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

VIA ELECTRONIC DELIVERY: regcomments@ncua.gov

RE: Prompt Corrective Action - Risk-Based Capital; RIN 3133-AD77

Dear Mr. Poliquin:

Please accept this correspondence as commentary concerning the National Credit Union Administration's (NCUA's) recently issued proposed rule to establish risk-based capital requirements for federally-insured credit unions. The Minnesota Credit Union Network ("MnCUN") appreciates the opportunity to comment on the risk-based capital ("RBC") proposed rule and work collaboratively for the benefit of the credit union industry. By way of background, MnCUN represents the interests of Minnesota's 133 credit unions and their 1.6 million members.

MnCUN generally supports a modern, detailed and robust capital system that is thoughtfully implemented over time. However, considering how well credit unions generally weathered the most recent recession, it is questionable whether a sufficient basis exists to increase capital requirements at this time. As for the proposed rule itself, we do not support the layered approach that the new RBC requirements would place on top of the current Prompt Corrective Action ("PCA") system. We respectfully provide the following comments in support of our position.

MnCUN appreciates NCUA's intention to help credit unions better absorb losses, establish a safer and more resilient credit union industry, and reduce risk to the National Credit Union Share Insurance Fund ("NCUSIF"). However, we cannot support the RBC proposed rule in its current form, and, although well-intended, find it carries significant, unintended consequences. We have a number of over-arching concerns regarding the proposed rule, including:

- The lack of empirical foundation for the assigned risk-weights, and in particular justification for inclusion of concentration escalators;
- The conflicts that exist in the current proposed risk-weight categories, as well as the over-generalized asset categories;

- The potential overall negative impact on credit unions, including putting them at a competitive disadvantage within the financial services market.
- NCUA's ability, presumably through its Examiners, to subjectively impose additional capital requirements on a case-by-case basis;
- The failure to include in the numerator certain "credits" to assist in balancing a credit union's overall portfolio, deductions of the NCUSIF deposit and goodwill, and general lack of consideration of mitigating factors;
- Lack of adequate implementation time for credit unions to come into compliance, including sufficient opportunity for credit unions to make strategic plan adjustments;
- Lack of consideration for a credit union's existing capital buffer;
- NCUA's definition of "complex" credit union in the proposed rule defined as holding assets in excess of $50 million is arbitrary and is too simplistic of a measure; and
- The overall implication from the tone of the rule that particular areas of a credit union's portfolio, such as consumer mortgages, member business loans ("MBLs"), and Credit Union Service Organizations ("CUSOs"), should be restricted areas of growth.

<u>Lack of empirical data and analysis for risk-weights</u>

In order to work more cooperatively on creating an RBC system, it would be beneficial for NCUA to provide an evidence-based RBC proposal that incorporates the underlying analysis, including any historical data used, on how types of risk-weight categories were assigned. While NCUA may have undertaken significant analysis and research to determine the various risk-weight categories, such analysis has not been provided as part of the proposed rule. Credit unions would be better served if NCUA would provide the basis for assigning certain risk-weight categories in order to engage in a healthy debate as opposed to creating confusion, misunderstanding and skepticism regarding the motives for risk-weighting certain categories. What has been put forth in the proposed rule is open to speculation, and appears to be based on NCUA's philosophical and theoretical perspective, as opposed to data collected from the credit union industry.

Specifically, credit unions would benefit from the underlying reasoning as to the basis for portioning out MBLs, consumer mortgage loans, and CUSOs, as particularly high-risk lending and investment areas. It would also be enlightening to be provided with what underlying information NCUA used to conclude that higher concentrations of certain assets should result in higher risk-weights.

<u>Conflicts in risk-weight categories and over-generalized asset categories (702.104(c))</u>

Generally, our credit unions have a number of concerns regarding the proposed risk-weights and find them to be confusing, unbalanced, and in some instances, onerous. While NCUA has indicated its intention to bring credit unions more in line with other federal regulatory risk-weighting systems, and specifically more akin to the Basel III system, by attempting to address multiple risks simultaneously – liquidity risk, concentration risk, interest rate risk, as well as credit risk – it creates conflict within the system because many of the resulting categories are inconsistent.

For example, practical experience from our credit unions suggests it to be highly irregular to assign the same risk category to a vehicle loan (being a secured loan), as an unsecured signature loan. Our credit unions have generally found that loss ratios are almost always higher on signature loans than on vehicle loans. The current RBC proposal fails to assign risk-weight categories based on the historical market experience of the industry, and in this specific example, to account for the higher average losses of unsecured loans versus lower average losses for secured loans.

If NCUA wants to capture actual risk, there is sufficient data in the current 5300 Call Report to fine-tune the categories more granularly to accommodate a more sophisticated risk-weighting system. For example, the proposed risk-weight system also generalizes first mortgages into one risk-weighted category without accounting for whether the mortgage is a variable or fixed rate loan; however, this information is already gathered in the Call Report and is available for use.

NCUA should also consider refining the type of mortgage loans within the concentration categories. There is inherently different real world risk between fixed-rate, adjustable rate, variable rate, and other types of mortgage loans. Further, there is a complete absence of consideration for loan to value ratios. To truly represent the market risk, these categories should be broken out and risk-weighted separately instead of lumped together as first mortgages and assigned a risk-weight based on concentration alone. There are mitigating factors that are taken into account as part of the underwriting process, NCUA needs to consider other factors when assigning risk-weights.

Fully insured assets risk-weighting

It should be clarified that any money held overnight in the Federal Reserve Bank should specifically be categorized as a zero percent risk-weight, instead of its current generalized treatment with cash on deposit and receiving a twenty percent risk weight. Further, any deposits or mortgages (FHA/VA) which are fully insured should also be removed from the twenty percent risk-weight, and re-allocated to a zero percent risk weight. Basel III treats government sponsored entity (GSE) loans as zero risk-weight. While the proposed rule reflects that a twenty percent rate is assigned because of potential interest rate risk, assigning any risk-weight to account for other types of risk is moot for fully insured real estate loans since any claim would pay the loan in full.

Credit union service organization risk-weighting

The overall risk-weight for investments in CUSOs in the two hundred fifty percent (250%) category is excessive. When determining the appropriate risk-weight for a CUSO, consideration for the underlying purpose and type of CUSO should be considered. Taking the time to analyze risk-weights based on contributing risk factors for CUSOs is appropriate, as real world experience has shown that certain types of CUSOs used specifically to carry out credit union's services are significantly less likely to contribute to losses.

Member business loan risk-weighting

NCUA should also take into consideration credit unions providing agricultural loans, particularly those credit unions permitted to lend above the MBL cap. These credit union loans are amassed with all credit unions extending MBLs, yet these credit unions, because of their historical MBL experience and well-managed portfolios, have been allowed to exceed the MBL cap because of their significant lending for agricultural purposes. Failing to take into consideration this subset of MBLs is a cause for serious concern for the future of our credit unions that fall into such a category and their ability to continue offering products to the agricultural community.

Competitive disadvantage to credit unions under the RBC proposed rule

Although similarities exist between the risk weights of the proposed rule and the Basel III requirements for banks, the RBC proposed requirements are much more restrictive, almost to the point of being punitive. In comparing the categories and their risk weightings, credit unions under the proposed rule will generally fall under higher risk-weight requirements than those required for banks in the same asset categories.

The following are examples of the differences in risk weightings between credit unions under the proposed rule and banks under the current Basel III requirements:

- The risk weight for residential mortgages guaranteed by the FHA or VA is 20% for credit unions under the proposed rule, yet the Basel III requirements for banks sets the risk weight for these assets at 0%.
- The risk weight for non-delinquent first mortgage residential loans begins at 50% for credit unions and increases based on concentration up to 100%, yet the Basel III requirements for banks set the risk weight for all non-delinquent first mortgage residential loans at 50% with no increase.
- Similarly, the risk weight for other real estate loans, such as subordinate lien loans, increases for credit unions from 100% to 150% based on concentration, yet banks risk weight remains static at 100%.
- Finally, MBLs show the most extreme differentiation between credit unions and banks. The risk weight for MBLs for credit unions begins at 100%, and increases up to 200% based upon concentration levels, yet banks under Basel III are again static at 100%.

MnCUN has serious concerns with these disparities. This disproportionate treatment will unquestionably cause a competitive disadvantage for credit unions, resulting in restricted lending for consumer mortgage loans, MBLs and agricultural loans.

In addition to providing empirical data and analysis regarding the risk-weights, MnCUN would like to see NCUA re-evaluate the risk-weights under the RBC proposed rule as they relate to Basel III, more thoughtfully consider the actual market effect on the credit union industry, produce more reasonably calibrated risk-weights, and reconsider the value of concentration escalators.

Imposition of additional capital requirements on case-by-case basis

MnCUN is opposed to the proposed rule's allowance for imposing additional capital requirements on a case-by-case basis. Generally, this provision is too vague, unreliable, and unpredictable. §702.105(c), "Standards for determination of appropriate individual minimum capital requirements", specifically reflects that minimum capital levels for an individual credit union cannot be based on objective formulaic criteria alone, and that the decision to impose additional capital requirements on an individual basis is necessarily grounded in the subjective judgment of NCUA's agency expertise. MnCUN objects to the notion that a well or adequately capitalized credit union might fall subject to additional capital requirements, regardless of its ability to maintain such a classification, because NCUA, and specifically an individual examiner, may have a different opinion on a credit union's decision to have certain concentrations in assets or invest in higher risk-weight assets or investments.

In addition to the above, the proposed regulation prompts many unanswered questions, such as:

- Are individual examiners going to be provided with the authority to make this determination?
- Will there be someone else in a position of authority at NCUA to review and/or approve or disapprove such determination?
- Will there be an appeals process?
- What will be done to prevent abuse for an examiner that may be overzealous in order to prevent failures under their supervision?

While we generally accept that NCUA has broad authority under "safety and soundness", this potential requirement is too far-reaching. Credit unions carefully consider and develop strategic plans, which would completely unravel if an examiner would unilaterally, and perhaps arbitrarily, make such a determination. While a formulaic system itself is not perfect, it provides parameters within which a credit union is clear it must operate.

There is also the broader issue and concern that credit unions continue to have some element of autonomy to run their credit unions in the way they determine is most beneficial for providing services to their members and communities. MnCUN believes this aspect of the proposed rule hampers a credit union's ability to operate independently and grow in the way that is best for each credit union.

Lack of "credits" in the numerator for the RBC ratio

In general, NCUA should look at all aspects of the balance sheet, and focus as well on the numerator of the risk-based net worth ratio, and not just the asset side as reflected in the denominator. The risk-weights should work both ways, whereby credit unions have the ability to hedge interest rate risk by obtaining "credit" in other low-weight assets, such as certificates of deposit. NCUA should also consider giving credit when a credit union builds in its own insurance through CDs or long-term borrowing; such investments are considered additional insurance that are being used to hedge interest rate risk.

In regard to the deduction side of the numerator, the NCUSIF deposit has been removed. While NCUA reflects in the commentary to the RBC proposal that it has been removed on both sides of the equation, we believe it should be re-introduced as an intangible asset taken into account as part of the numerator. Credit unions are required to maintain the deposit on an ongoing basis as a percentage of assets. As such, it is a part of the balance sheet and meant to help cover risk.

Another area of concern is that the Allowance for Loan and Lease Losses (ALLL) is limited to 1.25% of risk assets. If it is a dedicated item on the balance sheet, why limit or restrict it in any way, shape or form? We have not seen any persuasive information provided by NCUA to support this treatment. GAAP won't allow the ALLL to be an excessive amount, but the motivation for the RBC system is to maintain a proper capital allowance for the risk of losses, so the reasoning for limiting the ALLL is unclear. While the commentary in the proposed rule reflects that the ALLL limit is consistent with the Basel III framework, that in and of itself does not justify its application to the overall risk-based capital rule, particularly in light of credit unions' historically low loss rates compared to small banks.

Finally, the removal of goodwill from the numerator is also a cause for concern. The NCUA's commentary in the proposed rule is absent reasoning for this deduction, other than identifying it as an intangible quantity. Many credit unions rely on goodwill as an asset in order that healthy credit unions might acquire troubled credit unions at no cost to the NCUSIF. In the same way that the NCUA is focusing on accounting for all potential future risks, the overall proposed rule should also seek balance by accounting for assets purchased that represent reliable potential future benefit.

<u>Proposed eighteen month implementation period</u>

The proposed implementation period of eighteen months is insufficient. Many of our credit unions have strategically built up capital buffers over many years of planning – and have strategic plans three, four, even five or more years into the future, based on the current rules and regulations. Among the many reasons for strategically planning for a capital buffer, credit unions see the need to plan for upward growth swings in assets that could significantly reduce their capital ratio. So although a credit union may remain well-capitalized under the current proposal, many credit unions' buffers will be significantly reduced causing them to make strategic decisions affecting growth and capital rebuilding. Under the most recent revision made to the Basel III system, banks have had approximately nine years to plan accordingly for various portions of the system (banks are currently in year four, with the final portions of the Basel III system becoming effective in 2019). MnCUN urges NCUA to reconsider the proposed eighteen month implementation period in favor of a much longer period to allow our credit unions sufficient opportunity to make strategic decisions, instead of forcing quick decision-making for short term solutions.

Significant impact on credit unions' overall capital buffer

A major focus of a credit union is its capital level. Many credit unions have strategically planned to create and maintain a buffer above the well-capitalized level threshold. Many credit unions have taken years to reach these goals. In analyzing our credit unions, many of their capital buffers above the well-capitalized threshold would decrease significantly under the RBC proposal. In fact, estimates show the total buffer for Minnesota's credit unions reduces by over $200 million, or approximately forty percent (40%). MnCUN is concerned with this dramatic potential decrease among our credit unions, and the significant and far-reaching impact that may result. This decrease could cause many credit unions to revise their strategic goals more conservatively, hampering growth, and restricting the products and services they provide to members.

Definition of "complex" credit union

The proposed rule only applies to those credit unions that hold assets of $50 million or more, which the regulation defines as "complex credit unions." This monetary threshold is arbitrary and overbroad. Further, by other reasonable financial industry measures, a $50 million financial institution is considered relatively small. When determining whether or not a credit union meets the definition of complex, NCUA should consider more than just asset size. Such consideration should include a credit union's comprehensive book of assets, including all loans, investments, and liabilities, as well as whether a credit union's operations are sufficiently diverse to warrant a "complex" designation.

Final thoughts for consideration

Prior to putting in place a new risk-based capital system, it is imperative to consider allowing credit unions ready access to additional secondary capital. This is particularly important during the period immediately following the rule's final implementation and prior to its effective date, when credit unions will be evaluating their portfolios and begin certain decision-making processes. It is also necessary because credit unions are already at a disadvantage in the financial market because they do not have the ability to access additional capital outside of retained earnings.

Even though the RBC proposed rule may not directly affect small credit unions under the $50 million threshold, another potential unintended consequence of RBC is the prevention of mergers and the ripple effect caused in the industry. If a well-situated credit union relies on its goodwill to take over a troubled credit union, and is no longer able to take such a risk under RBC's implementation because of a lack of allowance for goodwill, NCUA is then forced to step-in which subsequently negatively impacts the NCUSIF, and further results in payment of additional premiums by all credit unions.

As is apparent in the industry, credit unions generally are more conservative in their lending practices, have a more well-balanced portfolio, and overall tend to hold higher quality loans. The credit union mission is to serve its members, and it is becoming increasingly more onerous for credit unions to provide readily available consumer lending products, particularly mortgage loans. While one aspect of NCUA's purpose is to protect the NCUSIF fund and limit risk, part of NCUA's mission also includes supporting the credit union movement and industry. Overall, the current risk-based capital proposed rule goes too far – in NCUA's zealousness to curb industry risk, the resulting proposal is a punitive system instead of providing credit unions with opportunities for healthy growth and success.

No RBC system can be created that will hedge all risks and account for all potential loss scenarios. Regardless of best efforts on NCUA's part, there will continue to be credit unions that fail due to events outside of NCUA's control. However, credit unions must continue to be permitted to develop appropriate services and strategic plans that best serve its membership. In order for the industry to remain strong, in addition to regulation there has to remain room for credit unions to evolve, grow and succeed.

If you have any questions about our comments, please do not hesitate to contact me at (651) 288-5170.

Sincerely,

John Wendland
General Counsel

cc: Senator Amy Klobuchar
Senator Al Franken
Representative Tim Walz
Representative John Kline
Representative Erik Paulsen
Representative Betty McCollum
Representative Keith Ellison
Representative Michele Bachmann
Representative Collin Peterson
Representative Rick Nolan