By electronic delivery to:
http://www.regulations.gov

Gerald Poliquin
Secretary of the Board
National Credit Union Administration 1775 Duke Street
Alexandria, VA 22314-3428

Re: RIN 3133-AD77 Risk-Based Capital

Mr. Poliquin:

FARIN & Associates appreciates the opportunity to submit our comments to the National Credit Union Administration on the proposed rule governing Prompt Corrective Action and Risk Based Capital.

FARIN & Associates is a national consulting, education and software firm serving the banking and credit union industry asset\liability needs and concerns for 30 years. During this time we have seen the evolution of capital regulations in response to many changes in business cycles across regulatory agencies. This regulatory response to the recent crisis is very familiar and that familiarity is a part of our concern.

It has been shown throughout time that after a major crisis in the industry, changes are enacted resulting in more regulation aimed at preventing the same crisis from repeating. Yet with each economic cycle, new and different challenges and risks emerge that cannot be foreseen. Sometimes these new risks are a direct result of changes to prior regulations pressuring institutions to adopt new ways of conducting business that carry new risks that were not considered. Other times risk is simply unknown and develops due to market forces that are outside the control of the institution. What we know is that the causes of past downturns are rarely revisited in the subsequent cycles. As new economic conditions take hold, new forms of potential risk and\or crisis are bred causing a change in supervisory practices by insurance regulators like the NCUA. Risk cannot be regulated too tightly. Attempting to squeeze out all risk from a credit union is akin to squeezing Jell-O. The harder you squeeze the more it squirts out other areas. It is critical to remember that no measure of regulation can take risk out of the business of "banking". Risk is the foundation of banking. Without risk return is not possible. It is our belief that the job of regulatory bodies should be to ensure proper institutional governance of the risks they decide to assume. This assumption is an elective process made consciously with the understanding of potential losses.

Based on the fact that we have still had crises despite past efforts to change rules, it is unlikely a different set of rules would have prevented this most recent crisis. What the RBC proposal is actually about is raising the deductible on the NCUSIF to protect against future potential losses due to risk taking. The concept of risk based capital itself recognizes need for institutions to in fact, take risk. The definition of risk asset classes says that not all instruments carry the same exposures to market conditions. Boards and management are required to have the risk management skills, systems and controls to manage their unique balance sheet exposures. The supervisory process is best used to assess such competencies when performed by those with the proper training and skill set. The examination must be carefully applied to adapt to individual credit unions based upon their unique set of risks and strategy.

Today, many credit unions report that the exam process does not consider the institutions situation but comes in with more of a systematic approach. For example, credit unions are being required to abandon their internal assumptions and apply "standard" assumptions. The use of standard assumptions can aid the agency in assessing the relative risk position of one credit union to others. However, the reality is many credit unions accept these new assumptions as default values despite their impact. This leads to less critical thinking and understanding of the real risks to the individual credit union, and thus the industry.

The most common example of misapplied assumptions happens in the assumptions around non-maturity shares. Credit unions that are currently well-capitalized and profitable under current RBC rules are being required to run NEV analysis using unfounded assumptions even when they have conducted internal studies. The knowledge to assess the adequacy of internal assumptions is a difficult job for the examiner to ascertain. We would support a process where a reasonable range is allowed and credit unions falling outside that range would be directed to specialists in cases where exposure, viability, or specific knowledge of risk concerns exists. In cases where the health and safety appear in order, the use of more aggressive assumptions in measures that are not material to the real risk to the insurance fund can be allowed for materiality. This would represent a change from current practice.

We see today cases where despite a seemingly healthy approach to risk management and safety, the credit union received an action item regarding risk management citing unreasonable assumptions. As a result their CAMELS ratings were downgraded. With the NCUA looking to implement share insurance premium changes based upon institution risk exposures, the exam process becomes a major cost control for management and the board to understand. The arbitrary use of assumptions to measure risk and subsequently assess insurance premiums is a potential consequence of this practice.

This example highlights the subjective nature of the current risk measurement process. Examiner judgment is critical to the overall exam process. We also understand the need for a prescreening process to identify potential outliers across the entire credit union system. We support a supervisory process that applies reasonable prescreens to identify outliers and then engage the outliers in conversation around the risk management concerns.

To clarify, we are not supporting the use of a standardized set of assumptions as anything more than a litmus test to determine what NCUA resources are required for proper examination.

In direct response to the Risk Based Capital proposal under consideration, FARIN understands the need for NCUA to react to Congressional requirements for regulation modernization. Overall we see this proposal as one that presents credit unions with a fair alternative relative to the bank requirements. We do however have some areas of concern within the current proposal.

First, this capital proposal specifies the proposed levels for achieving specific status of capital compliance levels as “minimum” levels. While the language has always stated thresholds as minimum levels, what concerns us is the vagueness around language indicating that credit union’s must have an “effective process” to determine the level of additional capital “buffer” required for institution specific risks. We support the general nature of the proposed language as it promotes institution specific responsibility for recognition and measurement of risk.

Individual risk management is paramount to the long-term industry health. Our concern lies with the previously mentioned implementation process. The examination process often places field examiners with less specialized skills in situations where they are asked or feel compelled to make judgments on effectiveness or appropriateness of the credit union's assumptions and approach. Our experience is that this often happens in situations where there is no real indication of higher risk levels. We support all efforts to retain the risk measurement and assessment as a part of the supervisory process. However, we firmly believe that credit unions with lower risk profiles and/or higher levels should be subjected to less rigorous examinations of risk management. Credit unions with higher risk levels against a given set of reasonable thresholds, or those with lower capital levels should have their examination or risk elevated to the risk management specialists within NCUA. Removing the field examiners with little specific knowledge from the examination findings and recommendation process would provide a more consistent exam. This necessitates the need to produce and define a set of known, published and reasonable set of filters to define outliers. Outlier assessment should include a cross risk look at risks due to concentrations, low capital or earnings levels, interest rate exposure, credit quality, etc.

We are aware that many in the industry are promoting a position that minimum standards be considered to be the absolute standard and that there is no need for additional "buffer" capital. We believe that in proposing a system of minimum standards, that NCUA must ensure that these standards represent a reasonable level of protection for less complex credit unions. In cases where the risk levels are assumed to be higher than a "normal" level, we feel it is prudent to require a level of capital beyond the floor levels set in the proposal. We first question if the thresholds set represent the right levels for less complex credit unions. IF not, then we have baked in the cake some buffer room to start. Assuming they are right, what we see as a key element missing from this proposal is any definition of how much more capital "buffer" is required for risk levels. We believe that given this approach, NCUA must publish a set of expectations for all complex credit unions to follow to again alleviate the possibility of general field exam staff making less informed judgment calls that impact decision making.

We feel that a buffer assessment process is a part of good the strategic planning process that looks at capital, earnings and growth projections and identifies the tradeoffs associated with different opportunities. Risk should not be discouraged provided the capital to cover risks beyond those that are "normal" levels is maintained. As such, it is our belief that NCUA should define clearly the elements of an effective capital and risk management process for credit unions that are complex to be subjected to RBC. Lacking specific guidance on this process from NCUA, the credit unions are left open to subjective assessment by field examination staff.

The proposal protects credit unions from receiving a lower the capital rating despite having actual capital ratios above the proposed minimums through a review system that requires many reviews and justifications be met before approval. A downgrade is only likely when doubt exists concerning the credit union's assessment, control, or level of risk. While this process offers protection to credit unions from arbitrary changes in a rating, it assumes that there is a recommended level of additional capital required for the level of concern. This process for to addressing the amount of additional capital needed for risks should be made clear with this rule in order to promote proper risk management, safety, soundness and measure of return. We feel this process for capital determination should be common across credit unions not unique to each case. Circumstances are unique to each credit union based on risk exposure, but the process of risk assessment is not unique. What should be common are minimum requirements and expectations for internal review. It is necessary to clarify the expectations of an effective process as a part of the rule. NCUA is charged in the Federal Credit Union Act to ensure adequate measures are in place to account for all material risks. With the explicit removal of the interest rate risk component that is in the current RBC, some argue that governance is lost. It is our belief that NCUA has this risk covered in recently released rules on interest rate risk expectations requiring effective process, policy governance, and controls are in place. What is lacking in the language and in the field application is a definition of effective. This supports the ideas put forth thus far in our reply. We believe more clarity on when, why and how a specialist examination team would be engaged would fulfill the mandate for governance by NCUA without creation of additional and potentially contradictory levels of regulatory burden.

We believe that NCUA has already written the blueprint on effective process design. Guidelines for effective process design and control are presented in white paper released in September 2014 on Capital Planning for large credit unions. This process represents an excellent framework for complex credit unions to model. The paper defines a robust process that may be more aggressive than what is needed in terms of frequency and some level of scope for smaller institutions. However, it does define an excellent framework that can and is already adopted by many smaller sized institutions today in their asset\liability management process. Here again the expectation is that smaller institutions with higher risk “indicators” should be asked to run more frequent and robust assessments than institutions with lower risk profiles. All credit unions under risk based capital rules should be expected to run the assessment at least annually, preferably as part of the business planning process.

Another concern deals with the field examination expectations surrounding objective capital at risk measurement practices. As an example, we see most frequently credit unions using traditional immediate, parallel rate shocks to assess interest rate risk. In many cases credit unions are advised by examination teams to run more extensive shocks like +400-500 basis points. These shocks not only are improbable, they are also extremely misleading in terms of risk exposure. Reliance on improbable sensitivity tests to assign real capital levels is dangerous and expensive to the industry. Furthermore, we believe that reliance on these measures as the primary risk tool for income and capital volatility fails to meet the 2010 FFIEC interest rate risk guidance. This guidance, which NCUA signed on to, states clearly that more robust rate projections that are required of institutions that include forecasted changes to levels, rates of change and changing slopes should become the norm for assessing risks. So as NCUA is considering the approach to measuring interest rate risk in a separate rule, please take note that many of the current practices are rooted in old measurement techniques.

Returning to the specifics of the RBC proposal, we are concerned about how this proposed rule would be impacted by future changes around supplemental forms of capital. Currently NCUA is considering changes to the supplemental capital area. These include new forms of capital sources. If the agency adopts new supplemental capital forms after adoption of the new RBC rule, we are concerned that this framework would need to once again be modified significantly prior to any implementation. The banking sector dealt with similar problems by breaking the traditional “primary Tier 1 Capital” definition into two separate types. Certain debt related items are removed from “common equity” forcing the institution balance reliance on internal capital with external. In the current credit union proposal we do not see a path for these potential new capital forms putting the new capital rules at odds with the banking counterparts.

The removal of risk weight tiers from major asset classes is another example of how the new proposal aligns more reasonably with the banking proposal. FARIN believes that such a statement presents a change to current field expectations regarding concentration limits. Credit unions were forced to adopt such limits during times when less rigorous capital rules were in place to govern risk. Given significant changes in risk weights and minimum thresholds, we believe the examination expectation that credit unions have written concentration limits should be eliminated and governed by the new risk based capital rules. We should abandon hard limits that place a limitation on the allocation of equity method. Credit unions wishing to carry higher concentrations will be forced to consider risk based pricing and return on capital considerations in the loan pricing function. Credit unions willing to increase exposures to a class of assets would now be directed to ensure sufficient return on required capital. Such a practice reinforces our belief that the credit unions have a firm grasp on risk management and pricing

The final area of concern deals with the long implementation cycle. Extending implementation until 2019 creates a dual standard for credit unions near threshold levels. What measure should be the plan for the coming 2-3 years? For some the change will result in better risk based capital levels than under current rules. But fixing the current capital levels under rules being phased out can cause real harm to memberships and credit union health.

Our hope is the final capital regulation changes foster an environment that rewards credit unions that understand and manage risks well. It is everyone's interest to build a robust credit union where member and asset growth is focused on market needs, not preconceived beliefs of risk. Credit unions need a capital policy that allows the system to go where member opportunity dictates and that the proper oversight of risk and capital be strong enough to ensure earnings are sufficient to meet this need prudently but profitably.

We thank you again for the opportunity to submit and appreciate your consideration of our thoughts and concerns.

Respectfully submitted,

David Koch
President\CEO
FARIN & Associates