From:	Kevin Cole
To:	_Regulatory Comments
Subject:	Kevin Cole - Comments on Proposed Rule: Risk Based Capital
Date:	Monday, April 27, 2015 11:52:55 AM

April 27, 2015

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

RE: Kevin Cole- Comments on the Proposed Rule: Risk Based Capital

Dear Mr. Poliquin:

I would like to commend the NCUA Board and staff for its responsiveness to comments received on the prior proposed rule. Clearly, this version is less harmful to the industry and represents a more reasoned approach to capital adequacy. I also appreciate the opportunity to comment on approaches to interest rate risk that could be adopted in relation to capital adequacy and the question of supplemental capital in the context of capital adequacy.

With regards to the proposed rule, it is still not evident that the NCUA has outlined a necessity for the new rule. The fact that so few credit unions will drop in PCA net worth category as a result of the new rule is evidence that the outliers in terms of risk levels could be managed through the existing examination process, much as NCUA proposes to manage interest rate risk now that it has been removed from the RBC rule. If in fact the Treasury and GAO are pressuring NCUA to adopt risk based capital rules for the sake of alignment with other regulatory agencies, the proposed rule is a way to do that with minimal impact on the competitiveness of the credit union industry.

It is concerning to see the proposed changes in section 702.101 to include a new capital adequacy provision not based on the proposed RBC standards but rather on supervisory guidance NCUA will develop and publish after the rule is approved. As is the case with many parts of the examination process, capital adequacy is likely to be evaluated disparately across regions and even among individual examiners. Having a net worth ratio, an RBC ratio, and an examiner driven level of capital adequacy seems to invite a lot of dispute over capital adequacy. The point is quite simple: if the exam driven process is going to represent the real standard to which credit unions are expected to comply, then publish a rule to that standard. If the standards are so complex or require such a level of examiner discretion that they cannot be codified, then they are not standards but merely opinions that result in management by the regulator as opposed to regulation.

With regards to the definition of complexity, my comment on the original RBC proposal encouraged NCUA to consider Congressional intent and to look beyond the mere quantity of assets and liabilities for a definition of complexity. After seeing the list of activities on page 159 of the proposed rule that the Board believes are indicators of complexity, I would encourage the Board to return to an asset based threshold, preferably above $250 million. I make this recommendation because the list of “complex” activities is inclusive of the normal operating activities of nearly any viable credit union and is clearly indicative that NCUA believes every viable credit union is complex and the issue simply comes down to risk to the NCUSIF based on asset size.

Since the most contentious and damaging elements of the original rule have been removed with the elimination of the IMCR and the removal of interest rate risk from the risk based capital standard, I would now like to suggest approaches that can be useful in accounting for interest rate risk from a capital adequacy perspective. As much as I question the need for more capital regulation, I question the need for more interest rate risk regulation in credit unions. However, it seems NCUA is insistent that credit unions need to be protected from themselves, so the ultimate approach taken by NCUA should be principles based and should be based broadly on the following principles:

1. Interest rate risk should be assessed in terms of actual risk to capital, as evidenced by losses that would be realized given changes in interest rates. This principle eliminates NEV and other present value techniques favored by NCUA today that do not reflect likely actual realizable cash flows.
2. The impact of time and earning capacity should be reflected in interest rate risk measures. If a loss is going to occur over the 30 year life of an asset that loss should be reflected in net worth as it occurs, not immediately through discounting to present value.
3. A substantial percentage of expected cash flows should be reflected in the analysis of interest rate risk. Any simulation or forecast used to assess interest rate risk should be long enough to reflect at least 80%-90% of the cash flows on both the asset and liability side, yet short enough to reflect primarily the effect of the interest rate shock for which measurement is sought. A 3-5 year simulation captures this for most credit unions and is also reflective of historical interest rate cycles.
4. The interest rate change scenarios should be data based on and reflective of reality. For example, NCUA utilizes a 300 bps parallel, instant rate shock. This has never occurred (back to 1962 according to my data sample). A more reasonable approach is to use a change period of 12 or 24 months and to use data sampling to develop a confidence interval for the magnitude of change to which credit unions should build their shock tests. As an example, using a 12 month rate change period and a 3 standard deviation confidence interval (99%+) we determined that a 500 bps change in short term rates and a 400 bps change in long term rates represented the range of rising rate scenarios for which risk should be assessed. The key principle is that the confidence level should be high (99% +) but the scenarios must be plausible, not simplified for ease of calculation.
5. Liquidity is an integral part of IRR management and should be evaluated in conjunction with IRR. Liquidity is the key to preventing unrealized losses from becoming realized losses. NCUA would likely decrease future losses to the NCUSIF if it shifted its current zealous focus on interest rate risk to more thorough examination of liquidity as a means of mitigating IRR. When liquidity is integrated into the IRR management process (for example through the implementation of the liquidity coverage ratio and net stable funding ratio as outlined by BASEL), liquidity requirements serve to limit IRR. This appears to be the approach FDIC has adopted with its recent liquidity rule.
6. Risk should be measured and managed at the balance sheet level. Decisions based on individual assets or even portfolios are not appropriate for IRR management. Any

measurement much incorporate both assets and liabilities and the interaction among different classes of assets and liabilities.

7. The regulator should be agnostic with regards to the portfolios of assets and liabilities. For example, a mortgage backed security with the same risk characteristics as a mortgage loan should be treated similarly.
8. The regulator should not penalize credit unions for assets and liabilities the regulator does not understand or if the credit union utilizes proper but advanced analysis techniques that the examiner does not understand. Credit unions should have the right to request capital market specialist review have an avenue of appeal when there are disagreements with field examination staff over IRR assessment.

The issue of secondary capital is another area in which the Board requested comments. With regards to capital adequacy secondary capital raises the potential for introducing a tier 1/tier 2 element to credit unions that does not currently exist. Secondary capital should be classified as tier 2 and a limit should be established for the ratio of tier 1 to tier 2 capital for capital adequacy purposes. The current secondary capital program for low-income credit unions could be improved with the following changes:

1. Allowing a call feature for the issuer, similar to redemption features available in FHLB capital and in most preferred stock. Allowing credit unions to retire secondary capital that is no longer needed would reduce the expense to the credit union and provide greater capital management flexibility for issuers without limiting the stability of the capital when it is needed by the credit union.
2. Expand the pool of available providers of secondary capital beyond non-natural persons. By expanding the pool of capital providers to natural persons credit unions would be able to raise capital more easily from people who are familiar with the credit union.
3. Impose a suitability requirement on credit unions for secondary capital providers that closely aligns with accredited investor statutes that exist in many states. The accredited investor criteria apply to most state registered securities and private placements and help insure that only investors for whom a secondary capital investment is suitable could be solicited by credit unions.

These 3 modest changes to either the existing low income program or any program approved by Congress for credit unions without a low income designation, would greatly enhance the ability to raise and manage capital in the system, thereby decreasing risk to the NCUSIF.

I would like to thank the Board and staff for addressing industry concerns with risk based capital as previously proposed. While this rule is not necessary it is also not overly harmful to the industry.

Respectfully Submitted,

Kevin Cole, CFA
Chief Financial Officer

Maps Credit Union
