world, so the NEV exercise is largely academic, which should not imply it has no value, but we should acknowledge what it is: a theoretical exercise. It can be useful to assess how a changing balance sheet composition (or mix) can impact the market value of financial assets and liabilities from period-to-period, especially if the same yield curve is applied across all periods. And this method can aid in determining how well management's business and strategic decisions are impacting a credit union's IRR across various time periods.

An addition to the academic nature of NEV, NEV also fails to provide context. And by context I mean how changing rates impact the operations and financial results of the credit union and why the rates have changed. The reason rates are changing is just as important as the direction they are changing, and NEV cannot capture this. Decreasing market value of longer-duration assets in rising-rate environment is not too problematic if rates are rising because of a booming economy with increasing wages, rising loan demand and low unemployment. Under such a scenario, loan demand will be robust, people will be trading up assets (so loan turn will increase), cash flow will increase, NII will increase, and credit losses will be low. It's another story in a struggling economy with high unemployment and a central bank raising rates to support its currency. In this scenario cash flow will slow, losses will mount and NII may be strained. Context matters because the liquidity characteristics and earnings power of a credit union will be vastly different in the two examples above, even though the NEV changes may be very similar. In the latter, declining NEV is a concern; in

[2] As defined on page 82 of RBC2

the former declining NEV is of little significance and a side-effect of an otherwise booming economy. Context matters.

At our credit union, we follow Inter-agency best practices for NEV calculations, we run calculations using multiple-yield curves and shapes, and we shock our deposit rate betas and deposit decay rates. In addition, we also run cash flow analysis and NII simulations under the same rate shock scenarios we evaluate NEV under. We do this to provide context, and we feel using all three (and under many different scenarios) provides a much more accurate depiction of IRR position than depending solely on NEV.

Shocking liquidity estimates under higher rate scenarios is very useful because, if a credit union can determine in an up-300 rate scenario that the contractual amortization of loans and investments can fulfill anticipated funding needs and/or cover expected deposit outflows, any drop in NEV becomes much less problematic. NII simulations in up-300 scenarios are equally useful. NII feeds net income, and net income feeds capital. If a credit union starts off in a strong capital position and can demonstrate that in an up-300 scenario its NII and, therefore, capital actually performs better, then any drop in NEV becomes less problematic. For example, even if liquidity gets pinched, any NEV decrease still remains less of a problem because alternative sources of liquidity such as the FHLB primarily evaluate your existing capital position and your capital trend. If both are strong, a credit union will generally benefit from an advantageous advance rate (on collateral) and will be able to, on a cost-effective basis, plug any liquidity gaps.

I feel that all three measures, evaluated individually and in combination provide a more accurate and comprehensive assessment of a credit union's IRR position versus having a disproportionate focus on NEV. It has been my personal experience, and that of my credit union peers, that the ALM portion of NCUA exams are focused on price sensitivity (NEV) and the NEV assumptions, largely ignoring the importance of cash flow and NII sensitivity. In fact during the height of the real estate crisis, one examiner told me he felt the NCUA would be OK with us posting negative earnings if that meant reducing our price sensitivity. Generally, I don't believe the NCUA would sanction such a position, but that statement is a good example of an almost single-minded focus on NEV. As explained above, changes in NEV are most important if there is a liquidity issue and/or low capital levels or a negative capital trend. If liquidity and capital levels are strong, changes in NEV are less germane. And forcing a credit union to divest of certain assets to then acquire others simply because the new assets are less price-sensitive, when liquidity or capital issues are not present, can actually weaken a credit union's capital and possibly liquidity position unnecessarily.

I'd like to close this topic with the following observations. From the detailed conversations I have had with examiners on this topic, I believe the majority understand and are comfortable with the concepts I discuss above. However, at the end of the exam, the focus still seems to remain, almost singularly, on NEV and its underlying assumptions. This suggests to me, that perhaps the examination framework is structured in such a way as to not take into account the importance of both cash flow and capital position. My suggestion to the NCUA Board is to design an ALM/IRR examination framework that takes into account, in equal measure, NEV, Cash Flow, and how Capital is impacted by NII under the standard rate shock scenarios and, just as importantly, takes into account how any changes in NEV will actually impact the operations and financial results of the credit union, given the credit union's liquidity and capital position (context). Context matters.

I thank the NCUA Board for the opportunity to comment on RBC2, and I sincerely thank the Board for all the consideration they gave to the comments on RBC1. I support the NCUA's desire to strengthen credit union capital adequacy measurements, and I feel that with a few more adjustments, as

described above, the NCUA can achieve that goal without creating burdens or unintended consequences that harm credit unions and the credit union system.

Respectfully,

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