Utah's Credit Unions
Utah Credit Union Association

May 20, 2014

Mr. Gerard Poliquin
Secretary to the NCUA Board
1775 Duke Street
Alexandria, VA 22314

Re: NCUA's risk-based capital proposal

Dear Mr. Poliquin:

Thank you for the opportunity to comment on the proposed risk-based capital rule. I represent the Utah Credit Union Association, which serves 72 credit unions in Utah. At the Association, we appreciate the difficulty of creating an effective rule that addresses such a complex and important issue. There are many factors in play, and how to balance them has no doubt been a topic of considerable analysis at NCUA.

We support the notion that credit unions that take on more risk should have more capital to cover that risk. The idea makes sense, and is fair to all credit unions. However, some details of the proposal should be modified or removed in order to create a sound rule.

The consumer good

The single largest concern we have with the rule is that it will likely—over time if not immediately—cause credit unions to think more about their capital and less about their members. Of course we need a sound credit union system, and that means adequate capital, but with the proposal structured as it is, there's a new element added to deciding how to treat members: how would granting this loan affect my capital?

That new consideration may outweigh other important factors, such as ability to repay, the income brought into the credit union, and the community good accomplished through the loan. It's no longer a question of treating members with equity, or ensuring the credit union has adequate income, but a question of preserving capital levels.

For example, it could happen that two people go to a credit union for a loan, and the second is denied simply because it would have tipped the credit union into an asset

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category it can't afford to be in—not because the loan itself was risky. The credit union was pushed into denying the loan through no fault of the consumer.

It may be appropriate—considering the unique structure and mission of credit unions—for the rule to include mitigating provisions that would soften such situations. For example, a credit union finding itself in a position of refusing loans because of concentration levels could be given time to increase capital, rather than the capital being required immediately. This would be a "grace period" of sorts, and takes into account the unique structure and purpose of credit unions.

One rule to rule them all

As the proposal stands, it almost feels as if there is nothing between credit unions and insolvency except for this rule. Of course that's not the case. There are many other practices, procedures, requirements, internal controls, and policies that all mitigate risk. Yet this rule seems to want to function as the catch-all solution to risk. Perhaps that is how risk-based capital functions inherently, but in reality it is simply one piece of a broader enterprise risk management effort.

What about a credit union's ALM program? What about its Interest Rate Risk policy? Its concentration policy? The ALLL calculation and funding? Its mortgage loan, business loan, and other underwriting policies? Collection policies and procedures? Investment policy? All those things also function to mitigate risk, and in most cases do a very good job. Creating a risk-based capital rule that encompasses all types of risk creates regulatory redundancy and burden.

We understand that NCUA is required to have the risk-based capital rule, and would submit that if the rule must consider many types of risk, then perhaps it would be in order to remove other rules that also address those types of risk. However, we feel that one "master" rule probably would not be as effective as several smaller, more precise rules that can be adjusted more easily if necessary.

The best solution really may be to work for a change in the law, so that the capital rule is not required to take into account all types of risk. The ideal situation seems to be individual rules addressing specific risks, as opposed to what this proposed rule would accomplish: keeping the existing rules and adding more controls to address the same risks, thereby creating redundancy.

Capital on a case-by-case basis
One troubling provision, in particular, allows NCUA to determine on a case-by-case basis that a credit union needs more capital. This provision should be completely removed. Short of that, rigorous guidelines for determining when a credit union needs additional capital should be developed, and possibly paired with a specific procedure for a credit union to disagree with the NCUA, and possibly the inclusion of a neutral arbitrator in the disagreement.

It's difficult to engage in a conversation with credit unions about NCUA without hearing comments about examiner inconsistency, bias, lack of expertise in some areas, and personality conflicts with credit union staff. Throwing those human tendencies into the mix of capital requirements—the single most important measure for credit unions—is a recipe for disaster, if not at least misuse.

In some ways, the entire proposed rule doesn't matter if NCUA would have the power to determine on a case-by-case basis if a credit union needs more capital. A credit union cannot depend on the rule if an examiner can determine that the rule is inadequate, especially without guidelines for determining when the rule isn't doing its job and that the credit union needs more capital.

This aspect of the rule is simply open to too many human errors to leave in.

Risk weights
We cannot speak specifically to the effect and appropriateness of the several risk weights, as we feel we don't have the data to do so. This data would include total losses to the insurance fund for each type of category, as well as losses to credit unions for each type of category, considered in tandem with total portfolios. Presumably, the risk weights for various types of assets were set based on that type of data and an appropriate analysis. For example, which types of assets caused the most losses at credit unions, and in what scenarios those types of risks caused losses—whether it was due to poor underwriting, or too much concentration, or inadequate liquidity, etc.

Given the fluid nature of the regulatory environment, we're interested in evaluating if the data is still accurate. For example, much of the data surely came from the recent financial crisis. Since then, NCUA has implemented numerous new rules and has increased oversight in many areas. Risk to the insurance fund should now be much lower than it was four or five years ago because of the increased oversight, changed rules, and more rigorous procedures. If so, the data from the recent recession may not accurately represent the risk of different types of assets because the risk has already been mitigated through other examination and regulation practices. We would submit that for this reason, risk weightings in the proposed rule are probably too high because data is from a period prior to increased oversight.

Another observation about the risk weights: they give the impression of "picking and choosing" risks to assign to asset categories.

For example, the rule seems to focus in on credit and concentration risk for mortgage loans. Yet, the total risk involved in a mortgage loan—or even a portfolio of mortgage loans extends to interest rate and liquidity. Why pick just credit and concentration for mortgage loans? It seems arbitrary.

Likewise, not considering the interest rate and liquidity risk of government-guaranteed loans seems arbitrary, when very similar types of assets are considered for interest rate risk and liquidity risk. Really, the only thing that changes is the "credit" risk of those assets.

Further, lumping all consumer loans together seems counterintuitive, as credit card loans, new auto loans, indirect auto loans, and used car loans do not seem to bear the same amount of credit risk. Perhaps the rule assumes that the risk of those types of loans is all about the same, based on underwriting procedures and practices, and if this is the case, why recognize those practices for this category, and not others?

Clearly, it would take some complex math to consider all types of risk for each type of asset category. We appreciate that NCUA is interested in *not* increasing the difficulty of reporting on the Call Report. We certainly concur with that goal. However, we cannot help but wonder if it wouldn't be worth increasing some of the reporting on the Call Report if it meant creating a better rule. In fact, given the fluid environment and the changes that have already taken place since the financial crisis, it seems like a good idea to improve the type of data collected, collect and study it over an extended period of time, and then edit the proposed risk-based rule based on that improved and up-to-date data. It would be a small trade off for such an important rule.

One more point regarding the general weight settings and why they may be too heavy. Until now, current levels of capital held by credit unions have typically adequate. This capital includes a buffer above and beyond the requirement to be well-capitalized. Credit unions manage their capital and risk with that buffer, considering it in conjunction with all of the other rules, regulations, and programs that they adhere to. In general, these capital levels have served credit unions well. In a sense, the credit union is risk-weighting its capital without being required to. Otherwise, they would maintain their capital levels right at 7 percent.

The fact that the buffer for such a large percentage of credit unions shrinks under the new proposal would indicate one of two things: either the weights are too heavy, or the way that credit unions and NCUA have managed their capital until now—including all the rules and regulations that NCUA enforces—have been inadequate until now. It seems more likely that the weights are too heavy, rather than that everyone in the system is managing capital wrong. We would submit that a correct weighting of assets would place credit unions in about the same capital position that they are today, including the buffer.

Complex credit unions

Another important consideration of the proposal is the definition of "complex." In our opinion, it appears that the definition of complex may not be in compliance with the requirements of the FCUA, which indicates that the definition of complex should be based on "the portfolios of assets and liabilities of credit unions." Potential issues:

1. The proposed rule's definition seems only to relate to assets, and not liabilities. It could be argued that a credit union's liabilities are naturally related to the assets, and therefore the definition of $50 million in assets includes a consideration of liabilities. But if that were the intent of the law, why bother speaking of assets and liabilities separately in the law?
2. The meaning of the word "portfolio." The proposed rule seems to accept portfolio to mean "total assets" of a credit union. Often, however, the term "portfolio" refers not simply to the sum of assets, but also to the mix. When asked what its loan portfolio is like, a credit union would not simply give a total amount. It would outline how much of each type of loan it had.

Given those points, it would make more sense to define "complexity" based on a mix of assets and liabilities rather than a lump sum of assets. Simply defining "complex" based on assets oversimplifies the issue, and imposes additional regulatory burden on credit unions that in reality aren't very complex. It appears that the rule, in an effort to simplify which credit unions are covered by the rule, disregards the intent of the law. Simplicity is desirable, but not at the expense of what was intended.

The definition of complex should be based on the mix of liabilities and assets a credit union has on its books, not simply the asset size. For example, consider two credit unions with $100 million in assets. One has many different types of assets with varying credit, liquidity, and concentration risks. It invests in instruments that most credit unions don't understand. The other credit union has only consumer and mortgage loans. Clearly, one is more complex with the other, yet the proposed rule treats them the same.

A more sensible way to define complex would entail examining the make-up of a balance sheet (both liabilities and assets), with more complicated assets and liabilities being the key to defining complex.

A few other notes

- All of the funds in the ALLL should be included in the capital calculation. The calculation of ALLL and GAP already encourage the credit union to have the right amount in the ALLL. There should be no need for the capital rule to try and accomplish the same thing.
- The effect of removing the NCUSIF deposit from capital is not made harmless by also removing it from the risk-asset calculation. In fact, it has an undue negative effect on the ratio because it makes up a much larger portion of the numerator than the denominator. It should remain in both the numerator and denominator of the calculation, weighted at 0% on the asset side, and counted at full dollar amount on the capital side. After all, if a credit union were to liquidate, that money would be returned to the credit union, and the share insurance fund would be no worse for the wear. If a credit union were to go under, needing to dip into the NCUSIF, if it dipped in to exactly the amount it had on deposit, it would basically not cost the insurance fund anything. The money a credit union has in the NCUSIF is the credit union's, not the NCUA's, and should be considered available to cover losses.
- For such a broad, far-reaching rule, the proposed implementation timeframe is quite short. Banks had much more time to prepare for Basel III. For a smooth transition into this new capital model, a longer lead-up period should be implemented. Eight or nine years is probably not necessary, but at least

five. This would give credit unions plenty of time to adjust balance sheet composition.

- It's also possible that the proposed rule will decrease income for credit unions. After all, the typically more lucrative types of loans are weighted heavier in the proposal. But if credit unions don't seek out those types of assets because of the increased capital burden, their income will lag. This will hinder growth for credit unions and hurt the American consumer.

Summary

In summary, the proposal will affect America's consumers by reducing the control they have over getting loans. Suddenly, there's another factor to obtaining credit outside their control. This is, perhaps, an inevitable factor of any method of implementing risk-based capital. Efforts should be taken to minimize this impact on consumers.

In addition, the "exception" aspect of the rule has the potential for many unforeseen consequences, and calls into question the efficacy of the rule. Why would we need exceptions if the rule were adequate?

And, finally, this rule is not the only thing standing between credit unions and insolvency. There are many other practices in place that mitigate risk. Many of those practices have been added since the recent financial meltdown. Those changes should be considered as part of the complete picture when evaluating the total risk picture of the credit union. Not all risk and risk mitigation factors are quantified in the numerator and denominator of the ratio.

Thank you for the opportunity to comment on the proposed rule, and thank you for your work on behalf of credit unions and their members.

Best regards,

Stephen Nelson

Stephen Nelson
Vice President of Credit Union Support