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Via e-mail to regcomments@ncua.gov.

May 27, 2014

Mr. Gerald Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Proposed Rule: Prompt Corrective Action--Risk Based Capital, RIN 3133-AD77

Dear Mr. Poliquin:

We are pleased to provide our comments on the NCUA's proposed amendments to its Prompt Corrective Action rule, 12 CFR 702. The Illinois Credit Union League represents 292 Federal credit unions and Illinois chartered credit unions.

The very large number of affected credit unions commenting on the proposed rule along with letters of concern from many members of Congress indicates the highly negative impact of the proposed rule. We have many areas of concern which are addressed below.

The Revisions Are Not Needed

We support the idea of risk based capital. A proper risk based capital system would impose a higher capital requirement for those who take on too much risk while allowing lower capital for credit unions with less risk. But we cannot support the current NCUA proposal, particularity in the absence of more comprehensive reform and believe the proposal should be withdrawn.

- There is no need for the proposed system. The NCUA has chosen an excessively blunt instrument that punishes too many credit unions with higher capital set-asides, especially in light of the fact that the current system held up incredibly well throughout the worst economic catastrophe since the Great Depression. <u>The average net worth to assets ratio for the 59 federally</u>

insured credit unions in Illinois over $50 million in assets is 10.20%--a very healthy 320 b.p. greater than the 7% well capitalized floor.

- The additional capital resources required by this proposal will not only result in significantly lower levels of member service and satisfaction but will also put credit unions at a distinct competitive disadvantage relative to the nation's for profit banking sector. This is a perverse result given the demonstrated historical conservative operations of credit unions and the role credit unions played during the downturn--both as a countercyclical force (lending as the banks pulled back) and a safe haven (taking in deposits as bank turned consumers away). Policy makers should be encouraging more of what credit unions do, not less and this proposal demands less.

The financial health of credit unions now and during the financial crisis indicates that the NCUA's proposed rewriting of part 702 is not justified. We believe that a transition to a calculation of a risk based capital ratio using risk weighted assets should be made only--

1. In conjunction with amendments to the Federal Credit Union Act to reduce the non-risk statutory ratios (leverage ratios) which are currently higher than the bank ratios; and to allow all natural person credit unions to access secondary capital.
2. Removal of the proposed authority to impose even higher risk based capital requirements on a case by case basis.
3. As discussed below, there must be (a) meaningful downward revision to the proposed risk weights, (b) changes to the calculation of the risk based capital ratio, and (c) other necessary changes to the proposal.

The Imposition of a Well-Capitalized Risk-Based Capital Standard Violates the Federal Credit Union Act.

The NCUA proposes to require both an 8% adequately capitalized risk based capital ratio and a 10.5% well capitalized risk based capital ratio. The Federal Credit Union Act does not permit a well-capitalized risk based capital requirement. The amendments to the Federal Credit Union Act that imposed Prompt Corrective Action required the NCUA to "design a 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." 12 USC 1790d(d)(2) (emphasis supplied).

As very clearly set forth in former Congressman Alphonse D'Amato's May 7, 2014 letter to the NCUA, the intent of Congress was to instruct NCUA "to construct only a risk-based net worth floor, to take account of situations where the 6% requirement to be adequately capitalized was not sufficient….If we

[Congress] had intended there should also be a separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so."

Given the financial health of credit unions, we believe that the 8% adequately-capitalized requirement sufficiently addresses the objective of protecting the NCUSIF.

Adverse Economic Impact of the Proposal

Currently all but one of the 59 federally insured credit unions in Illinois over $50 million in assets are classified as well capitalized. If the proposed 10.5% RBC well capitalized requirement is adopted three credit unions would be reclassified as "adequately capitalized."

However the negative impact of the proposal would actually extend to 36 of the 59 credit unions subject to the rule due to the substantial reduction in their "well-capitalized buffer"—the amount by which their capital exceeds the current 7% of assets requirement to be well capitalized.

If the 10.5% well-capitalized risk based capital ratio is imposed, the buffer of those 36 credit unions would decrease by $92.6 million—a 26.2% decrease. In order to restore their buffer, the credit unions would have to increase their net income. This would require obtaining greater income from members by increasing loan interest rates and imposing higher fees, and reducing expenses by lowering dividend rates on share savings and certificates of deposit and perhaps reducing the number of employees which could adversely impact service to members.

Risk Weighting Issues

Lack of empirical data and analysis.

The NCUA has failed to provide evidence that the assignment of risk weights is based on an underlying analysis of historical loss data and how the types of risk weight categories have been determined. If the NCUA did conduct significant research and analysis, its failure include the analysis has lead credit unions to believe that that the more extreme risk weights are an attempt to restrict certain types of loans and investments (real estate loans, member business loans, and CUSO investments).

Overly broad categories and concentration risk.

The lengthy portion of the 5300 call report on loan delinquency and losses by type of loan would enable the NCUA to address loan losses by type of loan rather than lump all loans other than real estate and MBLs into one risk weight. We also believe that the amount of increase in risk weight for higher concentrations of certain loans, or longer term investments is substantially too high in a number of categories. These issues will be addressed in our discussion of the weights assigned to specific types of assets.

First Mortgage Loans

Under Basel 3, applicable to small banks, the risk weight assigned to all non-delinquent first mortgage loans is 50%, irrespective of the concentration of such loans.

The proposed NCUA rule assigns a 50% risk weight to first mortgage loans with a 25% or less of assets concentration but would increase the risk weight to 75% for first mortgage concentrations over 25% of assets and further increase the risk weight to 100% for first mortgage concentration over 35% of assets. Data available from the financial crisis indicates the much higher quality of credit unions' first mortgage lending compared to banks. Imposition of the substantially higher weights (double the banks' risk weight for concentrations over 35%) will adversely affect credit unions in providing first mortgages to their members.

Second Mortgages.

The NCUA's proposal requires risk weights for junior liens (HELOCs and close-end second mortgages) of 100% risk weight for concentrations under 10% of assets, 125% risk weight for concentrations of 10% to 20% of assets, and 150% risk weight for concentrations over 20% of assets. These escalated weights are far above any actual increased risk compared to first mortgages and will have a chilling effect on offering second mortgages to members. The escalated weights and the percentage of asset levels appear to be rather arbitrary and do not take into account the type of loan products (fixed or variable), the credit union's credit underwriting standards, and its historical mortgage lending record.

MBLs

We note that the escalated MBL risk weights (150% and 200%) apply to MBL concentrations greater than 15% of assets. The Federal Credit Union Act generally limits federally insured credit union MBLs to 12.25% of assets with the exception of low income-designated credit unions and credit unions chartered primarily to make business loans. Given that almost all of the credit unions that would be affected by the escalated MBL risk weights would be low income credit unions, it appears that the NCUA is seeking to deter low income credit unions from holding MBLs in excess of 15% of assets. To paraphrase former Representative D'Amato, if Congress had wanted to restrict the exception from the statutory MBL limit for low income credit unions to 15% of assets, the 15% limit would have been in the Act. Banks have long opposed credit union business lending and CUNA's attempts to increase the limit. We would prefer the NCUA to assist credit unions rather than banks.

Delinquent Loans.

The NCUA and our state regulator have long closely monitored credit unions with respect to proper calculation and replenishment of the allowance for loan losses. Since the allowance for loan losses already anticipates future losses, it is unnecessary and duplicative to impose higher risk weights on delinquent loans.

Investments.

It is clear that the escalated investment risk weights based on the weighted average life of the investment is an attempt to target interest rate risk. However, interest rate risk can only be measured by evaluating the impact of interest rate change on both sides of the balance sheet.

The NCUA and state regulators have ensured that credit unions have a number of tools in place to address interest rate risk, including liquidity planning, ALM policies, and investment philosophy (such as laddering). Several of our credit unions have stated that asset liability models are substantially better at assessing interest rate risk than the proposed escalated risk weights based on the duration of the investment.

In addition, we cannot fathom how the NCUA could believe that it is appropriate to assign escalated risk weights to credit union investments that are 2.5 to 10 times that of a small bank's risk weight requirements.

CUSOs.

Credit Union Service Organizations reflect credit unions' cooperative principals by pooling resources to obtain better pricing for a CUSO's member credit unions and enable smaller credit unions to provide services to their members that would otherwise be cost prohibitive. Imposing a 250% risk weight on CUSO investments will provide a competitive advantage to non-CUSO providers whose interest is not primarily credit unions.

Risk Based Capital Ratio--NCUSIF Fund

The proposed risk based capital ratio is determined by dividing the risk based capital by the sum of the risk weighted assets. The NCUA's proposal, although assigning the NCUSIF deposit a 0% risk weight, states that the NCUSIF deposit must be subtracted from the net worth in determining the risk based capital. The proposal requires that the NCUSIF deposit is also subtracted from the risk weighted assets.

Goodwill and other intangible assets are also subtracted from the net worth because of the difficulty in determining their actual value.

While there may be some merit to the requirement that intangible assets should be subtracted from net worth to determine the risk based capital, the NCUSIF deposit is a tangible asset similar to any other investment and should be treated the same as other investments.

The only explanation provided by the NCUA for the proposed subtraction of the deposit from both the net worth numerator and the risk weighted assets denominator is contained in the supplementary information accompanying the proposed rule:

> The proposed rule would address concerns about the NCUSIF deposit reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. In the proposed rule, the NCUSIF deposit is subtracted from both the numerator and denominator of the risk-based capital ratio.[43]
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> 79 FR 11194 (February 27, 2014)

The footnote refers to a 2004 GAO Study regarding credit union secondary capital. The only reference to the NCUSIF deposit in the GAO study is the following:

> NCUA stated that under GAAP, which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on the financial statements of a credit union. Further, NCUA stated that the NCUSIF deposit is not related to a credit union's net worth from either an accounting or financial risk standpoint."
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> (GAO-04-849, page 36.)

We completely agree with the NCUA's statement to the GAO. The NCUSIF is a tangible asset of the credit union and is not related to the credit union's net worth from either an accounting or financial risk standpoint. The fact that the deposit is recorded as equity on the NCUSIF's balance sheet should have no impact on its treatment.

The proposed subtraction of a tangible asset from the net worth makes no sense but, because the NCUSIF deposit is typically greater than 9% of a credit union's total net worth, the subtraction will substantially reduce the numerator and the credit unions risk based capital ratio.

The NCUSIF deposit should be treated in the same manner as all other tangible assets. The proposal has appropriately assigned it a risk weight of 0%.

We mentioned earlier that the proposal would adversely affect the well-capitalized buffer of 36 Illinois credit unions and reduce the buffer by $92 million. If the NCUA deletes the requirement to subtract the NCUSIF deposit from the net worth and risk weighted assets and retains the 0% risk weight the proposal has assigned to the NCUSIF deposit, the number of adversely affected credit unions would decrease from 36 to 14 and the adverse reduction in the well capitalized buffer would be $30 million rather than $92 million, a $62 million improvement.

Subjective Determination of Higher Capital Amounts for Individual Credit Unions

We and our credit unions find the proposed authority to impose even higher capital requirements particularly troubling. The proposed rule would allow the NCUA it its sole judgment to impose whatever level of capital it deems appropriate with no advance notification. Despite the proposed "process" it appears that the NCUA board could delegate this authority down the chain—perhaps to the examiner level. Imposing an even higher capital level could be the final blow for a struggling credit union and could be used inappropriately.

This authority is overly broad and, given the substantial regulatory authority over the actions of a credit union that is less than adequately capitalized (a list of the enforcement powers the NCUA may use to ensure prompt corrective action occupy several pages of part 702) is definitely not needed.

Implementation Period

The NCUA has proposed an 18-month implementation period. We understand that the small banks are in the fourth year of an eight year implementation of their Basel 3 risk based capital requirements. Given the financial health of credit unions and their high level of capital, we believe the NCUA will find it difficult to justify the need for a quicker implementation period than the eight years granted the small banks.

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We appreciate the opportunity to respond on the NCUA's proposed prompt corrective action—risk based capital rule. Please contact Patrick Smith at 217-744-1802 or Con O'Mahoney at 630-456-4389 if you have any questions.

Very truly yours,

ILLINOIS CREDIT UNION LEAGUE

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