Western
FEDERAL CREDIT UNION

PO Box 10018 Manhattan Beach, CA 90267

May 27, 2014

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

Re: Risk-Based Capital

Dear Mr. Poliquin:

On behalf of the more than 160,000 member-owners who have entrusted more than $1.9 billion in assets, Western Federal Credit Union (Western) thanks the Agency for the opportunity to comment on the regulatory proposal creating a new "risk-based capital" approach for complex federally-insured credit unions.

While Western believes that the Agency proposed this rule with the best of intentions, however, Western must strongly oppose the rule as written dealing with risk-based capital and urge it not come before the NCUA Board in its current format.

History of "Complex" Risk-Based Capital Requirements

Federally-insured credit unions had a risk-based capital approach before the enactment of the *Credit Union Membership Access Act* (CUMAA) in August 1998. With CUMAA, Congress determined that a singular capital approach was best for credit unions. CUMAA amended the *Federal Credit Union Act* to mandate a seven percent capital ratio for federally insured credit unions to be considered "well-capitalized."

CUMAA also created an additional capital approach for those credit unions whose assets determined the credit union to be "complex." Western believes that the current proposal does not follow Congressional intent for "complex" credit unions and applies a "one-size fits all" approach.

During its consideration of H.R. 1151, which would become CUMAA, the Senate Banking Committee (Committee) published a report dealing with its consideration of the legislation (Senate Report 105-193, May 21, 1998). In that report's discussion of Section 301 (prompt corrective action) of the legislation, the Committee stated that:

> "For purposes of section 216(d), **"complex" refers to credit unions' portfolios of assets and liabilities**; it does not involve credit unions' field of membership...Other provisions of section 301 are intended to encourage the

> NCUA, in designing the risk-based capital requirement, to seek and receive broad input – to help assure that the requirement is workable, fair and effective. **(emphasis added)**

During Senate debate on the legislation (July 27, 1998), the issue of "complex" credit unions was specifically mentioned in light of the then-Secretary of the Treasury Robert E. Rubin's letter to Senate Majority Leader Trent Lott expressing the Clinton Administration's support of H.R. 1151. Rubin's letter referenced the extra capital measures that were going to be imposed on "complex" credit unions, not all federally insured credit unions.

In the Supplementary Information for the final "risk based net worth requirement" (RBNW) (65 FR 44954), credit unions asked for a simple asset threshold for meeting the "complex" definition. The Agency declined to act upon those comments. It required meeting the two separate definitions in order for a federally-insured credit union to meet the definition of "complex." Both the asset threshold ($10 million in assets) and the RBNW requirement of six percent capital (portfolios of assets and liabilities) had to satisfied.

The Agency's proposal states that the "complex" designation will be applied to all federally insured credit unions with assets of $50 million or more (Proposed 12 CFR 702.103). The Agency has not demonstrated why it should not comply with Congressional mandates in this definition when it explicitly states "portfolios of assets and liabilities" and why it changed its own definition of "complex" from the original final rule published in 2000.

Western believes that this was not what Congress intended for the "complex" credit union designation and strongly encourages the Agency reject this concept.

Supplemental Capital

When the Agency finalized its first capital requirements for "complex" credit unions, the issue of supplemental capital was raised by credit unions and state credit union trade associations. The argument for supplemental capital at that time was that the RBNW was a regulatory capital structure mandated by CUMAA and regulatory capital could be used within such a structure.

The Agency fell back upon the CUMAA requirement that net worth was retained earnings. But it acknowledged that supplemental capital would have a role in the capital structure of a federally-insured credit union within a regulatory capital scheme.

> 1. *Regulatory capital.* Numerous commenters reiterated the call for new forms of "regulatory capital" to play a role in PCA. NCUA may have the statutory authority to permit new sources of capital for federally-chartered credit unions. 12 U.S.C. 1757(7), 1757(9) (permitting NCUA to authorize regulatory capital in the form of

> shares and subordinated debt). However, CUMAA's express, limited definition of net worth—retained earnings under GAAP—clearly precludes all but low income-designated credit unions from classifying such regulatory capital as net worth for PCA purposes. § 1790d(o)(2). Nevertheless, NCUA recognizes that, if established, regulatory capital would be available to absorb losses, thereby insulating the NCUSIF from such losses. *See* § 702.206(e) (criterion in evaluating net worth restoration plans). Depending on how it is structured, regulatory capital on the balance sheet of a credit union that meets the definition of "complex" could conceivably reduce the risk for which the RBNW requirement is designed to compensate. In the future, therefore, NCUA may consider proposals to amend part 702 to allow regulatory capital to offset an RBNW requirement. *See, e.g.,* § 702.106(h) ("Allowance" component). (65 FR 44963)

Since this regulatory proposal would impose an additional – regulatory based rather than legally based – capital requirement on federally-insured credit unions, Western believes that the Agency must provide a supplemental capital alternative to meet that requirement. This is available to those credit unions as part of a net worth restoration plan under the RBNW regulations. It must be available to all federally-insured credit unions if this proposal is adopted as a final regulation. Western calls upon the Agency, if it imposes any type of additional regulatory capital structure on federally-insured credit unions, then, it must also give those credit unions a meaningful source of supplemental capital to meet those standards.

BASEL Standards – Credit Unions v Banks

In the past and including when the Agency looked to implement the RBNW requirements of the CUMAA, the Agency used its deference – as encouraged by Congress – to reflect the nature of credit unions including the limitations on capital formation. Western believes that the Agency has not used the deference in applying the BASEL 3 standards to federally-insured credit unions.

The Agency has usually allowed the federal banking regulatory agencies to take the lead in working out the international issues involved in BASEL with regulatory requirements of banking organizations in the United States. This time in 2014, it appears that the Agency has taken the lead among federal financial institution regulatory agencies.

Credit unions have long been defined as similar but not identical to other banking organizations (money center banks, community banks, mutual savings banks). Yet, the Agency uses the explanation that "Use of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions" as a reason for this regulatory proposal. (79 FR 11186) Banks have multiple sources of capital to meet risk-weighted assets while credit unions only have retained earnings. This argument makes no sense for an Agency that seeks to remain independent.

Section 102(a)(1)

The Agency is looking to impose a 10.5 percent risk-based capital requirement on federally insured credit unions as part of this regulatory proposal in 2016 (18 months after a final rule is published). Yet, the full and complete implementation of the BASEL capital requirements on banks and mutual savings banks will not become effective until 2019 as stated in the proposal. (79 FR 11192) If the federal banking regulatory agencies are giving their regulated entities until the end of the current decade to comply with "the complexity of implementing a capital conservation buffer," then why is the Agency forcing credit unions into a three-year advance head start? No reason is provided for this unjustified decision.

Using the 10.5 percent risk-based capital requirement "is designed to bolster the resiliency of complex credit unions throughout the financial cycles." (79 FR 11192) But the reality of this proposal is to mandate a higher capital requirement on those credit unions with $50 million or more in assets without a mandate from Congress. There is no true determination of whether the assets/liabilities of a specific credit union make it more "complex" or "risky" than those of a similar asset sized credit union.

Section 702.103

When the Agency increased the size definition of "small" credit unions from $10 million to $50 million, it did not consider what the other federal banking agencies considered to be a small institution. The other federal financial regulatory agencies and the Consumer Financial Protection Bureau use a $500 million threshold. If credit unions are going to be held to bank-like standards, then the small entity asset threshold should be increased to the same $500 million.

Section 104(c)(2)

The Agency has not demonstrated the need for a risk-waiting of 20 percent for "cash on deposit" in other financial institutions or short-term cash equivalent investments. Cash is cash and does not deserve a capital buffer for it.

This section begins to detail higher capital levels for specific assets based upon concentration within the credit union's portfolio. The banking agencies have not demanded banks have more capital based upon the percentage of the assets held. The Agency has not provided justification to credit unions for this different treatment from that applicable to banks.

The 150 percent capital requirement for delinquent vehicle and other consumer-based secured loans does not take into consideration the value of the underlying security or the fact that credit unions have accounted for those delinquent loans within the Allowance for Loan Losses (ALL).

Investments in CUSOs likewise would be subject to unjustifiable capital requirements. The Agency has encouraged credit unions to provide financial services to members that they want or desire. Yet, many credit unions cannot do this alone. They will partner with other credit unions and/or financial institutions to provide these services. Yet, the Agency makes no difference between widely owned cooperative organizations (CO-OP Network, PSCU, etc) that provide services to credit unions at affordable prices and limited ownership organizations designed for a specific reason. This is a reaction to the Telesis failure and its member business lending CUSO. But the majority of credit unions who have their only CUSO investments in the "widely owned cooperative organizations" must not be punished simply because they are treated similarly. In order to impose a 250 percent risk-based capital retention requirement on these CUSOs, the Agency must demonstrate a failure of a credit union and payout by the Insurance Fund was caused by the failure of a widely owned cooperative organization. Otherwise, credit unions would be forced to look to the banking community for such services and defeat the cooperative nature that exists between credit unions.

Similarly, there is accounting for the underlying value of a foreclosed or repossessed asset in making those assets subject to a 100 percent capital requirement. The same holds true for land and building. If a credit union has purchased land and building in the past and has an unrealized gain (market value exceeds the purchase price), then the credit union would be wasting that capital allocation.

The proposal does not account for those credit unions permitted to use derivative authority. It does not contain any capital credit for the liability used for the offsetting asset. Despite the credit union taking measures to reduce the interest rate risk, the proposal still requires capital associated with the underlying asset.

Risks mitigated

The Agency has taken this proposal to offset multiple risks that a credit union has within its operations and balance sheet into a one-size fits all model. It does not account for risk mitigation efforts to offset concentration or interest rate risks. On the banking side, these efforts are separate from the BASEL capital standards mandated by the banking regulators.

If the proposal does move forward, Western does strongly encourage the Agency to adopt the banking regulators approach and leave concentration/interest rate risks to other mitigation efforts.

Section 702.105

Western strongly objects to the proposal that would allow the examiner, without consultation or approval from the Regional or National Office, to impose a higher capital requirement for a federally insured credit union. There may be a limited number of circumstances that could require a credit union to maintain greater amounts of capital. However, that decision should be made by the Regional Director or the NCUA Board after through and complete discussions with the management and Board of Directors of the impacted credit union. This will ensure a fair approach that provides a level of checks and balances that protects the Insurance Fund and the member-owners of the impacted credit union.

Effective Date

The proposal states that federally insured credit union will have a minimum of 18 months from the publishing of the final rule to comply with the final rule. This timeframe is not sufficient for a federally insured credit union to change its asset, liability and operational structure to meet the requirements of a regulatory capital requirement. Banks had multiple years to prepare for changes in capital requirements and credit unions must be provided with a similar timeframe. Western strongly suggests that a four-year period be utilized for this conversion to an additional capital requirement. Because of the heavy regulatory burden this proposal imposes upon credit unions, there should be more than one examination cycle between the publishing the final rule and the final effective date. A longer time would allow the Agency to provide for full and complete training of its examination staff and opportunities for them to work with credit union management without serious disruption of products and services to the credit union member-owners. After all, it is the member-owners who will be the ultimate winners and/or losers if products and services need to be modified or eliminated as part of complying with this regulatory capital scheme.

Conclusion

This regulatory proposal appears to be an effort to prevent any future credit union problems by focusing on past issues. Yet, when the economy and credit unions face troubling times, it is usually due to different factors than the last economic downturn. Western requests the Agency look to the more even-handed approach to BASEL 3 by the banking regulators and revise this proposal, if truly needed, to accurately reflect the business nature and environment for federally-insured credit unions. This proposal does not do such. And as proposed, Western respectfully must oppose it and encourage the Agency to reject it completely.

If I can be of further assistance in this matter, please feel free to contact me at 310-536-5330.

Sincerely,

Greg Badovinac
Assistant Vice President – Compliance & Governmental Relations