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April 16, 2014

To: regcomments@ncua.gov

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

Re: Comments on Proposed Rule: PCA – Risk-Based Capital

Dear Mr. Poliquin:

Bellco Credit Union appreciates the opportunity to comment on the National Credit Union Administration ("NCUA") Board's proposal to revise and replace NCUA's current prompt corrective action ("PCA") rules, including a new method for computing NCUA's risk-based capital measure, for federally insured natural person credit unions (the "Proposed Rule"). According to NCUA's Federal Register release of the Proposed Rule (the "Federal Register Release"),[1] the risk-based capital requirements contained in the Proposed Rule would be more consistent with NCUA's risk-based capital requirement for corporate credit unions and the regulatory risk-based capital measures used by the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency (collectively, the "Other Federal Banking Regulatory Agencies").

We recognize that NCUA's rules defining the minimum capital requirements and PCA supervisory actions have remained largely unchanged since they were first adopted in 2000. Accordingly, we understand that NCUA believes that modernization of those rules is timely, especially in light of (a) the experiences of the 2007-2009 recession; (b) the publication by the Basel Committee on Banking Supervision of "A Global Regulatory Framework for More Resilient Bank and Banking Systems" in December 2010, as revised in June 2011 ("Basel III"); (c) FDIC's September 2013 issuance of its Interim Final Rule (with request for comments) (the "FDIC Interim Final Rule");[2] and (d) recent Governmental Accountability Office reviews of the PCA systems within the financial services industry.

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[1] *See,* 79 F.R. 11184 (February 27, 2014), National Credit Union Administration: "Prompt Corrective Action – Risk-Based Capital."

[2] *See,* 78 F.R. 55340 (September 10, 2013), Federal Deposit Insurance Corporation: "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and

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We believe that any such modernization should be reflected in a final version of the Proposed Rule that carefully balances (a) the need to better protect all credit unions and the National Credit Union Share Insurance Fund ("NCUSIF") by requiring higher minimum levels of capital for credit unions with higher risk exposures, with (b) the desirability of comparability with the PCA systems employed by the Other Federal Banking Regulatory Agencies, and with (c) the unique structure and purpose of credit unions, as well as the nature of their operations and the structure of their balance sheets. To that end, this letter presents several comments for the NCUA Board's consideration in reviewing, and developing a final version of, the Proposed Rule.

General Comments

1. The Proposed Rule attempts to address multiple types of financial risk exposures. By design, however, PCA systems are suited to addressing only credit risk, not other financial risk exposures.

As set forth in the Federal Register Release, in developing the new risk-based capital requirement for "complex" credit unions, NCUA established several goals. Among those goals was that NCUA's new PCA system "should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk." Indeed, the PCA system established in the Proposed Rule attempts to focus more broadly on the various types of risks to credit unions by addressing additional risk factors and assigning specific risk weights to delinquent loans, concentrations of member business loans ("MBLs") and real estate-secured loans, equity investments, and additional off-balance sheet exposures.

Contrary to the Proposed Rule's approach, however, PCA systems are designed to address credit risk and are not generally used to address other forms of risk to which financial institutions are exposed. Neither Basel III nor the FDIC Interim Final Rule attempts to capture interest rate risk, liquidity risk, market risk, or operational risk in its risk weightings. The FDIC specifically acknowledges this in the FDIC Interim Final Rule, stating,

> The FDIC's general risk-based capital rules indicate that the capital requirements are minimum standards generally based on broad ***credit-risk considerations***. ***The risk-based capital ratios under these rules do not explicitly take account*** of the quality of individual asset portfolios or ***the range of other types of risk to which FDIC-supervised institutions may be exposed, such as interest-rate, liquidity, market, or operational risks***. (Emphasis added.)[3]

Instead, both Basel III and the FDIC Interim Final Rule anticipate that banking regulatory authorities would employ other mechanisms to measure and control risks other than credit risk. For example, Basel III creates a "liquidity coverage ratio" and a "net stable funding ratio" to address liquidity risk. In addition, the FDIC Interim Final Rule provides for a "supervisory assessment of overall capital adequacy" that,

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Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule."

[3] *Id.*, at 55362.

> [takes] account of whether an FDIC-supervised institution plans appropriately to maintain an adequate level of capital given its activities and risk profile, as well as risks and other factors that can affect an FDIC-supervised institution's financial condition, including, for example, the level and severity of problem assets and its exposure to operational and interest rate risk, and significant asset concentrations. For this reason, a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of an FDIC-supervised institution's regulatory capital ratios.[4]

Thus, although FDIC acknowledges that risk exposures and factors other than credit risk may call for an institution to increase its capital levels, FDIC uses supervisory assessments, rather than PCA risk weightings, to tailor an individual institution's required capital to its unique size, complexity, and risk profile. In the Proposed Rule, NCUA adopts a comparable approach, allowing for the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirements that would otherwise apply to the credit union under the Proposed Rule. The Proposed Rule sets forth NCUA's approach in proposed Section 702.105, Individual Minimum Capital Requirements ("IMCRs").

As noted in the Federal Register Release, Section 1790d(b)(1)(A)(ii) of the Federal Credit Union Act (12 U.S.C. §216(b)(1)(A)(ii)) requires comparability with the PCA requirements employed by the Other Federal Banking Regulatory Agencies. The Federal Register Release also states that NCUA's proposed PCA system "would replace the risk-based net worth method currently used by credit unions with a new risk-based capital ratio method that is more commonly applied to depository institutions worldwide and that the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions." NCUA also states that, "[u]se of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions."[5]

Given that both the FDIC Interim Final Rule and Basel III's standard approach address only credit risk, by attempting to capture other risk exposures in its risk weightings, the Proposed Rule neither complies with the statutorily required comparability with the PCA requirements employed by the Other Federal Banking Regulatory Agencies nor promotes improved understanding between all types of federally insured financial institutions. Moreover, the Proposed Rule's approach is unnecessary inasmuch as the NCUA Rules include other regulatory measures and means to address risk exposures other than credit risk. For example, Part 723 of the NCUA Rules places concentration limits on MBLs. If adopted as set forth in the Proposed Rule, NCUA would be authorized to establish IMCRs for those credit unions whose elevated risk exposures merited increased capital adequacy.

Accordingly, we urge NCUA to remove the portions of the Proposed Rule that apply higher risk weights to asset categories based on asset concentrations. Instead, NCUA should use IMCRs to require additional capital for credit unions with elevated risk exposures that result from ineffective policies, procedures, and practices with regard to their assets and operations.

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[4] *Id.*

[5] 79 F.R. 11186.

2. The Proposed Rule potentially increases risk by promoting undue concentrations in certain asset categories.

The Proposed Rule creates a bias in favor of consumer loans as compared to other assets, such as MBLs and mortgage loans. Specifically, under the Proposed Rule, a credit union's consumer loans would be subjected to a 75 percent risk weighting, while its longer-term investments, MBLs, and real estate loans would be subjected to concentration-based tiered risk-weights. Although the Federal Register Release is silent on this point, this approach suggests that NCUA may be encouraging credit unions to increase their focus on consumer lending and de-emphasize or avoid altogether other business activities that are otherwise authorized under applicable law and regulations.

Perhaps such a bias could be a reflection of NCUA's experience with respect to the failure of nearly 100 credit unions between 2008 and 2011. According to the Government Accountability Office,[6] common themes among these failures included (a) ineffective management, poor planning and weak oversight, (b) concentration risk, (c) failure to properly establish or manage new program or to conduct third party vendor due diligence, (d) liquidity risk, credit risk, or both, and (e) poor examination procedures. We understand NCUA's desire to address each of these areas. However, we do not believe that a PCA system can, or should, be expected to perform a greater function than that for which it is best suited, *i.e.,* measuring and monitoring credit risk.

As an example, several of the recent credit union failures for which the Federal Credit Union Act mandated a material loss review[7] involved credit unions with higher concentrations of MBLs than their peers. However, NCUA has not demonstrated that the mere size of a credit union's MBL portfolio contributes to the credit union's instability to any greater degree than such factors as substandard underwriting, inaccurate appraisals, and inadequate collateral management. Ineffective policies, procedures, and practices with respect to ***any*** asset category, including consumer loans, could have equally deleterious effects on a credit union's resilience. Moreover, the application of the Proposed Rule's concentration-based tiered risk-weights to MBLs could have the anomalous effect of NCUA imposing a punitive capital charge on the same MBLs that NCUA has given the credit union special permission to hold via its waiver process.

If the Proposed Rule were to become final as initially issued, credit unions may have a perverse incentive to increase levels of poorer credit quality consumer loans at the expense of higher levels of even the strongest, most secure MBLs, real estate loans and longer-term investments. We fail to see how higher levels of low quality assets (whatever their category)

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[6] National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions, GAO Report 12-247 (January 2012).

[7] The Federal Credit Union Act (citation omitted) requires that the NCUA's Office of Inspector General conduct a "material loss review" of each failure of a federally insured credit union that results in a loss to the NCUSIF of more than $25 million and greater than or equal to 10 percent of the insured credit union's assets.

exposes the NCUSIF to less risk than higher levels high quality assets (whatever their category). Accordingly, we again urge NCUA to reconsider and remove the portions of the Proposed Rule that apply higher risk weights to asset categories based on the percentage of a credit union's assets represented by that category.

Section-by-Section Comments

1. **Subpart A – Prompt Corrective Action Section 702.104(c)(2)(ii) Risk-weights for on-balance sheet assets: Category 2 – 20 percent risk-weight** – *Deposits in Federal Reserve Banks should be risk-weighted at zero percent rather than 20 percent.*

The Proposed Rule classifies credit union deposits in Federal Reserve Banks as Category 2 assets, applying a 20 percent risk rating to such assets. More specifically, the Proposed Rule's failure to distinguish credit union deposits in Federal Reserve Banks from deposits in commercial banks and other financial institutions implies this result. We believe this approach fails to take into consideration the substantial differences between Federal Reserve Banks (which are integral parts of the Federal Reserve System – the world's leading central bank) and commercial banks and other financial institutions. Unlike commercial banks and other financial institutions, it is incontrovertible that the United States government and Board of Governors of the Federal Reserve System would not permit any Federal Reserve Bank to fail or to default on any of its obligations, including deposit obligations. Our nation's entire economic, financial, and payments systems depend on the collective belief in federal government support for the Federal Reserve Banks. Even the nation's acknowledged "systemically important" financial institutions, those deemed by the financial markets as being "too big to fail," cannot depend on such perceived support.

Perhaps one reason the Proposed Rule does not distinguish between credit union deposits in commercial banks and other financial institutions and credit union deposits in Federal Reserve Banks is that the Form 5300 Call Report does not make this distinction. Rather, the only relevant line item on the March 2014 NCUA Form 5300 Call Report is labeled, "Deposits in commercial banks, S&Ls, savings banks." We believe revising the Form 5300 Call Report to include a separate line item labeled, "Deposits in Federal Reserve Banks," would not only provide greater transparency with respect to credit unions' financial condition, but would facilitate more accurate credit risk reporting on their part. Moreover, this change would not be burdensome, either for credit unions or for NCUA.

We accordingly encourage NCUA to classify credit union deposits in Federal Reserve Banks at zero percent rather than at 20 percent and implement a corresponding change in Form 5300.

2. **Subpart A – Prompt Corrective Action Section 702.104(c)(2)(v) and (vii) Risk-weights for on-balance sheet assets: Category 5 – 100 percent risk weight and Category 7 – 150 percent risk weight** – *Additional tiered risk-weights for real estate-secured loans should be eliminated.*

Current NCUA Rules establish a risk-based net worth ("**RBNW**") requirement for "complex" credit unions. In this regard, current NCUA Rule 702.104 defines eight risk portfolios of complex credit union assets, liabilities, or contingent liabilities and current NCUA Rule 702.106 establishes the specific risk-weightings to be applied to the assets assigned to each risk portfolio. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk-weighting; a credit union's RBNW requirement is the sum of eight standard components. Under current NCUA Rule 702.106, the risk weighting for "long-term real estate loans" increases as the size of that portfolio increases as a percentage of total assets.

NCUA's tiered risk-weight approach for real estate-secured loans for both the current RBNW framework and the Proposed Rule's framework is arbitrary and unsupported by the administrative record. NCUA has not offered any specific analyses or other evidence of which we are aware to support either framework's implied assumption that there is a correlative relationship (much less a causal relationship) between the size of a credit union's portfolio of real estate-secured loans and the risk that portfolio presents to the NCUSIF. Instead, NCUA states that,

> [i]n recent years, the NCUSIF did experience several hundred millions of dollars in losses due to failures of individual credit unions holding inadequate levels of capital relative to the levels of risk associated with their assets and operations. Examiners did warn officials at these credit unions that they needed to hold higher levels of capital to offset the risks in their portfolios, but the credit union officials ignored the examiners' recommendations, which were unenforceable. [The Proposed Rule] seeks to incorporate the lessons learned from those failures and better account for risks not addressed by the current rule.[8]

This rationale is unsupportable when viewed in the light of two critical regulatory and supervisory elements. First, the Proposed Rule would clarify NCUA's authority to establish an IMCR for a credit union that would vary from any of the risk-based capital requirements that would otherwise apply to the credit union under the Proposed Rule. Second, NCUA officials have at their disposal various substantial supervisory enforcement measures (*e.g.,* private warning letters, letters of understanding, and cease and desist orders) to enforce an IMCR or other determination that a credit union needs to improve the alignment between its risk exposures and its available capital. NCUA and state regulatory officials can use these supervisory enforcement measures to more precisely address individual imbalances between risk exposure and capital adequacy rather than an across-the-board arbitrary framework that focuses on the size of the portfolio without due consideration of other factors that have a significantly more direct bearing on loss, such as substandard underwriting, inaccurate appraisals, and inadequate collateral management. That NCUA may not have vigorously employed such supervisory enforcement measures prior to or in connection with past credit union

[8] 79 F.R. 11186.

failures[9] is not evidence that such measures are insufficient or ineffective in and of themselves.

Although NCUA states that the Proposed Rule's PCA system replaces the current RBNW requirement with "a new risk-based capital ratio method that is more commonly applied to depository institutions worldwide," because neither Basel III nor the FDIC Interim Final Rule employs a similar approach, we fail to see how the Proposed Rule's tiered risk-weights for real estate-secured loans is consistent with NCUA's stated desire for comparability with the PCA systems employed by the Other Federal Banking Regulatory Agencies. Furthermore, the Proposed Rule's tiered risk-weights for real estate-secured loans is no less arbitrary than those contained in the current RBNW framework.

Accordingly, we encourage NCUA to classify risk weights for real estate secured loans in accordance with borrower creditworthiness and collateral sufficiency rather than by percentage of assets.

3. Subpart A – Prompt Corrective Action Section 702.104(c)(2)(vii) and (viii) Risk-weights for on-balance sheet assets: Category 7 – 150 percent risk weight and Category 8 – 200 percent risk weight – *Investments should be risk-weighted by issuer, rather than by term, using weights similar to those used by the Other Federal Banking Regulatory Agencies.*

The Proposed Rule's application of maturity-based tiered risk-weights imprecisely accounts for the actual risk exposures associated with investment assets and distorts comparability with FDIC-supervised institutions. In this regard, NCUA should recognize that its current guidelines on net interest income ("NII") and net economic value ("NEV") volatility already address interest rate risk and market risk and their effects on credit union capital adequacy. Further, NCUA guidelines for calculating NII and NEV are far more granular and thus more accurately capture interest rate risk than the Proposed Rule's risk-weights. In addition, the structure of the liability side of a credit union's balance sheet is not captured in the Proposed Rule's risk-weightings.

Under the Proposed Rule, a credit union's risk-based capital ratio could decrease dramatically because of lengthening in the weighted average maturities of the credit union's mortgage backed securities stemming from slowing prepayment activity. However, under the FDIC Interim Final Rule, a similarly situated FDIC-supervised institution would not experience such risk-based capital volatility in its risk based capital ratios because, as noted previously, the FDIC's PCA system is limited to credit risk.

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[9] *See, Capping Report On Material Loss Reviews*, National Credit Union Administration Office of Inspector General, Report No. OIG-10-20 (November 23, 2010), p. 2, in which the NCUA Inspector General states, "We believe had examiners acted more aggressively in their supervision actions over these credit issues, the looming safety and soundness concerns that were present early-on in the nearly every failed institution could have been identified sooner and the eventual losses to the NCUSIF could have been stopped or mitigated."

Accordingly, we encourage NCUA to classify investment risk weights in accordance with the creditworthiness of the issuer or guarantor rather than by maturity.

4. Subpart A – Prompt Corrective Action Section 702.104(c)(2)(ix) Risk-weights for on-balance sheet assets: Category 9 – 250 percent risk-weight – *Investments in CUSOs should be risk-weighted at 100 percent rather than 250 percent.*

The Proposed Rule imposes a 250 percent risk rating on a credit union's investment in a CUSO, presumably because NCUA is concerned that an insured credit union might be exposed to a loss of more than the funds it has invested in a CUSO. Given that NCUA Rule 712.4 specifically addresses the nature and extent of corporate separateness that a credit union must establish and maintain with respect to any CUSO in which it makes an investment, this proposed risk-rating is redundant, at best, and punitive, at worst. In addition to the statutory and regulatory limits on the amounts that credit unions may invest in CUSOs, under NCUA Rule 712.4, a credit union must take certain enumerated steps to ensure that the credit union has minimized its exposure to the risk that the corporate veil between the credit union and the CUSO would be pierced. Moreover, before investing in a CUSO, NCUA Rule 712.4 requires the credit union to obtain written legal advice to that effect. In order to comply with NCUA Rule 712.4's requirements, therefore, a credit union must first take extraordinary measures to limit its investment risk in a CUSO to no more than the amount of such investment. In other words, the credit union's maximum *investment* exposure to a CUSO is effectively limited to one hundred cents on the dollar. No other federally insured financial institutions are subject to comparable requirements.

Furthermore, NCUA has other adequate and more effective means to address concerns it may have regarding the various risks that may be presented by the business operations of CUSOs themselves. In this regard, NCUA recently finalized various amendments to Parts 712 and 741 of NCUA Rules "to increase transparency and address certain safety and soundness concerns" (the "**CUSO Rule Amendments**").[10] The CUSO Rule Amendments, among other things, require all CUSOs to annually provide basic profile information to NCUA and the appropriate state supervisory authority and require CUSOs engaging in certain complex or high-risk activities to additionally report more detailed information, including audited financial statements and general customer information.

Because NCUA has employed alternative means to limit a credit union's exposure to loss from an investment in a CUSO and because NCUA has effective oversight of CUSOs generally, we can find no supportable rationale for requiring more than a 100 percent risk weighting for a credit union's investment in a CUSO and we recommend that the Proposed Rule be so modified.

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[10] *See*, 78 F.R. 72537 (December 3, 2013), National Credit Union Administration: "Credit Union Service Organizations."

Thank you for the opportunity to comment on the Proposed Rule. Please let us know if you have any questions or comments regarding this letter, or need addition information to clarify Bellco Credit Union's perspective on the Proposed Rule.

Sincerely,

Dan Kampen

Dan Kampen
Executive Vice President/Chief Financial Officer