From: Kevin Cole
To: _Regulatory Comments
Subject: Kevin Cole - Comments on Proposed Rule: PCA Risk Based Capital
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May 14, 2014

Gerard Poliquin, Secretary of the Board,
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22134-3428

RE: Kevin Cole – Comments on Proposed Rule: PCA – Risk Based Capital

Dear Mr. Poliquin:

I am pleased to be able to offer comments on the Risk Based Capital rule proposed by the National Credit Union Administration (NCUA).

Reforming the capital system for credit unions is an important policy objective and I commend the NCUA Board for attempting to address it. Creating a modern regulatory capital requirement for credit unions, based on the principles utilized by the financial services industry worldwide would improve the competitiveness of the credit union charter. Unfortunately, as proposed, the risk based net worth rule provides little relief to credit unions, while imposing arbitrary and inconsistent capital requirements that attempt to impose the biases and flawed analysis of the regulator on the industry in a way that is detrimental. Furthermore, the proposed rule provides nearly unlimited discretionary regulatory authority for NCUA exam staff to impose additional arbitrary capital requirements on credit unions without an effective appeal or oversight process.

The NCUA Board should not adopt the proposed rule, or any rule that generally requires credit unions to retain more capital. However, if the NCUA Board does adopt a risk based net worth rule, implementing the suggestions in the second section of this letter would mitigate the detrimental impact of the proposed rule.

Section 1 - General Comments on the Proposal

1. The expected required increase in retained capital for credit unions under the proposed rule is neither prudent nor justified. Based upon analysis by several industry sources credit unions would be required to hold an additional level of capital- up to $9 billion more than currently held to comfortably remain well capitalized under the proposed rule. Given the composition of credit union balance sheets and the low number of credit union failures even during the economic stress of 2008-2012, there is little evidence to support the need for more capital across the system. Furthermore, to meet the increased capital levels credit unions are faced with choices that are detrimental to members including reducing service through expense reductions, serving fewer members to slow the growth in assets, or making fewer loans to reduce capital requirements under the proposed rule.
2. The Board should consider a lower risk based net worth ratio than 10.5% to be considered

well capitalized. Credit unions lack many of the incentives, balance sheet characteristics, and systematic risk to the financial system that were considered in setting the 10.5% threshold for banks. Having the same risk-based net worth requirement, paired with higher risk weights and limited access to raise capital places credit unions in a challenging competitive position and threatens the viability of the credit union charter. At the very least it encourages credit unions to strongly consider whether another charter would be more advantageous for meeting the borrowing and savings needs of members.

3. NCUA overestimates the level of interest rate risk in the credit union system. This results in excessively high risk weightings for longer term investments. NCUA's reliance on Net Economic Value (NEV) as the sole measure of interest rate risk and reliance on the assessment of risk based on a 300 basis point parallel interest rate shock is harmful to the credit union movement, well beyond its application to the proposed rule. NEV is a fair value measure, designed to measure valuation at a point in time. Since the vast majority of credit union assets and liabilities are not carried at fair value it is inaccurate measure of financial risk or performance unless one assumes liquidation. Furthermore, the handling of uncertain cash flows, to which most credit union assets and liabilities are subject, is questionable in NEV analysis. While this proposal is not about NEV, NCUA's overreliance on this deeply flawed and crudely implemented measure of risk lies at the heart of some of the problematic risk weightings assigned to investments. NEV is a measure of long term risk to earnings, not a measure that can be applied directly to credit union capital based on a point in time calculation. NCUA's reliance on it as a measure of risk to capital is flawed and should be replaced with a value at risk measure that is commonly used in the financial services industry.
4. Any final rule that addresses the risks outlined in Table 3 of the proposed rule should clarify how the rule interacts with existing regulatory guidance. Specifically, a sweeping capital rule that addresses these 9 risk areas should replace deficient or inadequate guidance that NCUA has already issued. The interaction between the proposed rule on risk based net worth and existing rules (particularly recently enacted rules on interest rate risk and liquidity) should be clarified in any final rule and the rules and/or regulatory guidance that the RBNW rule replace(s) should be identified and formally retired. While I support the idea of linking the required level of capital to levels of risk, the rules should be comprehensive, not additive in nature and potentially conflicting.
5. The authority granted to NCUA in the proposed rule to impose individual minimum capital requirements under Section702.105 is unjustified and the verbiage is excessively vague and subjects credit unions to arbitrary and unjust abuse of power by NCUA exam staff. The criteria outlined in part b of section 702.105 can be applied to any credit union. Furthermore, these conditions include vague and forward looking statements like "has or is expected to have" or the particularly problematic section b(5). Section b(5) states that if a credit union is growing at such a rate that it has risk that is not covered by any other NCUA regulation or guidance, NCUA can impose a higher capital standard. NCUA feels compelled to make a rule that allows it to impose higher capital standards on a credit union that is growing too fast (not defined) but is in compliance with all standards for all risk factors.

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   At a minimum, the decision to impose an individual minimum capital requirement on a credit union should be treated in the same manner as a decision to "downgrade" a credit

union a category under prompt corrective action due to a safety and soundness concern under section 747 of the NCUA Regulations. Under the FCU Act a credit union can at most be downgraded 1 category under PCA (from well to adequately capitalized for example) for a safety and soundness concern and this power is cannot be delegated by the NCUA Board. The proposed rule not only allows an effective downgrade by the examination staff of more than 1 net worth category, but also allows the exam staff to effectively impose a net worth restoration plan on credit unions that are well capitalized under PCA, a power that is not available under the FCU Act. An IMCR is effectively a downgrade under PCA and the FCU Act contains protections and due process that is required for NCUA to impose such a discretionary supervisory action. Such due process must be protected in any rule that allows an IMCR.

6. The idea that a credit union is "complex" simply based on having total assets of $50 million or more is a broad definition of complex. I would argue that Congress' intent in the FCU Act when it required NCUA to define the term "complex credit union based on the portfolios of assets and liabilities of credit unions" would have envisioned a more rigorous approach to complexity than a simple tally. While this is a minor point, it is relevant to the extent the NCUA uses this definition as a justification to include a substantial number of credit unions in the new rule, while the standards outlined under the existing RBNW requirement regime are applicable only to credit unions with specific types of risk assets. One must question the amount of impact imposing the proposed rule on credit unions less than $500 million in assets would have on the overall risk in the NCUSIF.
7. Limitations imposed by reliance on the existing data collected in the call reports should be removed. For example, defining the riskiness of investments purely by weighted average life (WAL) fails to properly assess the relevant risks of those investments. Credit unions would prefer to report the information needed to construct an effective risk based system, rather than build an ineffective system with a lower reporting burden. As an example, credit unions with investment portfolios should be able to provide the effective duration of each security or group of similar securities and the risk weights could be assigned based on a more robust risk measure than WAL. Ideally, NCUA would retain the existing simplified reporting structure for credit unions with basic or limited investment portfolios, while allowing those with investments with more complexity to report additional information on those investments to correctly assess the risk and appropriate risk weighting.

<u>Specific Recommendations to Improve the Current Proposal</u>

1. A lower risk weighting should be applied to high quality corporate claims. Under BASEL III corporate claims against highly rated parties are weighted at 20%. For credit unions, the primary asset affected would be credit union owned life insurance used to fund employee benefit programs. These investments generally provide minimal fair value risk and are backed by low risk investments. The current risk weights propose to subject these claims to a 100% risk weight.
2. Investments with the guarantee of a Government Sponsored Enterprise like FNMA or FHLMC should be afforded risk weightings equal to the risk weightings afforded to instruments with similar risk characteristics in the proposal. For example, a mortgage loan in a credit union portfolio that is exposed to regular credit risk is weighted at 50% or 75%, while an agency

mortgage backed security (MBS) that is exposed to no more (and probably less) credit risk is risk weighted at 75% or 150%, depending on WAL. It would be reasonable to apply the mortgage weights to agency MBS. It would be also be desirable if the thresholds for increasing the risk weights based on percentage of assets were adjusted to reflect the risk mitigation that occurs from the agency guarantee and geographic diversity of agency MBS pools. Another similar example is the disparate treatment between Treasury instruments and agency bonds (not MBS). For example, a credit union can hold a 30 year Treasury Bond at a 0% risk weight but a 5 year agency note is weighted at 150%. This is clearly at odds with the intent to address interest rate risk in the credit union system through the proposed rule. Under BASEL III agency bonds are risk weighted at 20%. Assuming NCUA wanted to reflect interest rate risk in the capital requirement, a risk weight based on effective duration might be a solution to this disparate treatment. Regardless of the specifics, it is important that NCUA construct the rule in such a way that similar risk is treated consistently. It would be very helpful for NCUA to share the specific methodology and basis for establishing risk weights. Such transparency would enable the industry to assess and understand the NCUA risk assessment process for different types of assets.

3. The risk weightings on many types of investments are excessive. Most credit union investments are not sources of material credit risk. This is not captured the proposed risk weighting scheme, as GSE investments are not treated any differently than corporate bonds, municipal bonds, or private label MBS. For GSE backed investments that are highly liquid and eligible collateral for borrowings, the requirement to hold 15.75% capital or 21% capital is excessive for the risk posed by these investments. NCUA is clearly relying on NEV to assess the risk of longer term investments. While it is conceivable these investments could decline in fair value if rates rise sharply, even a decline of 30% or more is not a risk to credit unions with sufficient liquidity. This is the reason for the Liquidity Rule and the reason the treatment of investments as Available for Sale under GAAP exists. In no case should GSE backed investments have a risk weighting in excess of 100% and shorter term investments should have even lower weights The proposed risk weights may be appropriate for uninsured investments, certain types of volatile private label MBS, and other things that credit unions do not normally invest in.
4. A lower risk weight should be applied to credit union fixed assets. Fixed assets are not subject to the major risks NCUA attempts to address with this proposal, yet they are risk weighted at 100%. Since fixed assets are not subject to credit risk, interest rate risk, or default risk, and there are existing limits on credit unions that limit concentration risk, a 20% risk weight is appropriate for fixed assets. Since the risk of destruction or expropriation is insured, the 20% risk weight aligns with the suggested risk weight for claims on high quality corporates.
5. The treatment of the NCUSIF should be revised. The current treatment is punitive in that it treats the NCUSIF deposit as a 100% charge against capital. While evidence from the period 2008-2013 indicates participation in the NCUSIF is possibly the single largest risk credit unions face, it seems unlikely given the reforms to the corporate system, that such a risk to NCUSIF deposits remains. If the proposed rule is passed and credit unions are required to hold even more capital, it would seem the risk of loss of capitalization deposits in the NCUSIF would decrease further.
6. Deposits at the Federal Reserve Bank should be provided a 0% risk weight. If it is the intent to provide this treatment, FRB overnight deposits should be itemized separately from other overnight deposits on the call report. These deposits are not exposed to credit, interest rate, or

liquidity risk. Deposits at Corporate Credit Unions, however, should not be afforded this treatment and should be treated like a claim on a high quality corporate, to the extent the corporate credit union is high quality.

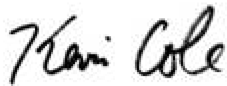
7. The risk weight assigned to CUSOs should be reduced. Although CUSOs are a small percentage of credit union assets, they are a source of innovation, collaboration, and economies of scale for the industry. The risk weight assigned in the proposal is excessive and not reflective of the risks posed by CUSOs. If CUSOs are not to be treated like general assets and risk weighted 100%, NCUA should at least classify them according to activity and establish risk weights based on the CUSOs potential to expose the credit union to the identified risks to be managed under the proposed rule. Since exposure to CUSOs is limited by rule and by the requirement for corporate separation, it seems excessive to assign a risk weight in excess of 100%.
8. The handling of derivatives in the proposed rule is less than optimal and does provide any capital relief when a credit union hedges risks for which capital is held, like interest rate risk. Basing risk weights on notional amounts of derivatives is flawed and inconsistent with the fair value based approach to risk weighting other assets and liabilities. The FASB has stated clearly and unambiguously that fair value is the only acceptable method for valuing derivatives and this is the approach NCUA should pursue. Furthermore, a derivative that is used in a qualifying hedge accounting relationship should be matched with the balance sheet item it is hedging and the instruments should be assigned a risk weight based on their combined (hedged) risk. For example, a 10 year fixed rate investment hedged with a swap converting the fixed payments to variable payments, should be risk weighted based on the combined effect, adjusted for credit risk exposure of the swap. In this example the risk weight of the combination of the investment and the swap should be risk weighted at 20-25%, as opposed to the proposed rule, which would risk weight the investment at 200% and add an additional capital requirement for the swap. Hedge accounting rules are very specific and must be tested for effectiveness so NCUA could easily specify that a hedge must qualify under GAAP for hedge accounting to receive this treatment under the RBNW calculation. In any case, the final rule should recognize that effective hedging is a risk reduction strategy and capital requirements should reflect this fact.
9. The 1250% risk weight that can be arbitrarily assigned by an examiner who determines that a credit union lacks sufficient understanding of the features of the investment is particularly problematic. This not only subjects credit unions to arbitrary abuses of power if the examiner does not understand the investment in question, appeals under this section are dependent upon the existing failed process that exists for appealing an NCUA determination. A reasonable process with 3rd party arbitration or expertise should be established as a pre-requisite for making a determination of this sort at the instrument level.

I would like to conclude by encouraging the NCUA Board to also consider the time allowed for credit unions to comply with any new standards adopted for capital. Forcing credit unions to make rapid changes to a balance sheet structure that has proven successful and resilient is reckless and negligent and the Board should allow a reasonable transition period of three to five years for credit unions to meet any new standards. While there are occasional credit union failures, there does not appear to be any imminent risk from lack of capital in the system. Banks were given until 2019 to meet new capital requirements and there is no reason a similar timeline would not be appropriate for credit unions.

The Board should also strongly consider expanding its proposal to allow credit unions to include secondary capital accounts in the risk based net worth calculation, even if secondary capital is not included in the net worth ratio as defined in the FCU Act for non-low income designated credit unions.

Finally I would like to thank those who have worked to date to advance this issue. Building a resilient capital structure that allows credit unions to provide as much value to members as possible should be an important policy goal of the NCUA Board and the credit union movement. There are many parts of the proposal that are very well conceived including the risk weighting for consumer loans that recognizes the historically strong performance of credit union portfolios and the treatment of cash and overnight funds that will help credit unions manage growth during flight to safety periods. I am confident that a forward thinking and effective solution can be developed with the cooperation of the Regulatory Agencies, the credit union movement, and the other stakeholders impacted by the issue.

Respectfully Submitted,



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