OHIO CREDIT
UNION LEAGUE

May 27, 2014

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

Re: Prompt Corrective Action—Risk-Based Capital
12 CFR Parts 700, 701, 702 et al.
RIN 3133–AD77

Dear Mr. Poliquin:

The Ohio Credit Union League (OCUL) appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) Proposed Rule modifying Prompt Corrective Action – Risk-Based Capital.

OCUL is a state trade association and advocates on behalf of Ohio's 335 federal- and state-chartered credit unions, serving 2.8 million members. The comments reflected in this letter represent the recommendations and suggestions that OCUL believes would be in the best interest of Ohio credit unions.

Risk-Based Capital is an admirable concept; however, as outlined in this Proposed Rule, it would have the effect of constraining future credit union growth. It would diminish the ability of credit unions to serve members. OCUL therefore requests that NCUA consider withdrawing this rule. Barring that, OCUL respectfully requests that NCUA modify numerous important aspects of the rule, as outlined below.

Supplemental Capital

NCUA's proposed rule is a flawed first step toward implementing capital modernization for credit unions. The imposition of a risk-based capital ratio scheme, without adding the other half of a capital modernization structure (i.e., modernizing sources for supplemental capital), leaves the plan incomplete. If new capital standards are necessary to protect the safety and soundness of the credit union system, then affording credit unions the ability to raise supplemental capital that counts toward net worth requirements should be included as part of the modernization plan.

The introduction of a risk-based capital system without providing access to supplemental capital places credit unions at an even bigger disadvantage as compared to banks. Credit unions have limited sources of capital, relying solely on retained earnings. Credit unions are the only type of U.S. financial institution limited in this way.

Further, current rules permit low-income credit unions to seek supplemental capital. Therefore, OCUL requests that NCUA add provisions permitting access to supplemental capital for all credit unions, and urges NCUA to seek additional commentary on that topic before instituting a final rule in this area.

NCUA Authority under the Federal Credit Union Act

NCUA does not expressly have authority to impose the proposed risk-based capital system under the Federal Credit Union Act (FCUA). The agency does have authority to implement Prompt Corrective Action (PCA), as written into the 1998 Credit Union Membership Access Act (CUMAA). That law defines a set of mandatory net worth categories and PCA requirements for credit unions, with a specific definition for "well-capitalized." NCUA's proposed rule changes this definition if the credit union is determined to be complex (defined in the proposed rule as a credit union with more than $50 million in assets) by the addition of a requirement that the credit union must have a risk-based capital ratio of 10.5% or higher. This exceeds the agency's authority, as stated in a recent letter to NCUA by former Senator Alphonse D'Amato and former Speaker of the House Newt Gingrich, central figures in writing the PCA provisions of the CUMAA.

Further, the FCUA requires that NCUA consider the cooperative nature of credit unions, which does not appear to have been accomplished in drafting the proposed rule. Because of the limited access to sources of capital (for credit unions, only retained earnings), imposition of this rule would have the effect of either requiring the credit union to liquidate assets, perhaps at "fire sale" prices, or limiting member services and raising fees. In either case, it is clear to OCUL that credit union members will bear the real-world costs of this flawed rule.

Risk-Based Capital Calculation Not Needed

NCUA's current regulations provide a regulatory framework that more accurately allows for credit unions to individually identify, manage and mitigate risk exposure. Risk is inherent to the business of financial cooperatives. It must be managed effectively by competent management (the credit union) and competent supervision (the regulator), not by an inflexible "one size fits all" rule.

Definition of "Complex Credit Union"

The proposal applies to credit unions with assets of $50 million or more, using that definition of a "complex credit union." That distinction is arbitrary. Complexity of a credit union should correlate to the variety of products and services offered and the nature of the balance sheet, not on a subjective bright line based solely on assets. NCUA should look at the credit union's comprehensive book of assets, including all loans, investments, and liabilities, to determine whether a credit union is complex and whether it is sufficiently capitalized. This can be accomplished through a management – supervision exchange, as NCUA is currently empowered, rather than through a new arbitrary rule.

Comparison with Community Bank Basel III Risk Weightings

NCUA has described its proposed rule as being necessary to bring the credit union industry in line with the risk-based capital rules under Basel III for banks. However, in many cases, the risk weightings assigned by NCUA's proposal are quite different from those imposed on banks under their version of Basel. Some examples of the differences are outlined in the table below.

Asset Type	NCUA	Bank Basel III
Non-delinquent 1st mortgages	50% – 100%	50%
Other real estate loans	100% - 150%	100%
MBLs	100% - 200%	100%
Non-delinquent consumer loans	75%	100%
Off-balance sheet items	75%	Varies by type

NCUA has offered no sound reasoning for the differences in risk weighting and the variances are arbitrary. Before instituting these risk-weighting variances, NCUA should provide support for the differences from the Basel III requirements for community banks, seeking comments before implementing a final rule. Further, NCUA has provided little in the way of rationale for why a for-profit bank capital system (Basel III) is a proper capital framework for non-profit financial cooperatives.

Specific Risk Weightings

Many of the risk weightings appear to be arbitrary and unsupported by real-world considerations. A few of these are outlined below.

A. **Credit Union Service Organizations (CUSOs)**
CUSOs are assigned a 250% risk weighting under the proposal. OCUL finds this a complete contradiction of the real-world benefits (and risks) that CUSOs provide for credit unions and their members. This does not take into account the various ways ownership of a CUSO benefits a credit union. While some CUSOs are designed as a source of additional income for the credit union, such as those that provide investment services to members or originate mortgage loans, other CUSOs are essentially operational in nature, performing back office services such as ACH and payment processing or compliance support.

B. **Mortgage servicing**
Risk-weighting of 250% has the effect of penalizing credit unions wanting to maintain a relationship with their members in connection with a mortgage loan. NCUA has not shown that these servicing rights are inherently risky to the extent that they deserve such a high risk weighting. NCUA has provided little evidence to explain its evident bias against credit unions that invest in servicing assets and controlled member relationships.

C. 1st Mortgages vs. Consumer loans (both secured & unsecured)

First mortgage loans are generally less risky than other types of loans, yet their risk weighting is 100%, while all types of consumer loans are weighted at 75%. Clearly, the distinction between the two types is based purely on the term of the loan, not on the underlying credit risk or presence of collateral securing the loan. Does the federal regulator for financial cooperatives propose to control interest rate risk by rule rather than competent management paired with effective supervision?

No distinction is made between secured loans (auto loans) and unsecured loans (credit cards), when clearly there is collateral to offset default in the case of a secured loan, making it less risky.

On a related note, one method of mitigating risk for first mortgage loans is to securitize them, however, doing so moves their risk weighting from 100% as a real estate loan to 200% as a security. Again, NCUA's proposed weightings, perhaps well-intended, defy real world experience and logic.

D. Fully-Insured Assets

Cash on hand has a risk weighting of 0%, while cash on deposit has a weighting of 20%, even if on deposit with an insured depository or the Federal Reserve. There is no basis for the different treatment of insured deposits.

Fully-insured mortgage loans are also assigned a 20% risk weight, to account for potential interest rate risk. This methodology is contrary to Basel III treatment of government-sponsored entities as zero risk-weight. The use of the risk-weighting system to account for other types of risk is inappropriate, and fully-insured mortgages should be assigned a zero percent weighting.

E. Corporate Perpetual Capital

Following the collapse of some of the corporate credit unions, NCUA revamped the corporate system to strengthen and recapitalize it. By assigning a risk weight of 200% for corporate perpetual capital, NCUA disincents credit unions from making further investments in the corporate credit union system. Apparently, NCUA considers its existing strict rule framework for corporate credit unions, in combination with its active corporate credit union supervision, to be insufficient.

Risk-Weighting System is Too Simplistic

NCUA's rule has a simplistic framework for determining the risk weights for various types of assets. Requirements are created based on general asset type rather than the individual credit quality and management of the asset. The risk weights do not take into account the strength of an individual credit union's policies, processes, and level of staff expertise to evaluate the risk of each unique loan or investment product. Typically, credit unions with a concentration in specific areas have more extensive policies, processes, and specific expertise to properly evaluate the risks.

The rule should allow some flexibility in assigning risk weightings (especially the escalation of weightings based on concentration) where the credit union has demonstrated sound risk mitigation practices to manage the concentration or interest rate risk. Further, use of effective asset-liability management techniques should be allowed to mitigate some of the assigned risk weightings.

The proposed risk weights for long-term investments do not take into account applicable credit or asset liability management considerations. To factor in the duration of assets absent the duration of liabilities and other interest rate risk mitigation techniques is deeply counterproductive to credit union success, member benefit, and safety and soundness.

ALLL, NCUSIF, & Goodwill as Parts of the Numerator

The Allowance for Loan and Lease Losses (ALLL) is limited to 1.25% of risk assets. If a credit union determined it should reserve at a greater level of allowance to risk assets, then the dollar amount above the 1.25% is not included in capital. As a dedicated item on the credit union's balance sheet, it is unclear why this should be limited in this way, particularly since GAAP would prevent it from being an excessive amount. Strong ALLL practices have long been a hallmark of credit union management, as demonstrated by the comparatively lower losses in the recent recession, and allowing credit for the entire ALLL recognizes that.

Another consideration for allowing the percentage of ALLL used in the numerator to be increased is the pending proposal of the Financial Accounting Standards Board adopting the Current Expected Loss model. Adoption of this model would likely increase normal reserves by a significant percentage, perhaps as much as 100% for some credit unions.

Subtracting the NCUSIF deposit removes an asset that has been a part of the calculation of risk-based net worth. It is a valid asset that can be refunded for various reasons, including conversion to a bank charter, credit union election of private insurance, or voluntary liquidation. The proposal essentially places it as a "no value" asset, rather than as a part of capital planning, and has not been justified by NCUA.

Disallowing goodwill from being considered an asset for purposes of the calculation will potentially have a chilling effect on future mergers, especially those where the merging credit union is in distress and the surviving credit union undertakes the merger at NCUA's request or in an effort to preserve the reputation of credit unions in general.

In the same way that NCUA has focused the proposed rule on accounting for all potential future risks, the rule should also consider all assets that represent potential future benefits.

NCUA's Ability to Impose Individual Minimum Capital Requirements (IMCR)

Proposed section 702.105(c) is deeply troubling in that NCUA would assume additional authority to impose higher capital requirements on individual credit unions that could exceed even well capitalized level requirements. Unlike under the existing statutory net worth rules known as Prompt Corrective Action (PCA) regulations, credit unions would no longer have clear rules to avoid prompt corrective action imposed by NCUA if the agency establishes its authority to use "judgment" on a credit union-by-credit union basis to make changes to risk ratings. This section of the proposed rule opens the door to inconsistent and potentially arbitrary application of the intended rules. In addition, the rule would significantly diminish the responsibility of boards and management to make critical financial judgments, determine the strategic direction of the credit union, and oversee policy. NCUA should remove section 702.105(c) from the proposed rule entirely.

Also troubling is the lack of a meaningful appeals process should a credit union wish to challenge the imposition of requirements for additional capital. Although there is an appeal process described in the proposed rule, the credit union must make a case why the higher reserve should not be imposed. The final decision is controlled by NCUA and its supervisors, who depend on the skill and expertise of their examiners. It seems unlikely that an examiner's determination would be reversed. The process completely lacks objectivity.

OCUL has direct experience with NCUA's current appeals process. In reality, credit unions do not have a functioning appeals process. What exists is completely biased in favor of NCUA. The procedure described in the proposed rule is also fundamentally biased against credit union interests. Because the appeals process is so badly flawed from a credit union's perspective, NCUA cannot be empowered to impose capital requirements beyond those outlined in the rule.

Longer Implementation Period Is Needed

Changes to risk weightings or capital requirements will require each management team to closely evaluate the credit union's future plans for growth. As credit unions do not have the same ability as other financial institutions to raise capital, any changes to capital requirements must have a longer implementation period. NCUA's proposed 18-month implementation period is absurdly short, reflecting little sensitivity for institutional/credit union or member/consumer disruption.

Also in support of this – the implementation of Basel requirements has been a multi-year process for banks, taking place over 10 years (2009 - 2019). It is unrealistic to expect credit unions to safely, and with all due consideration of the needs of their members, implement a complex new system of evaluating their assets, especially in light of their limited access to supplemental capital.

NCUA should lengthen the amount of time allowed for implementing the rule, making it comparable to that for small community banks, and set the implementation period at ten years.

States' Rights

NCUA is required to consult with state regulators on PCA and did not do so before releasing the proposal. NCUA continues to show insufficient regard for the proper legal authority of state supervisors.

Conclusion

Imposition of a risk-based capital system for credit unions will have far-reaching effects. OCUL considers these effects to be negative for Ohio credit unions and nearly 3 million Ohio credit union members. For this reason, OCUL recommends that NCUA withdraw the proposal. Imposition of regulations that do not take into consideration real-world effects have unintended consequences. In the case of this rule, those consequences might be a threat to safety and soundness of some credit unions as they liquidate assets to come into line with the risk-based capital ratio requirements, or drastic reductions in services to members as credit unions discontinue offering mortgages or business loans. The rule might therefore harm the credit union industry rather than protect it.

OCUL's recommendations are as follows:

1) Retract the proposal – it is not necessary, it is materially flawed, and it will harm credit union growth and diminish member service.
2) Short of retracting the proposal:
   a) Impose risk weights no greater than Basel III;
   b) Permit a much longer implementation period;
   c) Eliminate Individual Minimum Capital Requirements;
   d) Do not discount ALLL, NCUSIF or goodwill in the numerator;
   e) Improve NCUA supervision competencies to prevent occurrences such as St. Paul Croation FCU (which had nothing to do with risk-basing capital);
   f) Incorporate risk-based capital for credit unions in law and rule; and
   g) Do not disadvantage CUSO or corporate credit union investments.

The Ohio Credit Union League appreciates the opportunity to provide comments on the NCUA's proposed rule on Prompt Corrective Action – Risk-Based Capital, and is available to provide additional comments or information on this proposal if so requested. If you have any questions, please do not hesitate to contact me at (800) 486-2917, ext. 247, or pmercer@ohiocul.org.

Sincerely,

Paul L. Mercer
President

cc: OCUL Board of Directors
OCUL Government Affairs Committee
Credit Union National Association