PENNSYLVANIA
CREDIT UNION
ASSOCIATION

4309 North Front Street
Harrisburg, PA 17110-1618
800.932.0661 • 717.234.3156 • Fax 717.234.2695

May 16, 2014

Mr. Gerard Poliquin
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Proposed Rule on Risk Based Capital RIN 3133-AD77

Dear Mr. Poliquin:

The Pennsylvania Credit Union Association (PCUA) appreciates this opportunity to comment on the National Credit Union Administration's (NCUA) proposed rule on Risk Based Capital (RBC). PCUA is a state-wide advocacy organization that represents a majority of the nearly 500 credit unions located in the Commonwealth of Pennsylvania.

PCUA consulted with its Regulatory Review Committee and State Credit Union Advisory Committee (the Committees) in order to provide comments on the proposal. The Committees consist of credit union CEOs and senior management staff. Members of the Committees also represent credit unions of all asset sizes. The comments contained in this letter reflect the input of the Committees and PCUA staff.

In summary, Pennsylvania's credit unions would support a properly balanced structure for RBC. We support safety and soundness and the broad concept that a relatively riskier balance sheet should be boosted by an additional capital cushion. However, NCUA's current proposal goes far beyond a rational structure that provides additional protection for consumers and the National Credit Union Share Insurance Fund (NCUSIF). Overall, the RBC proposal presents risks to the economic recovery and jobs, exacts a toll on the availability of consumer and business credit, and unduly restricts board and management discretion on critical management functions.

Public Policy Concerns

We oppose the RBC proposal because it represents ill-timed public policy. Since the economic downturn of 2008 and 2009, the country's economy has grown in fits and starts. We are deeply concerned that the proposal will have a negative impact on housing starts and decrease lending activities, particularly credit available to small business. Pennsylvania's unemployment rate as of March, 2014 was 6.0%, meaning 390,000 Pennsylvanians are out of work. The proposal poses a significant drag on the future of the recovery, disabling credit unions from providing necessary credit to consumers and small business.

Further, such a radical overhaul of Prompt Corrective Action (PCA) and net worth standards are not justified by recent history. The "Great Recession" represented the most significant economic downturn of our era. Pennsylvania's credit unions weathered that storm quite well under the net worth standards and system of PCA that is currently in place. Pennsylvania's credit unions finished 2008 with average net worth of 11.36%. For 2009 and 2010, Pennsylvania experienced a very modest decline in average net worth to 10.83% and 10.72% respectively. Despite a decline, the NCUSIF had a very healthy cushion of protection from the net worth carried by Pennsylvania credit unions. The Commonwealth's credit unions then experienced a steady increase in average net worth, posting 11.32% at the end of 2013. [1]

Pennsylvania's experience is a strong indicator that the current proposal goes too far. We would support a rational mechanism for safety and soundness purposes. As a general proposition, carrying additional capital in an appropriate amount to mitigate tangible risk is prudent. That said, the current RBC proposal should be withdrawn and NCUA should work closely with credit union stakeholders to develop an appropriate scheme that is more in sync with the structure and purpose of credit unions. Our specific commentary leads the way to a significantly improved regulatory scheme.

Definition of Complex Credit Union

We disagree with the definition of a complex credit union. Proposed section 702.103 would define a credit union as complex if its quarter-end total assets exceed $50 million. Asset size alone is not an accurate indicator of risk. The components of a balance sheet are a much better measure. Safety and soundness concerns would be better addressed if the definition of the term complex credit union focused on actual risk attributes of the credit union and its balance sheet. The proposed definition needlessly pulls some credit unions into the scope of RBC.

In addition, the proposed definition of complex credit union appears to be inconsistent with the Federal Credit Union Act (FCUA). Section 216 requires the risk-based net worth requirement for complex credit unions be based on portfolios of assets and liabilities of credit unions. 12 U.S.C.A. § 1790d.(d)(1). The proposed definition is based solely on total assets.

Equity

The proposal could be improved by a more appropriate treatment of the Allowance for Loan and Lease Losses (ALLL) in the numerator of the RBC ratio. The proposed ALLL limit of 1.25% is too low. Proceeds accounted for in the ALLL provide protection to members and ultimately the NCUSIF. Recognizing that such funds offer protection, they are worthy of greater consideration.

[1] Source of statistics, Callahan & Associates, Peer to Peer Analytics

Since approximately 2010, the Financial Accounting Standards Board (FASB) has proposed amendments to the treatment of ALLL numerous times. The most recent FASB proposal advanced the concept of Current Expected Credit Loss. CECL would increase the funding of ALLL. That's more protection but results in an increase in sterile funds that are not available for extending credit or other services for members. Whether CECL is finalized, a greater portion of ALLL should be included in the RBC numerator. In light of the severity of the proposed risk weights, a significantly greater portion of ALLL should be included in the numerator.

Risk Weights

We oppose the scheme of risk weights detailed in the proposal and we explain our specific objections below. The common thread in the risk weights is that they: 1) unduly restrain the discretion of a credit union's board and management in terms of operations and risk management; 2) pose a significant threat to the continued availability of consumer credit; 3) pose a significant threat to the continued availability of small business credit; and 4) blatantly ignore the structure and purpose of credit unions.

a. Mortgages, Real Estate Loans

We oppose the proposed risk weighting of mortgage loans. NCUA proposes risk weights ranging from 20% to 150% depending on balance sheet concentrations and other attributes of the either the mortgage or real estate loan. NCUA's rationale, particularly for mortgages or real estate loans that fall into the higher risk-weight categories, is not sufficient to justify the impact on a credit union's balance sheet.

In the background and summary to the rule, NCUA merely notes concentration risk, inadequate underwriting practices and high-risk products as support for the risk weights on mortgages and real estate loans. NCUA makes no tie nor cites any evidence of loss history in connection with credit unions for the proposed risk weights – it's pure generalization. NCUA's rationale ignores the fact that credit unions did not engage in low-document or no-document products or practices that created the instruments that became known as toxic assets. There is no reference to mortgage lending posing any empirical or systemic threat to the NCUSIF.

A well-balanced, final rule would accommodate the significant differences between various types of real estate loans. For example, adjustable rate loans, balloon-note mortgages, and home equity products have different repayment histories and maturities. Credit union boards and management offer an array of mortgage or real estate loan products mindful of such distinctions and performance histories. It boils down to risk management and management of the balance sheet. Accordingly, the proposal should be redrafted and risk weights assigned to individual loan products. Further, the risk weights should not be based on generalizations. The risk weight should be derived from actual loss history.

Further, the risk weighting for banking institutions is 50 and 100 percent for residential mortgage exposures. It is astounding that NCUA would propose a risk weight for credit unions in an amount so much greater than banks. In addition to recognizing differences in performance between real estate loans, the risk weights for such loans should be no greater than thresholds applicable to banks.

b. CUSO Investments/Loans

The proposed risk weighting for loans to CUSOs is 100% and 250% for investments in CUSOs. Here again, NCUA's rationale does not hold up under scrutiny. There is no discussion of default risk in conjunction with loans to CUSOs. Investments bear the 250% risk weight, apparently, because these investments are dubbed "unsecured equity" and they are not publicly traded. 79 F.R. 11198. NCUA offers no analysis or support for its suggestion that securities offered pursuant to an exemption in the securities laws carry any greater risk than those that are registered and/or publicly traded.

CUSOs serve Pennsylvania credit unions very well and in a safe and sound manner. They are an efficient vehicle for credit unions to collaborate. CUSOs enable credit unions to offer more services in a cost-effective manner or on a scale not possible should a credit union undertake the service individually. CUSOs have facilitated credit union participation in mortgages, member business lending, indirect lending and shared branching in Pennsylvania, just to name a few services.

We fear RBC will create a chilling effect on CUSO activity. The proposal signals NCUA's belief that CUSOs are inherently risky. In response, credit unions will be reluctant to invest in or lend to CUSOs. Such reluctance will foreclose appropriate business opportunities that will hurt consumers and small businesses in the long run.

c. Member Business Lending

We strongly oppose the risk weights applicable to member business loans. The rule would set risk weights ranging from 100% to 200% depending on their concentration as a percentage of assets. Such risk weighting ignores the exacting safety and soundness requirements of the FCUA and Part 723 of the NCUA Rules and Regulations. Specifically, the record ignores that MBLs are capped at 12.25% of assets, with some limited exceptions or exemptions. This ceiling is a built-in safety valve, limiting the extent to which a credit union can engage in MBL. It further overlooks the loan-to-value requirements, personal guarantee requirements and experience requirements embedded in Part 723 that are more rigid than standards applicable to banks in connection with commercial lending. At year end 2013 the average loan amount or MBL outstanding in Pennsylvania was $154,088.[2] We think that illustrates that small business lending is done on a pragmatic and safe scale warranting relief in connection with the risk weighting of such loans.

[2] Source of statistics, Callahan & Associates, Peer to Peer Analytics

The public policy arguments presented earlier in this letter bear repeating in the MBL context. We anticipate that the risk weights proposed for MBL will have a stifling effect on small business lending. Management teams will scale back on the volume of MBL to satisfy the RBC ratio. This will diminish credit available to small businesses and hurt job growth as we noted above.

d. Investments

The proposal assigns unduly restrictive risk weights to a variety of investments. The risk weights range from 50% for investments with weighted average life greater than one year and less than or equal to three years to a 200% risk weight for investments with a weighted average life greater than ten years. These proposed risk weights will force credit unions to dramatically shorten the duration or maturities of investments on their balance sheet. This takes away management's discretion to direct its portfolio in the best interests of the membership. Additionally, as credit unions can only raise capital through earnings, the shortening of the balance sheet forecloses earnings opportunities.

We are deeply concerned that the risk weights that apply to longer term investments could capture Federal Home Loan Bank (FHLB) stock. FHLB stock is a great value for credit unions that choose to be members. Access to the FHLB system provides another tool for balance sheet management and liquidity as well as diversity in terms of a source of funding. Like credit unions, FHLBs are member-owned cooperatives and returns are applied to replenishing a reliable source of funds. Applying a significant risk weight to FHLB stock has the unintended consequence of punishing a credit union for availing itself of a prudent business opportunity. This asset should be examined in light of the actual loss history, if any, connected to ownership of FHLB stock. It should be assigned an individual risk weight likely less than 100%.

The background offers little support for the proposed risk weights on investments. A more appropriate system would seek to account for the performance attributes of investments. For example, in the case of a debt instrument, is there a quantifiable loss history indicative of default risk? If there are options associated with an instrument, does that option present risk that can be quantified? In the end, given credit unions' limited means to raise net worth, it is very important that the final rule assign risk in a meaningful way. Resting the risk weights for investments simply on weighted average life is an inadequate approach, particularly in light of the consequences for a credit union.

Also, we see no justification for cash on deposit to carry a 20% risk weight. It poses insignificant risk and should, ideally, carry a zero- percent risk weight, but no more than 10% in any event.

e. Corporate Credit Union Capital

NCUA's proposed rule assigns a 100% risk weight to non-perpetual capital and a 200% risk weight to perpetual capital in corporate credit unions. We realize the duration of capital investments is relatively long and would carry some risk as a consequence. However, in assigning such high risk weights, NCUA overlooks the cooperative nature of credit unions. The corporate credit union system is an important payments system alternative for credit unions. It enables credit unions, particularly smaller asset-sized institutions to be self-sufficient in the payments arena. Such high risk weights make a capital investment in corporates less attractive and could lead to a shift away from the corporate system. It makes no sense to punish credit unions for supporting their own, unique payments system alternative.

Also, within the last four years, NCUA substantially overhauled the corporate credit union regulation, Part 704. Knowing full well the structure of perpetual and non-perpetual capital, in legal terms, NCUA should be estopped from imposing such a demanding risk weight on capital investment in corporate credit unions. Recognizing credit unions as cooperatives and the unique supporting role that corporate credit unions play within the credit union movement, the risk weights for corporate credit union capital should be liberalized.

Individual Minimum Capital Requirement (IMCR)

The individual minimum capital requirement, proposed section 702.105, should be withdrawn from the proposal. The proposed scheme of RBC, combined with the recently finalized Capital Planning and Stress Testing rule and the liquidity regulations that took effect in March of 2014, are adequate defenses against risk. Examiners should not be given the discretion to mandate any individual capital requirement. The examination process is too informal for such a decision and examiners will substitute their judgment for that of the credit union's board and management. Further, the list of factors for imposing an additional capital requirement is grossly subjective and no amount of redrafting can cure this defect. So this aspect of the proposal must be withdrawn.

Further, we take no comfort in proposed section 747.2006, review of order imposing IMCR. The procedure is merely an extension of examination or supervisory enforcement functions. Subsection (c) places the burden of proof on the credit union when seeking relief. NCUA retains all of the discretion to impose the IMCR. Review or resort to NCUA's Ombudsman is insufficient. Imposition of IMCR should occur only as the result of a formal adjudication conducted pursuant to the Federal Rules of Evidence. There is simply too much at stake in terms of the management and operation of a federally insured credit union. The only way to provide transparency and a fair opportunity for a credit union to present its case for the manner in which it has managed its affairs is to formally adjudicate an additional capital mandate. In situations where NCUA seeks to impose additional capital it should bear the burden of proof, and support its case by findings of fact and conclusions of law.

NCUA Authority to Adopt the Proposal

In addition to the foregoing arguments, we maintain that the RBC proposal, in its current form, is inconsistent with the FCUA. This renders the rule an arbitrary and capricious exercise of the agency's discretion.

Specifically, section 216 of the FCUA requires a system of prompt corrective action that is comparable to that established by the Federal Deposit Insurance Act and also mandates:

> The Board shall design the system required under subparagraph (A) to take into account that credit unions are not-for-profit cooperatives that – (i) do not issue capital stock; (ii) must rely on retained earnings to build net worth; and (iii) have boards of directors that consist primarily of volunteers. 12 USCA § 1790.d.(b)(1)(B).

The proposal, itself, demonstrates that NCUA exceeded its authority under section 216. The rule is heavily reliant on bank requirements for RBC. The risk weights for real estate loans and mortgages are more restrictive than similar risk weights for banks. The risk weights applicable to investments will force credit unions to shorten their balance sheets thereby decreasing earnings opportunities. The risk weights imposed on capital investments in corporate credit unions are a deterrent to investing in and supporting the payments system mechanism specifically designed for credit unions. In sum, the administrative record amply illustrates that NCUA failed to account for the structure of credit unions in that they do not issue capital stock and the only means of building net worth is through earnings.

Prompt Corrective Action

The proposed system of PCA detailed in sections 702.107 through 702.109 is alarming. Notably, through the numerous discretionary supervisory actions, NCUA has enormous discretion to assume the operations of a federally insured credit union without taking the legal steps required to place an institution into conservatorship. NCUA reserves the authority to require prior approval for branches and new lines of business. NCUA can restrict asset growth, prohibit deposit taking, require divestiture of CUSO interests and restrict or prohibit lending. NCUA can insert itself into the very management of the credit union by ordering a new election of directors, restricting executive compensation and mandating who a credit union can employ. This constitutes an inappropriate and draconian scheme of supervisory enforcement grossly out of step with any threat to the NCUSIF.

Arguably, NCUA's most pernicious ploy in the proposal is its authority to require a credit union to dismiss any director or senior executive officer provided that such dismissal "shall not be construed to be a formal administrative action for removal under 12 U.S.C. § 1786(g)." See proposed sections 702.107(b)(7), 108(b)(8), and 109(b)(8). The background and summary to the proposal paints this series of PCA as conforming amendments. These removal provisions could place a credit union in significant risk of litigation where there is a contract of employment with an executive management official. At the same time, NCUA seeks to extract itself from the threat of litigation. Any removal action should be undertaken pursuant to section 1786(g), substantiated by evidence and the appropriate parties should have notice and opportunity to be heard.

Effective Date

NCUA proposed that RBC take effect approximately 18 months after publication of a final rule. NCUA argues that 18 months is sufficient lead time to plan for the new capital requirements and other aspects of the prompt corrective action regulation. We disagree. Banking regulators, led by the Federal Reserve created a graduated phase-in of Basel III of roughly nine years for full implementation. Given the impact that RBC will have on credit union management decisions and balance sheets, 18 months is too little time. We maintain that a minimum of sixty (60) months will be required to prepare for the rule.

Conclusion

In conclusion, NCUA and federally insured credit unions would be better served if NCUA would withdraw the current proposal and start fresh. In its current form, the RBC proposal represents bad public policy because of its potential impact on the nation's economic recovery and jobs. As detailed here, it is easy to anticipate diminished access to credit, for consumers and small businesses. Equally troubling is the compliance environment surrounding mortgage lending as a result of the Dodd-Frank Act's mortgage provisions. Again, as credit unions seek to manage the Dodd-Frank requirements and RBC in the near future, they will be forced to underwrite in the most antiseptic of ways resulting in less available credit at a time when public policy strongly requires a free flow of credit.

From a supervisory standpoint, we are extremely concerned about RBC's impact on management's ability to make rational business decisions. In recent years, NCUA has increased its regulation and scrutiny on interest rate risk and liquidity. In April of 2014, NCUA finalized a rule on capital planning and stress testing that is applicable to federally insured credit unions with assets of $10 billion or more. RBC is the next regulatory frontier. All of these rules taken together seek to homogenize credit union balance sheets and force management to articulate a risk management response to conditions that cannot be foreseen. Accordingly, RBC in its current form defies common sense. It undercuts management's discretion in terms of risk management. The NCUSIF, credit unions and consumers would be better served by an overhaul of the proposal that addresses actual loss histories. The administrative record should be much more developed and robust. NCUA should convene public hearings and take testimony on alternatives to risk management in support of a proposal that is more consistent with credit unions as cooperative financial institutions.

The proposal raises significant legal concerns. We maintain that NCUA overstepped its authority pursuant to the FCUA, notably because the scheme of risk weights places significant stress on a credit union's ability to achieve earnings. Consequently, NCUA has overlooked a material mandate of the FCUA that a scheme of PCA duly take account that credit unions can only raise net worth through earnings. The ICMR as proposed leaves NCUA with too much discretion over capital decisions and raises due process concerns. Many of the discretionary and mandatory PCA responses that have been proposed amount to NCUA inserting itself into the role of the board and management of a credit union absent the appropriate steps to place an institution into conservatorship.

We would be happy to discuss these comments with the NCUA Board and staff at your convenience.

Sincerely,

PENNSYLVANIA CREDIT UNION ASSOCIATION

Richard T Wargo

Richard T. Wargo, Jr., Esq.
Executive Vice President/General Counsel

RTW:llb

cc: P. Conway, President & CEO
Association Board
Regulatory Review Committee
State Credit Union Advisory Committee
M. Dunn