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NAFCU | Your Direct Connection to Education, Advocacy & Advancement

May 27, 2014

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

RE: Comments on NCUA Prompt Corrective Action – Risk-Based Capital Proposed Rule

Dear Mr. Poliquin:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents federal credit unions, I am writing to you regarding the proposed rule on prompt corrective action and risk-based capital. As the credit union community comments on this rule, NAFCU is hopeful that the National Credit Union Administration (NCUA or Agency) Board will realize the devastating effect that this proposal will have on the credit union industry, the American consumer, and our nation's small businesses. While we are supportive of the idea of a risk-based capital regime for credit unions, the current NCUA proposal is not appropriate for credit unions or the credit union industry. If it were to be implemented as proposed, credit unions would find themselves at a significant competitive disadvantage to banks. As proposed, the rule is one-size-fits-all and would serve to stifle growth, innovation, and diversification within credit unions. We ask that the NCUA Board withdraw the rule or alternatively make major modifications to the proposal before any rule is finalized.

NAFCU has many concerns with the proposed rule which we explain in detail below; however, our major concerns include:

- Several issues related to NCUA's legal authority to issue the rule as proposed, such as:
  - Comparability with banking regulatory requirements;
  - Substitution of statutorily defined legal terms;
  - Individual minimum capital requirements;
  - Definition of a "complex" credit union;
- The need for a legislative solution in order to achieve a fair and balanced risk-based capital system;
- NCUA's treatment of the regulatory process including the refusal to extend the comment period and form an industry working group prior to releasing a

proposed rule, and the need for an additional notice of proposed rulemaking with public comment period;

- NCUA's drastic understatement of credit unions that will be affected by this rule and whose balance sheets and business plans will need adjustment;
- NCUA's proposed risk-based capital ratio for well capitalized credit unions set at 10.5 percent;
- NCUA's treatment of risk-weighted assets and the lack of explanation for deviation from similar banking risk-weights;
- NCUA's incorporation of interest rate and concentration risk into risk-weighting for real estate, investments, and member business loans (MBL's);
- Individual minimum capital requirements for credit unions including issues with the subjectivity of their imposition;
- Components not included in the numerator portion of the risk-based capital ratio, such as goodwill;
- The 1.25 percent cap on Allowance for Loan and Lease Losses (ALLL) especially considering the Financial Accounting Standards Board's (FASB) most recent proposal on ALLL;
- Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule; and
- The proposed 18-month implementation timetable is not long enough for a rule as complex and impactful as this proposed rule.

Legal Authority

NAFCU does not believe that NCUA has the legal authority to issue the rule as proposed. There are several areas of the proposed rule where NAFCU questions whether the rule is consistent with the requirements of the Federal Credit Union Act (FCU Act.)

The FCU Act Requirements

The FCU Act 12 U.S.C. §1790d contains the requirements for Prompt Corrective Action (PCA), including the required regulations and the risk-based net worth requirement. These provisions were added to the FCU Act by the Credit Union Membership Access Act of 1998 (CUMAA).

NCUA acknowledges in the proposed rule that it derives its legal authority for promulgating the proposed risk-based capital rule from sections 1766[1] and 1790d of the FCU Act, and maintains that the proposed rule achieves the purposes that the FCU Act requires.

NCUA states in the proposed rule that "Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) A framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions defined as

[1] This section refers to powers of the NCUA Board.

'new'; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as 'complex.'"[2]

Comparability

The FCU Act requires that the NCUA Board "shall, by regulation, prescribe a system of prompt corrective action for insured credit unions that is—(i) consistent with this section; and (ii) **comparable** to section 1831o of this title."[3] (Emphasis added.) This reference to 12 U.S.C. §1831o is to the PCA requirements of the Federal Deposit Insurance Act, as implemented through the Federal Deposit Insurance Corporation (FDIC) regulations.

During the deliberations on CUMAA, Congress also stated on the record that "'Comparable' here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor."[4] This proposed rule goes far beyond this interpretation of comparable in a number of instances that are highlighted throughout this letter.

Risk-Based Net Worth vs. Risk-Based Capital Terminology

NCUA's proposed amendments to 12 C.F.R. §702.102 would replace statutorily defined terms with what it considers to be "functionally equivalent" terms.[5] NAFCU questions whether NCUA has the legal authority to deviate from these statutory terms. The FCU Act also requires a "risk based net worth requirement for complex credit unions;" the statutory requirement reads:

> ***"Risk-based net worth requirement for complex credit unions.—***
>
> *(1)* ***In general.****—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.*
>
> *(2)* ***Standard.****—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."*[6] *(Emphasis added.)*

The FCU Act also provides specific definitions for "net worth"[7] and "net worth ratio."[8] These terms are specifically defined in the FCU Act as follows:

> "(2) ***Net worth.—The term "net worth"***
> *(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined;*

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[2] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11185.
[3] 12 U.S.C. § 1790d(b)(1)(A).
[4] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).
[5] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11191.
[6] 12 U.S.C. § 1790d(d).
[7] 12 U.S.C. § 1790d(o)(2).
[8] 12 U.S.C. § 1790d(o)(3).

(B) with respect to any insured credit union, includes, at the Board's discretion and subject to rules and regulations established by the Board, assistance provided under section 208 to facilitate a least-cost resolution consistent with the best interests of the credit union system; and
(C) with respect to a low-income credit union, includes secondary capital accounts that are—
(i) uninsured; and
(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.[9]

(3) Net worth ratio.
The term "net worth ratio" means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union."[10] *(Emphasis added.)*

The preamble to the proposed rule discusses NCUA's proposed amendments to § 702.102, including changes to the terminology used. NCUA acknowledges that the FCU Act specifically uses the term "risk-based net worth requirement" but proposes to replace that terminology with "risk-based capital," which it contends is "functionally equivalent."[11]

The proposed rule also replaces the term "net worth" with the term "capital categories" to describe the combined "net worth ratio" and "risk-based net worth" measurements, as well as several other modifications to the terminology currently used.

NCUA contends that "no substantive changes to the requirements of section 216(c) are intended by these changes in terminology."[12] These changes are not only substantive, but redefine statutorily defined terms including "net worth" and "net worth ratio" with terms that do not encompass the same things.

These statutorily defined terms may not be redefined by NCUA through regulation in order to place an ill-fitting risk-based capital system on top of the current PCA system. NAFCU believes that if NCUA really wants to institute a working risk-based capital system that would be comparable to what banks have, then NCUA would need Congress to change the FCU Act to give it the authority to do so.

Individual Minimum Capital Requirements

NAFCU questions whether NCUA has the statutory authority to institute individual minimum capital requirements. Under the proposed rule, NCUA introduces a new power to raise individual minimum capital requirements for credit unions "that varies from any of the risk-based capital requirement (s) that would otherwise apply to the credit union…"[13] The proposed rule contains a list of circumstances where NCUA could raise a credit union's individual minimum capital requirements that includes, among others, a credit union receiving special supervisory attention or a portfolio that reflects weak credit quality or significant likelihood of financial loss. The FCU Act 12 U.S.C. § 1790d(h) states:

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[9] 12 U.S.C. § 1790d(o)(2).
[10] 12 U.S.C. § 1790d(o)(3).
[11] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11191.
[12] *Id.*
[13] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11216 (to be codified at 12 C.F.R. § 702.105(a)).

> ***"(h) More stringent treatment based on other supervisory criteria***
>
> *With respect to the exercise of authority by the Board under regulations comparable to section 1831o(g) of this title—*
>
> *(1) the Board may not reclassify an insured credit union into a lower net worth category, or treat an insured credit union as if it were in a lower net worth category, for reasons not pertaining to the safety and soundness of that credit union; and*
>
> *(2) the Board may not delegate its authority to reclassify an insured credit union into a lower net worth category or to treat an insured credit union as if it were in a lower net worth category." (Emphasis added.)*

A broad interpretation of the statute[14] would allow for NCUA to use issues of safety and soundness to reclassify an insured credit union or treat it as though it were in a lower net-worth category. By doing so, the NCUA Board could subject those individual credit unions that did not meet the individual minimum capital requirements to the same restrictions as those credit unions that are less than well capitalized. The statute, if read broadly, could allow for the NCUA Board to downgrade a credit union in cases pertaining to safety and soundness.

Taking a more narrow interpretation of the statute, one could argue that having the authority to treat an insured credit union as if it were in a lower net worth category is not the same as having the authority to arbitrarily subject individual credit unions to different individual minimum capital requirements. While the effects of lowering a credit union's net worth category could be similar for a credit union under the proposed individual minimum capital requirement, it is not the same as being authorized to be able to pick the point at which a credit union would not be safe and sound.

Finally, a strict reading of the statute would not provide the authority necessary for the NCUA Board to promulgate a rule that includes proposed § 702.105. Nowhere in the statute does Congress specifically authorize the NCUA Board to provide different minimum capital requirements for individual credit unions.

There is a second major issue regarding individual minimum capital requirements. Assuming the NCUA Board is deemed to have the authority to institute a system that would allow for individual minimum capital requirements because of its interpretation of 12 U.S.C. § 1790d(h)(1), at issue is whether the NCUA Board can delegate that authority to anyone other than itself, such as an examiner or regional director. Congress was clear in its intent that this authority is not to be delegated to anyone other than the NCUA Board.[15]

The proposed rule uses phrases such as "The decision is necessarily based, in part, on subjective judgment grounded in agency expertise…"[16] and "NCUA may establish

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[14] 12 U.S.C. § 1790d(h).
[15] 12 U.S.C. § 1790d(h)(2).
[16] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11217 (to be codified at 12 C.F.R. § 702.105(c)).

increased individual minimum capital requirements…"[17] The proposed § 702.105 uses the term NCUA, not NCUA Board, as is used in other parts of the proposed rule.[18] The proposed rule also specifically sets out in the summary that the initials "NCUA" are meant to mean the National Credit Union Administration as a whole agency and "Board" to mean the NCUA Board.[19] NAFCU believes this proposed rule intends to delegate the power to raise individual minimum capital requirements from the NCUA Board to other individuals or departments within the NCUA. This would fall directly outside the power authorized by Congress in 12 U.S.C. § 1790d. These discrepancies must be addressed in any final rule that is issued.

Definition of Complex

The proposed rule seeks to establish new more stringent risk-based capital standards for all credit unions with more than $50 million in assets, which NCUA has defined as "complex." NCUA's re-definition of a "complex" credit union is outside of the scope of the authority designated to it by Congress. The proposed rule arbitrarily sets the threshold at $50 million in assets with no additional tests to actually determine if the credit union itself is "complex."

The FCU Act[20] directs NCUA to develop a risk-based net worth system for complex credit unions that is based on the "portfolios of assets and liabilities of credit unions."[21] Congress could have directed NCUA to focus only on asset size in defining "complex." Instead, the FCU Act[22] requires NCUA to consider the complexity of a credit union's book of assets such as types of investments and loans, as well as liabilities. The definition of "complex" must be based on whether the credit union's financial activities and operations are sufficiently elaborate to warrant that credit union be designated as "complex" rather than just on its asset size.

As NAFCU has previously stated, the size of an institution does not determine the complexity of the assets and liabilities of a given credit union. There are many credit unions with well over $50 million in assets that are run out of one branch with only a handful of employees that often engage in only the most basic of transactions for members. Furthermore, there are many large credit unions that have very simple portfolios and are not involved in "risky" activities. There are also some smaller credit unions that engage in more risky activities that would require them to hold more capital. Limiting the definition of "complex" for credit unions to only those credit unions over $50 million is completely arbitrary and contrary to Congressional mandate.

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[17] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11216 (to be codified at 12 C.F.R. § 702.105(b)).
[18] See Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184 (to be codified at 12 C.F.R. §§ 702.110, 702.111, 702.112).
[19] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184.
[20] 12 U.S.C. 1790d(d).
[21] *Id*.
[22] As modified by The Credit Union Membership Access Act of 1998 (CUMAA).

Legislative Solution

NAFCU supports a risk-based capital system for credit unions. We support less capital for lower-risk credit unions and more capital for higher-risk credit unions. However, we continue to believe that we need Congress to make statutory changes to the FCU Act to achieve a fair system.

Ongoing discussions with NAFCU member credit unions led to the unveiling of NAFCU's "Five Point Plan for Regulatory Relief" in February 2013, and a call for Congress to enact meaningful legislative reforms that would provide much needed assistance to our nation's credit unions. In NAFCU's "Five Point Plan for Regulatory Relief," NAFCU calls on Congress to direct NCUA and industry representatives to conduct a study on PCA and recommend changes. It also calls on Congress to modernize capital standards by directing the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks and allows the NCUA Board to authorize supplemental capital. Finally, it asks Congress to establish special capital requirements for newly chartered federal credit unions that recognizes the unique nature and challenges of starting a new credit union.

NCUA's proposed rule on risk-based capital does not achieve a truly risk-based capital system for credit unions. NAFCU believes that the proposal is conceptually flawed, deviates from statutory requirements for PCA, and tries to establish an ill-fitting risk-based capital system without the necessary legislative solution. This results in a one-size-fits-all rule that will ultimately hurt credit unions while disregarding Congressional intent, and will require credit unions to hold additional unnecessary capital.

The FCU Act also prescribes that credit unions have net worth ratios of six percent to be considered adequately capitalized and seven percent for well capitalized,[23] while banks have leverage ratios of four percent to be adequately capitalized and five percent for well capitalized.[24] Credit unions are already at a competitive disadvantage to banks in this regard, and this proposed rule only serves to multiply that competitive disadvantage by requiring credit unions to hold even more capital as compared to banks.

These additional requirements are increasing the capital that credit unions cannot use to help members by providing loans. Furthermore, credit unions also have to account for a one percent contribution to the NCUSIF which constructively limits the amount of funds available for credit unions to extend credit, placing additional capital burdens on credit unions. NAFCU believes that NCUA should work with Congress to change PCA requirements such that credit unions are put on equal footing with and better able to compete with banks.

Should NCUA's current proposed rule go forward with little or no changes, the new rule would precipitate the need for other Congressional action to bring about capital changes for credit unions such as H.R. 719, the Capital Access for Small Businesses and Jobs Act,

[23] 12 U.S.C. § 1790d(c).
[24] 12 U.S.C. § 1831o.

which would allow credit unions to have access to supplemental capital sources. Additionally, the inclusion of an individual minimum capital requirement that starts with the examiner in any final rule only reinforces the need for action on H.R. 1553, the Financial Institutions Examination Fairness and Reform Act.

The Regulatory Process

Capital touches every part of a credit union's operations and decision-making. NAFCU believes that this proposed rule is one of the most important rulemakings to come out of the Agency in recent history. It is troubling that NCUA has refused to work with credit unions throughout the rulemaking process.

On May 8, 2013, NAFCU sent a letter to the NCUA Board requesting it to consider creating a working group on reforming current regulatory capital requirements for credit unions. That request specifically sought a working group made up of industry stakeholders to be formed and convened prior to any rulemaking by NCUA. NAFCU continued to stress to NCUA the need for a capital working group to perform an analysis prior to the issuance of a proposed rule on risk-based capital. Unfortunately, a working group was not convened prior to the release of this proposed rule.

Furthermore, NAFCU believes that for complex and important rules it is appropriate to issue an Advanced Notice of Proposed Rulemaking (ANPR) to collect public input on key issues. NCUA did not issue an ANPR prior to the release of the risk-based capital proposed rule. A risk-based capital rule is one such issue that is complex and important enough that an ANPR made sense for both the Agency and the credit union industry. It would also have given NCUA an opportunity to gather data from credit unions about the true effects of any changes in the capital regime. NAFCU believes that NCUA should have issued an ANPR to solicit comments from the public instead of releasing a proposed rule without credit union input either by formal comment period or working group.

Additionally, NCUA released a "Risk-Based Capital Calculator" when the NCUA Board approved the proposed rule in January 2014, and made this calculator available to the public. The calculator uses the most recent 5300 Call Report data and generates a credit union's current net worth ratio, net worth classification, and most importantly what the credit union's risk-based capital ratio would be pursuant to the proposed rule.

NAFCU believes that this calculator should not have been made available to the public. While this may be a useful tool for a credit union to understand what its capital position would be under the proposed rule, its public disclosure could have unintended consequences such as damage to a credit union's reputation. The proposed rule is complex and an uninformed viewer of this information could draw the wrong conclusions about the strength of the credit union, particularly as the rule is still in the proposal stage and subject to change. A better alternative would have been to provide credit unions with access to the calculator through a secure portal on NCUA's website.

On February 28, 2014, NAFCU sent a joint letter along with the Credit Union National Association (CUNA) to Chairman Matz to request an extension of the comment period by

90 days to give credit unions more time to understand this complex rule and to provide valuable feedback to NCUA about the possible effects of the rule on their credit union. Chairman Matz denied this request and in doing so, stated that the comment period provided enough time for credit unions to understand the rule and provide constructive comments to the Agency.

After Chairman Matz denied the request, credit unions continued to ask for more time and NAFCU, along with CUNA, wrote another letter to all members of the NCUA Board to again request that the comment period for the rule be extended for 90 days. That request was also denied. This rule is too important to rush the rulemaking process. Giving credit unions extra time to realize the full effects of the rule on present and future portfolios and business decisions easily outweighs any possible negatives in delaying its implementation.

Given the recent comments from NCUA Board members regarding the significant changes that will be made to the rule before it is finalized, NAFCU believes that NCUA should re-issue the proposed rule with any changes made using the input received from this comment period and the scheduled listening sessions through a notice of proposed rulemaking. This would give credit unions an opportunity to see those significant changes and contribute comments. If NCUA intends the final rule to include as many changes as the NCUA Board members have indicated, then NCUA will need to re-issue a proposed rule with another public comment period as required by the Administrative Procedure Act.

Affected Credit Unions

NCUA has stated publicly that this proposed rule would only affect around 200 credit unions.[25] That number simply includes those credit unions whose net worth classification will be downgraded. While there may only be around 200 credit unions whose net worth categories will be downgraded, there are many more credit unions that will be affected by this proposed rule. There are 1,404 federally-insured credit unions (FICUs)[26] that currently have more than $50 million in assets but are not currently defined as complex pursuant to PCA requirements. These credit unions would be defined as complex by the proposed rule. This means that 1,404 additional FICUs would be subject to a risk-based capital standard that would otherwise not be affected, based solely on the change in definition of "complex." All credit unions subject to the requirements of this proposed rule will need to carefully examine their balance sheets and potentially make substantial portfolio changes.

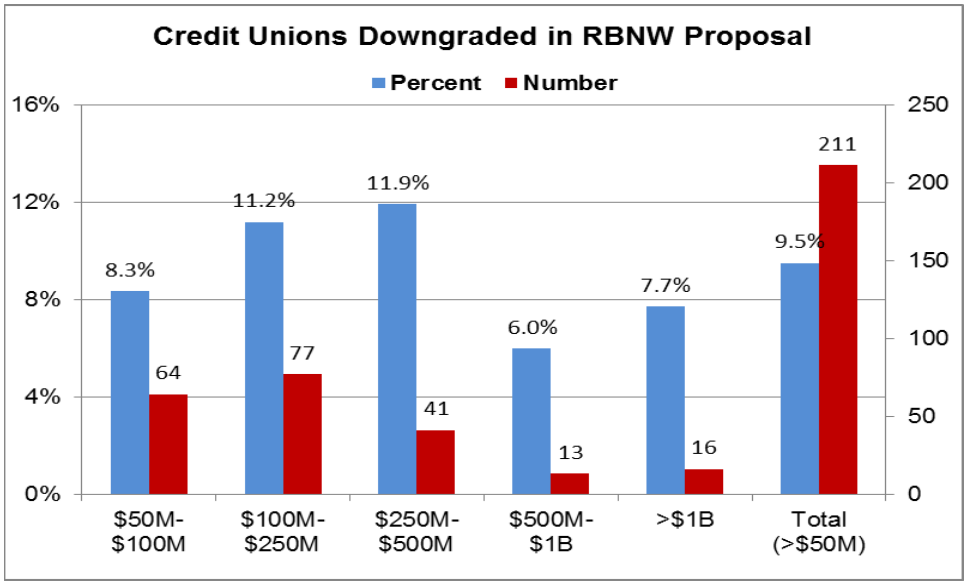
A survey of NAFCU's membership taken in April 2014 found that nearly 60 percent of respondents believe the proposed rule would force their credit union to hold more capital, while nearly 65 percent believe this proposal would force them to realign their balance sheet. If the NCUA implements this rule as proposed, most credit unions will have to hold more capital. This additional capital requirement is not commensurate with the actual risks

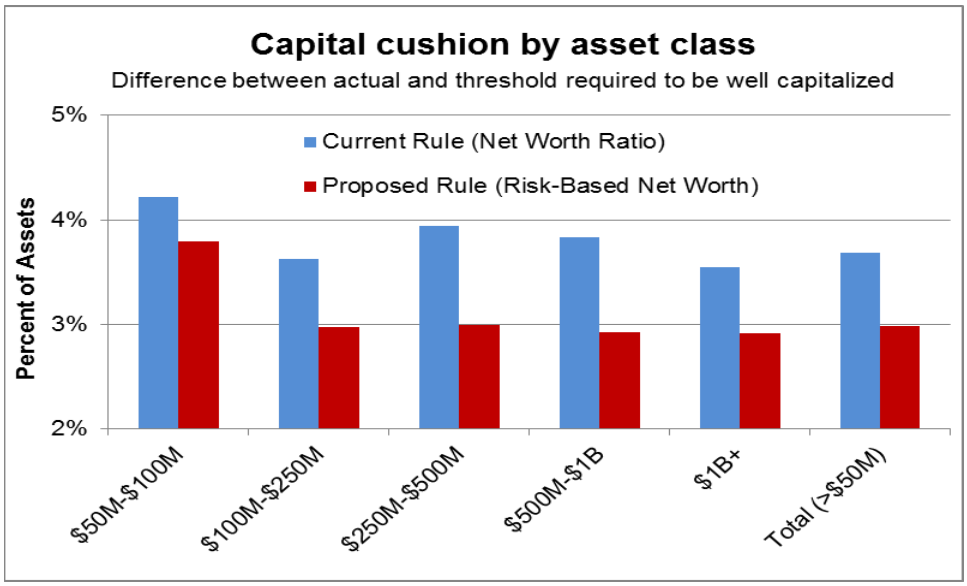
[25] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11188.

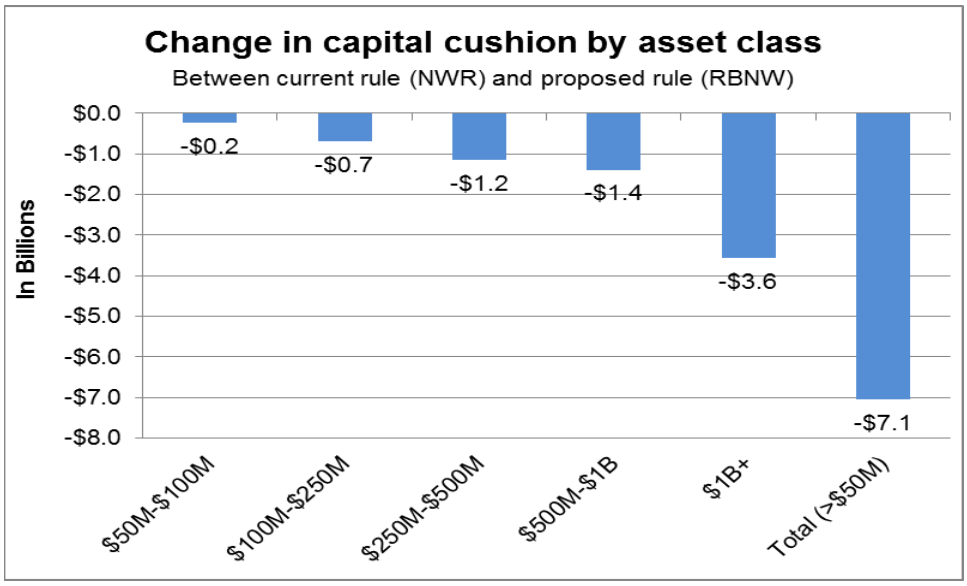
[26] As of December 31, 2013, there are 2,222 FICUs with assets over $50 million. 818 FICU's have a risk-based net worth over 6% and are currently rated as complex.1,404 FICU's have a risk-based net worth less than or equal to 6% and are therefore not considered complex by the current definition, but would be under the proposed rule.

of a credit union's portfolio, nor will it serve the intended purpose of protecting the National Credit Union Share Insurance Fund (NCUSIF).

NAFCU's Economics and Research department prepared the impact analysis graphs found below that outline the impact the proposal would have on credit unions based on asset size. Our analysis of the proposed rule determined that credit unions with more than $50 million in assets will have to hold $7.1 billion more in additional reserves to achieve the same currently maintained capital cushion. Because credit unions cannot raise capital from the open market like other financial institutions, this cost will undoubtedly be passed on to the 97 million credit union members across the country in the form of higher loan rates and lower rates on share accounts.







NAFCU questions whether it is appropriate to finalize a rule that would require credit unions to hold so much more capital as compared with the actual costs to the NCUSIF. Below is a chart that details the number of, and cost to, the NCUSIF of liquidated or assisted merger credit unions by asset class and year for credit unions under $250 million in assets. The total cost to the share insurance fund for all credit unions between $50 million and $250 million in assets from 2003 through 2012 was less than $285 million. This stands out as disproportionate when compared to the $898 million more in additional capital that would be required under the proposed rule for credit unions between $50 million and $250 million in assets to maintain the same capital cushion as in the current rule. Essentially, credit unions would be required to hold $898 million more in capital to maintain the same capital cushion as currently held in order to prevent what was less than $285 million in losses over the past 10 years.

The Number of and Cost to Insurance Fund of Liquidated or Assisted Merger Credit Unions by Asset Class and Year												
	Assets < $250M				Assets < $100M				Assets < $50M			
Year	Number		Cost to Ins Fund		Number		Cost to Ins Fund		Number		Cost to Ins Fund	
2003	13	$	10,158,257		13	$	10,158,257		13	$	10,158,257	
2004	21	$	11,892,786		21	$	11,892,786		21	$	11,892,786	
2005	15	$	15,088,257		15	$	15,088,257		15	$	15,088,257	
2006	16	$	6,717,182		16	$	6,717,182		16	$	6,717,182	
2007	11	$	9,470,960		10	$	7,539,629		10	$	7,539,629	
2008	17	$	32,989,171		16	$	32,989,171		14	$	31,334,427	
2009	26	$	156,497,713		24	$	137,520,215		18	$	36,954,777	
2010	27	$	60,346,866		23	$	26,803,469		23	$	26,803,469	
2011	16	$	52,876,674		14	$	31,100,299		13	$	18,259,280	
2012	21	$	138,544,436		19	$	58,687,421		17	$	48,865,808	
Total	**183**	**$**	**494,582,303**		**171**	**$**	**338,496,687**		**160**	**$**	**213,613,873**	
Source: NCUA FOIA response 13-FOI-00097												

Between the years 2003-2012 there were 190 total credit union failures, but only 7 of these failures were credit unions above $250 million in assets. During this time period, the total number of credit unions under $250 million in assets that failed was 183. However, 160 of those failed credit unions were under $50 million in assets. There were only 23 failed credit unions between $50 million and $250 million in assets during that time period.

Additionally, almost half of the losses to the NCUSIF from 2003-2012 for those credit unions under $250 million in assets were incurred because of failures of credit unions with under $50 million in assets.

This rule will not cover those credit unions with under $50 million in assets. Meaning, if this proposed rule had been implemented prior to those failures, it would not have helped to prevent the losses to the NCUSIF. While holding additional capital for assets that do carry higher risk makes sense in a true risk-based system, holding more capital for the sake of holding more capital is not the solution, and will not prevent failures.

10.5% Risk-Based Capital Ratio

The proposed rule introduces a 10.5 percent risk-based capital ratio requirement in order for a credit union to be categorized as well capitalized. This ratio will make credit unions less competitive than their banking counterparts. NCUA reasons that the proposed "10.5 percent risk-based capital ratio target is comparable to the [o]ther [f]ederal [b]anking [r]egulatory [a]gencies' 8 percent plus the 2.5 percent capital conservation buffer…"[27] The Agency states this was done in order to "avoid the complexity of implementing a capital

[27] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11192.

conservation buffer."[28] In its efforts to avoid complexity, NCUA is proposing an ill-fitting risk-based capital ratio for credit unions.

The impact of the 2.5 percent capital conservation buffer was designed specifically for banks and does not work for credit unions, and will result in an unnecessary additional increase to credit union capital requirements. The banking regulators developed the capital conservation buffer in order to ensure that banks retained capital in times when it was needed most. During the crisis, distressed banks were distributing capital to shareholders and employees even though it was negatively affecting their capital ratios. This led the banking regulators to include a capital conservation buffer of 2.5 percent on top of the Tier 1 risk-based capital ratio minimum level of 8 percent as part of the FDIC rules that become effective over the next five years.

The specific purpose of the capital conservation buffer is to ensure that banks are only able to pay stock dividends and share buybacks if they meet their 2.5 percent capital conservation buffer and not just the 8 percent Tier 1 risk-based capital minimum. This approach to capital distribution does fit the credit union business model.

NCUA failed to include any rationale or data for why it chose to have a 10.5 percent minimum capital requirement to be well capitalized other than to "avoid the complexity of implementing a capital conservation buffer."[29] NAFCU believes that the FDIC Tier 1 ratios are more consistent to the types of capital that credit unions are allowed to hold, as opposed to the FDIC's other risk-based capital ratios, as indicated in the chart below.

Net Worth Classification	**Proposed Risk-Based Capital Ratio**	**FDIC Tier 1 Capital Requirements**	**NAFCU's Alternative**
Well Capitalized	10.5% or above	8% or above	8% or above
Adequately Capitalized	8% to 10.49%	6% to 7.99%	6% to 7.99%
Undercapitalized	Less than 8%	Under 6%	Under 6%

NAFCU believes that unless NCUA provide compelling rationale and/or data to differ from the FDIC rule, NCUA should remove the 2.5 percent capital buffer component of the minimum risk-based capital ratios and make capital categories mirror the FDIC Tier 1 capital requirements.

Risk Weights

The proposed rule revises the risk-weights for many of NCUA's current asset classifications and requires higher minimum levels of capital for credit unions that are perceived as having riskier portfolios. NAFCU and its member credit unions have identified several key areas where risk-weighting in the proposal does not accurately capture the risks associated with the asset in question. In particular, a number of the NCUA proposed risk-weights require credit unions to hold much more capital as compared with the FDIC and Basel III requirements for community banks ─ often without solid justification for the deviations.

[28] *Id.*
[29] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11192.

Concentration Risk and Interest Rate Risk

As discussed above, the FCU Act requires that the system of prompt corrective action that the NCUA prescribes by regulation be comparable to those that the banking regulators institute.[30] In the many iterations of Basel and most recent rules that the FDIC has finalized, banking regulators have chosen not to incorporate interest rate risk and concentration risk into their risk-weights. However, NCUA's proposed rule incorporates concentration risk and interest rate risk into many of its proposed risk-weights. NAFCU acknowledges that interest rate and concentration risk are risks that every credit union needs to manage and plan for, but this rule is not the way to avoid losses due to those risks in the future.

NAFCU urges NCUA to eliminate the interest rate and concentration risk components of the risk-weighting for non-delinquent first mortgage real estate loans, other real estate secured loans, member business loans (MBLs), and investments. Rather, NCUA should change those risk-weights to be consistent with the risk-weighting given to those assets by the FDIC.

A risk-based capital rule is a poor tool for managing these additional risks, and simply requiring credit unions to hold more capital does not address or solve any issues that individual credit unions have when trying to manage those risks. Both Basel III and the FDIC interim final rule are constructed in such a way that authorities would employ other mechanisms to measure and control for risk other than credit risk. In order to comply with the comparability mandate of The FCU Act,[31] NCUA should follow the other federal banking regulatory agencies in this regard.

To better control for interest rate risk, NAFCU believes that a more sensible alternative to the proposed rule would be to continue to apply industry-accepted methods as part of a competent supervision and examination process.[32] Banking regulators have prescribed this as well and by holding credit unions to significantly different standards, NAFCU is concerned that NCUA may be running afoul of the will of Congress regarding the requirement that the rule be comparable to what banks have to follow.

This rule will also constrict capital availability that would otherwise be used for loans to members because credit unions will be required to hold more capital for interest rate and concentration risk. This is harmful to credit unions and to their members. During the financial crisis credit unions continued to lend when banks and other financial institutions pulled back. This rule would constrict the ability of credit unions to lend to members because so much more of their capital would have to be held for interest rate and

[30] 12 U.S.C. §1790d(b)(1)(A)(ii).
[31] *Id*.
[32] NCUA already has a number of requirements and guidance regarding interest rate risk that credit unions must comply with, such as the interest-rate risk final rule, a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (13-CU-01). Instead of making credit unions hold more capital, NCUA should first look to its existing requirements and regulations.

concentration risk. This is another reason this rule puts credit unions at a disadvantage to banks.

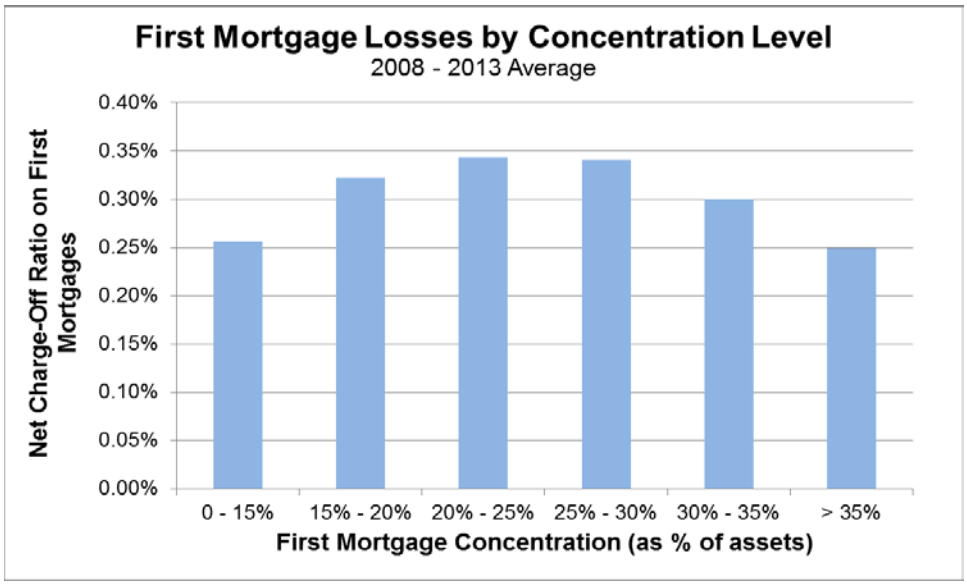
Non-Delinquent First Mortgage Real Estate Loans

NCUA's proposed rule uses the non-delinquent first mortgage real estate loans risk-weights to compensate for concentration risk by increasing the risk-weights to correspond with the percentage of those assets held by the credit union in its portfolio. The FDIC on the other hand, does not take into consideration concentration risk through its capital standards and assigns risk-weights for non-delinquent first mortgage real estate loans at 50 percent regardless of the concentration in the portfolio.

NAFCU believes that in any final rule, NCUA should set all non-delinquent first mortgage real estate loan risk-weights at 50 percent so as to align with FDIC weights as seen in the chart below.

Non-delinquent 1st Lien Real Estate Loans	**NCUA Proposed Risk-Weights**	**FDIC Risk-Weights**
<25% percent of assets	50 percent	50 percent
25 to 35% of assets	75 percent	50 percent
>35% of assets	100 percent	50 percent

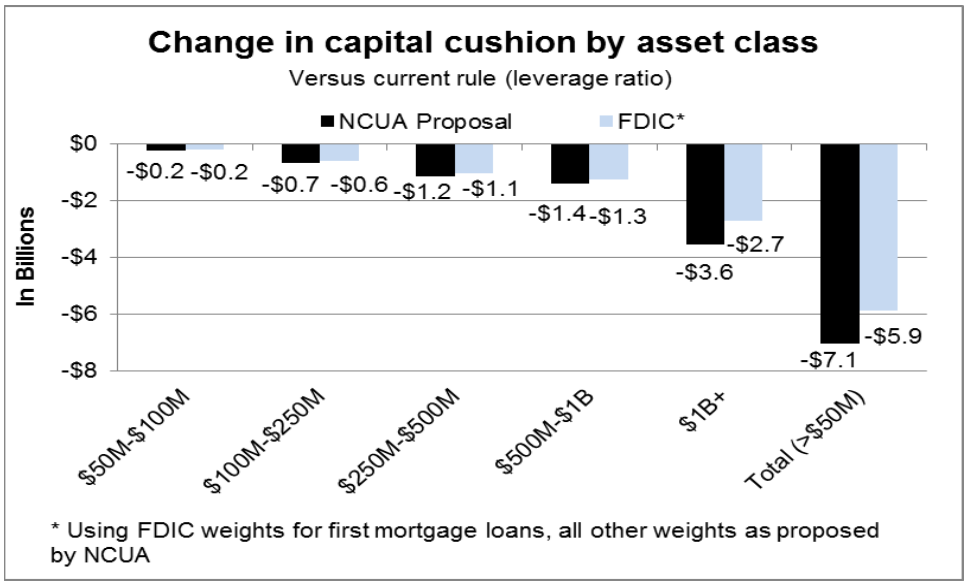
The risk-weights for each asset should also be rooted in the loss histories associated with that asset. When considering whether variable weights to account for concentration risk are warranted, it makes sense to look at the loss history for different levels of concentration for a given asset. Only in the case where higher asset concentrations are shown to result in higher loss histories would there be justification for increased risk-weights. In the case of non-delinquent first lien mortgage loans, the data shows that for different concentration levels, there has been no significant difference in average charge-offs since the onset of the financial crisis. Therefore, NCUA should do away with the risk-weights associated with higher concentrations of non-delinquent first mortgage loans and simply use a single risk-weight – 50 percent – for all outstanding loans.



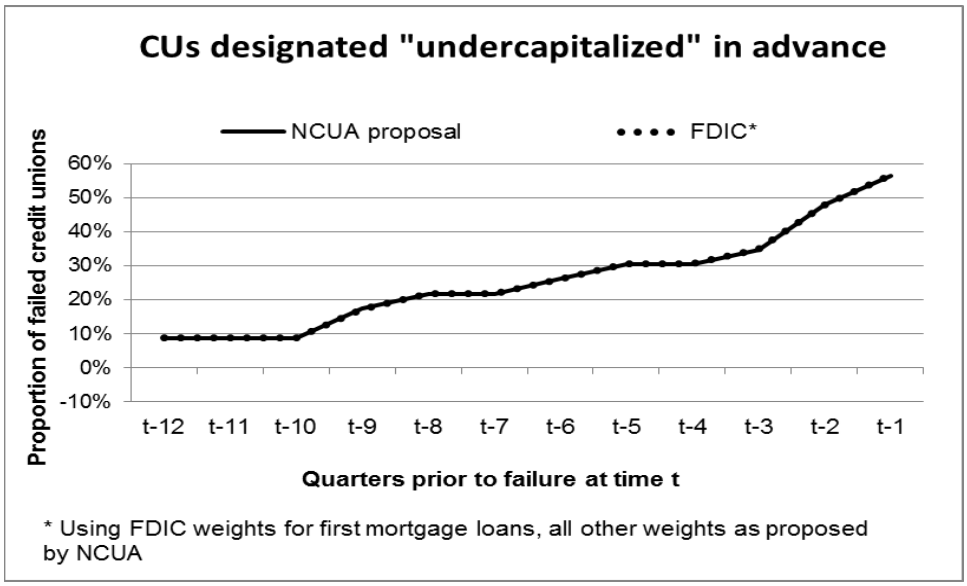
The graph above shows that aggregate losses for the highest concentrated credit unions (the "> 35%" group on the right) are equal to or lower than the losses for any other concentration group. NCUA argues that high concentrations of real estate and MBL loans led to numerous failures during recent years. This one-size fits all approach is not appropriate. Credit unions with high concentrations of mortgage loans on their books do not experience a higher loss rate on those loans than other credit unions, on average.

NAFCU also believes that concentration risk should be controlled through the supervision and examination process and not a one-size fits all capital regime that requires credit unions to hold more capital without allowing those credit unions with less risk to hold less capital.

The next chart shows that the capital cushion for credit unions would still shrink from current levels using FDIC risk-weights for non-delinquent first mortgage real estate loans, but the impact would not be as severe as under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset group above $100 million in assets as compared to the NCUA proposal.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for non-delinquent first mortgage real estate loans. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is no difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for other real estate loans will not detract at all from NCUA's intention that the proposed rule would act as an early warning system for troubled credit unions.



There are a number of other concerns regarding the logical inconsistencies with this one-size-fits-all capital rule. For example, the proposed rule's treatment of real estate presents issues where a credit union may take steps to remove credit and liquidity risk from its portfolio by selling a 30-year mortgage that is currently risk-weighted at 50 percent. If that same credit union were to sell these mortgages to Fannie Mae and take back a Fannie Mae security with an average life of seven years, that mortgage-backed security would be risk-weighted at 150 percent. By doing so, the credit union has minimized its liquidity and credit risk while not providing any more interest rate risk. The result is that the credit union will be required to hold three times as much capital while having a less risky asset. This represents just one of many examples of the proposed risk-weights in this rule that do not match the actual risks posed to the credit union.

Other Real Estate Loans

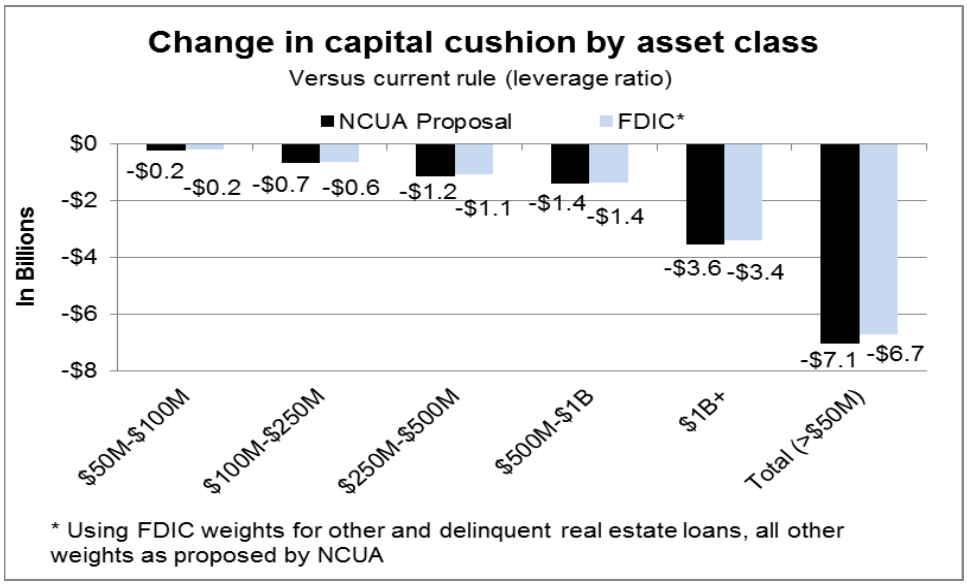
According to the proposed rule, "real estate-secured loans not meeting the definition of first mortgage real estate loans would be referred to as 'other real estate loans.'"[33] In the proposed rule, the risk-weights for these other real estate loans would incorporate concentration risk and increase as the percentage of these assets held by the credit union in its portfolio increases. The FDIC weights for these types of loans are 100 percent regardless of concentration.

NAFCU believes that in any final rule, NCUA should align other real estate loans risk-weights with FDIC weights as seen in the next table.

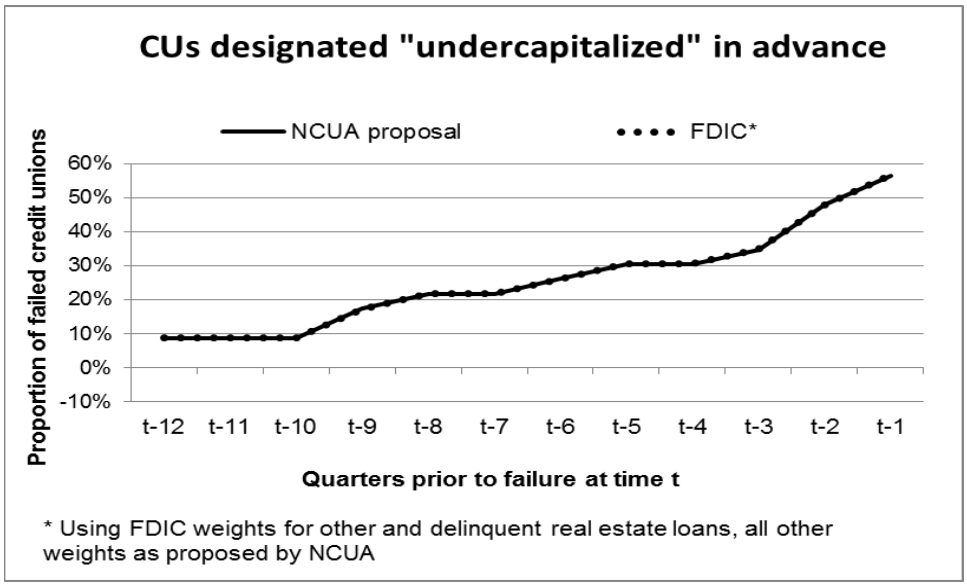
Other Real Estate Loans	**NCUA Proposed Risk-Weights**	**FDIC Risk-Weights**
0-10% percent of assets	100 percent	100 percent
>10 to 20% of assets	125 percent	100 percent
>20% of assets	150 percent	100 percent

The next chart shows that the capital cushion for credit unions would still shrink from current levels using the FDIC weights for other real estate loans, but the impact would not be as severe as under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset level size except $500 million ─ $1 billion (no change) as compared to the proposed rule as seen in the next graph.

[33] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11197.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for other real estate loans. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is no difference between when the NCUA or NAFCU weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for other real estate loans will not detract at all from NCUA's intention that the proposed rule would act as an early warning system for troubled credit unions.



Investments

The proposed rule uses the investment risk-weights to compensate for interest rate risk. This is apparent in the differences in proposed risk-weights for investments based on the Weighted-Average Life of Investments (WAL).

NAFCU has a number of issues with the proposed rule's risk-weights for investments. First, any final rule should eliminate the interest risk component from the capital requirements to align itself with FDIC risk-weights for investments. As noted above, credit unions already monitor and control for interest rate risk through internal policies and in accordance with NCUA examination and supervision policies. It is unnecessary and redundant for a risk-based capital regime to perform this function. This proposed rule is a one-size-fits-all requirement to hold more capital for almost all types of investments as a means to control for interest rate risk. Requiring more capital only serves as a disincentive to invest in longer-term investments, it does not provide the in-depth analysis to evaluate investments that is needed and brought about through the current supervision and examination process. [34]

As NAFCU compares the NCUA proposal to the FDIC requirements for risk-based capital, we note that for those investments that credit unions are permitted to make, the FDIC does not incorporate interest rate risk into the investment risk-weights for community banks. Instead, it generally weights the investments that credit unions can make with a single risk-weight regardless of maturity. FDIC weights most types of investments that credit unions are able to make at a 20 percent risk-weight regardless of the WAL. This is another example of how this rule would put credit unions at a competitive disadvantage to banks. NCUA's proposal also does not account for any mitigation efforts, such as variable-rate assets or derivatives, which would offset some exposure for credit unions to interest rate risk.

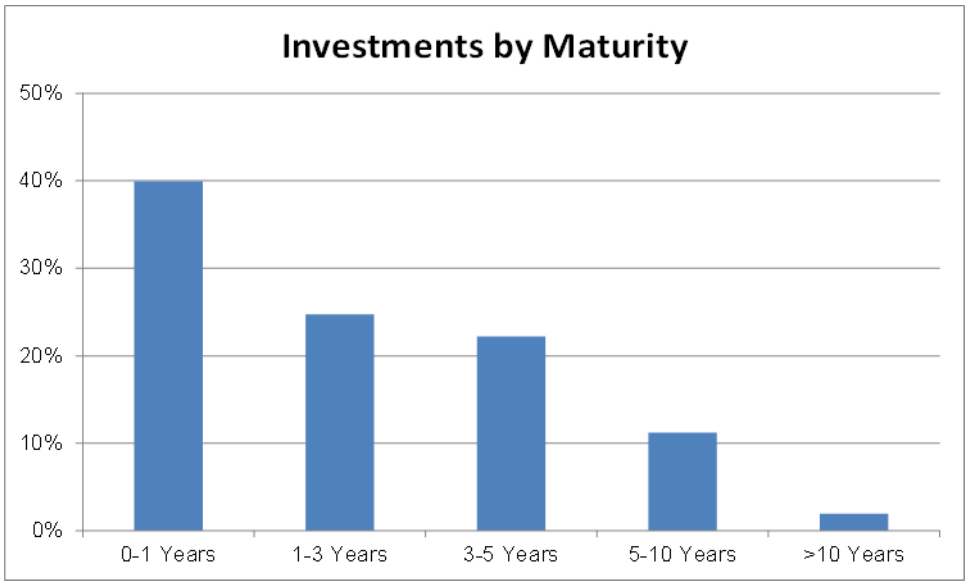
According to the proposed rule, the specific risk-weights are based primarily upon the 300 basis point interest rate shock used to prepare for a worst-case scenario of interest rate fluctuation. This means the NCUA has selected the increments for the investment weight scale to match the loss that would take place due to a 300 basis point interest rate shock. NAFCU believes that this methodology is flawed and does not result in the appropriate risk-weights for investments.

NAFCU strongly believes that NCUA should stay within their statutorily mandate and use the 20 percent FDIC risk-weights for investments regardless of WAL, as illustrated in the next chart.

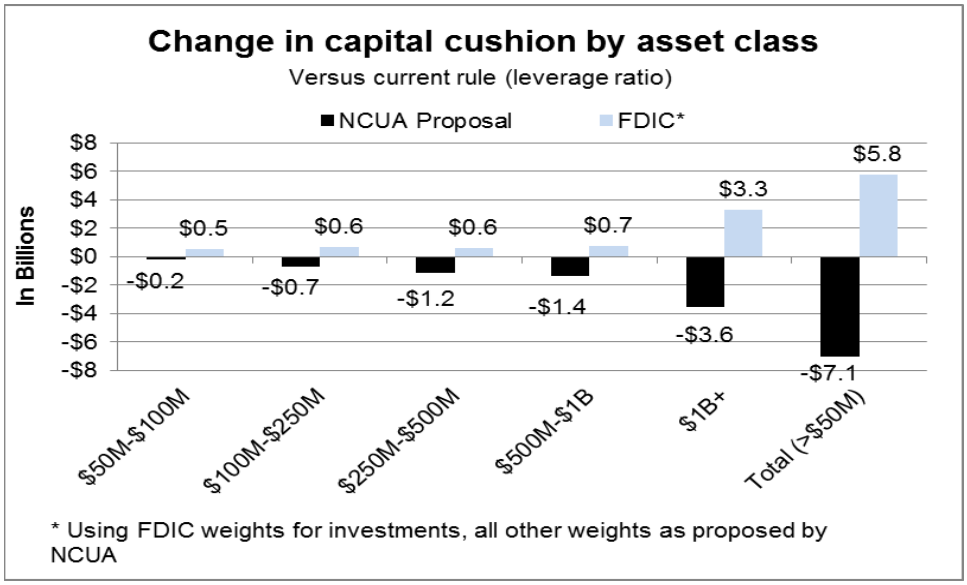
[34] NCUA already has a number of requirements and guidance that credit unions must comply with such as the interest-rate risk final rule, a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (13-CU-01). Instead of making credit unions hold more capital, NCUA should first look to its existing requirements and regulations.

Investments By WAL	NCUA Proposed Risk-Weights	FDIC Risk-Weights
0-1 year	20 percent	20 percent
1-3 years	50 percent	20 percent
3-5 years	75 percent	20 percent
5-10 years	150 percent	20 percent
>10 years	200 percent	20 percent

NCUA should also be mindful of the cooling effects of the final rule on short- and medium-term investments. The chart below shows the distribution of total credit union investments by maturity bucket. Note that only about 13 percent of credit union investments have an average life of over five years.

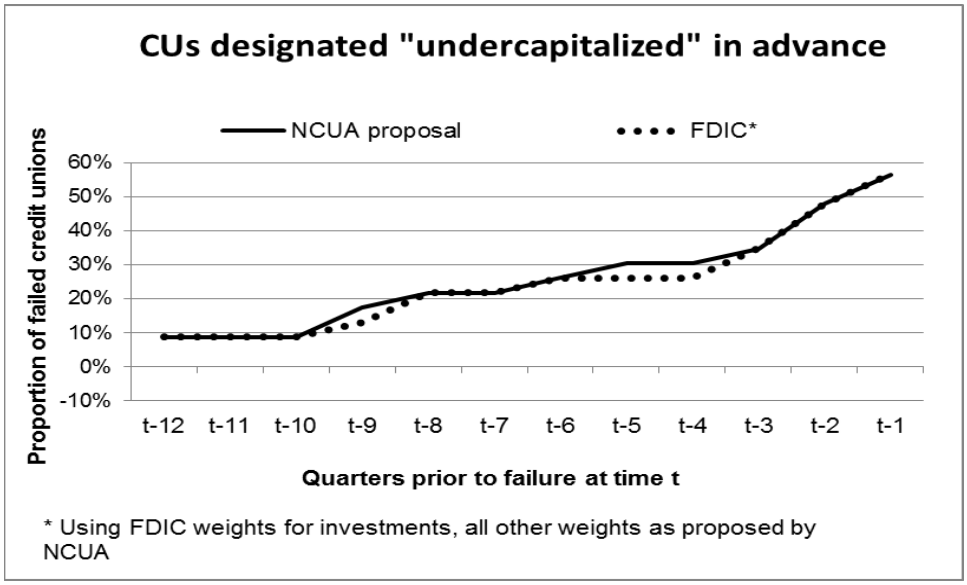


The FDIC risk-weights would benefit the capital cushion for credit unions at every asset level size as compared to the proposed rule. This is illustrated in the next graph.



Changing the risk-weighting to the FDIC risk-weights does not significantly affect the warning available prior to a failure of a troubled credit union. The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights. This proportion is tracked over the twelve quarters prior to a credit union's failure, serving as an early warning sign to NCUA that capital issues were on the horizon.

As the graph on the next page shows, using the FDIC risk-weights for investments would result in negligible changes in the early warning signs for troubled credit unions as compared to the proposed rule. As illustrated, the alternative investment risk-weights deviate only slightly in the t-6 through t-3 and t-10 through t-8 timeframes prior to failure.



To summarize, NAFCU strongly urges NCUA to remove the interest rate risk component from any final rule. Interest rate risk should continue to be controlled for and monitored through the supervision and examination process, continuing to incorporate industry standard methods. Finally, NCUA should use the FDIC risk-weights of 20 percent for investments regardless of the WAL of the investment.

Federal Reserve Deposits

The proposed rule does not specifically identify how cash held at the Federal Reserve is to be treated. The rule does address how cash on deposit (which is normally interpreted as cash on deposit at other insured financial institutions), cash equivalents, and cash on hand are to be treated, but does not propose a specific risk-weight for cash held at the Federal Reserve. Credit unions often have balances at the Federal Reserve as a repository for excess cash or to satisfy their minimum reserve requirement.

NAFCU believes that cash held at the Federal Reserve should have a risk-weight of zero percent. A zero percent risk-weight would take into account the Federal Reserve's unique relationship with the U.S. Government. NCUA should risk-weight all balances held at the Federal Reserve at zero percent.

Federal Home Loan Banks

The proposed rule also does not specifically address Federal Home Loan Banks (FHLB). NAFCU believes that the proposed rule could risk-rate FHLB consolidated obligations and stock from 20 percent to 200 percent creating a distinct disadvantage when compared to other insured depository institutions and potentially restricting credit extensions to the communities served by credit unions.

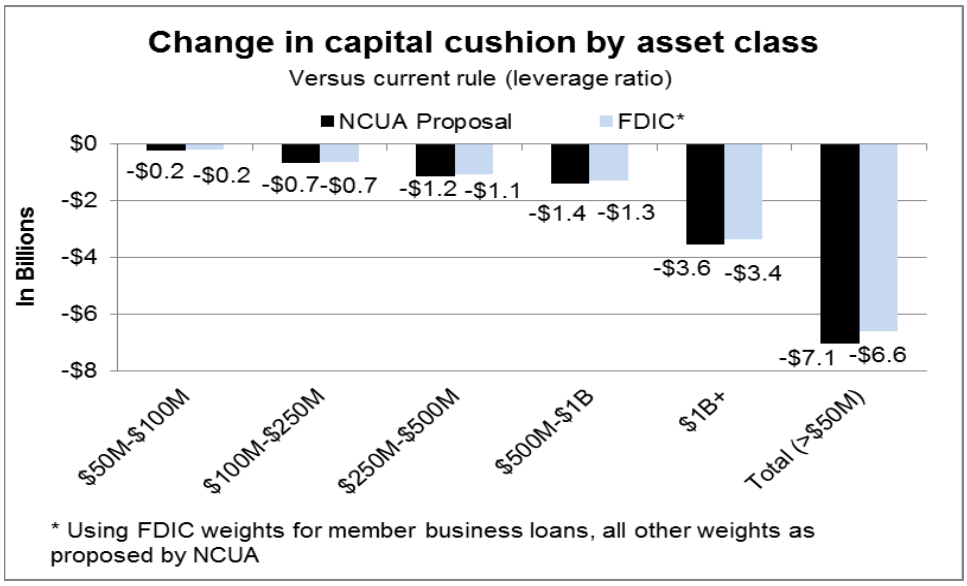
NAFCU notes that the risk weighting for FHLB consolidated obligations (highly liquid and safe – generally rated AAA and track treasuries) and FHLB stock (statutorily mandated to be redeemed at par and no member has ever lost a cent on stock) are weighted at 20 percent under Basel and by the other banking regulators. NCUA should weight FHLB consolidated obligations and stock at 20 percent to be comparable to other banking regulators.

Member Business Lending

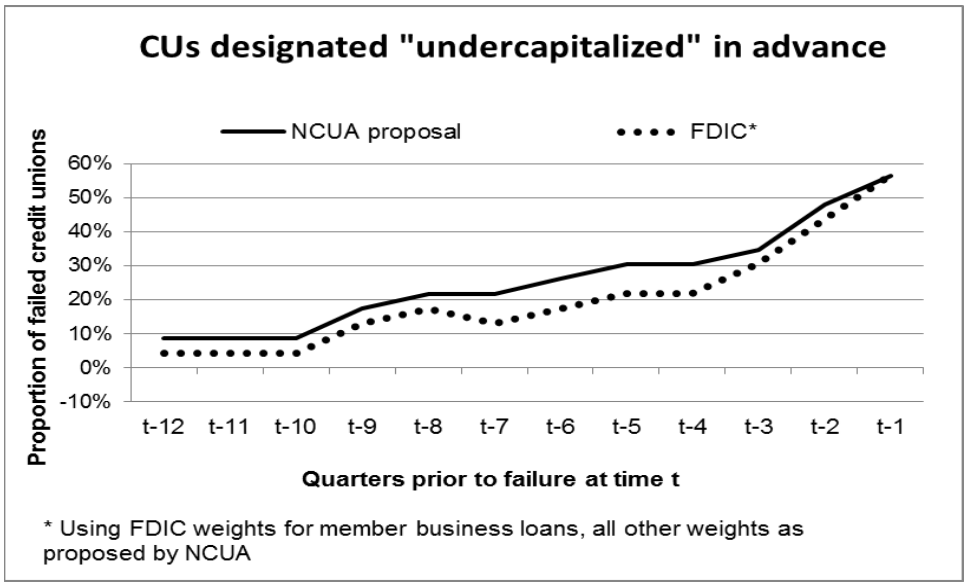
The proposed rule factors concentration risk into the proposed risk-weighting for MBLs by setting the risk-weights to correspond with the percent of assets in MBLs held by the credit union. As mentioned above, NAFCU believes that concentration risk should be controlled through the supervision and examination process and not a one-size-fits-all capital regime that requires credit unions to hold more capital without allowing those credit unions with less risk to hold less capital. The FDIC does not take concentration risk into consideration and risk-weights all business loans at 100 percent. NAFCU believes that NCUA should follow the FDIC and risk-weight MBLs at 100 percent regardless of the concentration of credit union's assets in MBLs as seen in the chart below.

MBL's as % of CU Assets	**NCUA Proposed Risk-Weights**	**FDIC Risk-Weights**
0-15% percent of assets	100 percent	100 percent
>15 to 25% of assets	150 percent	100 percent
>25% of assets	200 percent	100 percent

The next chart shows that the capital cushion for credit unions would still shrink from current levels using the FDIC weights for MBLs, but the impact would not be as severe as it would be under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset level size above $250 million as compared to the proposed rule as seen in the next graph.



The next chart uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for MBLs. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is very little difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for MBLs will only slightly change the early warning system indications for troubled credit unions as compared with NCUA's proposed rule.



Furthermore, there are a number of credit unions chartered historically for business-loan purposes that will be significantly hurt by this proposed rule. The risks to the portfolios of these special credit unions, including concentration risk, should be managed through the examination and supervision process, not through these capital risk-weights. NAFCU

believes that credit unions with proven minimal losses in business lending should be given credit for diversified portfolios and proven underwriting standards. Additionally, the proposed risk-weights would negatively impact credit unions with the low income credit union designation (LICUs), which are not subject to the statutory MBL cap. These LICUs would have a disincentive to utilize their ability to exceed the MBL cap in order to provide business loans to their members due to the restrictive requirements to hold more capital.

The proposed rule states that "MBLs that are government guaranteed at least 75 percent, normally by the Small Business Administration (SBA) or U.S. Department of Agriculture, would receive a lower risk-weight of 20 percent under the proposed rule."[35] This 75 percent threshold does not include beneficial programs that are guaranteed at between 50 percent and 75 percent such as the SBA Express program which helps many member small businesses. NCUA should factor in all guarantees made by the SBA or U.S. Department of Agriculture when determining risk-weighting for MBLs.

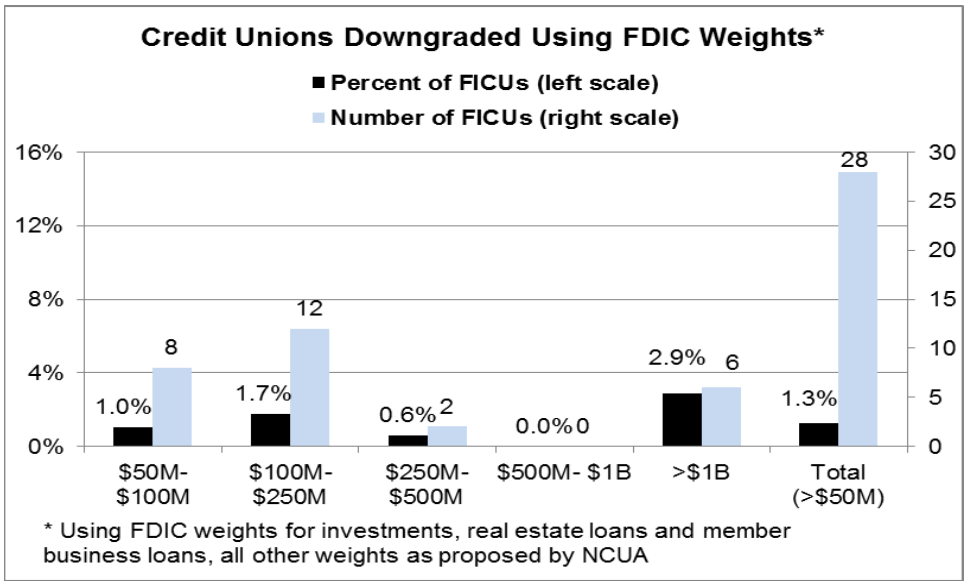
Another issue that NCUA has failed to address with this proposed rule is the difference risks based on the types of MBL loans by category. For example, risk-weights could also be broken down into types of loans using call report data and given appropriate risk-weights based on actual risk for the following categories: (1) agricultural MBLs; (2) construction and development; (3) non-farm, non-residential; (4) commercial and industrial loans; and (5) unsecured business loans. At this time the call report does not collect information on write-offs for different types of MBLs, but NCUA could modify the call report to collect this information.

The Effects of Combined FDIC Weights

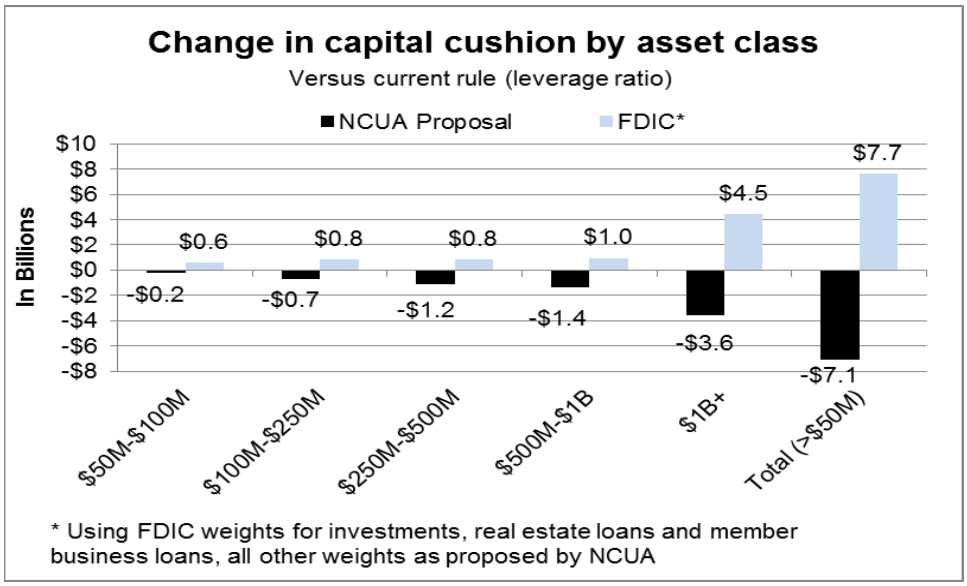
As shown in the sections above, NAFCU believes that NCUA should use the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs rather than the NCUA's proposed risk-weights that incorporate interest rate and concentration risk. While previous graphs show the industry wide benefits to credit unions of changing the individual risk-weights from what was proposed by the NCUA to the FDIC risk-weights, the following graphs show the *combined* benefit of changing the proposed risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs to FDIC risk-weights.

This first graph shows the number and percent of credit unions that will be downgraded by asset class as a result of changing non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs to FDIC risk-weights. 28 federally insured credit unions will be downgraded as opposed to more than 200 which would be downgraded under the proposed rule. NAFCU believes that this is a more appropriate result and represents a more balanced system.

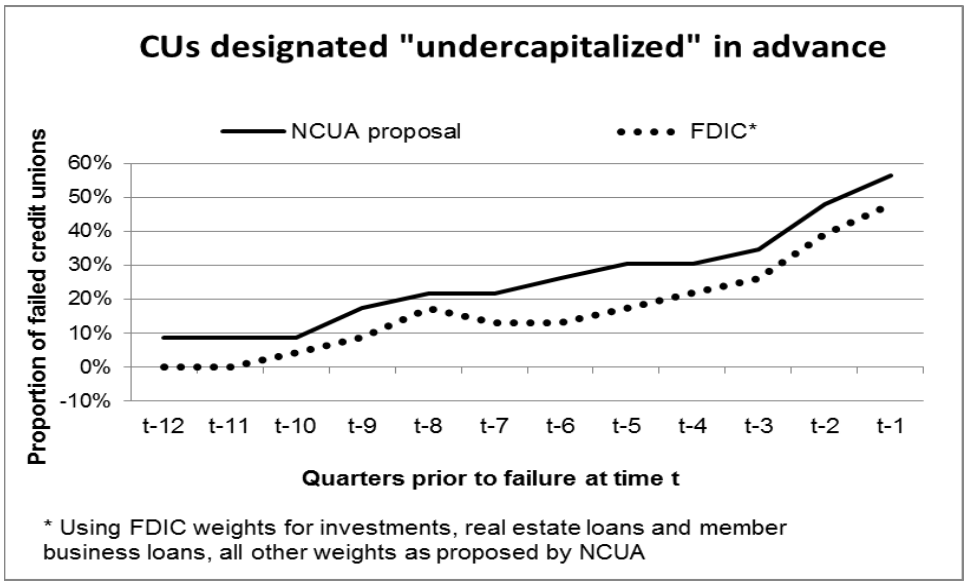
[35] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11196.



The next graph shows the change in capital cushion by asset class as a result of changing the individual risk-weights from what was proposed to the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs. It shows a benefit to credit unions capital cushion for credit unions in every asset category as compared to the proposed rule.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is very little difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure.



Importantly, changing the risk-weighting for these assets to the FDIC risk-weights does not compromise the NCUA's stated intent for the proposed rule to serve as an early warning system for troubled credit unions. Using the FDIC risk-weights will still accomplish this essential function of a balanced risk-based capital system. NAFCU strongly believes that NCUA should align the risk-weights for these assets with the FDIC risk-weights.

Credit Union Service Organizations (CUSOs)

The proposed rule sets a 250 percent risk-weight for investments in CUSOs and 100 percent for loans to a CUSO. In the proposed rule, NCUA does not include rationale as to why investments in CUSOs should get a proposed risk-weight of 250 percent except to say that a CUSO is an unsecured equity investment with no secondary market. Any final rule should include more detailed rationale, as well as any data used to support the final risk-weight.

The proposed rule also fails to explain the difference in proposed risk-weights between the 250 percent for investments in CUSOs and 100 percent for loans to CUSOs. This would suggest that loans to CUSOs are 2.5 times safer than investments in CUSOs, or in the reverse, that investments in CUSOs are 2.5 times riskier than a loan to a CUSO. Consumer debt that is over sixty days delinquent is currently rated at 150 percent while investments in a CUSO are rated at 250 percent.

Although there have been a couple of high-profile credit union losses partially driven by bad CUSO investments, the overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale, and providing much needed non-interest income to the credit union owners. During a time of increased regulatory costs, shrinking fee income, and artificially depressed interest rates, it is imperative that credit unions are able to use CUSOs to decrease overhead costs while increasing business.

NCUA's argument that CUSOs represent a safety and soundness threat to the NCUSIF is also without merit. Less than 22 basis points of credit union assets are invested in CUSOs

and do not represent a systematic risk that could take down the share insurance fund. Those same 22 basis points are less than what credit unions have paid in annual corporate assessments in 2012. Each credit union may only invest less than 1 percent of its assets into CUSOs.[36] For example, suppose that in an unlikely scenario a credit union lost its entire investment in a CUSO. This loss alone would not be material and the consequences of requiring a disproportionate amount of capital, as compared with actual risk, are more far reaching as credit unions will not enjoy those cost savings made available only through the collaborative model of CUSOs.

NCUA is making policy decisions that affect business decisions for credit unions through these proposed risk-weights. This proposed rule could force credit unions to reconsider current and future investments in CUSOs. Credit unions might divest currently held investments and not invest in future CUSOs. This will hurt members and credit unions alike.

If NCUA declines to lower the risk-weighting to a reasonable level for investments in CUSOs, NCUA should at least consider differentiating between different types of CUSOs and assessing a risk-weight that accurately measures the risk of loss. Some of the possible factors to consider would be the types of services provided by a given CUSO (mortgage servicing, IT, compliance, etc.), whether the amount of investment is material, whether the CUSO has a history of profitability or loss, or whether the investment has already been recovered by the credit union through income or savings. Then NCUA could provide lower risk weights for CUSOs that present less of a risk to credit union assets.

Mortgage Servicing Assets (MSA)

The proposed rule would set the risk-weight at 250 percent for mortgage servicing assets (MSAs). This is an artificially high and excessive risk-weight relative to the actual risk presented by the underlying assets. The 250 percent weight is punitive and indicates a change in NCUA's view regarding loan participations.

Last year NCUA finalized a rule on loan participations that was intended to help credit unions and NCUA better manage the potential concentration risk in loan participations. The loan participation rule is working and should be allowed to continue to do so instead of assigning artificially higher risk-weights for mortgage servicing assets.

The proposed rule does not include a mechanism for NCUA to differentiate between an asset that is sold with recourse versus one that is sold without recourse. This would change the actual risk to a credit union depending on the underlying loans in a mortgage servicing asset. This one-size fits all approach does not appropriately measure actual risk.

MSAs are fairly liquid and gain value as rates rise. These present excellent opportunities to gain income and help prevent against some forms of interest rate risk. Also, credit unions do a great job servicing loans and want to continue to serve members. Many credit unions originate loans and then sell those loans to reduce interest rate and liquidity risk, yet retain

[36] 12 CFR 712.2(a).

the servicing due to the relationship with the member and because these are valuable assets. This arbitrary risk-weight provides a disincentive to retain those servicing rights.

NAFCU believes that NCUA should set the risk-weights for mortgage servicing assets at 150 percent. NCUA should also find a way to consider whether the loan is a recourse loan and assign those a 150 percent risk-weight. NCUA could then allow a lower weighting of 100 percent if the loans are sold without recourse but are serviced by the credit union.

Corporates Paid-In Capital

The proposed rule would set a risk-weight for paid-in corporate capital at 200 percent. This is one of the higher risk-weights proposed by this rule and does not appear to accurately represent the unique nature of corporate credit unions.

The corporate credit unions have had more regulatory changes over the past five years than any other sector of the credit union system including additional capital requirements. These changes include: stricter investment limits, concentration risk prohibitions, and governance changes. These prior regulatory changes to the corporate credit union system and the eliminated risks should be represented through a lower risk-weight.

The proposed risk-weight does not reflect the actual risk of this asset. The proposed rule suggests that corporate paid-in capital is two times as risky as a dollar invested in a mortgage loan in excess of 35 percent of assets. This could also serve as a disincentive to credit unions to invest in corporate credit unions and thereby endanger the current corporate credit union structure.

A weight that reflects the actual risk for paid-in capital to corporate credit unions would benefit natural person credit unions, corporate credit unions, and the share insurance fund. Paid-in capital would be more appropriately weighted at 125 percent to recognize that the corporate credit union structure is different than it once was, and now presents less risk to the credit union system. The 125 percent also recognizes that the corporates paid-in capital is riskier than safer investments such as treasuries or consumer loans.

Individual Minimum Capital Requirements

The proposed rule provides NCUA with the ability to require a higher minimum risk-based capital ratio for an individual credit union in any case where the Agency determines the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. This means NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is, or may become, inadequate in light of the credit union's circumstances, regardless of the actual risk-based capital ratio of the credit union.

In other words, NCUA can increase a credit union's individual risk-based capital requirement by subjective action through the examination process or "supervisory assessment" based on the determination that the credit union needs additional capital based

on the credit union's balance sheet risk. A survey of NAFCU's membership taken in April 2014 found that over 65 percent of respondents have serious concerns about this portion of the rule.

NAFCU believes there are serious concerns regarding the legal authority of NCUA to enact this portion of the rule, as discussed above.

In addition to potential legal issues, this portion of the proposal seems to undermine the stated purpose of the rule. On the one hand, credit unions are led to believe that the proposal is designed to factor in a number of different risks including interest rate and concentration risk. On the other hand, if the risk-based capital ratios laid out in the proposal do not result in the numbers NCUA examiners would like to see, NCUA can change the rules for an individual credit union. This makes it nearly impossible for a credit union to make a sound business decision concerning its portfolio makeup, leading to even more uncertainty for credit unions and credit union members.

Individual Minimum Capital Requirement Appeals Process

The proposed appeals process does not alleviate any of the underlying concerns with the individual minimum capital requirements portion of the rule. The process itself lays a great deal of burden on individual credit unions to prove that the NCUA action was not an appropriate exercise of discretion by the Agency. The process also requires credit unions to appeal to the same NCUA Board that, according to statute, is required to make the judgment in the first place.

While the proposed rule allows credit unions to seek the opinion of the NCUA's Ombudsman, the NCUA Board is not bound by, or required to give deference to, the Ombudsman's recommendations. NAFCU believes that NCUA should enact an independent appeals process free of examiner retaliation. It is important that the independent appeals process include appeals to non-interested parties that do not have an opportunity to retaliate against individual credit unions that make appeals.

Goodwill and Other Issues

The proposed rule fails to include a number of components to the numerator portion of the risk-based capital ratio including goodwill, other intangible assets, and identified losses not reflected as adjustments to components of the risk-based numerator.

The loss of goodwill within the risk-based capital ratio numerator presents two significant issues to consider. First, it penalizes credit unions for past actions. Goodwill is present on the balance sheets of credit unions recently involved in mergers. Without goodwill, credit unions will be unable to fully realize the benefit of merging in troubled credit unions.

Secondly, this can present significant problems in the future. The credit union industry has seen increased consolidation in the past few years and this is a trend that is likely to continue. Without goodwill as a component of the numerator, a healthy credit union is less likely to agree to take on a troubled credit union as a partner (even at the request of

NCUA). This is going to make it harder and more expensive for NCUA (and the industry as a whole) to find merger partners for troubled or failing credit unions that will ultimately lead to more expensive liquidations for the NCUSIF.

NAFCU believes that NCUA should reconsider removing goodwill from the numerator portion of the risk-based capital ratio.

Allowance for Loan and Lease Losses

In the capital elements of the risk-based capital ratio numerator, the proposed rule limits ALLL to 1.25 percent of risk assets. The discussion in the rule states this limitation is proposed to provide an incentive for granting quality loans and recording loan losses timely. The disregard for excess ALLL does not provide an equitable solution.

Credit unions are generally more conservative than banks when it comes to ALLL. This cap of 1.25 percent will penalize a credit union for being conservative with its allowance and provide a disincentive for holding ALLL above the 1.25 percent cap.

NAFCU encourages NCUA to consider changing the 1.25 percent cap to 1.50 percent of risk assets to provide a better incentive for fully funding ALLL above 1.25 percent. In addition, in the most recent Financial Accounting Standards Board (FASB) proposal on ALLL (the Current Expected Credit Loss model), issued in December 2012, if put into place, has the potential to significantly increase ALLL reserves by as much as 20-50 percent. If those changes are put into place, NCUA should increase the limit of ALLL to be included in the risk-based capital numerator comparable to the additional levels of ALLL required.

Supplemental Capital

Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule. NCUA should continue to call on Congress to pass a legislative solution that modernizes capital standards to allow supplemental capital.

Currently, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth ─ such as growth resulting from taking deposits ─ can dilute a credit union's regulatory capital ratio and trigger non-discretionary supervisory actions under PCA rules. Allowing eligible credit unions access to supplemental capital, in addition to retained earning sources, will help ensure that healthy credit unions can achieve manageable asset growth and continue to serve member-owners efficiently.

While supplemental capital authority is important for those credit unions that are able to raise it, it is important to understand that supplemental capital authority is not the answer to all of the problems with this proposed rule. There is a difference between the authority to raise supplemental capital and the ability of individual credit unions to actually obtain it.

Not every credit union would be able to use that important tool to actually raise significant capital even if the credit union were given the authority to do so.

Implementation Date

NCUA has proposed an implementation time period and effective date of 18 months after the passage of a final rule and its publication in the *Federal Register*. During that 18 months implementation period, credit unions would need to prepare balance sheets for the new risk-based capital ratio requirements, and would also be required to continue to comply with the current PCA requirements of part 702 on NCUA's rules and regulations.

NAFCU believes that the proposed 18-month implementation timetable is not long enough for a rule as complex and impactful as this proposed rule. The proposed revisions to net-worth and capital requirements will vastly affect a credit union's decision making and it will take time for a credit union to adjust its balance sheets related to this new regulation. Credit unions will also need to adjust internal systems and operations well in advance of the effective date.

Credit unions will be faced with difficult decisions when attempting to raise risk-based capital ratios under the proposed rule. Credit unions will have to either divest assets that are more heavily risk weighted or generate retained earnings. It is difficult to generate retained earnings in a short period of time when credit unions are being forced to divest the assets that have the largest returns and produce the most retained earnings.

When comparing NCUA's proposed timeframe and the time frame afforded to banks during the implementation of BASEL standards, it is evident that the proposed implementation timeframe is insufficient. Given the difficulties that credit unions will face to accumulate additional capital through retained earnings, a longer time frame for the implementation of this rule is necessary.

NAFCU believes any implementation period should be no less than three years after passage of any final rule. Credit unions will need at least that long to make safe and sound decisions about potentially fundamental changes to core business decisions including investments and product offerings. This would also be more consistent with the time frame given to the banking industry during the BASEL standards implementation. On September 10, 2013, the FDIC issued a consolidated interim final rule (Basel III interim final rule) and its final rule was issued on April 14, 2014. While some portions of the rule take effect as soon as two years after the final rule, all portions of the rule do not become fully effective until January 1, 2019, almost five years after the rule was finalized.

Conclusion

In conclusion, NAFCU is supportive of the idea of a risk-based capital regime for credit unions; however, the current NCUA proposal does not achieve the desired system and would ultimately harm credit unions. If it were to be implemented as proposed, credit unions would be at a significant competitive disadvantage to banks. As proposed, the rule is one-size-fits-all and would serve to stifle growth, innovation, and diversification at

credit unions. NAFCU hopes that the NCUA Board will ultimately withdraw the proposal and work with Congress to modernize capital standards in accordance with the recommendations in NAFCU's "Five Point Plan for Regulatory Relief"

Alternatively, should the NCUA Board fail to withdraw the proposal, it should remove the interest rate and concentration risk components that are currently incorporated into the risk weightings and lower the risk-weights to accurately reflect the risk associated with specific assets and to become comparable to the standards of other banking regulators. The NCUA Board should also remove the provision regarding individual capital requirements as this authority rests on questionable legal grounds and its inclusion increases uncertainty for credit unions.

Thank you for your continued commitment to listen to feedback from credit unions on this important issue. Should you have any questions or would like to discuss these issues further, please feel free to contact me or PJ Hoffman, Regulatory Affairs Counsel, at PJHoffman@nafcu.org or (703) 842-2212.

Sincerely,

B. Dan Berger
President and CEO
National Association of Federal Credit Unions

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