FIRST EMPIRE SECURITIES
Member FINRA/SIPC

100 Motor Parkway, 2nd Floor
Hauppauge, NY 11788
Tel: 631.979.0097
Toll Free: 800.645.5424
Fax: 631.979.0448
www.1empire.com

April 27, 2015

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

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

Re: Comments on the Second Proposal for 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.

As stated in my comment letter on the first proposal, I agree 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.

I was concerned that the first proposal may have had 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 no longer have that concern because the second proposed rule is singularly focused on credit risk.

I was concerned that aspects of the first proposed rule, especially the asset risk weightings, appeared inconsistent within the rule, with other NCUA rules, and possibly with the Federal Credit Union Act. I no longer have that concern because the attempt to include interest rate risk in the rule was abandoned. Its removal addressed those inconsistencies and has now made the rule more comparable with the prompt corrective action requirements of the other federal banking agencies, as required by the Federal Credit Union Act.

Because the revisions to the proposed rule addressed my primary concerns with the original proposal, I am not going to provide any further comment on the second proposal itself, but rather dedicate the remainder of this comment letter solely to answer your request for comment on how to address the subject of interest rate risk.

Interest Rate Risk

The Board has specifically requested comment on alternative approaches that could be taken in the future to reasonably account for IRR. The Board stated in the commentary that based on long term balance sheet trends at credit unions and NCUA's experiences with dealing with problem credit unions that the Board has concluded that NCUA's current regulations and supervisory process alone cannot adequately address IRR. I respectfully disagree. I do not believe that any more regulation is needed and I do believe that it is the examination process that should be best suited to supervise this risk.

It has been my experience as a former National Bank Examiner with the Office of the Comptroller of the Currency that the only way to accurately evaluate IRR is through the examination process. The accurate evaluation of IRR can only be done through both a quantitative and qualitative assessment of both the level of IRR and the quality of IRR management. Some would argue that the same holds true of a proper credit risk assessment, for which I can only agree. However, the two primary differences between the quantification of IRR from that of credit risk is that:

> 1.) The modeling of IRR requires significant assumptions that by their nature can never be held as factual truths with 100 percent confidence, and
>
> 2.) Unlike credit risk, there is no "absolute zero" for interest rate risk.

Credit risk has an absolute zero—zero delinquency and/or zero charge-off are two measures that most would agree would illustrate a zero (or near zero) level of risk. There is no similar measure for IRR. If an institution only had 30-year assets, most observers would say there is a high level of IRR, but that would only be true in a rising interest rate environment.

Conversely, if all of that institution's assets were in overnights, then observers might say that there is a low level of IRR. But to be clear, a low interest rate risk scenario would only be true in a rising rate environment. There would still be a very high level of risk to falling rates or rates not changing.

It is clear to me that IRR cannot be accurately measured by the asset side alone (as was attempted in the existing rule and the first proposal). The Board's commentary states that it now recognizes that an IRR measure should be based on a comprehensive measure, like NEV, that takes into account offsetting risk effects between assets and liabilities (and including derivatives). I completely agree that NEV modeling is the most comprehensive measure of capital at risk, while NII simulation is the most comprehensive measure of earnings at risk. Both earnings and capital must be considered when evaluating IRR. However, that leaves us with the first point I make above and that is what to do about assumptions. The Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation (agencies/bank regulators) struggled with this question in 1995 as they attempted to implement the portion of section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) addressing risk-based capital standards for interest rate risk. Portions of the bank regulators Joint Agency Policy Statement follow:

> After much deliberation, the bank regulators "elected not to pursue a standardized measure and explicit capital charge for interest rate risk at this time. This decision reflects concerns about the burden, accuracy, and complexity of a standardized measure and recognition that industry techniques for measuring interest rate risk are continuing to evolve. Rather than dampening incentives to improve risk measures by adopting a standardized measure at this time, the agencies hope to encourage these industry efforts. Nonetheless, the agencies will continue to place significant emphasis on the level of a bank's interest rate risk exposure and the quality of its risk management process when evaluating a bank's capital adequacy."[1]
>
> The bank regulators explained that "The final rule did not adopt a measurement framework for assessing the level of a bank's interest rate risk exposure, nor did it specify a formula for determining the amount of capital that would be required. The intent of the agencies at that time was to implement an explicit minimum capital charge for interest rate risk at a future date, after the agencies and the industry had gained more experience with a proposed supervisory measure that the agencies issued for comment in August 1995. See 60 FR 39495 (August 2, 1995). The agencies have undertaken considerable efforts to develop a supervisory measure for interest rate risk that provides sufficient accuracy, transparency, and predictability for establishing an explicit charge for interest rate risk. These efforts, and the comments the agencies received on them, are summarized in (the joint agency policy statement). After careful consideration of those comments and additional analyses and research by agencies' staff, the agencies have decided that concerns about the burdens, costs, and potential incentives of implementing a standardized measure and explicit capital treatment currently outweigh the potential benefits that such measures would provide. The agencies are cognizant that techniques for measuring interest rate risk are continuing to evolve, and they do not want to impede that progress by mandating or implementing prescribed risk measurement techniques. Rather, the agencies wish to work with the industry to encourage efforts to improve risk measurement techniques. These efforts, the agencies believe, may lead to greater convergence within the industry on the methodologies used for measuring this risk and may, at a future date, facilitate more quantitative and explicit capital treatments for interest rate risk. Hence, the agencies have concluded that the best course of action at this time, is to continue to assess capital adequacy for interest rate risk under a risk assessment approach and to provide the industry with further guidance on prudent interest rate risk management practices."[1]

Recommendations

It has been nearly twenty years since the bank regulators issued that Joint Agency Policy Statement, and the bank regulators have yet to adopt any measurement or formula for interest rate risk in its risk-based capital rules. Instead, the bank regulators have been diligent in publishing interagency guidance (along with the NCUA), publishing examination guidance for its examination staff, introducing the "S" component to the CAMELS rating system, development of a risk assessment methodology that details both quantity of risk as well as quality of risk management in order to determine an overall risk assessment, and increasing examiner training on interest rate risk.

[1] DEPARTMENT OF THE TREASURY Office of the Comptroller of the Currency [Docket No. 96–13] FEDERAL RESERVE SYSTEM [Docket No. R–0802]; FEDERAL DEPOSIT INSURANCE CORPORATION: Joint Agency Policy Statement: Interest Rate Risk

My recommendation for the Board is to follow the bank regulators lead on this important topic. Cease attempting to devise a simple bright line for the assessment of IRR that can never be accurately applied across the industry, and instead devote the agency's resources towards improving its capacity to supervise this risk and provide the necessary level of published guidance to its examiners.

I am a strong advocate and supporter of the NCUA's existing Interest Rate Risk Regulation. NCUA rules contained in 12 CFR 741 require sound interest rate risk management processes that are commensurate with the levels of risk being taken. 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. New regulation is not needed on this subject. What is needed is that sufficient resources are dedicated to ensuring its compliance. Also, it is my belief that all credit unions, no matter their size, should have an IRR policy and program that is commensurate with its risk. Current discussions to expand the asset size exemption to institutions up to $100 million are concerning.

I suggest that the NCUA also follow the bank regulators lead in making greater use of its power to publish significant supervisory concerns. Publishing formal agreements with institutions not only is a deterrent to taking uncontrolled risk but also provides the industry a greater understanding of what is considered an unsafe and unsound practice. Increasing this transparency benefits the industry because the examiners will be tasked with having to take greater care in making the determination to cease an activity and will allow for the development of a history of qualitative judgment.

One step that the NCUA can take that the bank regulators have not done is to require the reporting of NEV and NII on the Call Report, along with certain NMD factors. The OCC recently published a special study of these levels for 1,500 community and midsize banks (see attachment). Regularly gathering data on the assumptions and the resulting NII and NEV could be useful to improve the supervision process, rather than relying on simplistic and often inaccurate proxies that have been misused. The examination process could then be more focused on the accuracy of the Call Report disclosure, risk measurement methodologies, and overall risk management.

In Conclusion:

I recognize that the Federal Credit Union Act requires the NCUA's risk-based capital rule to account for all material risks. However, the account for the risk must be an accurate portrayal. I do not believe it is possible when dealing with the highly complex subject matter of interest rate risk for a formula to be devised that would be accurate across the industry. I think that most would agree that fraud or cyber-security are material risks, but there is no accurate way of including those risks in a risk-based capital computation either.

We must rely upon and trust in the supervision process. If the Board has concluded that the NCUA's supervisory process cannot adequately address IRR, then the Board should devote sufficient resources to make that process adequate. I extend a sincere offer to assist in providing the NCUA examination staff with ALM training and educational resources.

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

E. Prescott Ford, CFA
Managing Director, Office of Regulatory Affairs
First Empire Securities

Attachment: Bank reported NII, NEV, and NMD assumptions from the OCC's Risk Perspectives Report (Fall 2014)

Attachment: Bank reported NII, NEV, and NMD assumptions from the OCC's Risk Perspectives Report (Fall 2014)

Figure 28: Bank-Reported EAR Exposure

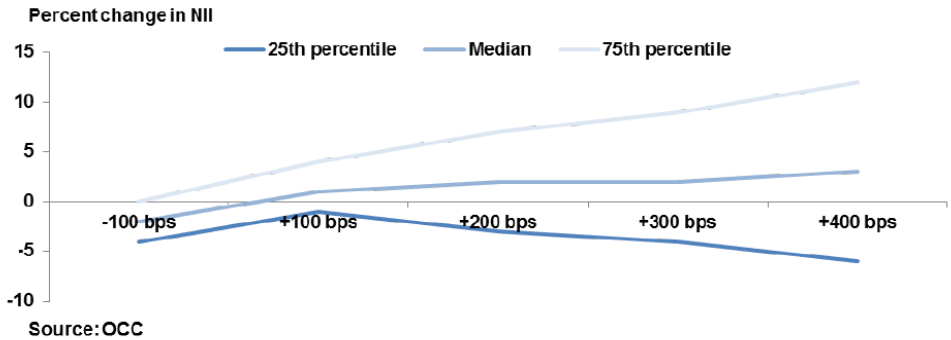


Figure 29: Bank-Reported Expected Percent Change in Repricing for NMDs

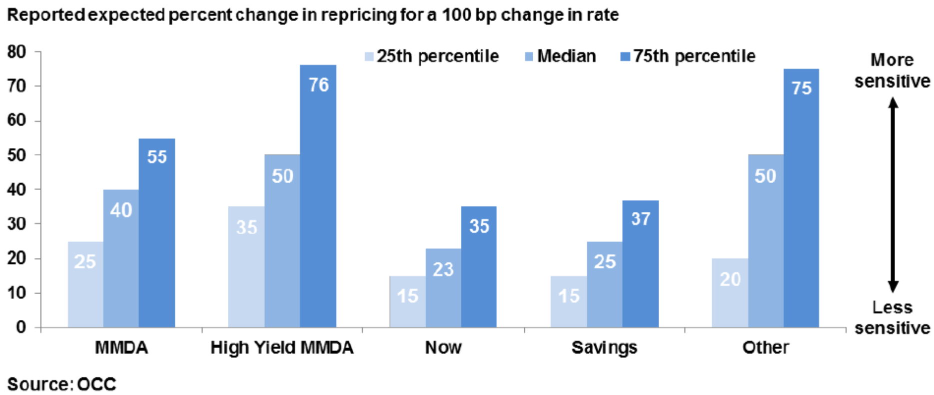


Figure 30: Bank-Reported EVE Exposure

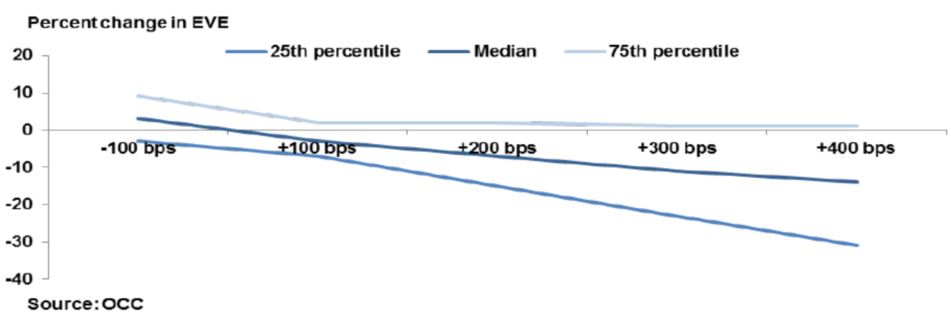
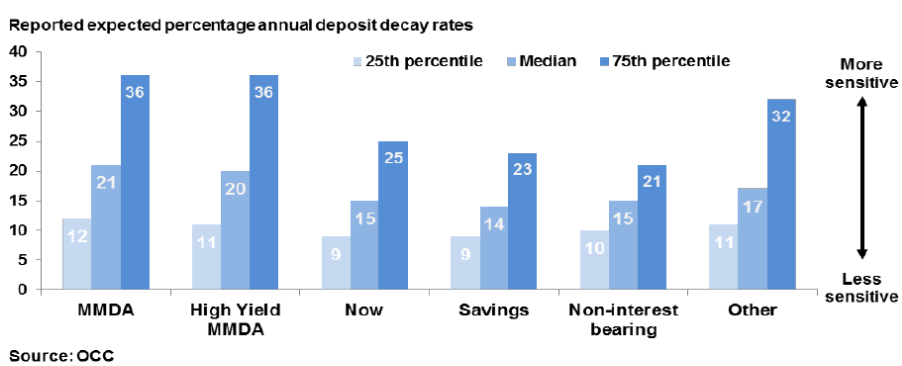


Figure 31: Bank-Reported Expected Decay Rate Assumptions for NMDs for an Up 100 bp Scenario



[2]

[2] OCC's Risk Perspectives Report (Fall 2014)