

May 28, 2014

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428
Filed via: regcomments@ncua.gov

Re: RIN 3133-AD77, NCUA Proposed Rule:
Prompt Corrective Action–Risk-Based Capital

Dear Mr. Poliquin:

This letter represents the views of the Credit Union National Association on the agency’s proposed Prompt Corrective Action–Risk-Based Capital regulation, which was published in the *Federal Register* February 27, 2014. By way of background, CUNA is the largest credit union advocacy organization in this country, representing state and federal credit unions, which serve over 99 million consumers and small businesses. CUNA’s letter was developed under the auspices of our Examination and Supervision Subcommittee.

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Executive Summary

CUNA is a strong, historic supporter of risk-based capital, but speaking on behalf of the credit union movement, we ardently oppose this proposal and urge NCUA to withdraw it based on the following concerns.

First, risk-based capital should not be addressed in isolation as the proposal would do, but should be part of a multi-faceted capital reform strategy. Under this approach, NCUA should coordinate with the credit union system and Congress to achieve statutory changes that adjust Tier I net worth ratios and authorize supplemental capital.

Second, the proposal would substitute a punitive capital rule for effective examination and supervision. NCUA should undertake major improvements in the training of

examiners to address deficiencies that have contributed significantly to the failures of credit unions.

Third, the proposal has a number of defects, as detailed below. Of primary concern, the proposal is legally defective, including under the Administrative Procedure Act¹ for the following key statutory, public policy, and operational reasons:

- The proposal's well-capitalized risk-based capital requirements violate the Federal Credit Union Act (FCU Act) and are not well-tailored to produce appropriate levels of credit union capital;
- The proposal contains a number of other flaws, identified in our letter, that contradict the FCU Act and would needlessly interfere with credit unions' operational capabilities to meet the credit and other financial necessities of their communities;
- The proposal would not effectively identify potential credit union failures nor would it significantly reduce losses to the National Credit Union Share Insurance Fund (NCUSIF), without overcapitalization of other, healthy credit unions;
- The proposal does not reflect credit unions' historical financial performance including during times of severe financial market distress. NCUA cannot justify the proposal in light of the vigorous health of federally insured credit unions in general; and
- The overall negative impact of the proposal would be far greater than the agency has anticipated and would result in a much smaller credit union system over the long term.

Fourth, considering the major weaknesses in the proposed system—which will seriously constrict credit union growth and financial performance—it would be far better to maintain the current risk-based rule than to move forward with the proposal. This is an appropriate approach, given the health of federally insured credit unions.

Should NCUA decide to move forward with some form of its risk-based capital proposal, we urge the agency to address the numerous fundamental concerns we are raising by incorporating our recommendations and reissuing a new proposal for comments from the credit union system and other stakeholders.

¹ 5 U.S.C. § 553; see also *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-843 (1984).

I. RBC Should Be One Component of Comprehensive Capital Reform for Credit Unions

An overarching concern with NCUA's proposed risk-based mechanism is that it focuses on but one issue: how to require additional risk-based capital from federally insured credit unions based on overstated concerns about protecting the NCUSIF.

Yet, the strategy for real capital reform should be comprehensive and the goals far broader. This approach is necessary in order to protect the NCUSIF adequately without limiting the ability of well-managed credit unions to meet the changing financial needs of their members. This effort can only take place in the context of comprehensive reform of overall credit union capital requirements, which cannot be achieved without legislative and regulatory actions.

In that connection, the optimal risk-based capital system for credit unions will require the following components:

Statutory Supplemental Capital Authority. In order for most credit unions to use Supplemental Capital to meet Tier I requirements, Congress will have to approve an amendment to the FCU Act granting NCUA the authority to permit the use of such capital. We urge NCUA to work, proactively, with the credit union system to pursue legislative changes that provide access to forms of supplemental capital that would not compromise the cooperative ownership and governance structure of credit unions.

Statutory Leverage Ratio Requirements. NCUA should also work with the credit union system to seek an amendment to the FCU Act that would address the specific net worth levels corresponding to prompt corrective action (PCA) classifications. The current statutorily-specified levels should be replaced with provisions that grant authority for the agency to establish these levels, similar to the approach provided to federal banking regulators. The current statutory net worth levels for the well-capitalized and adequately capitalized PCA classifications do not appropriately reflect credit unions' low-risk profiles, yet they are two percentage points higher than the levels in effect for community banks in the United States.

Basel Style Risk-Based Capital (RBC) System. Once these legislative changes are secured, NCUA should work with the credit union system to establish a Basel-style risk-based capital approach for federally insured credit unions. Such a system, rather than the current proposal, would include appropriate risk weightings that fully consider credit unions' operational history and organizational structure. Only when reduced leverage ratio requirements to be adequately and

well-capitalized have been adopted would it be appropriate for NCUA to establish new risk-based capital ratio levels.

The establishment of risk-weights under a Basel-style system should be based on these principles:

- Risk weightings should generally be similar to those applied to community banks in the United States.
- For those assets where credit union loss experience is historically lower than bank loss rates, credit union risk weightings should be at or below bank risk weightings.
- Concentration risk and interest rate risk should not be incorporated into the risk-based capital system. Instead, they should be addressed in the regulatory, examination and supervision process.

Examiner Training. The stated purpose of the proposal is to mitigate losses to the NCUSIF that could result from inadequate capital at credit unions. Yet as Government Accountability Office and NCUA Office of Inspector General reports demonstrate deficiencies in the examination process contributed substantially to losses during the financial crisis, and such deficiencies continue to be a significant factor in more recent credit unions failures.² NCUA has provided no indications to the credit union system of its efforts to address these intra-agency concerns in the context of seeking to change risk-based capital requirements for credit unions. Instead of focusing singularly on risk-based capital for credit unions to contain NCUSIF losses, NCUA should be improving examiner training so that agency field staff can more readily identify material risks without micromanaging well-managed credit unions and without increasing the agency's budget, which is funded by credit unions.³

II. While Not in the Best Interests of CUs or the NCUSIF – If NCUA Must Proceed with a Singular RBC Proposal, It Should Develop a New Approach

Because of significant legal, public policy, and operational concerns with the proposal, we urge the agency to withdraw it. As we detail in our letter, the current system is generally working well and maintaining it is far preferable to adopting the proposal.

² U.S. Government Accountability Office, National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions, Jan. 2012 (GAO-12-247).

³ The GAO study raised concerns about NCUA's implementation of PCA through the examination process but did not recommend additional capital to be held by federally insured credit unions. *Id.*

If the agency feels compelled to proceed with a modification to credit unions' risk-based capital requirements in the absence of legislation to address the issues of statutory net worth ratio (leverage) requirements and supplemental capital, it should follow a Basel-style risk-based capital system with the following characteristics.

- Consistent with current law, and because of higher leverage requirements for credit unions to be well capitalized, the risk-based aspect of prompt corrective action should apply **ONLY** to the adequately capitalized classification. The identical risk-based requirement, coupled with a 7% net worth ratio, would apply to the well-capitalized PCA classification.
- The risk-based requirements should only apply to credit unions that are complex, and complexity should not be defined by asset size alone.
- Credit unions should have authority to use supplemental capital to meet risk-based capital requirements.
- Risk weightings should generally be similar to those applied to community banks in the United States, taking into consideration the operational history and organizational structure of credit unions.
- Risk weightings should include the following changes to the system proposed by NCUA:

Given lower historical loss rates on residential mortgage and small business loans at credit unions compared to community banks, and the fact that credit unions with higher concentrations of these loans tend to experience lower loss rates than their peers, weightings and concentration thresholds for these types of loans should be far lower than the proposal indicates and lower than what banks must meet.

Asset Type	Small Bank Basel Risk Weightings	CUNA's RBC Proposed Risk Weightings
Residential Mortgage Loans	50% (regardless of concentration)	30% (0%-25% of assets) 50% (25%-35% of assets) 70% (35% and up of assets)
Junior Lien Mortgages	100% (regardless of concentration)	75% (0%-10% of assets) 100% (10%-20% of assets) 125% (20% and up of assets)
Small Business Loans	100% (regardless of concentration)	80% (0%-25% of assets) 100% (25%-35% of assets) 120% (35% and up of assets)

- Investments with a Weighted Average Life (WAL) of under five years should have a risk weighting of 20%. Those with a WAL over five years should have

a risk weight of 100% to the extent they exceed the sum of 50% of core deposits (share drafts and regular savings), borrowings with a WAL of over five years, and member certificates of deposit with a WAL of over five years and sufficient early withdrawal penalties. All other investments with a WAL of over five years (those matched by longer term liabilities) would have a risk weighting of 20%.

- Loans to and investments in CUSOs should have a risk weighting of 100%.
- The NCUSIF deposit should NOT be deducted from the numerator of the risk-based capital ratio.
- Goodwill should not be immediately deducted from the numerator of the risk-based capital ratio. It should be phased out over a ten-year period.
- There should not be Individual Minimum Capital Requirements.
- There should be ample time for credit unions to comply, at least three years or more, and there should be a process for credit unions to receive even more time if needed on an individual basis.
- There should be a risk mitigation credit as there is now under the current PCA system.
- The revised proposal should be reissued for comments.

III. Why the Proposal Is Unwarranted; NCUA Cannot Justify It Based On Federally Insured CUs' Financial Performance or By Ignoring Their Unique Structure

NCUA has not provided an adequate justification for the major changes it is proposing to the current risk-based net worth system. We question whether, given credit unions' solid performance throughout the financial crisis to the present and projected financial trends, it is possible to justify the proposal, particularly in light of its anticipated impact.

Indeed, there is no credible analysis available that suggests credit unions overall are unlikely to perform well under the current prompt corrective action system, which includes a risk-based net worth requirement.

The financial strength of credit unions is inextricably linked to their unique, cooperative structure. The structure of credit unions and of their management (such as generally uncompensated volunteer boards, the absence of stock options for senior management and board members, the absence of pressure from stockholders to maximize profits, and severe limitations on their ability to raise capital) induces management to eschew

higher-risk, higher-return strategies.⁴ As a result, credit union operations are less risky than those of other depository institutions and subject to less volatility over the business cycle. For example, from 1992 to 2013, the average annual net charge-off rate on credit union loans was 0.61%, with a standard deviation of 0.22%. In contrast, the similarly computed average at banks over the same period was 0.98%, with a much greater standard deviation of 0.62%. This dramatically lower volatility in loss rates over many years demonstrates a much lower risk exposure in credit unions.

Research has shown that these differences have resulted historically in credit unions serving a distinct and critical role in economic downturns. When financial markets are in turmoil, credit unions have served as a “safe harbor” for depositors and as a countercyclical influence, helping to counterbalance declines in commercial bank lending that often occur when the overall economy is weak.⁵

A. Credit Unions Performed Remarkably Well During the Financial Crisis

This countercyclical activity was certainly evident during the Great Recession—the most severe economic and financial crisis in modern history. This was no doubt a very trying time for many credit unions and credit union regulators. The widespread economic disruption of the recession placed significant financial pressures on credit unions and caused the worst results in credit union operations in modern times.

However, in the face of the near collapse of world financial markets, U.S. natural person credit unions were relatively unscathed compared to other financial institutions. They continued to lend to consumers in need while the for-profit financial sector hunkered down and turned consumers away. Overall, bank loans declined by 5% during the recession and total bank loans outstanding remained lower at year-end 2013 than they did at the start of the recession. In contrast, credit union loans grew by nearly 8% during the recession and increased by over 21% between the start of the recession and year-end 2013.

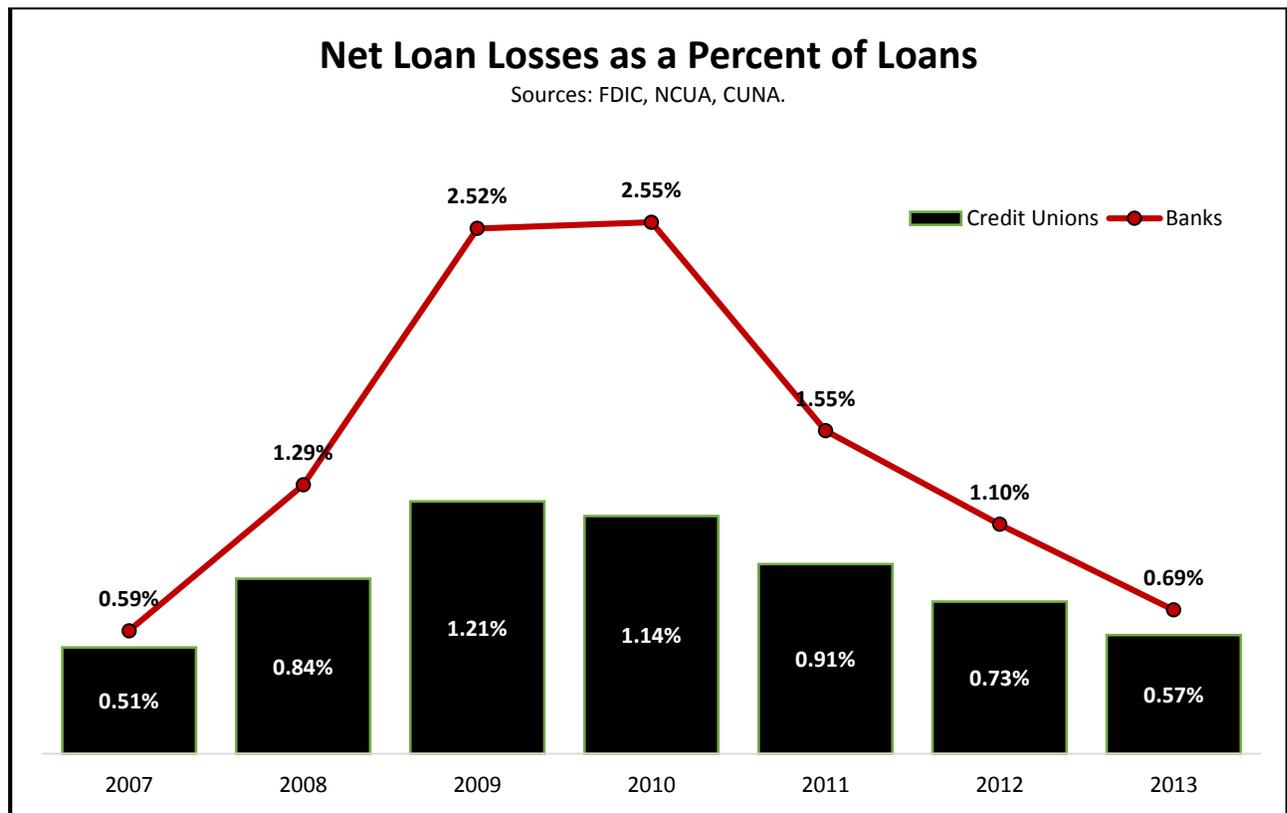
Throughout modern history, compared to banks, credit unions have held higher capital levels, suffered substantially lower loan losses, and have imposed far lower losses on their deposit insurer—and NONE on taxpayers.

⁴ Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers*, *Journal of Banking and Finance*, 20 (Sept. 1996), pp. 1305-1327. Kane and Hendershott describe how the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.

⁵ James Wilcox, *Reforming Credit Union Capital Requirements*, (Mar. 2011), pp. 15-17.

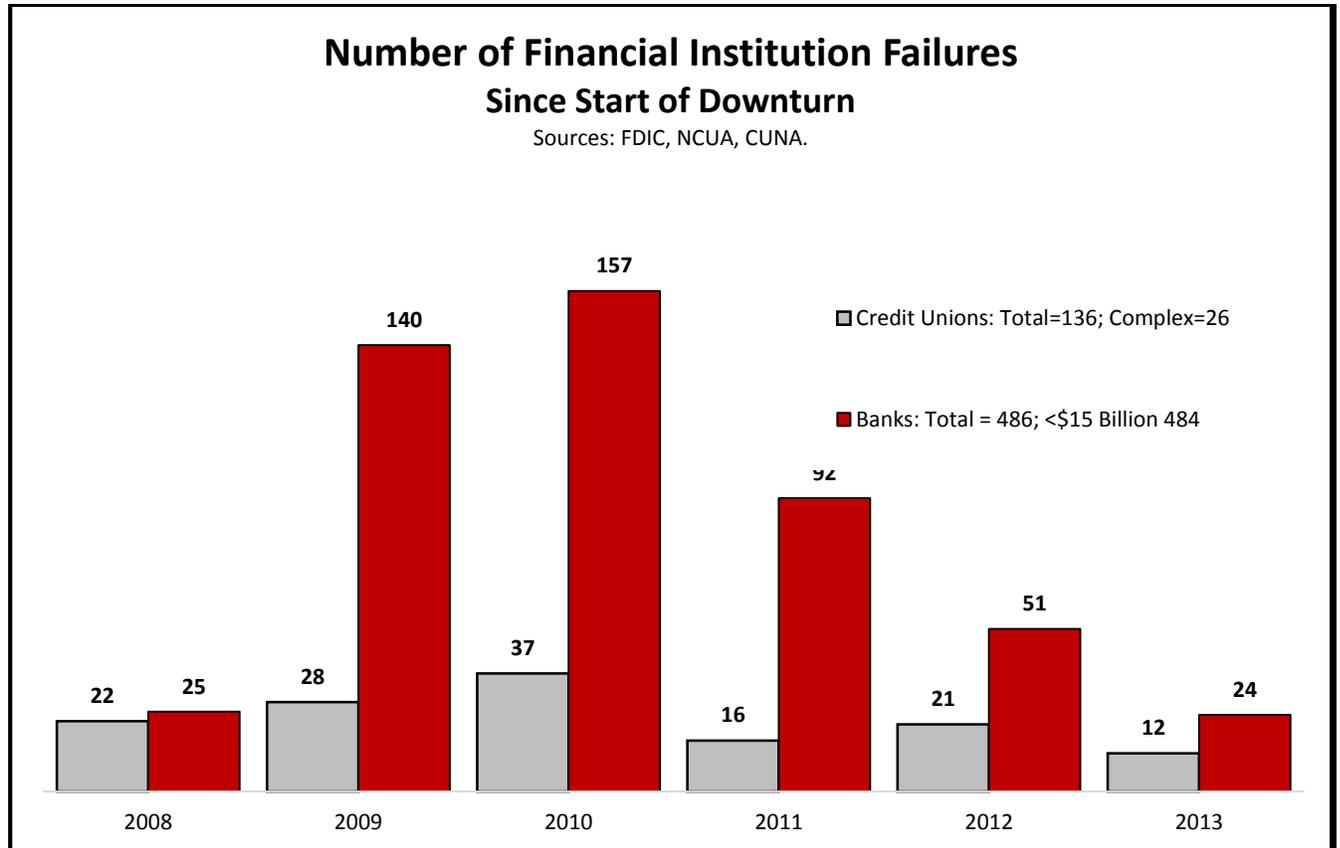
The comparative performance of credit unions and banks during the Great Recession and its aftermath demonstrates how the current credit union system, including its cooperative structure, regulatory regime, and capital requirements, is well-suited to withstand even the most severe of future financial crises. Since the beginning of the Great Recession, the following results occurred that support this conclusion:

- Credit union loan losses, while elevated, peaked at 1.21%—less than half the peak level reported by the nation’s banking industry. Overall, credit union loan losses averaged 0.90% between 2008 and 2013, while banking institution losses averaged 1.62% over the same period.⁶



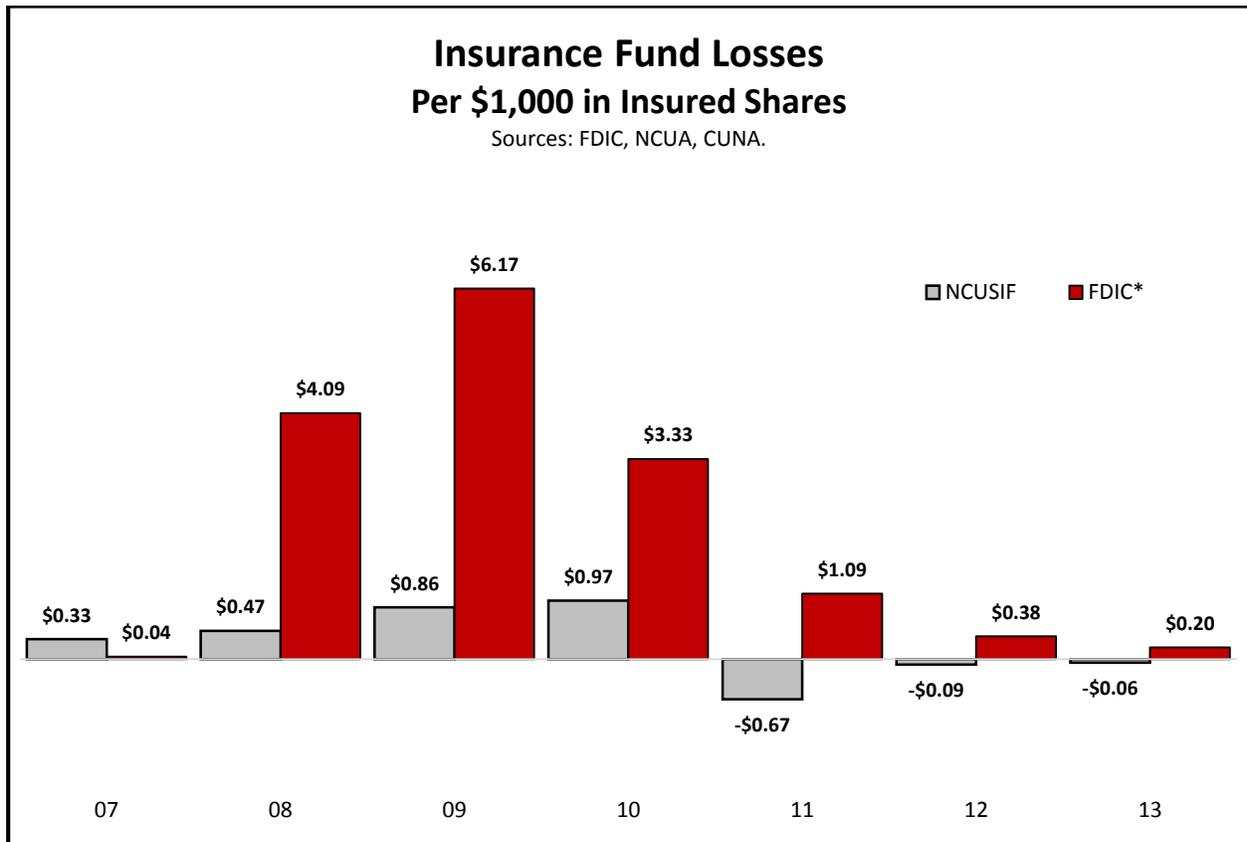
⁶ FFIEC: Net Loan Losses to Average Total Loans for all U.S. Banks, available at <http://research.stlouisfed.org/fred2/series/USLSTL>.

- Credit union failures paled in comparison to those in the banking industry. Between 2008 and 2013 only 26 credit unions (with \$50 million+ in assets) failed while nearly 500 community banks failed. Indeed, the number of bank failures would have been far higher without massive capital infusions via the government's Troubled Asset Relief Program.⁷



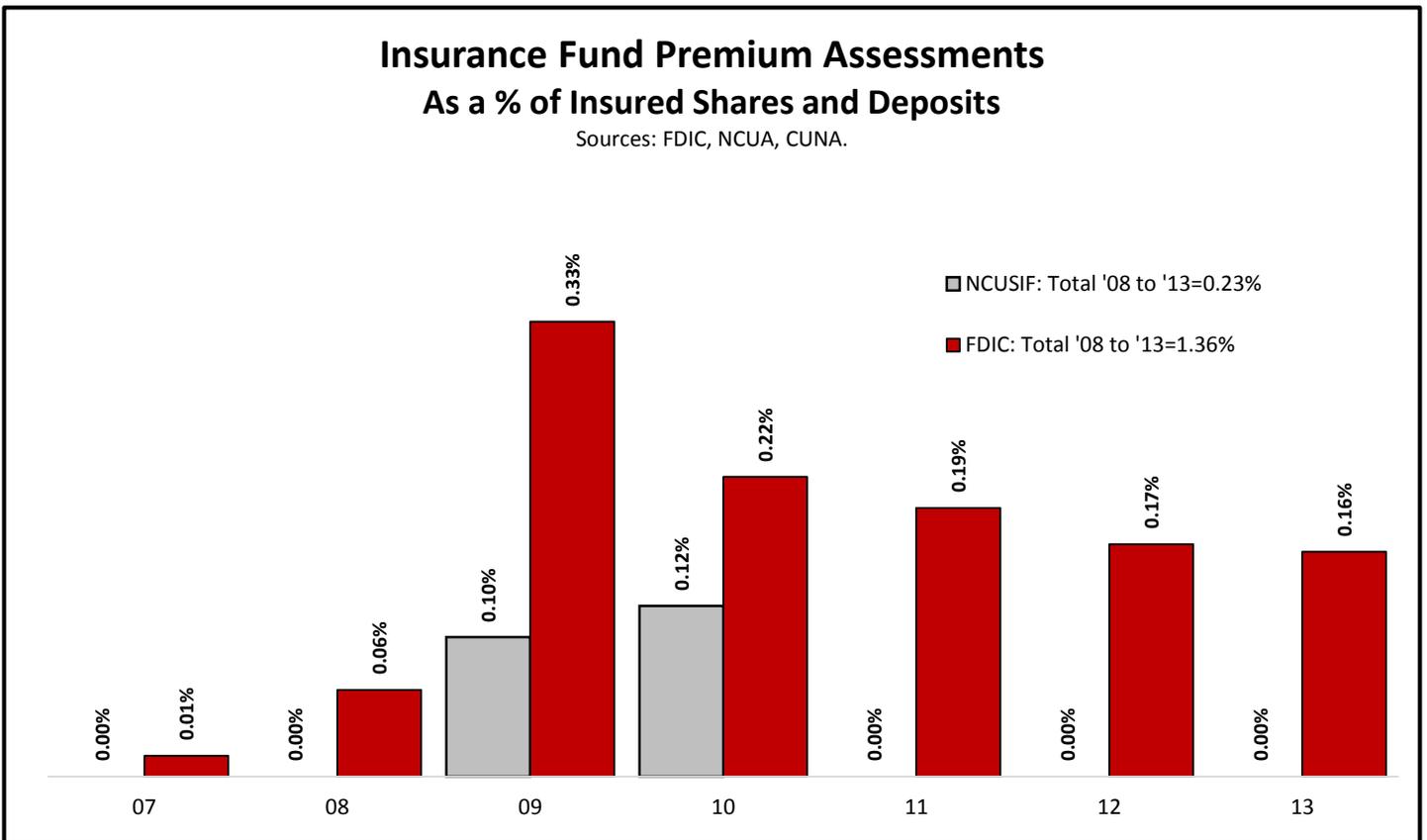
⁷ Credit unions achieved their lower failure rate despite their ineligibility for the most part to receive TARP funds. NCUA: Supervisory Actions (Closed Credit Unions) in 2014, available at <http://www.ncua.gov/Legal/Regs/Pages/Closed2014.aspx>; FDIC: Failed Bank List, available at <http://www.fdic.gov/bank/individual/failed/banklist.html>; U.S. Treasury: TARP Programs, available at <http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx>.

- Between 2008 and 2013 NCUSIF losses per \$1,000 in insured shares averaged less than one-tenth the losses suffered by the FDIC.⁸

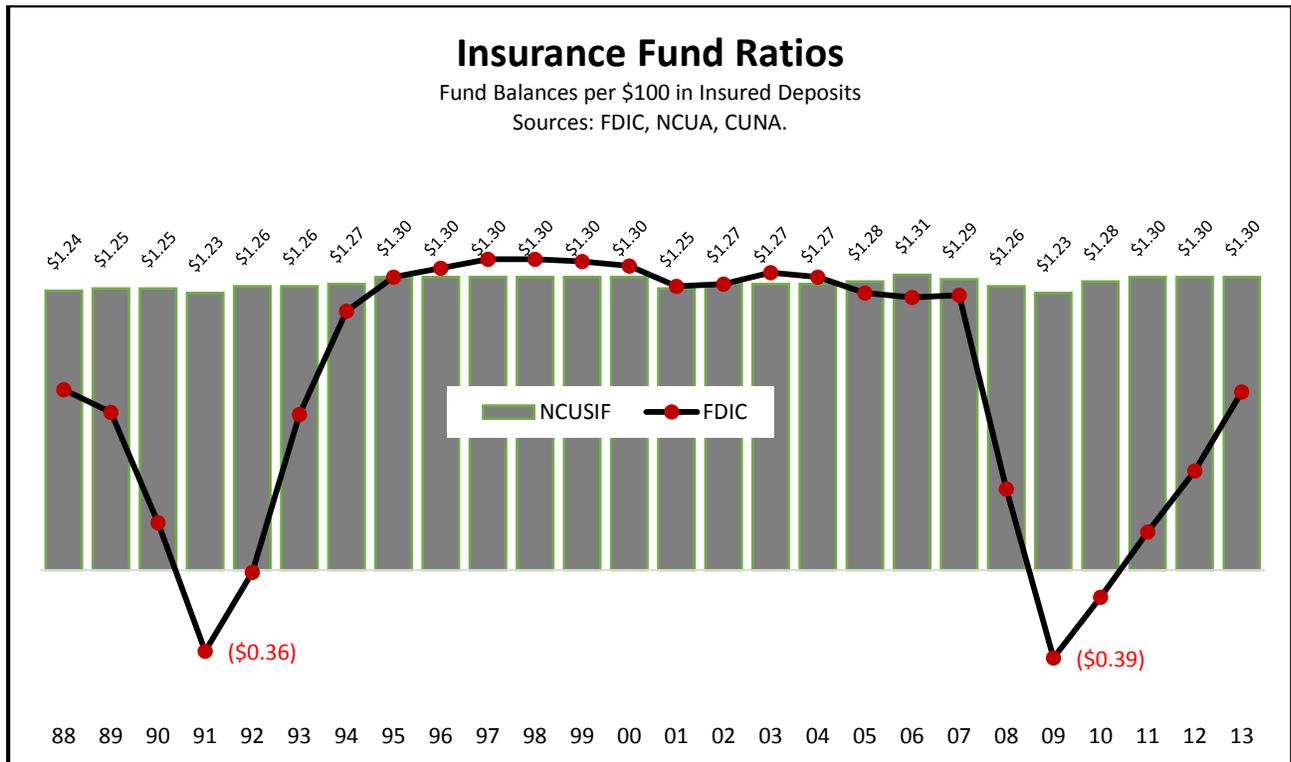


⁸ NCUA Share Insurance Fund Information, Reports, and Statements, *available at* <http://www.ncua.gov/DataApps/Pages/SI-Reports.aspx>; FDIC Deposit Insurance Fund Management, *available at* <http://www.fdic.gov/deposit/insurance/fund.html>.

- The NCUSIF fund balance remained above \$1.20 per \$100 in insured shares throughout the economic crisis, but the FDIC balance plummeted from \$1.22 per \$100 in 2007 to -\$0.39 in 2009 and remained in negative territory in 2010 as well.
- Even more revealing is that FDIC has had to levy total insurance premiums of 1.36% on insured deposits since the beginning of the crisis—that’s six times higher than the 0.23% total of NCUSIF premiums over the same period.



- Even today the contrast is stark: the NCUSIF fund balance is \$1.30 while the FDIC reports a balance of just \$0.79 per \$100 in insured funds. As shown in the graph below, this is not the first time such drastically different performance was seen: Since 1988, the NCUSIF has not dipped below \$1.20 per \$100 in insured shares, while the FDIC plunged into negative territory more than once.⁹



B. The Financial Performance of Credit Unions Is Strong Evidence of the Effectiveness of the Current System

Yet, as this letter highlights throughout its discussion of the deficiencies of the proposal, the agency has not sufficiently taken the financial performance and distinctive structure of credit unions into account in developing the proposed rule. This failure is problematic for two major reasons. First, the agency is required to take the nature of credit unions into account in the regulation of prompt corrective action, which encompasses risk-based requirements.¹⁰ Second, ignoring credit union differences and the lower level of risk that credit unions demonstrate as a result has led NCUA to develop a risk-based capital system that would require too much capital from well-managed credit unions.

⁹ *Ibid.*

¹⁰ 12 U.S.C. § 1790d(b)(1)(B).

In recognition of these factors and given credit unions' record—especially a mere 26 failures of “complex” credit unions during the worst financial crisis in modern history—it appears that NCUA's proposal is a solution looking for a problem. The agency cannot justify the proposal based on the financial performance and projected financial condition of the credit union system or on a likely significant reduction in future NCUSIF losses as described later in this letter. Moreover, any risk-based capital system adopted by NCUA that fails to account for the unique structure of credit unions is inherently arbitrary and legally defective.

IV. The Proposal's Well-Capitalized RBC Requirements Violate the FCU Act and Are Not Well-Tailored to Produce Appropriate Levels of Credit Union Capital

The proposal contradicts the FCU Act regarding risk-based capital in a number of ways, as discussed below. The most significant deviation from the FCU Act's provisions involves the proposal's higher risk-based capital requirement for a credit union to be well-capitalized compared to the proposed requirement for adequately capitalized credit unions. The prompt corrective action provisions of the FCU Act that authorize the agency to develop a risk-based net worth system are very specific on this point:

Risk-based net worth requirement for complex credit unions.¹¹

(1) **In general.**—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.

(2) **Standard.**—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be **adequately** capitalized may not provide adequate protection. (Emphasis added.)

This is the entirety of the language in the FCU Act dealing with the risk-based component of PCA, and it could not be any more direct. It orders NCUA to connect risk-based requirements to the sufficiency of a credit union's net worth for the **adequately capitalized classification only**. Yet under the proposal, the agency would subject well-capitalized credit unions to risk-based capital requirements that are 2.5% of risk assets higher than those proposed for adequately capitalized credit unions. This is neither what Congress had in mind nor what the FCU Act permits NCUA to do in implementing risk-based capital requirements.

While the statutory provisions are clear, the legislative history of the Credit Union Membership Access Act, PL 105-219 (August 7, 1998) is also instructive in terms of

¹¹ 12 U.S.C. § 1790d(d).

reinforcing the strong intent of the FCU Act, which it amends, regarding how NCUA must structure risk-based capital requirements. As NCUA is well aware, the U.S. Department of the Treasury participated in the development of 12 U.S.C. § 1790d that was part of PL 105-219. In testimony on March 11, 1998 before the House Committee on Banking and Financial Services, Assistant Secretary of the U.S. Department of the Treasury Richard S. Carnell stated:

We recommend that Congress direct the NCUA to develop an appropriate risk-based capital requirement for complex credit unions. **This risk-based requirement would supplement the simple 6% net worth requirement.**

The U.S. Treasury's approach of calibrating risk-based capital to the adequately capitalized level rather than the well-capitalized level was incorporated into the statute as explained in U.S. Senate Report 105-193:

The NCUA must design the **risk-based net worth requirement to take into account any material risks against which the 6 percent net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.** Thus, the NCUA should, for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks.¹²

It cannot be more clear that the FCU Act does not authorize NCUA to impose a higher risk-based capital requirement for a credit union to be well-capitalized than the requirement to be adequately capitalized.

Considering that when Congress passed the prompt corrective action section of the FCU Act in 1998, banks were subject to risk-based capital ratio standards for both the adequate and well-capitalized classifications, it is fair to ask what the rationale was for limiting the risk-based portion of credit union PCA to the adequately capitalized standard only. The reason was a recognition of the higher Tier 1 simple net worth ratio requirements imposed on credit unions than on banks. Because the Tier 1 requirement for credit unions to be well-capitalized (7% of total assets) is 40% higher than the 5% requirement for banks, Congress felt there was no need for a well-capitalized risk-based requirement on credit unions to supplement their net worth requirement for being well-capitalized.¹³

Instead, the risk-based component was intended to provide a fallback or floor to cover those assets that were more risky than average and might render a credit union less than adequately capitalized. Therefore, not only do statutory requirements direct

¹² S. Rep. No. 105-193, at 14 (1998) (emphasis added).

¹³ 12 U.S.C. § 1790d(d)(2).

NCUA to refrain from imposing a higher risk-based capital requirement for the well-capitalized threshold, sound public policy also supports pegging risk-based capital requirements to the adequately capitalized threshold. That is because a higher risk-based requirement for a credit union to be well-capitalized is simply not necessary given the 7% leverage ratio requirement.

The proposed higher risk-based capital requirements for well-capitalized credit unions are also counter to federal administrative directives. Under Executive Order 13579, President Barack Obama has instructed independent agencies to comply with Executive Order 13563. In connection with those orders, the White House has stated that agencies should propose a rule only on a reasoned determination that its benefits justify its costs. As we describe throughout this letter, any benefits in terms of reduced NCUSIF losses would be minor at best and the very real costs of unnecessarily high capital requirements would be substantial.

Agencies are also instructed to tailor recommendations to impose the least burden; select, in choosing among alternatives, approaches that maximize benefits; and identify alternatives to direct regulation.

We believe NCUA has not met any of these standards with this proposal, the sweep of which is too broad and will result in many credit unions having to set aside more capital than their risks would justify. In fact, NCUA has not provided any explanation as part of the request for comments on the proposal that it has considered these standards.

V. The Impact of the Proposal, Including the Higher RBC Requirements for Well-Capitalized CUs, Would be Highly Detrimental

The misinterpretations of the FCU Act that underpin the proposal would exact a very damaging toll on the credit union system. The most significant, negative impact of the proposal, as discussed below, would be on well-capitalized credit unions that would experience reduced capital buffers above the well-capitalized requirement.

NCUA has apparently ignored this effect. The *Supplementary Information* accompanying the proposed rule dramatically underestimates the impact that the rule would have on credit unions generally were it adopted in final form.¹⁴ The agency considers only the narrowest notion of the impact of the proposal, ignoring the significant immediate and long-term effects that the proposal would have on the majority of affected credit unions and the credit union system.

¹⁴ 79 Fed. Reg. 11,184.

NCUA indicates that more than 90% of covered credit unions would be unaffected by the proposal. Specifically, the *Supplementary Information* to the proposal states that of the 2,237 credit unions with more than \$50 million in assets as of June 2013, only 199, or 8.9%, would have experienced a reduction in capital classification from well-capitalized status had the proposal been in effect. Of these, 189 would be reclassified as adequately capitalized, and 10 would become undercapitalized. The 10 inadequately capitalized credit unions would have been required to have raised a total of \$63 million of additional capital to become adequately capitalized, given no changes to their balance sheets.¹⁵

The agency's limited view that only 10 credit unions rendered inadequately capitalized by the proposal would need to raise additional capital ignores reality. The 189 credit unions that would be reclassified from well to adequately capitalized would certainly find it necessarily prudent to attempt to raise sufficient capital quickly to restore their well-capitalized status. Doing so would require \$480 million in additional capital. Further, the many other credit unions that would come perilously close to having their capital classifications reduced from well- to adequately capitalized would face similar pressures. Credit unions cannot easily manage their capital to the exact dollar level that equates to NCUA's PCA rule standards, and the consequences of missing the net worth standards, even unintentionally, are very serious. As a result, the management of credit unions typically strives to maintain sufficient space or buffers between their actual net worth ratios and the minimum required levels to be well-capitalized. NCUA's approach also disregards historical practices of examiners who likely would bring considerable pressures on such credit unions to raise capital.

In any case, the impact on the 199 credit unions that would fall from being well-capitalized is a starting point for analysis, not an ending one as NCUA has depicted. In fact, the effects of the proposal would go far beyond this small group.

To evaluate the total effects of the proposal, CUNA considered all credit unions with at least \$40 million in assets as of December 2013, the latest data available. We included credit unions with up to \$10 million less than \$50 million in assets considering that most of them would be at or over the \$50 million threshold by the time the rule took effect, or soon thereafter. There were approximately 2,490 such credit unions as of December.

For fully 1,688 credit unions, or 67.8% of those potentially affected, the rule would increase the amount of capital required to be well-capitalized above the current level of 7% of total assets. This is because for most credit unions, although risk assets are less than total assets, 10.5% of risk assets amounts to more than 7% of total assets, depending, of course, on the ratio of risk assets to total assets. The breakeven ratio is 66.7%, i.e., for any credit union with a ratio of risk-assets-to-total-assets of over 66.7%,

¹⁵ 79 Fed. Reg. 11,188.

10.5% of risk assets will be more than 7% of total assets. On net, across all potentially affected credit unions (those with more than \$40 million in assets), the total amount of capital necessary to be well-capitalized would increase by \$7.6 billion. That represents 0.76% of total assets in all potentially affected credit unions. In other words, the proposal would increase the net worth ratio required to be well-capitalized, on average, from 7% to 7.76%.¹⁶

For some credit unions, the size of the increase in capital requirements would be minor. However, for others it would be significant:

- 546 credit unions (21.9% of potentially affected credit unions) would face increases in well-capitalized requirements of less than 50 bp of total assets, i.e., to between 7% and 7.5% of total assets.
- 523 (21%) would face increased capital requirements of 50 bp to 100 bp of total assets, i.e., to between 7.5% and 8% of total assets.
- 619 (24.9%) would face increased capital requirements of more than 100 bp, i.e., to more than 8% of total assets.¹⁷

It is worth noting that for a well-capitalized credit union, an increase in the amount of capital necessary to remain well-capitalized is equivalent to a decrease in that credit union's buffer or margin above being well-capitalized. Therefore, simply put, the proposal would reduce the total buffers that credit unions currently hold above well-capitalized minimums by billions of dollars. In fact, if the only determinant of a credit union's desired capital level was maintaining a given buffer above being well-capitalized, credit unions would collectively need to raise an additional \$7.6 billion in capital, or alter their asset compositions, were the rule adopted as proposed.

Of course, there are many other factors that determine capital sufficiency. Even so, the closer a credit union's capital level is to the minimum amount necessary to be well-capitalized under the regulation—the smaller its capital buffer and the more binding PCA constraints become. For such credit unions, buffer protection would take a more significant role in capital management strategy. In other words, for those credit unions with capital cushions well above the minimum amount to be well capitalized, any

¹⁶ The dollar-weighted average ratio of risk assets to total assets is 70%, and 10.5% of 70% is only 7.35%, not 7.76%. The reason for this seeming discrepancy is that those credit unions with risk assets less than 67% of total assets (so that 10.5% of risk assets is less than 7%) would still need to meet the 7% leverage requirement. This means that for those credit unions for which 10.5% of risk assets is greater than 7% of total assets, the average amount of additional capital required is greater than 0.76% to total assets.

¹⁷ We found that 753 credit unions (30.3% of those potentially affected) would experience no change in well-capitalized requirements (they have risk-asset to total asset ratios of less than 66.7%) and 47 credit unions (1.9%) would see well capitalized requirements decrease (they had unadjusted risk-based net worth requirements under the current rule more than 10.5% of proposed risk assets).

reduction in their buffer caused by the proposed rule should not be an issue, but for well-capitalized credit unions with smaller margins, buffer reductions will be a very significant event.

There is no reason to believe that capital cushions would become less necessary if the agency's proposal were adopted. The cushion would simply rest on top of a higher chair.

VI. Impact of the Proposal on Capital Buffers

To consider the realistic impact the proposal might have on credit unions, we measured the total amount that capital buffers would be reduced excluding all cases where the ending buffer was above a certain threshold. This approach allows us to ignore reductions in buffers in those cases in which credit unions are so well-capitalized that even after the increase in capital requirements, the resulting buffer is still large. Recalling that, with no exclusions, the total buffer reduction would be \$7.6 billion at the 1,688 credit unions that would experience buffer reductions, we found that:

- 1,302 credit unions would experience total buffer reductions of \$6.0 billion if only those buffer reductions that result in buffers of less than 4% of total assets are considered;
- 1,130 credit unions would experience total buffer reductions of \$4.6 billion if only those buffer reductions that result in buffers of less than 3% of total assets are considered; and
- 800 credit unions would experience total buffer reductions of \$3.1 billion if only those buffer reductions that result in buffers of less than 2% of total assets are considered.

Of course, different credit unions will have different reactions to becoming suddenly closer to the adequately capitalized level. For some credit unions, buffers of as much as 4% or 5% of total assets might not be sufficient. For others, a buffer of 2% could be considered adequate. Prior to the recent recession, credit unions maintained an average net worth ratio of 11.5%, or 4.5 percentage points above the 7% minimum required amount. The margin is again approaching 4 percentage points. Although there may be reasons other than PCA considerations for credit unions to maintain net worth ratios that high, this strongly suggests that if buffers fall to below 3% or 2%, many credit unions would feel capital constrained under the proposal.

Using the case above in which only reductions of capital buffers to less than 3% of total assets are included, were the rule to take effect as proposed, 1,130 credit unions (45% of potentially affected credit unions) would find it necessary to acquire an additional \$4.6 billion in capital to restore desired capital cushions. Even in the more conservative case of only considering buffer reductions to less than 2% of total assets, 800 credit unions

(32%) would likely feel compelled to raise more than \$3 billion in capital, or rearrange their balance sheets.

This is far more than a mere \$63 million effect on only 10 credit unions. It is a three-to four-and-a-half billion dollar effect on around 1,000 credit unions and would require a significant increase in their net income. For these credit unions the proposal would mean offering less attractive pricing or reduced services to members. In the absence of any clearly demonstrated case that credit unions are currently undercapitalized and are thereby imposing undue risks on the NCUSIF, those outcomes are totally unjustified and wholly undesirable.

VII. The Long-Term Impact of the Proposal Would be Crippling

In addition to the one-time effect of credit unions having to raise additional capital, the imposition of higher capital requirements would have significant negative consequences in the long run. A higher required capital-to-asset ratio will cause credit union asset growth to stagnate and decline over the long term, for any given rate of return on assets. This decline in credit union asset growth (accepting deposits and making loans) will lead to reduced member services and lower national economic growth. We hope NCUA has tried to quantify these costs and has weighed them against the uncertain benefit of minor reductions in the relative cost of credit union failures. This agency analysis should be made part of the administrative record of this rulemaking procedure.

We can estimate the effect of the proposal on long-term credit union asset growth using the rule that the sustainable asset growth rate is equal to the return on equity or $\text{Asset Growth Rate} = \text{ROA} / \text{Capital Ratio}$. This equation calculates the permissible asset growth rate that is associated with a given capital ratio and earnings rate (ROA).

Using a few simple assumptions, we can demonstrate the slower balance sheet growth credit unions could experience in the long run under NCUA's risk-based capital proposal. We assume that without the risk-based capital proposal, credit unions would want to return to pre-crisis ten-year average capital ratios of 11% and return on assets ratios of almost 1%. At that earnings rate, to maintain the average 11% capital ratio, credit union assets could increase by 9.1% each year.

If we now assume that credit unions respond to the risk-based capital proposal by increasing, on average, their desired capital ratios by 0.35% (slightly below the midpoint of the 2% and 3% buffer cases described above) to 11.35% and the return on assets decreases to 90 basis points (due to increased risk aversion and balance sheet repositioning induced by the proposal), then asset growth would have to slow to 8.0%, or 1.1 percentage point lower than without the proposal.

A one-percentage-point reduction in annual growth may not sound like much, but over a 20-30 year period, it would result in a significantly smaller credit union movement. The table below shows the dramatic difference in the future size of the credit union system that would result from these different growth rates. Indeed, the difference between the two cases in twenty years, \$1.2 trillion, is larger than the size of the movement today. **After thirty years, the movement would be one-third smaller than it would be without this proposal.**

Annual Asset Growth Rate	TOTAL CREDIT UNION ASSETS AFTER:	
	20 YEARS	30 YEARS
9.1%	\$6.3 trillion	\$15.0 trillion
8.0%	\$5.1 trillion	\$10.0 trillion
Difference:	\$1.2 trillion	\$ 5.0 trillion

This stagnation by overcapitalization would also mean credit unions would cede market share to banks, putting credit unions at a serious competitive disadvantage in an industry where economies of scale are a major determinant of success; smaller credit unions would be put at an even greater disadvantage. This proposal therefore fails to meet the NCUA’s stated goal of comparability of risk-adjusted capital levels across financial institutions.

To maintain faster asset growth rates while operating with higher capital-to-asset ratios, credit unions may try boosting their return on assets. However, to increase earnings, credit unions would need to price loans and deposits at less than competitive rates compared with banks, charge higher fees, restrict the products and services offered to members, and/or seek higher yields by holding riskier assets. None of these options would be in the best interests of the credit union’s members or the NCUSIF.

Based on our analysis, the conclusion is unavoidable that this proposal would condemn the credit union movement in the long-run to an inconsequential role in the financial marketplace, to the detriment of our economy, communities, small businesses, and consumers.

VIII. NCUA Should Not Raise the Adequately Capitalized RBC Level

If the agency agrees that the well-capitalized risk-based capital requirement should not exceed that of the adequately capitalized level, it may be tempted to simply set the risk-based capital requirement for both adequately capitalized and well-capitalized credit unions at 10.5%. However, the agency has already indicated in the proposal that a risk-based requirement that is no higher than 8% is reasonable for an adequately capitalized credit union.¹⁸ Further, since credit unions have overly high leverage ratio requirements

¹⁸ 79 Fed. Reg. 11,191.

to begin with at the adequately and well-capitalized levels, an 8% risk-based ratio to be adequately and well-capitalized is sufficient. Moreover, as the Senate Report mentioned above states:

The design of the risk-based capital requirement should reflect a reasoned judgment about the actual risks involved.¹⁹

Because it would be unreasonable to require adequately capitalized credit unions to maintain a 10.5% risk-based capital component, we urge the agency to set the level for both adequately capitalized and well-capitalized credit unions at no higher than 8%.

IX. The Proposal Contains a Number of Additional Fundamental Flaws

A. The Proposal Would Not Materially Reduce NCUSIF Losses

The agency justifies the proposal on the basis that, although most credit unions were well-capitalized according to current PCA standards set prior to the financial crisis, those credit unions that failed did not have sufficient capital commensurate with the risks on their balance sheets.²⁰ NCUA maintains that had a better risk-based capital requirement been in place (presumably such as the one being proposed), those credit unions would have been required to hold more capital or reduce their exposure to riskier assets, thereby reducing losses to the NCUSIF. The facts do not support NCUA's conclusions.

For NCUA's view to be correct, had the rule been in place prior to the onset of the Great Recession in 2008, a significant number of the credit unions that eventually failed would have been rendered inadequately capitalized under the proposal. They would then have been required to operate according to net worth restoration plans, or would at least have been required or induced to hold substantially more capital than they did. As a result, losses to the NCUSIF would have been reduced during the crisis because of the proposal.

CUNA analyzed how the existence of the proposal might have reduced losses to the NCUSIF during the recent financial crisis and Great Recession. A total of 26 credit unions with assets of more than \$50 million have failed since December 2007.²¹ In the *Supplementary Information* to the proposed rule, NCUA reports that "in recent years, the NCUSIF did experience several hundred millions of dollars in losses due to failures

¹⁹ S. Rep. No. 105-193, at 14 (1998).

²⁰ 79 Fed. Reg. 11,186.

²¹ However, one of these credit unions was already insolvent at the beginning of the period, so we have excluded it from the analysis.

of individual credit unions holding inadequate levels of capital relative to the levels of risk associated with their assets and operations.”²² More specifically, we have been informed that losses from failures of credit unions with more \$50 million in assets since the recession began have amounted to about \$750 million. The insurance loss at the one credit union that was already insolvent at the end of 2007 was approximately \$200 million. Therefore, total insurance losses at the 25 “complex” credit unions that have failed since the beginning of the crisis total about \$550 million.

We analyzed the potential effects of the proposal on the twenty-five failed credit unions in two ways. First, we considered how many of these failed credit unions would have been rendered less than well-capitalized, and more specifically undercapitalized, had the proposal been in effect, as the proposal should have signaled to both the credit unions and their examiners the need for additional capital. We also compared this result to how many credit unions that did not subsequently fail would have been rendered less than well-capitalized or undercapitalized under the proposal. This step is necessary to consider the incidence of false positives, i.e., labeling a credit union as a likely failure when it in fact survives. Second, we estimated how much additional capital the failed credit unions would likely have accumulated had the rule been in effect for some time before 2007, as an estimate of the reduction in NCUSIF losses.

B. The Proposal Would Have Avoided Few If Any Failures

The table below shows how credit union capital classifications would have changed had the proposal been in place before the financial crisis. As of December 2007, there were 2,268 federally insured credit unions with at least \$50 million in assets. Of these, applying current PCA standards, 2,245 (99.0%) were well-capitalized, 14 (0.6%) were adequately capitalized, and 9 (0.4%) were inadequately capitalized, for a total of 23 (1%) credit unions that were less than well-capitalized. Had the proposal been imposed at the end of 2007, a total of 119 credit unions (5.3% of all potentially covered credit unions) would have lost their well-capitalized status. That compares to about 9% of credit unions that would fall from being well-capitalized today. Of these 119 credit unions, 111 would have become adequately capitalized, and eight would have been classified as inadequately capitalized. (See chart on the next page.)

²² 79 Fed. Reg. 11,186.

Comparing Credit Unions that Did and Did Not Fail Based on Capital Classifications as of December 2007

All Credit Unions with Assets Over \$50M

	Total Number of CUs	Well Capitalized	Adequately Capitalized	Under Capitalized
Current System	2,268	2,245	14	9
Proposal	2,268	2,126	125	17
Change		-119	111	8

Credit Unions that Did Not Fail

	Total Number of CUs	Well Capitalized	Adequately Capitalized	Under Capitalized
Current System	2,243	2,224	12	7
Proposal	2,243	2,111	120	12
Change		-113	108	5

Credit Unions that Failed

	Total Number of CUs	Well Capitalized	Adequately Capitalized	Under Capitalized
Current System	25	21	2	2
Proposal	25	15	5	5
Change		-6	3	3

The table shows that credit unions that subsequently failed were indeed more likely to have had their capital classifications reduced than were credit unions that did not fail. However, the vast majority of those that failed would not have suffered a capital classification reduction under the proposed rule. Of the 25 credit unions that failed, six previously well-capitalized credit unions, or 24% of the failed credit unions, would have experienced a decline in their capital classification. There would have been a net increase of three to adequately capitalized and three to undercapitalized. Of the 2,243 credit unions that did not fail, 113 (5%) would have seen their classification reduced, 108 to adequately capitalized and 5 to undercapitalized.

A number of conclusions can be drawn from this data:

- The fact that only 1.1% of credit unions with more than \$50 million in assets have failed in the six and a half years since the beginning of the worst financial

crisis and recession in 80 years suggests the current PCA system was very effective in minimizing long-term losses to the NCUSIF during the Great Recession and its aftermath. This is in sharp contrast to the statistics on banks that failed over the same period.

- The proposed system would have been only slightly more effective than the current system in identifying credit unions that subsequently failed. Of the 25 credit unions that failed, an additional six would have been identified as less than well-capitalized by the proposed system compared to the current system, but only three of these would have been classified as undercapitalized. This means that 20 of the 23 failed credit unions previously rated as at least adequately capitalized would not have become undercapitalized had the proposed rule been in effect. That represents a very high proportion of false negatives: 87%.
- The vast majority of warning signals generated by the proposed system would have been false positives. Of the 119 credit unions whose classifications would have been lowered by a switch to the proposed system, only six (5%) failed. Fully 113 (95%) of the reclassified credit unions did not fail.
- The incidence of false positives is particularly striking among those credit unions that would have been rendered adequately capitalized by the proposed rule, i.e., that would not have passed the higher well-capitalized requirement of the proposal. There were 111 such credit unions, and only three (2.7%) of them failed. The other 108 (97.3%) of these credit unions survived what turned out to be a severe financial crisis. This is convincing evidence that the higher risk-based threshold for a credit union to be **well-capitalized** would have been of almost no value in predicting failures, and instead, by generating almost all false positive signals, would have unnecessarily increased capital requirements on those credit unions.
- The risk-based requirement to be **adequately capitalized** was relatively more effective in predicting failures, and generated much fewer false signals. Eight credit unions would have been reclassified to inadequately capitalized because of the proposal, and three of these (37.5%) subsequently failed. Thus the rate of false positives was 62.5%. That is still a high rate of false positives, but is much more reasonable than the 97% rate that would have resulted based on the well-capitalized requirement.
- Balancing correct calls and false positives, to the extent the proposal might have avoided failures since 2007, it is primarily the adequately capitalized risk-based requirement that would have been effective. The risk-based requirement to be well capitalized generated almost exclusively false positive signals.

These factors suggest that the proposed risk-based capital system, or indeed any risk-based system, is likely not to be that effective in predicting or preventing a meaningful proportion of credit union failures. Only three of the 25 failures would have been

targeted as undercapitalized had the proposed rule been in effect. Financial institution failures tend to be idiosyncratic. Unfortunately, they don't follow simple patterns, which makes it very difficult to design an asset-weighting system to prevent failures.

This is borne out by a review of the Material Loss Reviews of larger insurance fund losses during the recession. Much more than the amounts of particular assets on the balance sheet, it is the speed with which a credit union might have embarked on a new line of business with which it was not familiar that is likely to presage a failure. Such high-risk, higher-probability-of-failure developments cannot be dealt with by a risk-based capital regime. Instead, because they can vary so much from case to case, high-risk occurrences require appropriate examination and supervision, as recommended by the Basel Committee to be in the Second pillar of the Basel approach.

C. The Amount of Additional Capital That Troubled CUs Would Have Raised If the Proposal Were In Effect Earlier Is Minimal

Another way the proposed rule might have reduced the costs of the resolution of failed credit unions during the Great Recession is through its impact on increasing the amount of capital that would have been held by credit unions prior to the recession. By raising the effective capital requirement faced by many credit unions, including both those that failed and those that did not, some of the failures may not have happened, and/or resolution costs at those that did fail would have been reduced.

We estimated the amount of additional capital that might have been held by the 25 failed credit unions in four ways as shown in the table below. For the first three of these effects—involving credit unions rendered less than well-capitalized by the proposal—we did not include those credit unions that were already less than well-capitalized under the current system.

Four Ways Failed Credit Unions Might have Increased Capital in Response to the Proposal

CUs undercapitalized by the rule restoring to being adequately capitalized	\$7.1 million
CUs undercapitalized by the rule restoring to being well-capitalized	\$27.3 million
CUs adequately capitalized under the proposal restoring to being well-capitalized	\$24.6 million
All failed CUs restoring buffers above well-capitalized requirement, up to 3% of total assets	\$89.8 million
TOTAL	\$148.8 million

The \$7.1 million amount for credit unions to restore their status from undercapitalized to adequately capitalized is analogous to the \$63 million that would have been needed by

the 10 credit unions rendered inadequately capitalized as described in the *Supplementary Information* to the proposal. The total of the rest of the effects, or \$141.7 million, is analogous to the \$4.6 billion that would be required of all potentially affected credit unions to restore well-capitalized buffers, ignoring buffer reductions that would have resulted in buffers of more than 3% of assets.

The two values of \$7.1 million and \$148.8 million bracket the amount of additional capital that might have been held by the 25 credit unions that subsequently failed during the Great Recession and its aftermath, if the proposed rule had been in effect for a while. If indeed the only effect would have been for the inadequately capitalized credit unions to acquire sufficient capital to be adequately capitalized (as indicated in the *Supplementary Information*) the \$7.1 million in additional capital would not have even made a dent in the \$550 million in insurance losses. Further, at those credit unions, the greatest increase in capital would have represented less than 2% of assets, suggesting that none of the failures would have been prevented.

However, it is likely that many credit unions that subsequently failed might have found it prudent to attempt to restore their previous buffers above being well-capitalized, had the proposal been in effect. In that case, the total increase in capital might have approached \$150 million, which could have reduced ultimate insurance losses by as much as 25%, or even more if the greater capital cushions would have helped some credit unions avoid failure. However, since many of these credit unions were in fragile financial condition for reasons other than those highlighted by the proposed rule, it is highly unlikely that they would have been able to acquire all of that additional capital. Therefore, the total amount of increased capital, or reduced insurance losses, is likely to have been considerably less than \$150 million.

Even considering this most optimistic case—a reduction of \$150 million of insurance losses during an exceptionally severe financial crisis—the benefit to all credit unions pales in comparison to the enormous costs to many well-capitalized credit unions of having to hold excess capital as described elsewhere in this letter. Insurance losses at NCUSIF since the beginning of the crisis total \$1 billion.²³ Subtracting the \$200 million loss at the credit union that was insolvent at the beginning of the period, the \$800 million of insurance losses over the four years from 2008 through 2011 average 2.7 basis points of insured shares. The \$150 million reduction in costs that might, under very optimistic assumptions, have occurred due to the rule represents an average of just 0.5 basis points a year, and would have lowered the four-year average of insurance losses from 2.7 bp to 2.2 bp of insured shares. Although this more optimistic estimate of \$150 million of loss reduction is notable, because it would require credit unions to hold an additional \$3 billion to \$4.5 billion of unnecessary capital, and would stunt long-term credit union growth, it is impossible to justify on a cost/benefit basis.

²³ With total losses of \$1B, and losses at “complex” credit unions of about \$750M, losses at the 110 smaller credit unions that failed total approximately \$250M.

X. The FCU Act Does Not Authorize NCUA to Assess Additional Minimum Capital on Credit Unions above the Proposed RBC Ratio Levels

Under the proposal, NCUA would be empowered to require credit unions on a case-by-basis to meet an Individual Minimum Capital Requirement (IMCR) – in addition to the level of capital required under the proposal to meet risk-based or Tier I requirements. We urge the NCUA Board to eliminate this proposed claim of authority.

Congress could have chosen to provide such discretion to NCUA, but there is no language in the law or legislative history suggesting it did. Moreover, this approach is counter to the intent and letter of the FCU Act. In particular, given there are no apparent limitations on the amount of additional capital that could be required under this provision, the proposed IMCR appears to ignore the FCU Act's directive that the agency consider that net worth is only accumulated through retained earnings, making it much harder for credit unions to build capital than for stock institutions. Also, the problem created by the proposal's higher risk-based capital component for well-capitalized credit unions would be exacerbated by the imposition of additional minimum capital. Because NCUA would be able to impose higher risk-based capital than the proposed 10.5% component, an even greater difference between the risk-based capital for a well-capitalized credit union and an adequately capitalized one could result, contrary to the result the FCU Act permits.

As stated by the U.S. Treasury in its description of prompt corrective action for credit unions, of which risk-based capital is a component, the system should “promote fair, consistent treatment of similarly situated credit unions.”²⁴ Yet under the proposal, similarly situated credit unions could be subject to far different risk-based capital requirements as a result of the application of this provision by different examiners.

It is unclear from the proposal who at the agency would be authorized to set and impose the additional requirements. The proposed rule frequently refers to “NCUA” as the entity that would implement the additional minimum capital requirements, opening the door to examiners to determine this matter for the credit unions they supervise.²⁵ Moreover, it appears that only if a credit union appeals an agency staff decision for additional capital would the NCUA Board be required to perform a role in the outcome.

Among other concerns, this result would be contrary to the recommendations of the Government Accountability Office in its January 2012 report.²⁶ Also, the specter of

²⁴ U.S. Treasury Report to Congress, Credit Unions, at 8 (Dec. 1, 1997).

²⁵ See proposed § 702.105, Individual minimum capital requirements. 79 Fed. Reg. 11,216.

²⁶ GAO-12-247.

having to meet additional capital requirements above the stated requirements of the rule undermines the certainty of having a regulation in the first place. Credit unions face too many uncertainties already without having to contend with whether NCUA will impose additional capital beyond what they have planned to provide, in order to meet specific risk-based requirements.

The proposal would establish a process under which a credit union could challenge an order to set aside additional minimum capital and would require that NCUA provide reasonable prior notice and an independent process for appealing NCUA staff decisions to impose IMCR. However, credit unions believe that the process would not afford them any real due process and that even if a credit union risks examiner retaliation and seeks to appeal, the agency, in practice, would routinely follow the recommendations of examiners seeking to impose additional capital on particular credit unions.

As stated elsewhere in this letter, rather than more capital from credit unions, NCUA should consider additional steps the agency could take to improve the examination process. Material safety and soundness problems should be identified sooner but without intruding on the ability of credit union boards and management to make reasonable business decisions, even when they reasonably disagree with their examiner.

XI. The Proposed Definition of “Complex” Credit Union is Faulty

The agency has proposed to define a “complex” credit union simply on the basis of its size. This approach is wholly inconsistent with the directives of Congress as provided in Section 1790d(d)(1) of the FCU Act. That provision directs NCUA to establish a risk-based net worth system for “complex” credit unions, but does not give the agency complete discretion on how the system must be structured and applied to credit unions. Rather, the law includes significant limitations on how NCUA must define “complex” credit unions.²⁷

Congress chose not to confine the definition of “complex” to the size of a credit union, but directed NCUA to define “complex” based on the “portfolios of assets and liabilities of credit unions.” In addition, the FCU Act provides that risk-based capital requirements should be applied only to those complex credit unions for which the 6% adequately capitalized net worth level does not provide adequate protection.²⁸

Yet despite these specific instructions, the agency has sidestepped these congressional directives by equating size only -- credit unions with more than \$50 million in assets -- with complexity. That is clearly not what the FCU Act requires or the Congress

²⁷ S. Rep. No. 105-193, at 14 (1998).

²⁸ 12 U.S.C. § 1790d(b)(1)(B).

commanded. As the testimony of the U.S. Treasury indicates, the population of “complex” credit unions that would be required to set aside additional, risk-based capital was intended to be limited.²⁹

In addition, as NCUA already has developed a Complexity Index based on deposit account types, member services, loan and investment types, and portfolio composition. Given the availability of such a measure, which does explicitly take into account “the portfolio of assets and liabilities” of credit unions, it is unnecessary for the agency to employ such a simple, non-targeted definition of “complex” as it is proposing to do.

Moreover, such a single-dimension definition does not account for actual operational complexity. In fact, many larger credit unions have limited service offerings and/or narrow portfolio composition; they simply are not complex institutions.

There are approximately 1,170 credit unions with assets of more than \$50 million (i.e., those the proposal deems “complex”) that have NCUA Complexity Index values below 17. That is the same level of complexity that applies to fully 97% of credit unions with less than \$50 million in assets, which are not covered by the proposal.

These institutions above \$50 million in assets either are “plain vanilla” or reflect comparatively limited operations. They tend to be on the small end of the asset category, holding \$255 billion in total assets. This amount is roughly equal to 25% of the total assets in all credit unions deemed “complex” using the proposal’s simple \$50 million asset-size definition of complexity.

NCUA Complexity Index – Distribution of Values by CU Size Year-End 2013. Source: NCUA and CUNA.			
Index Value	Number with Assets <\$50 Mil	Number with Assets > \$50 Mil	Assets in those > \$50 Million
10 or Less	2,623	54	\$10,479,577,291
11 to 13	986	309	44,329,943,176
14 to 16	493	811	200,721,726,120
17 to 19	114	834	479,571,268,938
20+	4	200	262,932,040,854
Totals	4,220	2,208	\$998,034,556,379

Clearly, NCUA’s own Complexity Index shows that using asset size alone does not result in a careful determination as to which credit unions should be subject to risk-based capital requirements.

²⁹ U.S. Treasury Report to Congress, Credit Unions, at 7 (Dec. 1, 1997).

In light of these concerns, we urge the agency to avoid relying exclusively on an arbitrary asset cut-off level in defining “complex” credit unions. Rather, based on the above distinctions and inadequacies of the proposal’s one-dimensional definition of “complex” credit unions, we urge that the proposed \$50 million threshold be raised to \$250 million **and** that the threshold be used in combination with actual operational complexity as measured by the agency’s Complexity Index. Thus, we propose that all federally insured credit unions with assets of \$250 million or under be excluded from the definition of “complex” and that only those credit unions with assets above \$250 million and that have an NCUA Complexity Index value of 17 or higher be required to meet risk-based capital requirements.

We also urge the agency to adjust for inflation any asset-size threshold used in the definition of complex. In addition, consistent with current practice, any credit union that is identified as “complex” by NCUA should be able to present evidence to the agency as to why it is not complex and thus, should not be subject to risk-based capital requirements. The process for contesting an agency designation of “complex” should also be detailed in the final rule.

In short, we urge NCUA to provide a more refined and accurate definition of “complex” credit unions. The revised definition should ensure that the only credit unions covered are those with activities that pose extraordinary risk, beyond routine loans and investments, for which their adequately-capitalized-level net worth does not provide adequate protection. This approach is consistent with the FCU Act and will result in a more reasonable application of risk-based capital requirements.

XII. NCUA’s Proposal Attempts To Account For Interest Rate Risk With A Risk-Based Capital Model That Is Ill-Suited For This Purpose

Risk-based capital models are specifically suited to address credit risk, not other financial risk exposures. We are aware that the FCU Act directs the agency to develop a risk-based net worth system:

[T]o take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.³⁰

The legislative history of 12 U.S.C. § 1790d(d)(2) indicates that NCUA should:

³⁰ 12 U.S.C. § 1790d(d)(2).

[C]onsider whether the 6 percent requirement provides adequate protection against interest rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks.³¹

However, neither the statute nor the legislative history indicate that NCUA **must** account for interest rate risk in its risk-based system, only that the agency must consider whether this type of risk should be addressed. Moreover, the legislative history indicates that risk-based capital must reflect “a reasoned judgment” about “actual risks.” As discussed below, we do not believe that NCUA’s proposed effort to encompass interest rate risk is well-reasoned.

NCUA’s risk-based capital proposal suffers from a *prima facie* failure to measure interest rate risk accurately. By focusing exclusively on concentrations of longer-term assets, the proposal fails to account for how the maturity structure of liabilities can mitigate interest rate risk. Further, it does not follow the general approach of Basel with respect to interest rate risk. It ignores the existence of NCUA rules that already address interest rate risk, and it provides no data to support the proposed risk-weightings and concentration escalators presumably used to measure interest rate risk.

Interest rate risk focuses on the repricing speed of an institution’s assets relative to its liabilities. NCUA attempts to measure the repricing speed of assets by using concentration thresholds of mortgages and investments. Yet, the proposal does not include any measure of the repricing speed of a credit union’s liabilities. Because there has been no consideration of this factor, it seems self-evident that NCUA’s risk-based capital approach to measuring interest rate risk is inadequate.

Because it is extraordinarily difficult to use a risk-based capital model to measure interest rate risk, we recommend NCUA drop the weightings for long-term assets. In the alternative, at a minimum, NCUA should allow credit unions to net out long-term liabilities. For example, the rule should allow credit unions to offset long-term investments with one-half of core deposits (share drafts and regular share accounts), and all long-term borrowings and long-term member share certificates with sufficient early withdrawal penalties. By taking account of the liability side of the balance sheet in this manner, the proposal would not punish credit unions that strategically use longer-term liabilities as a form of insurance against the risk of rising interest rates. NCUA’s proposal also fails to follow the general approach of Basel with respect to interest rate risk. The proposal deviates from the spirit of Basel by attempting to require additional capital for interest rate risk, which was not intended under the Basel system. The main objective of Basel is to ensure that a financial institution’s capital allocation is more sensitive to the institution’s risk profile—credit, operational, and market risk—and that these risks are quantified based on data and formal techniques.

³¹ S. Rep. No. 105-193, at 14 (1998).

To accomplish this goal, Basel uses a “three pillars” approach. The first pillar consists of setting minimum capital requirements to address credit risk primarily. The second pillar consists of addressing interest rate risk and other risks **in the supervisory process**. The third pillar consists of boosting transparency and market discipline.

The “second pillar” of supervisory review gives regulators tools and a framework for dealing with interest rate risk, concentration risk, liquidity risk, and systemic risk. The Basel Committee created this second pillar precisely because of the difficulty of effectively dealing with these risks with a risk-based capital model. We believe NCUA should also adopt this “second pillar” approach to manage interest rate risk because such risk is best addressed through policies, procedures and robust measurement systems, rather than through risk-based capital. Indeed, NCUA’s recently issued Interest Rate Risk rule is an example of the application of the second pillar of the Basel approach.

The rule, which took effect September 30, 2012, imposes different requirements on federally insured credit unions depending on their asset size. Such requirements include the development and adoption of a written policy on interest rate risk management and a program to effectively implement that policy as part of their asset-liability management responsibilities.

The guidance provided in the appendix to the interest rate risk rule describes best practices for credit unions to consider as they write their interest rate risk policy and construct interest rate risk management programs. It deals with the responsibilities of boards and management, addresses interest rate risk measurement and monitoring, internal controls, and the integration of interest rate risk results into a credit union’s decision making. The guidance also provides additional considerations if a credit union is large with complex or high-risk balance sheets.

We are also concerned that NCUA’s approach for accounting for interest rate risk is not comparable to that of other federal regulatory agencies. The FDIC Regulatory Capital Interim Final Rule does not take into account interest rate risk, liquidity risk, market risk, or operational risk in its risk weightings. The FDIC specifically acknowledges this in the FDIC Interim Final Rule, stating:

The FDIC’s general risk-based capital rules indicate that the capital requirements are minimum standards based on broad credit risk considerations. The risk-based capital ratios under these rules do not explicitly take account of the quality of individual asset portfolios or the

range of the types of risk to which FDIC-supervised institutions may be exposed, such as interest-rate, liquidity, market, or operational risks.³²

The FDIC Regulatory Capital Interim Final Rule anticipates that the banking regulatory authorities will employ other mechanisms to measure and control interest rate risks similar to the “second pillar” Basel approach mentioned above. This would include a supervisory assessment of overall capital adequacy and a comprehensive measure of interest rate risk. To provide a full balance sheet view of interest rate risk, NCUA should handle this issue outside of a risk-based capital scheme, as is done by federal bank regulators.

The FCU Act does provide authority for NCUA to tailor its prompt corrective action system, including risk-based net worth, to take into consideration the unique structure of credit unions, including the fact that net worth may generally only be accumulated through retained earnings. However, because interest rate risk is not unique to credit unions, we do not think NCUA should depart from the approach employed by the FDIC to supervise for interest rate risk management.

Credit unions have an enviable record of appropriate interest rate risk management and repeatedly have shown their ability to adequately manage, monitor and control such risk.

For example, at the beginning of 2004, one-third of all credit unions with \$50 million or more in total assets reported a Net Long-Term Asset ratio exceeding 30% of total assets. In all, 170 of these credit unions reported a ratio between 40% and 50% of total assets and 83 reported a ratio that exceeded 50% of total assets. Beginning in June of 2004 the Federal Reserve Board began to raise short-term interest rates, and by July 2006 the Federal Funds interest rate had increased by roughly 425 basis points to a monthly average of 5.24%. As a result, interest rates available to consumers rose dramatically. The average yield on money market mutual fund accounts rose from around 1% in 2004 to almost 5% in 2006.

Despite this substantial market interest rate shock, we are unable to identify—either through material loss reports (MLRs) or by other means—any strain on the NCUSIF caused by natural person credit union exposure to interest rate risk. The NCUSIF ratio actually increased over the period from \$1.27 per \$100 in insured shares at the start of 2004 to \$1.31 per \$100 at year-end 2006. Similarly, we are unable to identify any natural person credit union with over \$50 million in assets that failed as a result of too-high exposure to interest rate risk. It is quite likely that some credit unions experienced reduced net interest income as a result of the rise in interest rates, but there is no evidence that this caused losses to the NCUSIF. In fact, the total of \$20 million in insurance losses in the three years from 2004 to 2006, following the dramatic increase in interest rates, is less than half the \$50 million in losses in the two previous years. As

³² 78 Fed. Reg. 55,362.

we address elsewhere in this letter, the agency provides no rigorous analysis on this issue to accompany its proposal.

If NCUA is not persuaded by these important factors and determines to proceed with its proposed treatment of interest rate risk, the agency should at the very least be transparent in its determination of the risk-weighting categories and concentration escalators that it plans to use to measure interest rate risk. This should include any historical data analysis on credit union interest rate risk and its impact on credit union capital. We also believe the asset categories are too general to measure interest rate risk accurately, and that NCUA should provide the supporting quantitative analysis used to determine the asset categories.

XIII. The Proposed Risk Weighting System Is Deficient

The agency focuses roughly five pages of its *Supplementary Information* on a description of its current credit union asset risk weightings, comparing those weightings to banking industry requirements, and outlining its proposed changes to current credit union asset risk weightings.³³ However, the 44-page *Federal Register* document contains no concrete statistical analysis of credit union losses or failures, no clearly quantified and summarized data on historical NCUSIF experiences, and no data-based comparisons of the loss or failure rates at banks to rationalize any of the proposed asset risk weightings. While we have many concerns about the risk weightings, we agree that the proposed risk weightings for consumer loans and home equity/second mortgages seem appropriate based on losses at comparable banks and credit unions.

The absence of rigorous quantitative analysis accompanying the proposal's risk weightings raises many questions and makes it exceedingly difficult to respond fully to the agency's proposal.

Nevertheless, in our efforts to review the proposed risk weightings, we examined NCUA Office of Inspector General Material Loss Reviews (MLRs) on the small number of credit unions with more than \$50 million in assets that failed during the Great Recession with insurance losses of greater than \$25 million.

Significantly, in nearly every case, the Inspector General's reports note that NCUA and/or state examiners could have prevented or mitigated the losses **through the supervisory process**. Time after time, the MLRs conclude that examiners did not respond aggressively or timely enough to a failed credit union's increasing risks and consequently missed opportunities to slow or stop the growth of excessive risk.

³³ 79 Fed. Reg. 11,184.

These reports suggest that the primary need is a supervisory process review—not a completely revamped risk weighting/capital scheme imposed on all credit unions. The agency’s proposed increases to various risk weightings in our view are excessively blunt given the small number of failures and the MLR narratives we reviewed.³⁴

We urge NCUA to consider that the misalignment of these weights will have both real and unnecessarily harsh consequences on credit unions and on their members and communities. Hardworking consumers and small business owners—from farmers in the nation’s heartland who need credit to plant crops to the recent immigrant taxi driver needing a medallion loan to become his or her own boss—these will be among the many whose lives will be affected in a tangible way if the proposed problematic asset weights are approved and lending is reduced at credit unions.

Business lending at credit unions is much safer than similar lending at U.S. banking institutions, and the risk weightings should reflect that. Historically, such loans have constituted one of the safest segments of credit union lending activity. Of the 55 credit union failures in 2009 and 2010, only one failure was primarily related to MBLs. MBLs were one of several factors contributing to the failure of eight other credit unions. Thus, the vast majority (46) of credit union failures during this period were unrelated to member business lending.³⁵

These concerns are why we must strenuously oppose many of the agency’s proposed risk weightings, which seem to inappropriately and greatly exceed similar requirements for small banks, on a risk-adjusted basis.³⁶ We arrive at this conclusion by comparing credit union and bank loan loss rates. In each case, we compare losses at credit unions with over \$50 million in assets to losses at community banks with \$15 billion or less in assets. We examine and compare credit union and bank losses over three time periods: over the long term (going back as far as 1997 when possible); since the start of the Great Recession (2008-2013); and at the peak value (regardless of the year).³⁷

A. Mortgage Loan and Mortgage Business Loan (MBL) Risk Weightings

We have identified two key areas that reflect an especially obvious disconnect between actual credit union and bank historical performance:

³⁴ NCUA Office of Inspector General, Material Loss Reviews: OIG-14-06, OIG-13-13, OIG-13-10, OIG-13-09, OIG-13-05, OIG-12-14, OIG-12-11, OIG-12-05, OIG-11-10, OIG-11-09, OIG-11-08, OIG-11-07, OIG-11-01, OIG-10-20, OIG-10-19, OIG-10-17, OIG-10-16, OIG-10-15, OIG-10-14, OIG-10-04, OIG-10-03, OIG-10-02, OIG-10-01, OIG-09-03, OIG-09-01, OIG-08-10.

³⁵ Senate Committee on Banking, Housing, and Urban Affairs Credit Unions: Member Business Lending (June 16th 2011). Statement of the Nation Credit Union Administration.

³⁶ The analysis is based on FDIC and NCUA call report filings.

³⁷ We also analyzed the results of all banks and of those with less than \$250 billion in assets – in both cases losses within these groups greatly exceeded the losses at banks with less than \$15 billion in assets. The group averages we highlight here thus represent the most conservative of the three comparison groups we studied.

- NCUA’s proposed 50% base risk weighting (i.e., excluding the escalators for concentration risk) for credit union first mortgages is equal to the bank risk weighting. However credit union losses on these loans historically have been approximately equal to 60% of community bank loss totals. As shown below, this is the case over the long term, since the start of the Great Recession, and at peak value losses:
 - The long-run average loss rate on credit union first mortgages is 0.15% while the comparable rate at community banks was 0.33%.
 - Credit union losses on first mortgages since the start of the Great Recession averaged 0.25% while the comparable rate at community banks was 0.40%.
 - The peak value loss on first mortgages was 0.41% at credit unions (observed in 2011) while the comparable rate at community banks was 0.66% (observed in 2010).
 - Thus, if the appropriate bank risk weighting on residential first mortgages is indeed 50%, the history-based weighting for “complex” credit unions ought to be close to 30% (i.e., 60% of 50%).

- NCUA’s proposed 100% base risk weighting for credit union MBLs also is equal to the bank risk weighting. However, credit union losses on these loans historically have also been equal to no more than 60% of community bank loss totals. Again, this is the case over the long term, since the start of the Great Recession, and at peak value losses:
 - The long-run average loss rate on credit union MBLs is 0.28% while the comparable rate at small community banks was 0.52%.
 - Credit union losses on MBLs since the start of the Great Recession averaged 0.55% while the comparable rate at community banks was 0.93%.
 - The peak value loss on MBLs was 0.89% at credit unions (observed in 2011) while the comparable rate at community banks was 1.69% (observed in 2009).
 - Thus, if the appropriate bank risk weighting on business loans is indeed 100%, the history-based weighting for “complex” credit unions ought to be close to 60% (i.e., 60% of 100%).

The proposal imposes higher risk weights on higher concentrations of residential mortgages and MBLs. However, these asset concentration escalators are inconsistent with actual credit union loss experience.³⁸ The proposal contains no data suggesting otherwise.

- Our detailed analysis of historical losses reveals credit unions with higher loan concentrations actually experience **lower** overall losses compared to

³⁸ *Ibid.*

their counterparts with lower concentrations—as shown in the tables which follow.

- This suggests that those with higher concentrations have more experience and more expertise than those with lower concentrations. It further suggests that the real issue regarding concentration risk lies among a small number of institutions that make big forays into new areas over a short period of time.
- The data suggests that if anything, higher concentrations of certain assets should be associated with lower risk weights.
- We therefore believe these concentration risk concerns might be better addressed through the supervisory process.

Lower Losses at Higher Concentrations: MBLs

		Historical Loss Rates		
Concentration (% of total assets)	Proposed Risk Weighting	Long-Run Avg (Since 1997)	Great Rec: 2008-2013	Peak Year Value
Less than 15%	100%	0.30%	0.70%	1.00%
15% to 25%	150%	0.28%	0.51%	0.92%
25% or more	200%	0.20%	0.39%	0.64%

Lower Losses at Higher Concentrations: 1st Mortgages

		Historical Loss Rates		
Concentration (% of total assets)	Proposed Risk Weighting	Long-Run Avg (Since 1997)	Great Rec: 2008-2013	Peak Year Value
Less than 25%	50%	0.13%	0.33%	0.48%
25% to 35%	75%	0.12%	0.31%	0.43%
35% or more	100%	0.09%	0.23%	0.30%

Lower Losses at Higher Concentrations: HEL/2nd Mortgage

		Historical Loss Rates		
Concentration (% of total assets)	Proposed Risk Weighting	Long-Run Avg (Since 1997)	Great Rec: 2008-2013	Peak Year Value
Less than 20%	100%	0.41%	1.04%	1.43%
20% to 25%	125%	0.36%	0.91%	1.32%
25% or more	150%	0.27%	0.67%	1.09%

B. CUSO Investments Risk Weighting

CUNA is concerned that the proposed 250% risk weighting on credit union service organization (CUSO) investments is too high, has not been justified, and will restrict and reduce the collaborative efforts through CUSOs that credit unions need in an increasingly competitive financial marketplace.

Under the FCU Act, federal credit unions may only invest up to one percent of assets in CUSOs and “complex” FCUs currently have only 0.17% of assets so invested. Federally insured state credit unions in some states are permitted to invest more than 1% of assets in CUSOs. However, exposure to CUSO investments among these credit unions is also very light. Of the 985 federally insured state credit unions with more than \$50 million in assets, only 38 have more than 1% of assets invested in CUSOs, and only three of these have more than 3%. In total, federally insured state credit unions have only 0.19% of assets invested in CUSOs, about the same as for federal credit unions.

In light of these facts and because most CUSOs carry out day-to-day credit union operations, a more appropriate and justified risk weighting should be no higher than 100%.

C. Mortgage Servicing Rights (MSR) Risk Weightings

Likewise, the proposed 250% risk weighting on mortgage servicing rights would be punitive and unnecessary; it should also be reduced to 100%. An active market exists for mortgage servicing rights, which allows for the establishment of current market values of such rights during changing economic and interest rate environments. This allows for frequent “marking-to-market” of servicing rights, which prevents losses from accumulating. Higher concentrations of MSRs (for example, to the extent they exceed the net worth of the credit union) could be assigned the higher risk weight of 250%.

D. Impermissible Investments Used to Fund Employee Benefits Risk Weightings

The proposed risk based capital Risk Based Capital rule does not take into account some critical factors as it relates to impermissible investments that are purchased for the purpose of funding for employee and executive benefit plans:

- The proposed rule does not take into account the purpose of the assets and their applicability to benefits funding, potentially creating risks from both a fiduciary stand point front as well as the loyalty of employees and executives.

- The rule aggregates mutual funds and related investments without considering the relative risks of the underlying holdings, management, investment strategies and objectives.

As a result of the currently proposed risk based capital rule, credit unions would be less likely to offer and fund executive benefit plans. This would render them less attractive to quality executive talent, and lead to a long term decline in overall credit union competitiveness compared to banks and other financial services related industries.

In addition, credit unions will be less likely to fund appropriately for employee benefits in general. With employee benefits costs rising faster than the rate of inflation and faster than the prevailing interest rates at which credit unions may invest, more money will have to be used to provide benefits. This would result in leading to less money being available to fund other credit union initiatives, ultimately hurting the ability of credit unions to support their members.

- We recommend life insurance be recorded on the balance sheet as an “Other Asset.” For whole life insurance, we recommend a risk weight of 20%; for universal life and indexed universal life, we recommend a 100% weight; for variable universal life, we recommend weighting consistent with the underlying subaccounts and weighting according to the risk profile of those specific subaccounts, between 20% - 150% as outlined with mutual funds below.
- We recommend annuities be recorded on balance sheets as an “Other Asset.” For fixed and indexed annuities, we recommend a risk weighting of 100%. For variable annuities, we recommend weighting consistent with the underlying subaccounts and according to the risk profile of those specific subaccounts, between 20% - 150% as outlined with mutual funds below.
- Mutual funds should be weighted according the risk profile of the fund’s underlying investment strategy and managed money according to actual holdings:
 - State and federal governmental funds: 20%
 - Municipal bond fund strategies: 50%
 - Asset backed, mortgage backed, bank loan funds: 100%
 - Other funds, including ETFs: 150%
 - Bonds: according to WAL (remaining duration)
 - Equity securities: 200%

For all recommended risk weightings on impermissible investments used to fund employee benefits, NCUA should also consider modification if sufficient justification is presented and approved by the NCUA.

XIV. NCUA Should Not Discount the 1% NCUSIF Deposit in the RBC Ratio

The proposal would require a credit union to subtract its 1% NCUSIF deposit from the numerator before calculating its Risk-Based Capital Ratio. We are very concerned about this approach, given the proposals limitations on the amount of the Allowance for Loan and Lease Loss (ALLL) provision that may be included in a credit union's risk-based capital calculation. The stated purpose of this step is to "address concerns relating to the NCUSIF deposit being reflected on NCUSIF's balance sheet both as "equity to pay losses and as an asset of the insured credit unions."³⁹ These concerns regarding the "double counting" of credit unions' 1% NCUSIF deposits were raised by the U. S. Department of the Treasury and the Government Accountability Office. In the case of a system-wide catastrophe among credit unions requiring the NCUSIF to deplete its capital, federally insured credit unions would be required to write-down and replenish their NCUSIF deposits.

Even so, the numerator of the proposed risk-based capital ratio is intended to reflect "equity available to cover losses in the event of liquidation."⁴⁰ In the case of an individual credit union's balance sheet, the NCUSIF deposit is one of the most reliable assets available to cover losses. The only condition under which it would not be available is during a system-wide catastrophe, in which case most other credit union assets, other than cash, would similarly be subject to substantial losses. Former NCUA Chairman Joann Johnson recognized this fact in a letter to GAO in 2004:

Under GAAP, which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on the financial statements of a credit union. Further supporting its treatment as a credit union asset, it has been NCUA's long standing practice to return this deposit when a credit union exits federally insured status or converts to another form of financial institution. **These funds are also available to absorb losses in the event of a liquidation or purchase and assumption of a failed credit union.** The NCUSIF deposit is not related to a credit union's net worth from either an accounting or financial risk standpoint. It would take a highly improbable massive systemic event to trigger a write-off of the NCUSIF deposit and recapitalization of the insurance fund. Further, if the NCUSIF equity ratio declines below 1.2%, CUMAA mandates that NCUA charge an insurance premium to restore the fund to at least 1.2%.⁴¹

As this statement reinforces, there is no reason to believe the NCUSIF deposit is not available to cover losses, and it should not be excluded from the numerator of the risk-based capital ratio.

³⁹ 79 Fed. Reg. 11,194.

⁴⁰ 79 Fed. Reg. 11,194.

⁴¹ GAO-04-849, Appendix IV (emphasis added).

XV. Goodwill Treatment Should be Revised

Under the proposal, goodwill along with other intangible assets would be deducted from the risk-based capital numerator and denominator. NCUA's concern is that these intangible assets may have an uncertain value and may not add to a credit union's ability to cover losses in an economic downturn. However, this approach could be disruptive for credit unions that have merged with or acquired other credit unions, including in situations in which NCUA has encouraged the merger. We urge NCUA to allow goodwill as part of equity in the numerator of the risk-based capital calculation to be phased out over a ten-year period, or longer on a case-by-case basis.

XVI. The Proposal Would Undermine the Ability of State Regulators to Supervise State Chartered Institutions

CUNA, Leagues, and state chartered credit unions are very concerned about the broad grant of authority the proposal confers on NCUA in establishing the proposed risk-based capital requirements and implementing them. The proposal does not seem to anticipate much role for the state regulators to have a different view or approach from that of NCUA.

The long-term erosion of the authority of state credit union regulators to be part of the decision-making process on issues as significant as risk-based capital, rather than just informed of an outcome, is real and troublesome.

The FCU Act is clear that while the NCUSIF insures state chartered, federally insured credit unions, NCUA must respect the sovereignty of state regulators in defining and setting certain standards of operation for institutions chartered by a state.⁴² This includes working collaboratively with state supervisors to develop a regulatory framework that is feasible, effective, justified and warranted. It does not appear that has been the process for the development of this proposal.

We urge the agency to reconsider the importance of the dual chartering system to the future of credit unions. In that light, the agency should ensure that under a final risk-based capital rule, NCUA will properly implement directives in the FCU Act and coordinate with state officials in implementing risk-based requirements and prompt corrective action.⁴³

⁴² 12 U.S.C. § 1790d(k)(1)

⁴³ *Id.*

XVII. NCUA Should Provide a Risk Mitigation Credit as Under the Current Rule

Under NCUA's current PCA rules, a credit union may apply for and receive a risk mitigation credit. This process is designed to reduce a credit union's risk-based net worth requirement when it can document it has properly mitigated credit risk and/or interest rate risk. The proposal would not continue this approach.

We urge NCUA to include risk mitigation credits, certainly for managing credit risk, in the final rule. The agency has well-developed procedures for credit unions under its rule, 12 CFR 701.108, as well as for examiners under its "Guidelines for Evaluation of an Application for a PCA Risk Mitigation Credit." Such an approach is consistent with the agency's objective of protecting the NCUSIF through better management of risk by credit unions. Also, this authority could provide an important incentive for credit unions to manage certain risks more proactively—and receive an added benefit of seeing their risk-based capital requirements at least somewhat reduced as a result.

XVIII. NCUA Should Provide Much More Time for Credit Unions to Comply

The proposal does not provide a time frame for implementation, although the *Supplementary Information* indicates that NCUA would provide 18 months for credit unions to come into compliance from the time the final rule is published in the *Federal Register*.⁴⁴

The implementation period associated with the rule is far too short given the planning and operational changes that credit unions may need to implement. If the agency does not adopt significant changes as CUNA is urging, then we believe it is reasonable for NCUA to provide at least five years for most credit unions—and more time on a case-by-case basis for some credit unions—to conform to the rule.

If revisions of the scope and nature that CUNA is urging are incorporated into the final rule, then less time will be needed to transition to the new system. However, 18 months will still be too short for credit unions to prepare to come under the rule. A more reasonable time frame would be a delay of three years, or longer as needed for individual credit unions. That is because credit union CEOs and boards will need to review strategic decisions, possibly make asset/liability management changes, and consider how best to position their balance sheets and activities to minimize the impact of the rule on their operations.

⁴⁴ 79 Fed. Reg. 11,208.

Given the health of the credit union system, there is no need to rush the effective date of the rule. Premature compliance could cause needless disruptions and impose costly initiatives on credit unions that could be avoided if more time is provided to conform to the rule.

XIX. NCUA Should Permit Supplemental Capital for RBC Purposes

NCUA has chosen to use the term, “risk-based capital” instead of “risk-based net worth” in the new proposal, even though the FCU Act only addresses NCUA’s authority to regulate “risk- based net worth.” Ordinarily, the use of one term versus another would have little significance in practice. However, this is one area in which the distinctions between these terms are highly significant. Although supplemental capital cannot be included in net worth for most credit unions without a change in law, it certainly could be included in the numerator of the risk-based capital ratio under current law. That proposed numerator already includes items that are not part of net worth, and the agency has authority to incorporate supplemental capital.

Under the proposal, the definition of “capital,” consistent with Generally Accepted Accounting Principles (GAAP), refers to equity available to a credit union to cover losses, while net worth is confined to retained earnings.⁴⁵ We believe GAAP would permit the use of supplemental capital for risk-based capital purposes by any natural person credit union as a category of equity to cover losses, while under GAAP, net worth comprised of retained earnings would not.

We realize that even if GAAP would permit such treatment, it must also be permissible under the FCU Act and the proposal. We believe the use of supplemental capital as part of risk-based capital would be authorized under these documents.

Low-income designated credit unions are expressly permitted to accept non-member deposits (12 U.S.C. 1752(5) and 1756(6)), and the definition of “net worth” in the FCU Act specifically allows such deposits to be used as supplemental capital by low-income designated credit unions for purposes of meeting Tier I requirements (12 U.S.C. 1757a(2) and 1790d(o)(2)(C)).

NCUA has long interpreted those provisions to mean that credit unions that are not low-income designated may not have access to supplemental capital, because such credit unions cannot accept nonmember deposits and their net worth is confined to retained earnings, which excludes supplemental capital.

While we recognize these limitations, the FCU Act does not expressly prohibit the use of supplemental capital by any credit union. In light of that, we believe that the concept of

⁴⁵ 79 Fed. Reg. 11,188.

risk-based “capital” under the proposal, which is broader than “net worth,” would support the use of supplemental capital for risk-based purposes only (not for Tier I purposes) by credit unions that do not have a low-income designation. (We also support the use of supplemental capital by low-income credit unions to meet Tier I or risk-based capital requirements.)

The FCU Act does not authorize federal credit unions without a low-income designation to accept non-member deposits, but state law should determine whether a state chartered credit union could do so. If so authorized, such deposits should be permitted for risk-based capital purposes. For federally chartered credit unions, we note that in the past, NCUA has authorized the use of certificates of indebtedness. These instruments were neither loans to members nor share certificate deposits, but rather functioned as a loan from the holder to the credit union with an interest rate paid to the holder. We do not see any prohibitions under the FCU Act that would preclude the agency from reauthorizing such instruments for federal credit unions, which could utilize such proceeds to help meet risk-based capital requirements.

XX. Additional Comments on a New Proposal Should be Sought

If NCUA is convinced, based on the FCU Act and the financial performance of credit unions, that it must proceed with a risk-based proposal, we are confident that a better approach in comparison to the current proposed rule can be created. Such a new proposal should be developed that could support credit union risk-management but without unduly limiting credit union growth as the current proposal would do. We respectfully request that NCUA use the comments it receives during the comment period from CUNA and others and at the NCUA Listening Sessions to develop a substantially different proposal on which credit unions and other stakeholders are given another opportunity to comment under the Administrative Procedure Act before any changes to the present system are adopted in final form.

Conclusion

Credit unions have been subjected to a number of new rules in the wake of the financial crisis, but none of them is as potentially harmful as this proposal. Indeed, the economic and legal issues spawned by the proposal are numerous; the policy questions are real; and, as evidenced by the overwhelming level of interest in this rule, the stakes for credit unions and their 99 million member-owners could not be higher.

In order to be well-positioned for future growth and increasing significance in the financial marketplace, credit unions need and deserve meaningful capital reform that corrects statutory deficiencies and creates incentives for them to manage their risks without having to avoid them. NCUA should be encouraging credit unions to do more of

what they do now to serve their members and communities—not limiting them so they can only do less.

This proposal would at the least stymie credit unions in their efforts to pursue greater opportunities to reach and serve members. More likely, the proposal would doom credit unions to a marginal role in the financial marketplace. The proposal would not even achieve NCUA's objectives effectively as it would only clumsily identify credit unions in need of additional capital while resulting in overcapitalization of many other well-managed credit unions.

In light of the inherent flaws in the proposal and the damaging impact it would generate, we urge the NCUA Board not to proceed with this proposal.

Instead, the agency should retain the current system while it is undertaking welcomed and needed efforts to seek and achieve positive and meaningful reform related to capital and prompt correction action.

Such efforts must include working with Congress and the credit union system to pursue revised Tier I requirements for credit unions that are at least adequately capitalized and to support supplemental capital to meet Tier I requirements if a credit union so chooses. Upgrading examiner training significantly to improve the ability of examiners to identify material safety and soundness problems without micromanaging credit unions in the process is also important.

If the agency determines it must proceed with a singular proposal devoid of more significant reform efforts, then we urge the Board to incorporate the changes CUNA is urging and reissue a new proposal for comments from credit unions and other interested parties.

CUNA would appreciate meeting with each of the NCUA Board members regarding this letter and will be following up to arrange those discussions. In the meantime, if you or others at NCUA have any questions about our letter, please do not hesitate to contact Bill Hampel, Eric Richard, Mary Dunn, Mike Schenk, Steve Rick or me.

Best regards,

A handwritten signature in black ink, appearing to read 'Bill Cheney', with a long, sweeping underline that extends to the right.

Bill Cheney
CUNA President and CEO