NACUSO℠
THE NATIONAL CENTER FOR
COLLABORATION & INNOVATION

March 4, 2014

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

Re: Comment to the Proposed Prompt Corrective Action – Risk-Based Capital Regulation

Dear Mr. Poliquin:

The National Association of Credit Union Service Organizations ("NACUSO") is a trade association of credit union service organizations and credit unions. The mission of NACUSO is to strengthen credit unions through collaboration. On behalf of NACUSO, we would like to provide the following official comment letter regarding the NCUA's recently proposed risk-based capital rule.

Our primary comments stem from the risk weighting of 250% assigned in the proposal to investments in CUSOs which we feel is arbitrary, not supported with any empirical data and counter-productive to the collaborative risk mitigating model that CUSOs represent as a net income resource for credit unions. CUSOs have been used effectively by credit unions for decades to reduce costs and generate income. We intend to provide, through this comment letter, examples of how the credit union industry as a whole – and individual credit unions in particular – are benefiting from CUSOs. We encourage NCUA to revisit the risk weighting proposed for CUSO investments so that NCUA does not bring about unintended consequences that actually make credit unions less safe and sound, not more.

While there have been a handful of CUSO investment losses that are routinely cited by the agency as a reason for the agency's perceived lack of confidence in CUSOs, there are hundreds of CUSOs that have been formed and are performing splendidly over the past several decades. It is surprising that the agency has not taken the time to fully appreciate or articulate the overwhelming positive impact CUSOs have had on credit unions. Rather than focus on a very small number of CUSOs that produced losses as if the exception supplants the rule, we would like to instead provide some specific examples of the considerable value CUSOs bring to credit unions and how this proposed risk weighting is disproportionate to the risk/reward scenario in CUSO investments.

Operational Services CUSOs

The whole purpose of a CUSO providing operational services is to pool resources to reduce operational costs by achieving economies of scale they cannot achieve on their own, and to be able to afford a higher level of services. Credit unions use a CUSO to leverage the money they spend on operational services. Net income is generated by savings. These operational CUSOs are not designed to make a profit.

Today's explosion of regulation from agencies ranging from the CFPB to NCUA itself is driving up compliance costs for credit unions to unprecedented levels. Even large credit unions are forming CUSOs to help reduce those costs. Four large credit unions elected to from a CUSO to collectively provide compliance services to each other. The four credit unions each invested $250,000. The CUSO is managed by an attorney and has nine employees. The services are considered by the credit unions to be much better than the credit union owners could perform on their own. The credit union owner we contacted estimated that the credit union's compliance costs were reduced by $250,000 in the first year through staff reductions and greater efficiencies. In other words, the investment amount return was fully recovered in year one and the credit union is receiving better compliance services from a highly skilled staff.

There is another CUSO owned by three large credit unions that manages IT support for the credit unions. Each credit union invested approximately $2 million in the CUSO. The credit union owners estimate that the CUSO saves each credit union approximately $4 million per year. The reduction in IT support staff accounts for $2 million of the savings and reduced vendor costs through greater bargaining power results in another $2 million in savings. This CUSO measures service levels very closely and is directly accountable to the owners. The credit unions created the CUSO to not only save money but also improve service levels and provide a greater level of expertise than the credit unions could fund on their own. For example, the CUSO has an information security team with three high-end certified CISSP security engineers who provide a greater degree of security than any of the credit unions would have if they acted individually.

The proposed regulation seems to suggest that unless the CUSO pays a cash dividend to the credit union owners, there has not been a return on the investment and the investment is at risk. In many cases, nothing could be further from the facts. The credit unions that are receiving annual returns of 100% to 200% on their investments through cost savings, together with markedly higher service levels than they could otherwise achieve on their own, see the CUSO investment risk and return quite differently than NCUA.

As Ben Franklin famously said, "A penny saved is a penny earned." CUSOs are saving a lot of pennies in the credit union system today – a result that NCUA should be encouraging, not discouraging – as is the case with the proposed 250% risk weight.

Without a CUSO, the operational costs credit unions incur are internal expenses and no capital reserve is required. With a CUSO, the funds to pay for the shared operational costs are called investments. The operational services CUSOs that serve the credit union owners are, in essence, the collaborative extensions of the credit unions. The money the credit union spends for operational expenses is money that the credit union would have to spend regardless if the services were performed in a credit union or CUSO. The only difference is that in a CUSO the costs are less. Why penalize credit unions for saving money? There should be zero capital risk for operational services CUSOs.

Fee Generating CUSOs

There are also CUSOs that generate fee income for their credit union owners. For example, a CUSO that is a broker/dealer is co-owned by more than 50 credit unions. The CUSO was formed in 1997. Since its formation the CUSO has paid more than $30 million in distributions to the owners and more than $1 billion in networking fees. The average annual return based on the current offering price has been approximately 12% over the past ten years with early investors receiving 70%-80% annual returns based on their original investment. We know of a credit union that was able to fully offset its losses from a poorly performing lending portfolio through the fee income it received from this CUSO.

Another credit union formed a CUSO that is a RESPA compliant title agency in 2004 with an investment of $50,000. The CUSO is co-owned with a well-established title agency. The credit union owns 51% of the CUSO. Through 2013, the credit union has earned $11 million in dividend returns.

We note that generating fee income generally takes much less capital than generating interest income. For example, in order for the credit union owner to generate $11 million in gross interest income over the same ten-year period at a 5% interest rate, the credit union would have had to lend $22 million per year with the attendant credit risk.

We do not see any justifiable reason to assign a high capital risk to financial services. The amount that can be invested in a CUSO under the regulation is not material and the need to find additional revenue streams should be encouraged. Non-interest income tends to be less cyclical than loan demand and provides a steady source of income. Credit unions are not penalized for making internal investments in costs to launch a new credit union product to generate income and serve their members. Credit unions should also not be discouraged from making an investment to launch a financial product within a financial services CUSO – a decision that can both generate fee income and also help them better serve their members' financial needs.

Loan Origination CUSOs

A small number of CUSOs originate and fund business loans, mortgage loans and credit card loans. We are not aware of any CUSOs originating and funding student loans. There is no difference in the credit risk of a credit union making these loans versus a CUSO making the loans. The investments in these CUSOs should be analyzed on the credit risk of the underlying loans and not as a CUSO investment. The risk rating for an investment in a CUSO originating a loan should be the same risk rating as if the credit union made the loan. Anything different is, in our view, arbitrarily punishing the credit union for loan origination through a CUSO versus through the credit union – again, a deterrent to the collaborative risk sharing model that serves both credit unions and NCUA well.

Comments on the CUSO Investment Risk Rating

Our first comment is the absurd disproportionality of how the CUSO risk rating compares to other risk ratings. For example, delinquent consumer debt over sixty days is risk rated at 150% and delinquent first lien mortgage debt is risk rated at 100%. Yet investments in CUSOs that have added millions to the bottom line in the form of both earnings and savings to credit unions over the past decades are somehow deemed riskier, with a 250% risk rating. We do not understand this reasoning.

The CUSO Regulation requires an attorney opinion that the risk to the credit union is limited to the credit union's investment or loan. If that is accurate the credit union's investment risk should be no more than 100%. The perception is that NCUA is building in a one-size fits all CUSO operational risk component. The message received by credit unions is to work with non-CUSO service providers where capital reserves are not required.

All CUSOs are not alike. There is no consideration in the CUSO investment risk analysis for (a) what types of services are being provided, (b) whether the investment represents necessary operational expenses that would be otherwise incurred, (c) whether the amount invested is material, (d) whether the CUSO has a history of profitability, or (e) whether the investment amount has been fully recovered by the credit union through savings or income. Even if there is a risk assessment for the initial CUSO investment, there is no reason to continue to have a risk assessment if the amount of the investment has been fully offset by net income or cost savings for the credit union that was generated by the CUSO.

We understand that the CUSO investment risk rating was calculated from some attempt to incorporate an approach similar to how BASEL risk rates bank equity investments. With all due respect, this is an apples and oranges analysis. Banks have the power to make investments in a number of types of organizations and the value to the bank is measured in the ability to receive income through dividends or upon an equity sale. These bank investments are not made in companies that are serving as collaborative cost sharing platforms. We have already documented how credit unions benefit greatly by CUSOs that never make any distributions. Unlike the banking investment powers, the CUSO risk exposure is limited to an immaterial level. There are only 22 basis points of credit union assets invested in CUSOs industry-wide; less than the annual corporate assessments. Each federal credit union may only invest less than 1% of assets in CUSOs. Credit unions could lose all their CUSO investments and the loss would not be material yet the upside potential could be very significant. NCUA would be making a huge mistake by not recognizing the adverse policy implications of applying the BASEL bank investment risk ratings to CUSO investments.

We have been advised that NCUA intends to apply the CUSO capital risk rating to both the cash investment made by the credit union *and upon the appreciated value in the CUSO*. We find it hard to fathom that NCUA would penalize the success of a CUSO by requiring that the credit union reach into its pocket and set aside additional capital on the profits earned by the CUSO. If NCUA seeks to discourage CUSO investment as an agency policy goal, this would indeed be an excellent method to use. However, we would hope that NCUA does not have that goal and will not impose risk based capital on the net income generated in a CUSO.

There is a real sustainability risk in credit unions today. The traditional credit union model was sustained in the past on the net interest margin. Net interest income was sufficient to pay the operating costs, build reserves and sometimes make special dividend payments to members. That model is under extreme stress today. Interest rates are at record low levels. The operational costs, especially in areas of personnel costs, compliance and technology, are increasing exponentially.

Coupled with the challenges most credit unions are experiencing in generating quality loans, the average net interest margin in the industry is very thin and in some credit unions the net interest margin is even negative. Many credit unions are slowly depleting their capital in what could amount to a slow liquidation of those credit unions or, at the very least, a steady slide toward the need for forced mergers that drains capital from the continuing credit unions.

We lose 3% of our credit unions every year and that rate could increase when the full impact of the new regulatory compliance onslaught overwhelms credit unions. At the very time that CUSOs are needed to help sustain credit unions, we are greatly concerned that NCUA may be creating a regulation that will be a disincentive for investments in CUSOs. The true risk is not the investment or loan to a CUSO, rather it is *not* investing in a CUSO to share risk, reduce costs and increase income.

We respectfully request that NCUA remove any risk weighting above 100% for CUSO investments and loans due to the already established CUSO investment and loan regulatory limits in place and the fact that disincentive to collaboration and risk sharing models such as CUSOs is inconsistent with the long term best interest of the credit union industry – and, frankly, its regulator and insurer as well. We further recommend that NCUA make it a priority to better understand the positive impact CUSOs have as a collaborative tool for credit unions to manage their sustainability risk.

Change of Risk Ratings by Examiner Discretion

In addition to the above referenced concerns about the risk weighting of CUSO investments, we are also very troubled by proposed Section 702.105(c). Unlike under the existing statutory net worth rules known as Prompt Corrective Action (PCA) regulations, credit unions will no longer have clear rules by which to run their credit union to avoid prompt corrective action by their regulatory agency. NCUA can "move the goalposts" any time they want. Why have any tables of risk rating if the levels can be changed on a credit union by credit union basis?

This proposed section invites inconsistent and potentially arbitrary applications of rules. To provide the clarity of capital and net worth expectation that a credit union board and management team must have in order to make strategic business and fiduciary decisions, subjective standards must be eliminated. Therefore, in our view, Section 702.105(c) should be deleted in its entirety.

Historical Perspective of the Statutory Net Worth Amount

The statutory net worth requirement for well-capitalized credit unions at 7% was not set by empirical studies but rather was a negotiated term in the passage of the Credit Union Membership Access Act. Bankers who have a lower net worth requirement wanted to set a high net worth requirement for credit unions to slow the growth of credit unions. NCUA is now proposing to build upon that artificially high net worth requirement that will only serve to enhance the banking industry's goal of retarding the growth of credit unions for competitive reasons. We do not object to additional capital requirements for some credit unions if justified by higher risks but the risk levels should be established with this historical perspective.

We note that, while perhaps imperfect and indeed "one size first all" in its approach, the current 7% net worth requirement was sufficient to sustain the credit union industry through the recent financial crisis, and credit unions did not require a taxpayer bailout.

Business Loan Risk Rating

We note that business loans are risk rated at 100%, 150% and 200% depending on the percentage of assets that business loans represent in the credit union. There are several aspects of this we do not understand. Why are business loans given different ratings based on the percentage of assets they represent? While we expect that the answer may be based in a concern over concentration risk, we call to your attention in the name of "comparability" that banks do not have such a tiered risk weighting system based upon percentage of assets. They address concentration risk through the examination and supervisory process, not the actual risk weight in their capital system.

The banking regulators recognize, as should the credit union regulators and insurer, that an individual business loan's risk does not change based on the number of other business loans the credit union is holding. The risk weight should be equal for all business loans and any concentration risk issues should be addressed through supervision and examination.

We would also point out on behalf of a number of credit unions with ownership interests in CUSOs that this system, if implemented as proposed, would very much disproportionately impact those credit unions that are traditionally business lenders and have lending portfolios that are primarily or exclusively business loans – whether they do so through the credit union or through a CUSO.

There seems to be no consideration given for the risk of types of business loans. For example, the risk of a mortgage loan in a commercial property at 50% LTV in a stable economic market is certainly much less than a loan secured by inventory that turns over quickly yet the risk rating is the same. Yet, there is no consideration for the difference in risk among business loans, nor is there any credit provided from the risk weights based upon the historical and current performance of a credit union's business loan portfolio. In our view, if a credit union has a proven history of low delinquencies and charge-offs in its business loan portfolio, that performance history – easily verified through the same 5300 Call Report data as the other numbers in the formula – should be incorporated into the system in a manner that will result in a lower risk rating than would be the case in a credit union with higher delinquencies and charge offs currently and over recent years.

NACUSO supports the use of incentives to maintain the risk rating standards established by NCUA. We advocate that those credit unions that exceed the capital risk rating established by NCUA, as well as remaining over the statutory 7% net worth provision under the Prompt Corrective Action law and regulations, be permitted to waive personal guarantees in order to provide loans to top member credits – many of which are currently being served primarily by banks, largely due to the requirement for a personal guarantee under current NCUA regulation (or the delay it takes to get a waiver of this requirement from NCUA).

<u>Capital Restoration Plan Remedy</u>

We still see value in the statutory net worth level established by law at 7% reserves to total assets. We would expect that Congress, which passed this standard in 1998, also sees value in that standard. Therefore, we would recommend that any credit union with over 7% net worth as a percentage of total assets but fails to exceed its required risk-based capital level under this proposed regulation be given consideration in any proposed corrective action required under the risk-based capital regulation. We strongly encourage NCUA to limit the remedy in such cases to a capital restoration plan that allows the credit union a reasonable and appropriate period of time to improve its risk-based capital ratio – even as they maintain their statutory net worth ratio above 7%. In our view, the draconian measures that can be used by law and regulation in a prompt corrective action are not appropriate when the statutory minimum of 7% net worth is met, even if the risk-based capital ratio is below 10.5%. Any corrective action removing volunteers, dismissing management officials and severely restricting business options is an unwarranted overreach for a credit union with over 7% net worth. The 7% net worth level is a well-established and conservative statutory requirement that has been in place and managed toward for over fifteen years.

Mortgage Loan Servicing Risk Rating is Excessive
The mortgage servicing risk rating of 250% is likewise excessive, in our view. There is an active market for mortgage servicing rights which have established values and do not deserve a high-risk rating. The high-risk rating could discourage loan participations. Without loan participations, many credit unions would not have sufficient interest income to survive. We strongly encourage NCUA to reduce this risk rating significantly. When compared to other risk ratings, we recommend 100%.

Supplemental Capital
The introduction of a risk based capital system requires more options for all credit unions to raise supplemental capital. We encourage NCUA to accelerate the efforts to implement supplemental capital options for all credit unions, in conjunction with the Risk Based Capital Rule implementation, providing an important tool for those credit unions that will no longer be well capitalized as a result of this rule and for others that need strategic options to assist them in managing to the new risk based capital standards. As some commentators have suggested, we believe NCUA has the power to authorize supplemental capital for risk-based capital purposes.

Implementation Date
The proposed implementation date is eighteen months after final passage. This is an unreasonably short time period considering the long term and significant impact of this new rule on credit union strategic business decisions. Credit unions have very limited means to raise capital under present statute and regulation. It will necessarily take a considerable amount of time to make adjustments within the balance sheet when the rules are suddenly changed. We recommend that an implementation period of no less than three years from final passage is much more appropriate. Again, in the interest of comparability, this is much more consistent with the time frames extended to the banking industry as their regulators have implemented the BASEL capital standards; even though they have more access to capital management, and capital building options, than credit unions.

<u>Conclusion</u>

While we support a truly well-balanced risk-based capital system that replaces the current PCA net worth standards and incorporates both benefits and penalties based upon the structure and management of balance sheet risk, this proposed rule has a considerable number of improvements needed in order to accomplish its stated purpose.

This proposal seems to supplement the current one-size-fits-all net worth system in place since 1998 with what is little more than a revised, and more complicated, one-size-fits-all risk based capital version. The one-size-fits-all nature of the proposed risk ratings is admittedly easier to apply for NCUA than would be a system with credits for historical risk management performance and risk weights that are documented by empirical data on a large scale basis; however, we feel that the proposed rule does not reflect a fair assessment of the actual risks of assets held by a particular credit union, e.g. all types of business loans should not be risk rated the same in every credit union and all CUSO investments should not be rated as high-risk.

If regulations unnecessarily serve to discourage or prevent necessary adaptations in the business model, the credit union industry will be put at risk. Credit unions cannot generate sufficient net income in today's economic and regulatory climate if they are shackled to a regulatory scheme that is designed to regulate the credit union industry as if it were the 1980's. Just as the credit union business model is changing to meet today's economic challenges, so must the approach of the regulator. Safety and soundness is not sacrificed but how credit unions operate to meet the economic challenges is modified. CUSOs are a big part of those necessary modifications.

There is certainly a danger to credit unions not having enough capital to cover the risks credit unions pose to the share insurance fund. However, there is also a danger to the sustainability of credit unions if an unnecessary amount of capital must be reserved in proportion to an individual credit union's balance sheet risk. If credit unions are required to reserve an excessive amount of capital, member services, net income opportunities and the growth of credit unions will suffer.

Thank you for the opportunity to comment.

Very truly yours,

Jack M Antonini

Jack M. Antonini
President and CEO

cc. Deborah Matz, Chairman
Michael Fryzel, Board Member
Richard Metsger, Board Member