May 23, 2014

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

Dear Mr. Poliquin,

The National Federation of Community Development Credit Unions (the Federation) appreciates the opportunity to submit these comments on the proposed risk-based capital rule proposed by NCUA to better evaluate the capital adequacy of complex credit unions.

The Federation is a non-profit financial intermediary and association of credit unions with a primary mission of community development. The Federation provides capital, technical assistance, training, programming support and consulting services to credit unions to help them promote financial independence, asset building support and community development in some of our nation's poorest communities.

The new risk-based capital rule will apply to 26% of our members who would fall under the proposed designation as a "complex" credit union. These institutions serve some of the poorest communities in our country providing a range of financial products and services to underserved people. As the leading secondary capital investor in credit unions nationally, the Federation can appreciate the agency's intent to develop more relevant, risk-based tools to evaluate the capital adequacy of credit unions. We recognize that a revised risk-based capital standard that more accurately reflects the risk profile of credit unions and adds additional capital buffers will strengthen credit unions and protect investors, thereby drawing more capital to our collective work and mission.

At the same time, we feel the current proposed rule falls short in several fundamental ways. We hope that by submitting these comments, we may further the necessary dialogue the NCUA must engage in with the movement to determine a more appropriate and accurate tool.

1. **The proposed threshold for Complex Credit Union as $50 million in assets appears arbitrary and unnecessarily low.**

With 40 years' experience in providing technical assistance and training, we find that just as credit unions are reaching $50 million in assets they are beginning to hit their stride and begin yielding significant impact upon their communities. Imposing risk capital measures on credit unions at this size will restrain and limit growth. At this size, credit unions are still seeking to achieve greater economies of scale that increase their operating efficiencies and improve their margins. The Federation strongly

believes that the imposition of additional capital standards at this stage will limit these institutions in moving to the next level of size, capacity and impact on their communities. Moreover, these are generally strong institutions that become stronger as they grow. Credit unions between $50 million and $250 million currently pose relatively little overall risk to the Insurance Fund. We recommend raising the threshold for complex credit unions to $250 million in assets.

2. **Proposed §702.104(b)(2) Risk-based Capital Numerator Deductions**

We were concerned to see that the NCUSIF Share Insurance Capitalization Deposit was subtracted from net worth in the proposed rules. The rationale in the proposed regulation fails to make the case about the risk to credit unions. Subtracting the Deposit from a credit union's net worth in essence treats these funds as unavailable to cover risks or losses. The purpose of deducting intangible assets from a risk-based capital calculation is to exclude assets that are unavailable to the NCUSIF in the event of a credit union's liquidation. While it is true that neither a credit union nor the NCUA can sell a credit union's NCUSIF deposit, that deposit is available to the insurance fund itself to cover losses. In fact, NCUA's procedure is to seize the NCUSIF deposit of a liquidated credit union prior to assigning losses to the general fund itself. The NCUSIF Share Insurance Capitalization Deposit should be treated as a tangible investment for risk-based capital purposes and therefore be considered fully in the calculation of net worth as it is in the calculation of assets.

3. **Section 702.104(c) Total Risk-Weighted Assets**

The Federation has numerous specific comments and concerns regarding the assignment of risk weighting on different asset classes. The Federation and its members, like other commenters, believe the risk weights assigned in the proposed rules are not aligned with the actual risk represented by the asset category. By over-emphasizing certain risks, the NCUA runs the overall system risk of unnecessarily constraining credit unions from certain high-impact activities that provide reasonable risk-adjusted returns to the credit union, disadvantaging the credit unions in the marketplace, and (of equal importance) unnecessarily constraining important community development activities. There are two critical concerns about the methodology employed that permeate throughout specific areas identified.

- **Unnecessary and duplicative weighting of concentration risk.** By developing formulas for risk weights that attempt to account for credit, interest rate and concentration risk, the formulas concocted in these proposed rules place unnecessary, duplicative capital requirements for credit unions specializing in select lending activities. This inadvertently undermines an important component of credit risk weighting which is the recognition that credit unions that specialize in certain lending activities tend to be better at those activities than those that do not. If the activity itself is deemed to be of higher risk to the institution or system, that is already accounted for in the base risk weighting. Thus credit unions having more than 25% of their portfolio in member-business lending will already have to demonstrate higher capital levels than credit unions with lower member-business loan balances. The proposed rules duplicate the penalty for portfolio concentration creating a double jeopardy for the credit union engaging in this activity. If a credit union specializes in a certain type of lending, and that lending is deemed to be of greater risk, then the risk weighting should be sufficient. Placing an additional weight for portfolio concentration will have the unfortunate consequence of constraining that form of lending and preventing institutional differentiation and specialization. We believe that pushing a credit union to lend in an area outside its core competence may, in fact, increase that institution's risk, rather than focusing on its area of highest competence.

- **Rules invoke Basel III but the assignment of risks are unrelated, less nuanced and less robust than the weight categories assigned under Basel, thereby disadvantaging credit unions in the marketplace.** Asset risk weightings under the Basel system are an exclusive function of credit risk. While other risk charges are also required for banks operating under Basel, those requirements are based on discrete, developed methodologies. Under the proposed rule, asset risk weightings for credit unions would incorporate credit, interest rate risk, and concentration risk. The marginal contribution of interest rate and concentration risk is both unsupported and misguided. Additional capital requirements for greater concentrations of long-term assets do not incorporate the degree of duration matching in a credit union's asset and liability portfolios. This approach is especially misguided given recent (and very positive) regulatory changes which allow for the use of interest rate swaps in rectifying duration gaps. Interest rate risk and asset concentration risk are both real risks, to be sure. But their inclusion in credit union capital requirements, if warranted, should be based on robust, clear methodologies, not simplifying assumptions and approximations.

The Federation and its members have significant concerns about the extent and degree to which the proposed risk-weightings vary substantively from the Basel III rules.

4. **Section 702.104(c)(2) Risk-Weights for On-Balance Sheet Assets**

The specific risk-weightings for mortgage loans and member business loans appear punitive compared to the standards applied to banks and appear to be structured to discourage credit unions from engaging in these forms of lending. As community development credit unions grow and thrive in their communities, it has been clear that the pathway to scale and sustainability is to grow the credit unions products and expertise beyond small consumer loans. Virtually no CDCU has ever gotten to a self-sustaining, high-impact scale without a concentration in mortgage and/or member business lending. Many that fail to get to scale try to compete in every product segment and struggle with the weight of being inexpert at many things.

- **Real Estate Loans:** Overall the Federation has heard from its members concerns that the calculations of risk in the proposed rules are not only more stringent than those applied to small banks under Basel, but will work to restrict the vital role of providing homeownership to individuals and in communities otherwise underserved. Credit unions, and particularly community development credit unions have fared exceptionally well in their real estate lending when compared to almost all other lenders. CDCUs suffered minimal losses to their home mortgage portfolio as compared to banks during and following the mortgage crisis. They suffer minimal losses and pose little risk to the system because their lending is generally coupled with supportive services in the form of counseling and the loans themselves are structured to the capacity of the borrowers. CDCUs did not participate in high-risk, speculative practices of many for-profit lenders but rather structured loans to ensure the ability of the homeowner to succeed.

- **Member Business Lending:** The risk weighting of member business loans under this proposed rule are far greater than comparable risk weighting under Basel III. This is again a case in which increasing the weight factor due to specialization places an undue and vastly overestimated risk calculation on a credit union. A credit union with a large business lending portfolio could easily have 25% or more of its assets in safe, performing MBLs backed by real estate or other collateral. To require a 200% weighting is completely disproportionate to the risk and restrains

credit union specialization in business lending. The justification in the proposed rule for setting a threshold of 15 percent "…*to provide for the possibility of a decline in asset size once a credit union reaches the 12.25 percent statutory limit for MBLs*" fails to take into account the close to 30% of the credit union system that are low-income designated and therefore not subject to the limit.

- **Delinquent loans:** Assigning a higher risk weighting of capital for delinquent loans presents an unfair disadvantage to those credit unions serving Americans of the most modest means. The capital requirements for delinquent consumer loans in this proposed rule are 50% greater than Basel III. CDCUs have historically demonstrated that while they generally manage a higher delinquency rate when compared to mainstream credit unions, the charge-off rates are either at or often below industry standards. Lower-income people experience shocks to their income throughout the year, are more likely to be engaged in seasonal employment and often patch together household income from multiple sources of income. This may result in income flows that are less stable than middle and upper income households and cause them to periodically be late payers to the credit union. However, they also recognize that the credit union is often their best or last resort and they take pains to make payments. The calculation of greater risk to delinquent loans as opposed to historic charge-offs may limit or constrain important lending activity in some of our nation's most distressed communities. This risk calculation runs counter to the NCUA's own examiners' guide on low-income credit unions, which recognizes that higher delinquency doesn't always translate to higher losses. The Federation supports matching the Basel III capital weights for delinquent loans, but does not believe credit unions should be held to a higher standard for those same loans, which induces credit unions to be more conservative in their lending than mainstream banks in spite of their better performance history.

5. **Section 702.104(c) (3) Risk-Weights for Off-Balance Sheet Activities**

Under the proposed Risk-Based Capital Rule, credit unions appear to be penalized for having unfunded commitments on non-business loans and business loans with an unnecessarily high risk assignment. In order to improve the risk-based capital calculation, a credit union may look to terminate or decrease lines of credit to consumers or small business owners.

Consumers (and particularly those of modest means) need to access these funds when they feel it necessary. They may need access to these funds for emergencies, seasonal ebbs and flows in household income and other important occasional needs. Similarly, small businesses need lines of credit for working capital, seasonal needs, or to take advantage of opportunities to further their business.

It is a prudent and responsible business practice for small business borrowers to line up working capital -- lines of credit that may not be needed regularly or completely, but that are available when new opportunities present themselves or unanticipated events occur that may temporarily impact their business. Businesses that are able to access unused lines of credit during and immediately following natural disasters and other local emergencies, for example, survive and thrive at a much higher rate than those that do not have this immediate access to credit lines. This rule limits and may even eliminate a credit union's ability to offer these valuable tools for their local economy and for their member businesses.

6. **Section 702.105 Individual Minimum Capital Requirements.**

One of the most concerning aspect of the proposed rules is the introduction of undefined subjective judgment into an otherwise straightforward capital assessment. The proposed rule states "a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of a credit union's regulatory capital ratios." This language offers no metrics or parameters and introduces unnecessary inconsistency into a process which is intended to develop industry standards, allowing for meaningful comparisons both internally and externally. There is a substantial variation in the skill and experience of NCUA personnel, which will inevitably lead to some examiners making erroneous and inappropriate capital requirements in an ad-hoc fashion.

Moreover, the inclusion of examiner discretion prevents credit union board and management from engaging in thoughtful planning for growth, capitalization needs and strategies and the appropriate sequencing of new products and risk asset classes. As other commenters have noted: "…If there are going to be additional risk factors measured and factored into the risk-based capital formula, the logical step to take would be to list all possible factors and the related risk weights." If not handled in this manner, examiner judgment could create a risk factor with more weight than those risk components listed in the proposed rule. There is already a clear place for examiner and supervisory input into credit union performance and review through the examination process. It is our members' long-standing experience that less experienced examiners are often assigned to smaller credit unions, which increases the likelihood of arbitrary supervisory decisions for those complex credit unions on the smaller scale.

7. **Secondary Capital.**

The Federation strongly supports the inclusion of secondary capital as part of the capital numerator in the proposed risk-based capital regulation. This is consistent with NCUA's practice with the current risk-based net worth regulation and the reality that secondary capital funds are truly at risk for the investor and wholly available to the NCUSIF to cover losses in the event of a credit union liquidation. At the same time, we encourage NCUA to build on this decision to increase the availability of secondary capital for low-income credit unions.

For community development credit unions, an increasingly important segment of complex credit unions, the ability to continue to attract secondary capital and grow critical community development lending opportunities is essential. A critical complement to the risk capital rules will be the revision of the secondary capital rules that will facilitate the growth of outside capital into the credit union industry.

With the CDCI Initiative at US Treasury, the credit union industry increased by almost $70 million the outside capital brought into the system. As these investments mature and are repaid, it will be critical to continue to find and grow external sources of capital.

In the proposed risk capital rules, the NCUA Board recognizes that some credit unions would likely need a transition period to accumulate additional capital or change their asset structure to achieve their desired capital classification. The Board also recognizes that credit unions will need a reasonable period of time to update their internal systems, policies, and procedures to account for these changes. Secondary capital will become a significant vehicle whereby growth-oriented, stable low-income credit unions will be able to bring on high impact community development lending while remaining well-capitalized.

In an informal review with financial institutions, socially responsible investors and other potential secondary capital sources, the Federation has found that the structure of the secondary capital does not meet the needs of many investors. The long-term interest-only investment with a balloon repayment following at least five years, does not suit the needs of investors whose business model require regular inflows and outflows of investment dollars. Without repayment of principal, secondary capital becomes a much less appealing product for banks whose CRA investment and lending tests require demonstration of regular investments each year. Without the ability to revolve the principal, banks prefer to remain with shorter-term (but less needed) deposits or choose to bypass CDFI credit unions entirely in their lending portfolios.

The primary rationale for the structure, to date, has been the safety and soundness of the credit unions and the protection of the share insurance fund. In fact, one could argue that in the final five years of maturity as the 20% of the investment each year reverts to notes payable rather than net worth, the interest payment becomes pure cost to the credit union and poses little benefit.

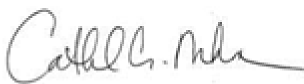
If the NCUA were to adjust the existing secondary capital regulations to allow for the amortization of the loan and repayment of principal to the investor, the Federation believes there will be a substantial market for secondary capital investments at attractive rates. This will greatly aid complex low-income credit unions to grow high-impact community development lending while maintaining adequate capital.

Summary

The Federation wishes to reiterate its support in concept for a process that evaluates capital adequacy based on the business model and risk inherent in different business activities. A well-structured tool may offer credit union clear benchmarks in growing their portfolios and serving their communities. However, the current rules place too great a burden on growing credit unions that relative to the much larger institution do not pose as great a risk to the Insurance Fund. The weighting mechanisms duplicate the risk calculation for important high-impact assets and do not allow for sufficient development of specialization and expertise. In short, this rule will need sufficient revision and refinement to achieve the intended goal while building and supporting a robust industry.

We appreciate the opportunity to share these comprehensive comments and look forward to an engaged dialogue with the Agency and our colleagues throughout the industry.

Sincerely,



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