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

RE: Comments on Capital Adequacy- 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 National Credit Union Administration's (NCUA) proposed rule to amend Part 702 of the agency's regulations on prompt corrective action (PCA) and risk-based capital (RBC). *See* 80 FR 4340 (January 27, 2015). While NAFCU and our members support the idea of an RBC regime for the credit union industry, we firmly believe this proposal is inappropriate and will only impose more regulatory burden on an already extremely well-capitalized industry.

If implemented as proposed, this RBC structure would stifle growth, innovation, and diversification within credit unions. As discussed in detail in this comment letter, NAFCU urges the NCUA Board to withdraw the proposal in its entirety. Alternatively, we recommend that the agency make major modifications before any rule is finalized. Additionally, NAFCU and our members request that NCUA support legislative reform to bring about a truly appropriate risk-based system for credit unions. As the agency is aware, the *Regulatory Relief for Credit Unions Act of 2013* included NCUA-supported language that would have brought about such reform. We call on the agency to work with Congress to enact such language before moving forward with an RBC regulatory regime.

General Comments

NAFCU wants to be clear – we support an RBC system for credit unions that would reflect lower capital requirements for lower-risk credit unions and higher capital requirements for higher-risk credit unions. However, we continue to believe that Congress needs to make statutory changes to the *Federal Credit Union Act* (FCU Act) in order to achieve a fair system. Such a system should move away from the static net-worth ratio to a system

where NCUA joins the other banking regulators in having greater flexibility in establishing capital standards for institutions. We also believe that capital reform must include access to supplemental capital for all credit unions.

NCUA, however, has chosen to proceed with a rulemaking that fails to achieve an appropriate risk-based system for credit unions. Further, NCUA has failed to consider the true impact this rulemaking would have on the entire credit union industry. Although NCUA estimates that only 19 credit unions would be downgraded if the proposal were in place today, NAFCU and our members believe that this proposal will impose astronomical costs and burdens on all credit unions. NAFCU believes that NCUA cannot look at the impact of the proposal in a vacuum and merely consider how many credit unions would be downgraded or forced to hold more capital. Instead, we believe the true impact of the proposal can only be measured by examining how it will impact the long term growth and strategic planning of all credit unions.

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

- NCUA's drastic understatement of credit unions negatively impacted by this rulemaking;
- NCUA's legal authority to prescribe separate RBC thresholds for "well capitalized" and "adequately capitalized" credit unions;
- NCUA's legal authority to require individual credit unions to hold capital above those required by statute or rulemaking;
- NCUA's use of a $100 million asset threshold as a proxy for "complex," rather than considering a credit union's portfolios of assets and liabilities;
- NCUA's proposed RBC ratio for "well capitalized" set at 10 percent;
- NCUA's treatment of risk-weighted assets, such as investments in CUSOs, mortgage servicing assets, and corporate paid-in capital;
- Components not included in the numerator portion of the RBC ratio, such as goodwill;
- The need for NCUA to promulgate a rule allowing all credit unions access to secondary capital for risk-based purposes;
- The need for a legislative solution to achieve a fair and balanced RBC system; and
- NCUA's existing supervisory and examination mechanisms provide the agency the appropriate ability to control interest rate risk at individual credit unions.

Impact Analysis

NAFCU has spoken individually with many of our members about how the proposal will affect the compositions of their balance sheets, as well as the products they will be able to provide, or some cases not provide their consumers. Our members believe this rulemaking is not only unnecessary given how extremely well-capitalized the industry is today, but they also fear this proposal will unjustifiably constrain their ability to grow and serve their communities. To illustrate these concerns, NAFCU would like to share the stories of two

of our member credit unions who we feel represent how this rulemaking will impact credit union growth and the member-service the industry will be able to provide to its nearly 100 million consumers. We have also analyzed how this proposal would severely hinder the industry's ability to weather any financial downturn in the future.

Impact on Credit Union Growth

A $500 million, well-capitalized NAFCU member credit union has indicated that this proposed rulemaking will prevent it from pursuing safe, conservative and effective growth opportunities both within its institution, and its larger community. This community chartered credit union currently serves over 50,000 members and employs over 150 people.

As part of its employee benefits program, this credit union currently maintains a defined-benefit plan, which it overfunded by 300 percent so the earnings on this asset offset premium deposits. As the costs of health insurance continue to rise, the credit union is looking for opportunities to offset these additional costs in order to ensure that it can provide crucial employee benefits at reasonable costs. To achieve this goal and keep revenue on the fund growing, the credit union is considering investing in Banked-Owned Life Insurance (BOLI) to help further offset the costs of employee benefits. Under the proposal, however, such an investment would cause the credit union's RBC ratio to drop by almost 5 percent.

Further, the credit union is also considering establishing member business lending (MBL) and loan participation programs to meet the lending needs for its community. Again, such a decision would cause the credit union's RBC ratio to drop by almost 5%. Because of the proposal, this credit union will likely choose to not pursue these safe, sound, and effective growth opportunities, which could result in reductions to its employee benefits plan and lending capacity.

Impact on Credit Union Members

Another NAFCU member credit union, with about $200 million in assets, has expressed concerns about how the proposal will impact its consumers. This community chartered credit union serving over 16,000 members is located in the Northeast, an area which suffered severe weather-related damages over the past several years. As a result, many of this credit union's members rely on the credit union for funding to make requisite repairs to their damaged homes.

Because of the proposed concentration thresholds for real estate-related loans, this credit union has indicated that it will likely have to turn away members seeking Home Equity Lines of Credit (HELOCs), as the credit union cannot build the necessary capital required by the elevated concentration thresholds. Access to liquidity for home repairs is a vital service that this credit union provides its members. Sadly, the proposal may hinder this credit union's ability to provide such a fundamental service to its community – a community that is in desperate need of funding. NAFCU and our members believe that

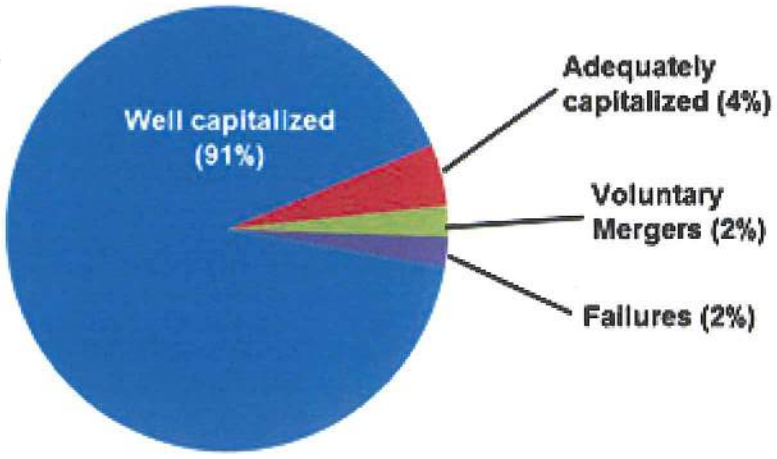
credit unions should not be prevented from providing that funding in a safe and sound manner because of arbitrary concentration thresholds.

Impact During Financial Downturn

While NCUA estimates that 19 credit unions would be downgraded if the proposal were in place today, NAFCU believes its real impact is best illustrated through the stories detailed above. We also examined the proposal's impact with a look at its implications during a financial downturn. Under the proposal, the number of credit unions downgraded more than doubles during a downturn in the business cycle. While NAFCU acknowledges that this analysis hinges on various assumptions because several proposed risk weight components are not currently available from Call Report data, NAFCU made conservative assumptions that provide an appropriate analysis of the how a credit union's RBC ratio would vary during a financial downturn.

Under our analysis, NAFCU estimates that 45 credit unions would have been downgraded during the most recent financial crisis if this proposal had been in place in 2009. Of those 45 credit unions, 41 would be "well-capitalized" today. To have avoided downgrade, the institutions would have had to increase capital by $145 million, or an average $3.2 million per institution. As the chart below demonstrates, almost all of the credit unions that would have been downgraded—95%—are "well capitalized" or "adequately capitalized" today. NAFCU believes this empirically proves that the proposal is unnecessary and unduly burdensome, as it would further strain the credit union system during a financial downturn.

Current status of the credit unions that would have been downgraded in 2009 under RBC2



Source: NCUA call report data

A Costly Experiment for Credit Unions

NAFCU and our member credit unions remain deeply concerned about the cost of this proposal. NAFCU's analysis estimates that credit unions' capital cushions, a practice encouraged by NCUA's own examiners, will suffer over a $470 million hit if NCUA promulgates separate RBC thresholds for "well capitalized" and "adequately capitalized" credit unions – a "two-tier" approach discussed in more detail below. Specifically, in order to satisfy the proposal's "well-capitalized" threshold, today's credit unions would need to hold at least an additional $729 million. On the other hand, to satisfy the proposal's "adequately capitalized" threshold, today's credit unions would need to hold at least an additional $260 million.

In addition to concerns about the cost of a "two-tiered" approach, NAFCU's members anticipate that this proposal will not only force them to hold considerably more capital in the long run, but will also unjustifiably slow their growth in the future. The funds used to meet the newly proposed onerous requirements could otherwise be used to make loans to consumers or small businesses and aid in our nation's economic recovery. The requirements in this proposal will restrict credit union lending to consumers by forcing them to park capital on their books rather than lending to their members.

Further, NAFCU and our members are deeply concerned about how much this proposal will cost NCUA to implement and administer on annual basis. NCUA's own direct cost estimate approximates that it will cost $3.75 million for the agency to adjust the Call Report, update its examination systems and train internal staff to implement the proposed requirements. NCUA also estimates credit unions would incur an ongoing $1.1 million expense to complete the adjusted Call Report fields. NCUA's conservative estimate states that it will only take a meager 40 hours to completely review the 450-page proposal against a credit union's current policies at a cost of over $5.1 million. We expect that the true costs will be much higher when credit unions have to comply.

Simply put- the proposal is an inappropriate use of credit union resources to address concerns about a few credit union outliers. Given that NCUA's budget is funded exclusively by the credit unions it regulates and insures, NAFCU is seriously concerned by how much money this proposal will cost the industry.

Legal Authority for "Two-Tiered" Framework

The proposed rule would make significant changes to NCUA's capital adequacy standards by replacing the current risk-based net worth (RBNW) ratio with a new RBC ratio. Part 702 currently evaluates a complex credit union's RBNW on a "pass/fail basis."[1] Each credit union calculates its RBNW based on its portfolio of assets, using weighting prescribed by Part 702. That calculation yields an RBNW percentage that is then compared to a credit union's net worth ratio.[2] A complex credit union's net worth ratio

[1] Prompt Corrective Action- Risk-Based Capital, 79 FR 11184, 11191 (February 27, 2014).
[2] *See* Appendix, 12 C.F.R. § 702.106.

must exceed its RBNW requirement. If a credit union's net worth ratio falls below its RBNW requirement, it will be deemed "undercapitalized."

NCUA's proposed rule seeks to establish a different approach. Unlike the current system, the proposal would require complex credit unions to calculate an RBC ratio. The RBC ratio must, itself, exceed certain thresholds. Most notably, for a complex credit union to be deemed "well capitalized," its RBC ratio must exceed 10 percent. The proposed rule would require complex credit unions that otherwise qualify as "well capitalized" based on their net worth ratio to also satisfy this separate 10 percent RBC threshold in order to maintain a "well capitalized" classification. As a result, under the proposal, a credit union that is otherwise "well capitalized" based on its net worth ratio could lose that designation if its RBC ratio falls between 8 percent and 9.99 percent, in which case it would be deemed "adequately capitalized." A comparable situation cannot occur under NCUA's current capital adequacy rules.

NAFCU does not believe that the FCU Act authorizes NCUA to adopt separate RBC thresholds for "well capitalized" and "adequately capitalized" credit unions. The statutory text expressly provides that NCUA shall implement an RBNW that "take[s] 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."[3] Because the term "adequately capitalized" plainly refers to the "adequately capitalized" net worth category provided in the FCU Act[4], NAFCU believes the provision expressly ties NCUA's statutory authority to its assessment of whether the 6 percent net worth ratio threshold provides "adequate protection."

The FCU Act does not provide any standard for NCUA to assess the appropriateness of the 7 percent net worth ratio for "well capitalized" institutions. Instead, the statute limits NCUA, in developing an RBNW requirement, to considering only "whether the 6 percent requirement provides adequate protection" against the risks faced by credit unions."[5] The FCU Act's "adequate protection" standard speaks only to whether an institution is "adequately capitalized," not "well capitalized." Thus, a plain language reading of the FCU Act concludes that NCUA lacks the authority to implement a separate RBNW or RBC threshold for the "well capitalized" net worth category.

Further, the legislative history of the FCU Act supports a conclusion that Section 216(d) implicitly bars NCUA from implementing a separate RBC ratio for "well capitalized" credit unions. An earlier version of the *Credit Union Membership Access Act* (CUMAA) passed by the House of Representatives gave NCUA the authority to:

> "establish reasonable net worth requirements, *including risk-based net worth requirements* in the case of complex credit unions, *for various categories of credit unions* and prescribe the manner in which net worth is calculated (for purposes of

[3] 12 U.S.C. § 1790d(d) (emphasis added).
[4] 12 U.S.C. § 1790d(c).
[5] 12 U.S.C. § 1790d(d); *see also* S. Rep. No. 105-193.

> such requirements) with regard to various types of investments, including investments in corporate credit unions, taking into account the unique nature and role of credit unions."[6]

This language was not included in the Senate version of the legislation, which instead included Section 216(d) as it was eventually enacted. NAFCU believes this legislative change demonstrates Congress' express consideration and rejection of NCUA's proposed approach of adopting separate RBC thresholds for "well capitalized" and "adequately capitalized" credit unions.

Supervisory Assessment of Capital Adequacy

NAFCU believes the FCU Act does not allow NCUA to promulgate the proposed capital adequacy provision. The proposed rule would require complex credit unions to maintain comprehensive written strategies appropriate for their level of capital and risk profiles.[7] During the supervisory process, NCUA will assess whether these written plans adequately address a credit union's activities and risk profile, as well as risks and other factors that can affect its financial condition.[8] In the preamble to the proposed rule, NCUA indicated that its assessment may include a review of the level and severity of problem assets and a credit union's exposure to operational risk, interest rate risk and significant asset concentrations.[9] In addition to evaluating the appropriateness of a credit union's capital plan, NCUA's supervisory assessment will also take into account the quality and trends in a credit union's capital composition, whether the credit union is entering new activities or introducing new products.[10]

NAFCU is very concerned about the subjective nature of this proposed capital adequacy provision, and we question whether the agency has the statutory authority to adopt a provision that would require individual credit unions to hold capital above those required by the proposal or the FCU Act. NCUA omitted the individual minimum capital requirements (IMCR) from this revised RBC proposal after receiving a legal opinion sought by NAFCU that found NCUA lacks the statutory authority to impose such requirements. NAFCU believes this proposed capital adequacy provision may also run the risk of violating the agency's statutory authority.

Congress authorized specific circumstances that a credit union could be "reclassif[ied]" and subjected to more stringent capital standards, but did not legislate a provision allowing NCUA to prescribe IMCRs for particular credit unions.[11] While the FCU Act establishes an RBNW for complex credit unions, it does not grant NCUA the authority to impose

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[6] H.R. Rep. 105-472, 1998 WL 141880, at *9 (1998)(emphasis added).
[7] 80 FR 4340, 4431 (January 27, 2015).
[8] 80 FR 4340, 4372 (January 27, 2015).
[9] *Id.*
[10] *Id.*
[11] 12 U.S.C. § 1790d(h).

IMCRs.[12] Together with the lack of any express authority, these provisions of the FCU Act suggest that Congress never intended for NCUA to have the power to proscribe IMCRs, either through the rulemaking or examination process.

Definition of "Complex"

The proposal would change the definition of a "complex" credit union, for the purposes of NCUA's capital requirements. The FCU Act directs NCUA to base its definition of "complex" credit unions "on the portfolios of assets and liabilities of credit unions."[13] Under the current rule, credit unions are "complex" and subject to the RBNW requirement only if they have quarter-end total assets over $50 million *and* they have a risk based net worth requirement exceeding 6 percent.[14] The proposed rule, however, seeks to define the term "complex" credit union using a single asset size threshold of $100 million as a proxy for a credit union's complexity. In other words, the proposal would establish a bright-line $100 million asset threshold to determine whether a credit union is complex for the purposes of NCUA's capital requirements.

As NAFCU has consistently maintained, the size of an institution does not determine its complexity. Credit unions are distinctly different from one another with regard to their products and liabilities. Such distinctions are indicators of their level of complexity. There are many credit unions well over $100 million in assets that have very simple portfolios and engage in the most basic transactions and services for their members. NAFCU and our members firmly believe the definition of "complex" must actually consider a credit union's portfolios of assets and liabilities, rather than an arbitrary asset threshold.

Further, NAFCU believes defining complexity by an asset threshold runs afoul of Congress' mandate in the FCU Act. Congress could have directed NCUA to focus solely on asset size in defining "complex." Instead, the FCU Act expressly requires NCUA to consider the complexity of a credit union's book of assets and liabilities. Congress clearly tailored a definition of "complex" that considers whether the elaborateness of a credit union's financial activities and operations warrant that credit union to be designated as "complex," rather than just its asset size.

NAFCU and our members strongly believe that NCUA should define complexity using a credit union's product offerings because the $100 million proxy does not appropriately or accurately gauge complexity. Even the NCUA Board acknowledges that it is not the asset size of the credit union that makes it "complex," but rather it is the fact that the credit union offers certain products and services that NCUA calls "inherently complex." Specifically, NCUA outlines fifteen activities that "are inherently complex based on the nature of their risk and the expertise and operational demands necessary to manage and administer such activities effectively." These include: member business loans,

[12] 12 U.S.C. § 1790d(d).
[13] 12 U.S.C. § 1790d(d).
[14] 12 C.F.R. § 702.103.

participation loans, interest-only loans, indirect loans, real estate loans, non-federally guaranteed student loans, non-agency mortgage-backed securities, derivatives, internet banking, and more.

Because NCUA is proposing to replace the existing RBNW framework, which considers whether a credit union's RBNW requirement that is in excess of 6 percent when determining complexity, NAFCU and our members strongly believe that the agency should consider a similar measure as it determines a credit union's complexity under an RBC structure.

In developing a definition of "complexity," NAFCU recommends NCUA take into consideration an approach similar to the existing RBNW framework. Specifically, NAFCU believes that the most analogous approach to the existing RBNW requirement would be a ratio of risk-weighted assets to total assets greater than 67 percent as measured by this proposal's risk-weights. While NAFCU acknowledges that the 67 percent threshold may not be a meaningful measure of risk for a credit union, we found that using different thresholds yielded similar results. Therefore, in analyzing the appropriateness of the $100 million proxy for complexity, NAFCU used a 67 percent threshold as described above.

As demonstrated by the chart below, NAFCU concluded that only seven of the fifteen enumerated activities are appropriate indicators of complexity. A number of the products and services were actually more prevalent among the credit unions that did not surpass the 67 percent threshold than in those that did.

Asset/Liability	Percent of FICUs under Ratio Threshold* with Asset/Liability	Percent of FICUs over Ratio Threshold* with Asset/Liability	Difference
Member business loans	31.0%	34.4%	3.4%
Participation loans	24.1%	29.5%	5.4%
Interest-only loans	9.4%	11.5%	2.1%
Indirect loans	28.7%	31.5%	2.8%
Real estate loans	72.0%	69.7%	-2.3%
Non-federally guaranteed student loans	10.0%	12.9%	2.9%
Investments with maturities of greater than 5 years (where investments are greater than one percent of total assets)	34.4%	18.5%	-15.9%
Non-agency mortgage-backed securities	2.7%	1.8%	-0.9%
Non-mortage-related securities with embedded options	20.1%	11.6%	-8.5%
Collateralized mortgage obligations/real estate mortgage investment conduits	17.2%	10.9%	-6.3%
Commercial mortgage-related securities	6.5%	3.2%	-3.3%
Borrowings	10.3%	18.3%	8.0%
Repurchase transactions	0.2%	0.1%	-0.1%
Derivatives	0.5%	0.5%	0.0%

** Those with a risk-weighted assets-to-total assets ratio over 67%, using RBC2 risk weights*

Accordingly, NAFCU recommends that NCUA ***not*** use the following assets or liabilities when determining complexity: real estate loans, investments with maturities of greater than five years, non-agency mortgage-backed securities, non-mortgage-related securities with embedded options, collateralized mortgage obligations/real estate mortgage investment conduits, commercial mortgage-related securities, and internet banking. We believe these do not adequately represent complexity. Further, NAFCU would like to note that "internet banking" is neither an asset nor a liability, but rather a service credit unions provide to their members. Therefore, we believe the FCU Act bars NCUA from considering internet banking when determining complexity, as the statute expressly directs the agency to only evaluate credit union's book of assets and liabilities, not its services.[15]

Of the seven remaining financial assets or liabilities on NCUA's enumerated list, NAFCU believes that a credit union should as a threshold matter only qualify as a "complex" if it engages in three or more. As demonstrated by the chart below, NAFCU concluded that using a "three or more" threshold subjects generally the same number of credit unions to the proposed rule as the $100 million asset threshold, but does so in a much more targeted fashion.

	<$100M FICUs		>=$100M FICUs		All FICUs		FICUs
# of Products	#	Percent over Ratio Threshold*	#	Percent over Ratio Threshold*	#	Percent over Ratio Threshold*	Downgraded under RBC2 Proposed Rule
None	3,104	26.2%	78	3.8%	3,182	25.6%	0
1	907	26.1%	187	10.7%	1,094	23.5%	1
2	433	27.5%	251	15.9%	684	23.2%	3
3	220	25.9%	341	21.7%	561	23.4%	4
4	103	36.9%	334	32.3%	437	33.4%	7
5	14	57.1%	218	39.4%	232	40.5%	7
6	3	100.0%	76	48.7%	79	50.6%	4
7	0	-	4	75.0%	4	75.0%	0
Total	4,784	26.7%	1,489	24.9%	6,273	26.2%	26
3 or more	340	31.2%	973	31.7%	1,313	31.5%	22
4 or more	120	40.8%	632	37.0%	752	37.6%	18
5 or more	17	64.7%	298	42.3%	315	43.5%	11

* Those with a risk-weighted assets-to-total assets ratio over 67%, using RBC2 risk weights

The chart above demonstrates that only 26.7 percent of credit unions over $100 million have a ratio that exceeds 67 percent, whereas 31.5 percent of all credit unions engaging in three or more of the seven "complex" assets or liabilities have a ratio above 67%. This analysis clearly shows that lifting the asset threshold, and instead examining a credit union's assets or liabilities yields a more targeted determination of complexity.

[15] *See* 12 U.S.C. § 1790d(d).

Accordingly, NAFCU recommends that NCUA define a "complex" credit union as one that is engaged in three or more of the following assets or liabilities:

1. Member Business Loans
2. Participation Loans
3. Interest-Only Loans
4. Indirect Loans
5. Non-Federally Guaranteed student loans
6. Borrowings
7. Derivatives

Using this definition of "complex," NAFCU found that NCUA would still capture the "outliers" that the current proposal reaches. Specifically, NAFCU estimates that our recommended definition for "complex" would capture 22 of the 26 credit unions that NAFCU estimates would be downgraded by the proposal today. There are currently 1,489 credit unions over the $100 million asset threshold that would be subject to the rule. By removing the asset class distinction and instead defining a "complex" credit union as one with three or more products outlined above, that number drops to 1,313. Accordingly NAFCU's recommended definition would capture the outliers NCUA seeks to address, while providing relief to the credit unions over $100 million who do not have complex balance sheets.

10 Percent Risk-Based Capital Ratio

The proposed rule would introduce a 10 percent RBC threshold for a complex credit union to be "well capitalized," and an 8 percent RBC threshold for a complex credit union to be "adequately capitalized." NCUA contends that these proposed thresholds would be comparable to the total RBC ratio requirements contained in banking regulations.[16] While NCUA's proposed 10 percent RBC threshold gives the appearance of parity with the banking regulations, it erroneously seeks to align NCUA's capital requirements with a bank's Total RBC, which encompasses sources of capital that are either unavailable to credit unions, or unmeasured by NCUA.

Banks can satisfy their Total RBC using a combination of Tier 1 and Tier 2 capital. Credit unions, however, do not have ability to engage in all the available Tier 2 capital instruments. Instead, credit unions must satisfy their capital requirements with elements more similar to a bank's Tier 1 capital. While the proposed rule would allow credit unions to count Allowance for Loan and Lease Losses (ALLL) towards their RBC ratios, it would not permit all credit unions to count secondary capital. Therefore, until NCUA promulgates a rule allowing all credit unions to issue secondary capital for risk-based purposes, NAFCU believes that Tier 1 capital more appropriately aligns with the compositions of all credit union capital. Accordingly, we recommend that NCUA set a single-tier requirement of 8 percent as such a threshold would bring NCUA's rule into parity with the banking agencies' Tier 1 capital requirements.

[16] 80 FR 4340, 4359 (January 27, 2015).

Risk Weight Categories

Investments in CUSOs

The proposal would set the risk-weight at 150 percent for investments in CUSOs and 100 percent for loans to a CUSO. The proposal would exclude loans and investments in CUSOs if those assets were already consolidated into the credit union's statement of financial condition under generally accepted accounting principles (GAAP). While this proposal incorporates important industry-sought changes, such as accounting for CUSOs consolidated into a credit union's books, it continues to assign different risk-weights to investments in CUSOs and loans to CUSOs.

NCUA justifies risk-weighting investments in CUSOs and loans to CUSOs differently because the agency believes "an equity investment in a CUSO is an unsecured, at-risk equity investment (first loss position), which is analogous to an investment in a non-publicly traded entity."[17] This conclusion, however, is unsupported by empirical evidence in the credit union industry. 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 National Credit Union Share Insurance Fund (NCUSIF). The proposal, on the other hand, could force credit unions to reconsider investments in CUSOs now and in the future. NAFCU and our members disagrees with NCUA's reliance on an anomaly, such as a CUSO causing a loss the NCUSIF, to justify an expensive a system-wide capital regime. We strongly believe that potential CUSO investment risk should be managed through the existing examination and supervision processes.

Despite many commenters, including NAFCU, arguing that there should be only one risk-weight for CUSO activity and that it should not exceed 100 percent, NCUA retained different treatments for investments in CUSOs and loans to CUSOs. While NCUA lowered the risk-weight for investments in CUSOs, the proposed 150 percent risk-weight still fails to consider the different types of services provided by a given CUSO. The overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale and providing much needed non-interest income to their credit union owners. NAFCU's member have indicated, however, that the proposed 150 percent risk-weight may deter them from utilizing CUSO investments in the future because they will be unable to build the capital required by the proposal. Because CUSOs have consistently been strong partners for credit unions in meeting their members' needs in a safe, sound, and cost-effective manner, NAFCU and our members believe that credit unions should not be prevented from utilizing these relationships due to an arbitrary risk-weight.

NCUA's stated basis for risk-weighting investments in CUSOs at 150 percent is parity with the Federal Deposit Insurance Corporation's (FDIC) capital regime. The FDIC approach, however, considers risks "across all equity exposures," and risk-weights equity

[17] 80 FR 4340, 4400 (January 27, 2015).

investments that are less than 10 percent of a bank's capital at 100 percent.[18] FDIC characterizes such investments as "insignificant."[19] While NCUA's proposed risk-weight gives the appearance of parity, it is actually much more stringent and burdensome than the approach taken by the FDIC for similar types of investment for banks.

NCUA already restricts the amount a federal credit union can invest in a CUSO to 1 percent of its total assets in the aggregate.[20] These codified restrictions on a federal credit union's ability to invest in CUSOs make it practically impossible to reach the higher risk-weight category that the FDIC approach contemplates in its risk-weighting structure. Given these restrictions on CUSO investments, NAFCU believes it would be more appropriate to mirror the FDIC's risk-weight for equity investments that are less than 10 percent of a bank's capital. Applying this method, investments in CUSOs would be considered "insignificant" and not subject to a risk-weight higher than 100 percent because they make up too low a percentage of a credit union's total assets to truly qualify as a higher-risk. In the preamble to the proposed rule, NCUA even acknowledges the "limited amount of credit union assets in CUSOs."[21] Accordingly, NAFCU and our members strongly urge the NCUA Board to recalibrate the investment in CUSOs risk-weight to 100 percent in order to more appropriately mirror the FDIC's approach for similar investments.

Should NCUA insist on assigning a higher risk-weight to investment in CUSOs, NAFCU believes that NCUA must, at the very least, revise the proposed risk-weight to consider the different types of services provided by a given CUSO. The proposal fails to accurately recognize the businesses of individual CUSOs or the actual risk that they pose to the industry and the NCUSIF. For example, an investment in a CUSO engaged in low-risk activities like providing compliance assistance would be assigned the same risk-weight as an investment in a CUSO engaged in mortgage or commercial loan underwriting. NAFCU and our members believe NCUA must make a more meaningful risk distinction between the risks various types of CUSOs pose.

Corporate Paid-In Capital

Corporate credit unions have endured more regulatory changes over the past five years than any other sector of the credit union system. In 2010, NCUA promulgated a comprehensive overhaul of the regulatory requirements governing the corporate credit union system, including imposing additional capital requirements, more strict investment limits, concentration risk prohibitions, and governance changes. In risk-weighting, NCUA should recognize how these stricter standards not only mitigate risks to natural person credit unions, but they also protect the NCUSIF from potential losses.

The proposal seeks to risk-weigh corporate paid-in capital at 150 percent. NAFCU and our members believe this risk-weight does not reflect the actual risk of this asset. Under the

[18] *See,* 12 C.F.R 324.52.
[19] *Id.*
[20] 12 C.F.R. § 721.2(a).
[21] 80 FR 4340, 4401 (January 27, 2015).

proposal, corporate paid-in capital is weighed twice as high as dollars invested in a mortgage loan in excess of 35 percent of assets, suggesting this activity is twice as risky. NAFCU firmly disagrees and is deeply concerned that this treatment could serve as a disincentive to credit unions for investing in corporate credit unions. NAFCU and our members believe that paid-in capital would be more appropriately weighed 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.

Mortgage Servicing Assets

Under this proposed rule, the term "mortgage servicing assets" (MSAs) would be defined as those assets, maintained in accordance with GAAP, resulting from contracts to service loans secured by real estate (that have been securitized or owned by others) for which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing.[22] The proposal would set the risk-weight at 250 percent for MSAs, even though the NCUA Board acknowledges that MSAs may provide some hedge against falling rates under certain circumstances.[23] The Board suggests that "MSA's effectiveness as a hedge, relative to a particular credit union's balance sheet is subject to too many variables."[24] While this statement acknowledges that the riskiness of MSAs varies for each credit union, the proposed 250 percent risk weight fails to recognize such distinctions and instead seeks to impose a stringent "one-size-fits-all" risk-weight measure across the entire industry.

While NAFCU acknowledges that the FCU Act requires NCUA to promulgate a capital regime that is "comparable"[25] to the other banking agencies, which have adopted a 250 percent risk-weight for MSAs,[26] we firmly believe the structure and composition of credit unions warrant a lower risk-weight for this asset class in our capital regime. In fact, Congress, during deliberations on CUMAA, stated that "[c]omparable means parallel in substance, [but] not necessarily identical in detail."[27] NAFCU believes that NCUA has the latitude to assign a risk-weight that recognizes the unique credit union-approach to MSAs. Specifically, NAFCU and our members believe that NCUA should reduce the risk-weight for MSAs to 150 percent because credit unions have a strong track record of maintaining personal member relationships throughout the life of the loan in a safe and sound manner.

Each credit union is in the best position to measure how effective its MSA portfolio is to hedge against future market risk. NAFCU's members have indicated that the proposed 250 percent risk-weight will not only be too onerous to comply with, but will also create more risk in the market because it will incentivize them to sell the mortgage or the servicing rights to get the assets off their books. Setting the risk-weight at 250 percent will

[22] 80 FR 4340, 4430 (January 27, 2015).
[23] 80 FR 4340, 4401 (January 27, 2015).
[24] *Id.*
[25] 12 U.S.C. § 1790d(b)(1)(A).
[26] *See* 12 CFR 324.32(l)(4)(i).
[27] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).

reduce the ability of credit unions to grant mortgage loans, engage in loan participations, and retain servicing of their member loans. If NCUA enacts a regulation that discourages credit unions from investing in these types of assets, it may create the unintended consequence of credit unions becoming unable to hedge against future rate changes. Such a system would be harmful to the millions of credit union members who rely on the personal member services of their credit union throughout the life of the mortgage loan.

Further, in 2013, 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 working instead of higher risk-weights for mortgage servicing assets. Because the NCUA has promulgated a stringent loan participations rule and pursued other efforts to minimize overall risk in the credit union industry, NAFCU and our members strongly urge NCUA to reduce the risk-weight to 150 percent.

Should NCUA insist on assigning a higher risk-weight to MSAs, NAFCU believes that the agency should, at minimum, consider whether the loan is a recourse or nonrecourse loan. NCUA could allow an even lower risk-weighting of 100 percent if the loans are sold without recourse but are serviced by the credit union.

Mortgage Partnership Finance Program

The proposed rule recognizes that many credit unions rely on the Mortgage Partnership Finance Program (MPF Program) offered by the Federal Home Loan Banks (FHLBs) throughout the country. The MPF Program uses a risk sharing structure that allows participating credit unions to retain the principle credit risk of the loans they originate and rewards their high quality underwriting practices, producing very strong credit performance over its history. For managing the credit risk of the loans and servicing the loan if they choose, credit unions then receive fees. Under this proposal, loans that qualify for the MFP Program are considered "off balance sheet" exposures, where the risk-weight is calculated with the outstanding loan balance as of the reporting date, net of any related valuation allowance.[28]

While we believe that the RBC treatment for MPF loans is a more appropriate capital treatment than the initial proposal, NAFCU and our members are concerned that the definition of the MPF Program includes language that could create ambiguity and we recommend that the NCUA Board clarify such ambiguity before promulgating a final rulemaking. Specifically, the proposal states, "[m]ortgage partnership finance program means a Federal Home Loan Bank program through which loans are originated by a depository institution that are purchased or funded by the Federal Home Loan Banks, where the depository institutions receive fees for managing the credit risk of the loans *and servicing them*." [29] NAFCU is concerned this proposed definition of the MPF Program could be limited to only loans that a credit union services. While many credit unions

[28] 80 FR 4340, 4430 (January 27, 2015).
[29] 80 FR 4340, 4429-4430 (January 27, 2015).

service their loans, many also choose to sell MPF loans to the FHLBank. Such a sale does not alter the credit enhancement obligation in any way. Thus, NAFCU recommends removing the phrase "and servicing them" to clarify that all loans sold by credit unions participating in the MPF Program receive the same treatment.

Further, NAFCU's members are concerned that the proposal is unclear about its application to loans administered through the Mortgage Purchase Program (MPP), a secondary market alternative offered by the FHLBanks of Cincinnati and Indianapolis. The MPP structure achieves credit enhancement by creating a contingent asset for credit union participants, in contrast to the contingent liability obligation created under the MPF Program. Because RBC seeks to ensure that credit unions hold capital against recourse risk of off-balance sheet activities, and MPP loans do not have such risk, NAFCU believes that MPP loans should fall outside of the definition of the MPF Program for RBC purposes. NAFCU and our members believe that NCUA should add clarifying language to any final rulemaking that specifics that the definition of the MPF Program does not apply to the MPP. This change will ensure that credit unions selling loans through the MPP are not inadvertently subject to an improper RBC requirement as a result of those sales.

Concentration Risk Thresholds

The proposed rule seeks to introduce a tiered risk-weight framework for high concentrations of residential real estate, equity, and commercial loans. Under this tiered framework, as a credit union's concentration in these asset classes increases, the proposal would require incrementally higher levels of capital.

NCUA's stated basis for this approach is to address the real estate and member business lending (MBL) concentration risk that led to credit union failures and NCUSIF losses during the recent financial crisis. In the preamble to the proposed rule, NCUA cites a 2012 GAO report that concluded credit concentration risk contributed to 27 of the 85 credit union failures between 2008 and 2011.[30] NCUA also relies on its Office of Inspector General's conclusion that the NCUSIF suffered $25 million in losses because of failed credit unions with larger real estate concentrations.[31] In particular, NCUA notes the failures of Cal State 9 Credit Union, Beehive Credit Union, and Ensign Federal Credit Union as examples of losses due to substantial residential real estate and equity loan concentrations.[32]

NAFCU disagrees with NCUA's stated justification because we believe credit union performance over the past seven years does not support different levels of concentration for a given asset. In analyzing the appropriateness of NCUA's proposed concentration thresholds, NAFCU examined the change in net worth between 2007 and 2014 for credit

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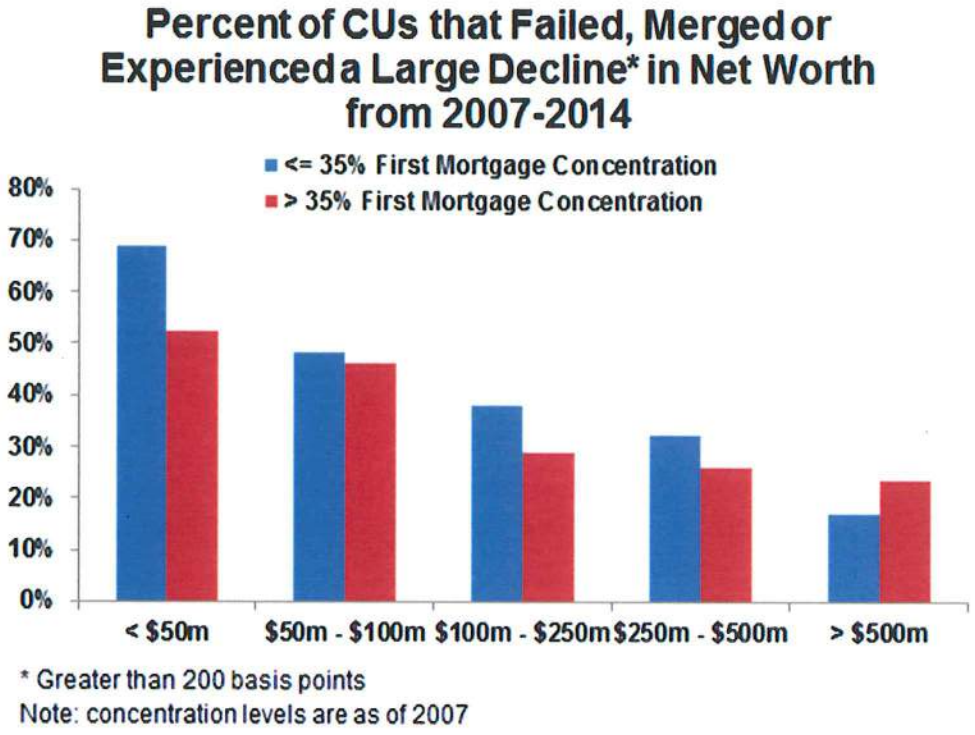
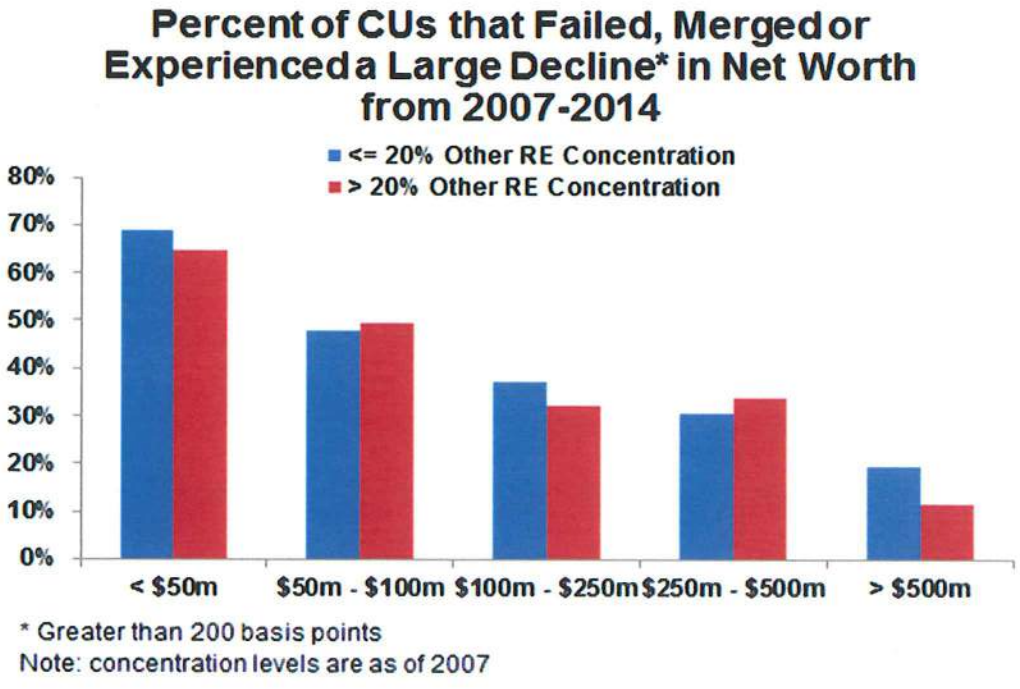
[30] 80 FR 4340, 4356 (January 27, 2015); *see also* U.S. Govt. Accountability Office, GAO–12–247, Earlier Actions are Needed to Better Address Troubled Credit Unions (2012), *available at http://www.gao.gov/products/GAO-12-247.*
[31] 80 FR 4340, 4356 (January 27, 2015);
[32] *Id.*

unions above and below NCUA's proposed concentration thresholds. As demonstrated on the charts below, our analysis concluded that there is no meaningful difference in the performance of credit unions with higher or lower levels of concentration in mortgages or equity loans.





For commercial loans, NAFCU did not include an analysis because NCUA's proposed definition of this asset class for risk-based purposes is currently unidentified on the 5300 Call Report. Further, NAFCU found that only a handful of credit unions would likely surpass the proposed 50 percent concentration threshold due to their MBL portfolios. At best, this data is inconclusive. Based on the results noted above, however, NAFCU believes it is reasonable to presume that credit unions would perform the same regardless of their concentration in commercial loans.

NAFCU also believes the proposed concentration thresholds for mortgages, equity loans, and commercial loans would put credit unions at an unjustifiable competitive disadvantage to banks. The banking agencies do not impose concentration risk thresholds in their risk-weights for these asset classes. By including concentration risk in its risk-weights, NCUA seeks to create a structure that would require credit unions to hold incrementally more capital than banks for similar levels in mortgages, equity loans, and commercial loans. NAFCU firmly believes such a structure would put credit unions at a competitive disadvantage to banks.

Also, NAFCU believes such a structure would violate NCUA's statutory mandate to establish a PCA system that is comparable with the bank system. Because the FCU Act fundamentally requires the NCUA Board to "prescribe a system of prompt corrective action" that is "comparable to section 1831o" of the Federal Deposit Insurance Corporation Act," as implemented through FDIC regulations,[33] NAFCU believes the proposed concentration thresholds would not only place credit unions at a competitive disadvantage, but they would also run afoul of NCUA's statutory mandate.

Further, NAFCU would like to note that the historical loss data cited by NCUA did not solely hinge on high concentrations in a given asset class. A survey of the Material Loss Reviews for Cal State 9 Credit Union, Beehive Credit Union, and Ensign Federal Credit Union revealed that fraud or board mismanagement played a pivotal, if not a determining role in the failures of these institutions. NAFCU does not believe NCUA should rely on these anomalies to justify a stringent regulatory regime for all credit unions.

Goodwill

The proposed rule would subtract a number of components from the numerator portion of the RBC ratio. These subtractions include goodwill, the NCUSIF deposit, other intangible assets, and identified losses not reflected as adjustments to components of the RBC numerator. In the case of a supervisory merger or consolidation that occurs before the publication of the final rule, the proposal would allow credit unions to include goodwill in their RBC numerator until December 31, 2024.

[33] *See* generally, 12 U.S.C. § 1790D(b)(1)(A).

NAFCU and our members believe deducting goodwill from the RBC numerator presents two significant issues. First, it penalizes credit unions who have recently gone through a merger. Second, it could disincentivize merger activity, which would prevent healthy industry consolidation and the combining of unhealthy credit unions with stronger ones in the future.

The credit union industry has seen significant consolidation in the past few years and this is a trend that is likely to continue. Without goodwill available to help balance out the equation going forward, 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 which will ultimately lead to more expensive liquidations for the NCUSIF.

NAFCU believes that NCUA should reconsider removing goodwill from the numerator portion of the RBC ratio all together, rather than just the proposed limited exception for supervisory mergers occurring before 2024.

Supplemental Capital

Supplemental capital authority is needed now more than ever considering the restrictions brought on by this proposed rule. NAFCU encourages NCUA to promulgate regulations that allow access to supplemental capital for risk-based purposes for ***all*** credit unions. Also, we believe the agency should continue to call on Congress to pass a legislative solution that modernizes capital standards to allow broader access to supplemental capital for all credit unions in all circumstances.

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, often derived 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, NAFCU believes that supplemental capital authority is not the answer to all of the problems associated 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. Accordingly, NAFCU reiterates our call to withdraw the proposal in its entirety.

Legislative Solution Needed

As we have steadfastly advocated, NAFCU supports an RBC system for credit unions that would reflect lower capital requirements for lower-risk credit unions and higher capital requirements for higher-risk credit unions. We continue to believe, however, that Congress needs to make statutory changes to the FCU Act to create an effective and workable RBC regime.

This proposal, like its predecessor, does not achieve a truly risk-based system for credit unions. NAFCU believes that the proposal is conceptually flawed because it deviates from statutory requirements for PCA and tries to establish an ill-fitting RBC system without the necessary legislative solution. This results in a "one-size-fits-all" rule that will ultimately require credit unions to hold additional unnecessary capital with a complete disregard for Congressional intent.

Based on feedback from our member credit unions, NAFCU established its "Five Point Plan for Regulatory Relief" in February 2014, which 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 RBC 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.

Should NCUA's current proposal 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 enacting H.R. 719, the *Capital Access for Small Businesses and Jobs Act*, 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*.

Interest Rate Risk

In the preamble to this proposed rule, NCUA indicated that the agency is currently considering an alternative approach to interest-rate risk (IRR), and specifically seeks comment on how it can reasonably account for IRR in the future.

NAFCU and our members strongly believe that NCUA can account for IRR with its existing regulatory and supervision tools. We recommend that the agency address IRR through continued application of industry-accepted methods as part of a competent supervision and examination process, rather than promulgating a separate, "one-size-fits-all" IRR regulatory standard.

As the agency acknowledged in the preamble to this proposed rule, NCUA already has a number of codified requirements and guidance regarding IRR. First, Part 741 requires federally-insured credit unions to develop and adopt a written policy on IRR and a program to effectively implement that policy.[34] This IRR policy and implementation program is among the factors NCUA considers in determining a credit union's insurability. Also, NCUA issued a supervisory letter to credit unions, 12-CU-05, advising the industry of widely accepted sound practices in IRR management. Further, IRR has been the top subject in the agency's 2014 and 2015 supervisory focuses.[35]

The other banking regulators account for IRR through their annual examination process by ensuring that banks maintain sufficient capital for IRR. NCUA's existing supervisory and examination mechanisms provide it the same authority to ensure that credit unions have enough capital to absorb the level of IRR on their balance sheets. If NCUA were to promulgate a rulemaking on IRR, the agency would hold credit unions to significantly different standard than banks. Further, NAFCU firmly believes that each credit union is in the best position to prudently and effectively manage IRR for its individual balance sheet better than any "one-size-fits-all" regulation. Simply put, NCUA's existing supervisory and examination mechanisms provide the agency the appropriate ability to control IRR at individual credit unions.

Pending Accounting Changes

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing the U.S. GAAP that govern the preparation of financial reports by nongovernmental entities. The FASB determined post-financial crisis that there was a need to establish a more predictive model for the financial reporting of credit losses on loans and other financial instruments held by lending institutions. In March 2015, FASB announced, after an exhaustive seven-year study of the issue, expectations to finalize the standard for timely financial reporting of credit losses in the third quarter of 2015.

The FASB proposal would establish a "current expected credit loss" (CECL) model for financial institutions. Under this model, the Allowance for Loan and Lease Loss (ALLL) would reflect a credit union's current *estimate* of the contractual cash flows that the credit union does not expect to collect, based on its assessment of credit risk as of the reporting date. Past events, the current economic environment, and other subjective forecasts about the future would factor into the institution's assessment of expected losses. This model would replace the current "incurred loss" model that does not require recognition of the credit loss until the loss is probable (or has been incurred). The practical effect of this change will be an immediate increase to the credit union's ALLL balance and reduce capital, which will impair the capital ratio.

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[34] 12 CFR 741.3(b)(5).

[35] NCUA Letter to Credit Unions, 15-CU-01, Supervisory Priorities for 2015 (January 2015); *see also* NCUA Letter to Credit Unions, 14-CU-01, Supervisory Priorities for 2014 (January 2014).

NCUA is clearly not the only entity making changes to the industry's capital requirements. NAFCU believes NCUA should carefully consider the possible effects of FASB's proposal in combination with the agency's own proposal in order to remove duplicative regulatory burdens on an already extremely safe and sound industry.

Conclusion

Given the onerous nature of this proposal on credit unions and the lack of legal authority to promulgate aspects of the rulemaking, NAFCU must oppose the proposed rule and urge its complete withdrawal. The issues NAFCU has highlighted above will have significant negative impacts on the credit union industry and its ability to serve its 100 million members. If the agency decides to proceed with this rulemaking, we respectfully urge NCUA to address the recommended improvements to the proposed rule as outlined in this letter.

NAFCU appreciates the opportunity to share its thoughts on the proposed amendments to Part 702's capital adequacy rules and would like to discuss this matter further. Should you have any questions or would like to discuss these issues, please contact me by telephone at (703)-842-2215, or Alicia Nealon, NAFCU's Director of Regulatory Affairs at (703) 842-2266 or anealon@nafcu.org.

Sincerely,

B. Dan Berger
President and CEO

cc: The Honorable Debbie Matz, Chairman
The Honorable Richard Metsger, Vice Chairman
The Honorable Mark McWatters, Board Member
Mr. Michael McKenna, General Counsel
Mr. Larry Fazio, Director of the Office of Examination and Insurance
Mr. Todd Harper, Director of the Office of Public and Congressional Affairs