May 28, 2014

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

Dear Mr. Poliquin,

On behalf of the Credit Union Association of New York & Affiliates, I am writing this letter to comment on NCUA's risk-based capital proposal. The Association supports RBC reform, but NCUA's proposed capital framework needs to be extensively revised. Rather than establish a more nuanced capital framework that enables credit unions to better manage their assets consistent with the unique attributes of the industry, it exaggerates the risk of industry assets and identifies potential risks based on anecdotal evidence and examiner judgment. The ultimate goal of a well-structured RBC framework should be to strengthen industry capital and enable credit unions to better manage their assets and capital. In contrast, this proposal would not establish a risk management system so much as a risk prevention system that would make it more difficult for credit unions, the vast majority of which are well run, to meet member needs.

Overview

NCUA's RBC proposal has been debated and analyzed by our credit unions more than any other agency proposal over the last decade. The Association has received surveys from more than 50 credit unions; more than 60 credit unions have submitted comments to the NCUA, and the Association has held three events over the last several months to discuss the implications of capital reform with interested stakeholders. With the caveat that no issue as complex and important as capital reform is going to generate complete uniformity of opinion, the opinions expressed in this letter represent a consensus on key issues that need to be addressed for a modern RBC framework to be put in place. The key points that should inform NCUA going forward include:

- Credit unions support risk-based capital reform. Therefore, NCUA should use the coming months to revise this proposal rather than table RBC regulations.
- NCUA has not adequately explained why there is a need for RBC reform and what it is hoping to accomplish with a more advanced framework.
- By placing too much emphasis on concentration risk and giving itself the power to impose customized capital requirements on specific credit unions, the NCUA is seeking to take too much power away from credit unions.

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- NCUA has the statutory authority to mandate that complex credit unions are "adequately capitalized" under an RBC framework, but it does not have the authority or the need to require these same credit unions to be "well capitalized."
- Eighteen months is too short a period for credit unions to comply with a new risk-based capital system. Many credit unions, in addition to those that are over $50 million in assets and are reclassified as less than "well capitalized," will need time to adjust to RBC requirements.
- A transition period should be included in the regulation for credit unions that reach the $50 million threshold so that credit unions are not deterred from growing simply to avoid being subject to RBC constraints.
- NCUA needs to reduce its risk-weights for CUSOs and perpetual corporate capital. The weightings both exaggerate the riskiness of credit union assets and discourage investment in the credit union industry.
- The proposed concentration risk threshold should be refined so that the underwriting experience and expertise of individual credit unions is reflected in a credit union's capital strength.
- Investment length should not be the sole metric used to trigger higher asset weightings.
- The proposed RBC framework is too inflexible. Because a $2 billion credit union has vastly different needs and expertise than a $50 million credit union, a tiered RBC system whereby credit unions have greater powers and responsibilities as they get larger, should be put in place.

I. NCUA needs to better explain why this rule is necessary and what it hopes to accomplish with a new RBC system

The most important step in developing an RBC framework the industry can support is to develop a consensus for why reform is needed and what its primary purpose should be. NCUA's explanations suggest that the agency can and should devise an RBC framework in response to the experiences of individual credit unions and examiners without showing that the risks being identified represent broader material risks to the industry. In contrast, if NCUA limited its authority to defining and addressing systemic risk, it could both strengthen the industry and empower well run credit unions to allocate capital more effectively.

In the preamble to this proposal, NCUA put forward the reasons why risk-based capital reform is necessary at this time. According to the NCUA, several hundred million dollars in Share Insurance Fund losses in recent years resulted from "individual credit unions holding inadequate levels of capital relative to" their assets and operations. What's more, NCUA warned these credit unions about the need for higher capital but their recommendations were ignored. (Prompt Corrective Action—Risk-Based Capital, 79 FR 11184-01,111, February 27, 2014). 11,186) In addition, the proposed RBC framework would put credit union capital requirements broadly in line with those of commercial banks, as reflected in the recently finalized Basel III regulations (FR vol. 78.No. 198 October 11, 2013 pages 62,018 et sec, hereinafter Basel III regulations).

Does this mean that NCUA has the right to prevent any activity by any credit union that could, when combined with a severe economic downturn, result in losses to the Share Insurance Fund? Or that credit unions should always try to align their RBC framework with banks? The answer to both these questions is "no."

The last five years provided credit unions with an unwanted real-life stress test. They demonstrated that the credit union system as a whole is extremely well-managed and has more than enough capital to withstand even a severe recession. To be sure, with over 6,000 federally insured credit unions, (more than 2,000 of which have at least $50 million in assets), a small percentage of credit unions invested too heavily in certain types of Member Business Loans, suffered as a result of poor management, ignored legitimate examiner concerns, or simply couldn't weather the economic storm. But, only 102 credit unions went into conservatorship over the last five years costing the Share Insurance Fund less than $1 billion. In contrast, since 2008, there have been 493 "failed banks" according to the FDIC and another thirteen that have needed special assistance. (Statistics available at http://www2.fdic.gov/hsob/hsobRpt.asp last visited May 27, 2014). The FDIC projects Deposit Fund losses of approximately $83 billion for the years 2008-13. (Update of Projected Deposit Insurance Fund Losses, Income, and Reserve Ratios for the Restoration Plan, March 28, 2014 Memorandum) Credit unions were even able to absorb the costs of losses stemming from the failure of Corporates while growing the amount of assets under management to more than $1 trillion.

Basel III reform is instructive for credit unions not because of a need for comparable capital requirements for credit unions but rather because of its overriding goal. The overriding goal of the Basel framework is not to prevent the failure of individual financial institutions but rather to prevent systemic risk from damaging the entire banking system and the economy as a whole.

There are two basic types of systemic threat: the failure of institutions so large that their failure could impact the industry as whole and, (2) interdependent relationships that magnify potential losses. (See generally "Attributing Systemic Loss to Individual Institutions," Bank for International Settlements **Working Papers NO. 308 May 2010** available at http://www.bis.org/publ/work308.htm; " Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems ." Bank for International Settlements December 2010 rev. June 2011, pages 7 – 8.

Instead of adopting an ad hoc approach to its RBC framework into which it is attempting to weave past guidance, examiner concerns and OIG findings, NCUA should limit itself only to those activities that regulate an interdependent relationship among credit unions such that the failure of the relationship would cause material harm to a substantial portion of the industry. There are only a handful of credit unions whose failure would harm the entire industry. Those credit unions should have enhanced scrutiny coupled with the flexibility needed to run larger financial institutions.

In addition, there are many credit unions that could better manage risk by having more, not less, flexibility to manage investments and make loans appropriately. Credit unions have long favored RBC reform because of the industry's recognition that much capital is not being put to maximum use. Crucially, if NCUA was to concentrate on systemic risk as the touchstone of RBC reform, it would still

have the ability to regulate individual credit unions; it simply would not let individual mistakes dictate capital constraints for all sophisticated institutions.

Specific Concerns

12 CFR 702.105 empowers NCUA to impose additional capital requirements on individual credit unions based on any one of several criteria laid out in the regulation, such as a determination that a "credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance" or that "A credit union has failed to properly plan for, or execute, necessary retained earnings growth." Once a credit union is subject to this oversight "{T}he appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise." Credit unions would be given notice of NCUA's decision to impose customized capital requirements and the opportunity to avail themselves of an administrative appeals process.

Since the ultimate goal of an RBC system should be to mitigate industry-wide risk, not strengthen examiner oversight over individual credit unions, this is the single most troubling aspect of NCUA's regulation. It means that credit unions could be in compliance with all of NCUA's capital regulations and still find their judgment trumped by the judgment of regulators. Since these judgments will be based primarily on the evaluations of field level examiners, this gives regulators, many of whom have less operational experience then the executives running the credit unions being questioned, even more influence than they already have over credit union operations. The mere possibility that an examiner could seek to exercise this power will give them a tremendous amount of additional leverage over credit unions even if the power to establish individual capital requirements is rarely employed.

NCUA is stretching its authority beyond what is required for RBC purposes. It would take core operational prerogatives away from individual credit unions based on vague criteria that don't provide adequate notice to credit unions. If NCUA feels that there are risks that are not adequately addressed in this proposal, then it should amend it only after giving credit unions the opportunity to comment on NCUA's regulations.

If NCUA is determined to promulgate this revision, it needs to dramatically limit its potential application and develop objective criteria to give credit unions adequate notice that NCUA may seek to impose customized safety and soundness constraints on their operations. For instance, the regulations should quantify, based on objective criteria delineated in the regulation, when a credit union has failed "to properly plan for necessary growth." Furthermore, the regulation should provide that at least three criteria have to be present in order for NCUA to seek customized capital plans.

12 CFR 702.102(a)-"Well capitalized credit unions"

NCUA lacks the authority to establish requirements for "well capitalized" credit unions subject to RBC regulations. Like all other agencies, NCUA's rulemaking authority is circumscribed by statute. Deference is given to Agency regulations of vague statutory texts. In contrast, when a statute is clear then an

agency is obligated to follow its plain meaning. (See Freeman v. Quicken Loans, Inc., 132 S. Ct. 2034, 2040, 182 L. Ed. 2d 955 (2012)).

PCA requirements are designed to ensure that all credit unions either are well capitalized or working to become so. The risk-based net worth regulations are additional regulations imposed on complex credit unions. In drafting the regulation, the Board must "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 U.S.C.A. § 1790d (West).

By creating a classification for "well capitalized" credit unions, NCUA is ignoring both the text and Congressional intent. As former New York Senator Alfonse D'Amato, who was the Chairman of the Senate Banking Committee when this statute was drafted, explained in a recent comment letter to NCUA, "If we had intended that 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."

A similar explanation has been provided by Newt Gingrich who was Speaker of the House when the current law was put in place. In a recent comment letter, he noted that NCUA's plan would subject well-capitalized credit unions to risk-based capital requirements that are 2.5% higher than those proposed for adequately capitalized credit unions. He explained Congress "never intended, nor even contemplated the possibility of, higher risk-based capital requirements for well-capitalized credit unions than those that apply to adequately capitalized credit unions."

But even if the creation of a "well classified" designation for credit unions with $50 million or more in assets was not of questionable legality, it still imposes burdens on credit unions in excess of any potential benefits. NCUA has argued that since over 90% of affected credit unions would be well capitalized under the new RBC framework, the regulation only imposes additional requirements on approximately 200 credit unions. However, the proposal would impact well capitalized credit unions in several ways.

Most importantly, most credit unions keep a capital buffer in place to ensure that they can withstand economic downturns and invest in unexpected growth opportunities without jeopardizing their PCA status. In minimizing the impact of this proposal, NCUA has chosen to totally ignore this prudent practice on the part of most credit unions. In contrast, in finalizing capital reforms for banks, regulators stressed "as a prudential matter a banking organization is generally expected to operate with capital positions well above the minimum risk-based ratios and to hold capital commensurate with the level in nature of the risks to which it is exposed." (Federal Register volume 78 number 198, October 11, 2013 pages 6204 2-6204 3).

By reducing the capital buffer of credit unions that are not only adequately capitalized but well capitalized, NCUA will force them to either reduce their size or to struggle to increase their capital in the short time that they have been given to comply with this regulation. For this regulation to truly be of minimal impact for the vast majority of credit unions which NCUA already considers well capitalized, it must eliminate its "well-capitalized" category.

702.104-Rsk-Based Capital Ratio Measures

In developing an RBC system for complex credit unions, Congress instructed NCUA to take the unique attributes of credit unions into consideration. With regard to several of the suggested risk weights, NCUA has neglected to do so and mischaracterized the risks posed by credit union lending and investment profiles. In so doing, it has stifled the ability of credit unions to manage their own affairs.

A. Category 4 Concentration limits for non-delinquent first lien mortgage loans that exceed 25% of total assets and 35% of assets

Credit unions have been repeatedly told that they did not engage in the activities that caused the mortgage crisis and that they should be allowed to continue to underwrite loans in the same manner they always have. This is one of the primary reasons why the Consumer Financial Protection Bureau exempted institutions with $2 billion or less in assets that hold on to their mortgages from many of the qualified mortgage requirements. Nevertheless, NCUA is seeking to categorically assume that credit unions holding any mortgages exceeding a 25% concentration risk threshold should be deterred from doing so.

As many New York State credit unions have pointed out, this approach makes no allowance for the quality of credit union underwriting. It also means that there will be members who are denied loans not because they are unqualified but because their mortgage exceeds an arbitrary threshold. If the goal is to allow credit unions to manage risk appropriately while guarding against systemic risk, then it is dubious at best to micromanage the lending judgments of individual credit unions. Very few credit unions failed because of poor mortgage underwriting and the number that do can hardly be described as representing, in the aggregate, a material risk to the Share Insurance Fund. As NCUA itself has noted it does not "proscribe a fixed, maximum percentage of mortgage loans. Each individual credit union has its own individual risk profile and individual risk tolerance level." (Letter to Federally Insured Credit Unions NO. 03-CU-15, Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed Rate Mortgage Portfolios," 2003).

Furthermore, to the extent that NCUA is using bank reform as a model, then there is no basis for the size of concentration weightings being proposed for credit unions. Finally, since NCUA is proposing that delinquent mortgage loans be given a higher risk-weight than well-performing loans, the weights already account for the potential that poor underwriting is affecting a credit union's capital.

If NCUA feels the need to address concentration limits it should do so in a manner that allows individual credit unions to have their underwriting strengths reflected in risk weights. For example, instead of imposing higher weights on mortgage concentrations, NCUA should consider only imposing higher risk rates on mortgage concentrations held by credit unions whose mortgage portfolio has been subject to foreclosure actions above the industry average for the proceeding 5 years. This method would allow NCUA to take a dynamic approach to RBC and credit unions with a proven track record of well underwritten mortgage loans would be able to continue to make the lending judgments that they feel are appropriate given the needs of their membership.

B. Category 8-200% risk weighting for all MBL's that exceed 25% of credit union assets

NCUA regulations already place constraints on the amount of MBL loans credit unions can make. Not only are credit unions, absent waivers, subject to the 12.25% cap on member business loans, NCUA mandates that credit union personnel making MBL lending decisions have at least 2 years of experience. NCUA has also strengthened its participation regulations to emphasize the requirements imposed on credit unions purchasing portions of MBL's.

Against this backdrop, NCUA's proposed risk weighting is problematic for several reasons. Most importantly, as with mortgage lending, NCUA makes no attempt to account for the quality of underwriting in making capital assessments for MBL loans. Some of the best performing loans that credit unions make - taxi medallion loans - would be given among the highest risk weights possible simply because there are some credit unions that specialize in making these types of loans, with no consideration of the fact that these are among the best performing credit union loans in the country.

The risk weightings are also problematic because they effectively retroactively penalize credit unions for engaging in the precise activities that NCUA judges them to be qualified to undertake in the first place. The MBL cap effectively means that almost no credit union reaching the 25% threshold has reached that threshold without a waiver from NCUA or by being grandfathered under federal legislation. To avoid the unfairness of NCUA changing the rules in the middle of the game, this risk weighting should only be imposed on credit unions that prospectively breach the 25% threshold. In addition, the weightings should be decreased for credit unions with a history of well-performing MBL loans.

C. Category 9-250% risk weighting for credit union investments in CUSOS

This weighting is the best example of NCUA not seeking to mitigate systemic risks but instead to engage in examiner reverse engineering. NCUA has already aggressively sought to regulate the activity of CUSOs and is now seeking to further stifle the industry by penalizing credit unions that choose to invest in these legal entities. On a policy level, this weighting discourages credit unions from keeping liquidity in the industry. Many CUSOs perform important third party services for credit unions. As Comptroller of the Currency, Thomas Curry has pointed out many financial institutions, particularly smaller ones, are going to become more, not less, dependent on vendor relationships (See Thomas J. Curry Comptroller of the Currency before a meeting of CES April 16, 2014). This risk weighting will discourage credit unions from joining together and providing services that the industry needs. It will also send a signal to all credit unions that they are doing something unsafe when they choose to use the services of CUSOs as opposed to non-CUSO vendors.

The weighting is also illogical from a prudential standpoint. Keeping in mind that the goal should be prevention of systemic risk, it is hard to see how any time a credit union chooses to invest in any type of CUSO it is posing a systemic risk to the industry; particularly since a well-functioning CUSO increases the safety and soundness of the industry. NCUA should reduce, at least by half, this weighting. It should also develop weightings which differentiate between different types of CUSOs. For instance, to the extent there are industries that have proven to be riskier for CUSOs and the credit unions that invest in them, these CUSOs should be subject to higher weightings. NCUA should justify in this regulation

precisely what those troublesome industries are and why it feels that additional weightings are necessary. Absent such a showing, NCUA should not be allowed to question the investment decisions of individual credit unions.

D. Risk Weightings Based on Investment Length

The RBC framework would weight investments based solely on their length so, for example, an investment that matures in five years would be given a higher risk weighting than one that matures in three years. There are two basic reasons for this approach. First, an argument can be made that the longer an investment, the more it makes a credit union vulnerable to interest rate shifts since it cannot adjust assets to reflect rate changes. A second, less credible argument is that a longer-term investment is riskier than a short-term investment. The latter argument is specious since investment length, without consideration of the underlying asset would lead to unwanted results. A 10-year bond should be considered a better investment than a note issued by Detroit.

NCUA's concerns about interest rate risk are more credible. However, NCUA has already required the institutions that will be covered by this proposal to demonstrate that they assess their interest-rate risk on an ongoing basis and obtain access to lenders of last resort. (See, e.g. 12 CFR 741.12; Letter to Credit unions 12-cu-05 Interest Rate Policy and Program Requirements). In short, NCUA has already created a framework which balances credit union judgment against the need for safety and soundness.

In addition, NCUA is wrong to assume that all long-term investments are inherently riskier than all shorter-term ones. While it is certainly true that virtually no credit union should have a disproportionate concentration of its investments in longer-term securities, it is equally true that a well-managed portfolio may include some longer-term investments.

E. Category 8-Investments in Corporate Perpetual Capital

Since the Association feels that the appropriate focus of a credit union RBC system should be systemic risk, it agrees with NCUA that a risk weighting has to be assigned to investments of perpetual capital. The breakdown of the corporate system represents a risk to the entire industry. However, NCUA is wrong to make perpetual capital one of the most dangerous investments a credit union can make. First, the reforms that NCUA put in place to recapitalize the corporate system have resulted in a corporate system that is much safer than it was five years ago. The corporates have more rigorous capital requirements and more limited investment authority. In addition, many corporates have reduced the scope of the services they provide for credit unions. As a result, there is no evidence to suggest that perpetual capital is a greater investment risk than many other types of investments a credit union can make.

In addition to the technical reasons, there are also issues of simple fairness at stake. Credit unions invested perpetual capital subject to restraints placed on them by NCUA, which greatly restricted the ability of these credit unions to sell their capital. Many of the credit unions that made these investments did so not because they needed a corporate system but because they believe that a corporate system is important to the Movement as a whole. These credit unions should not be told by

the same regulator that established the requirements for purchasing perpetual capital that they have now made a bad investment according to its assessment. In addition, like NCUA's proposed CUSO weighting, this proposal has the potential to diminish liquidity for small credit unions by discouraging investments in the institutions that are of most benefit to their institutions. Consequently, the Association suggests that perpetual capital be given no more than a 1.00 risk weight.

The $50 million Threshold

In implementing RBC reform, commercial bank regulators have adopted a tiered approach. First, not all banks are subject to all of RBC requirements and certain capital requirements and investment authorities are reserved for only the largest, systemically important institutions. (See Enhanced Prudential Standards for Bank Holding Companies and Foreign Banks Federal Register Vol. 79 , No. 59 Thursday, March 27, 2014 Available at http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm

NCUA should also consider a tiered approach, whereby larger credit unions have greater freedoms but also greater responsibilities. A similar approach was recently taken in finalizing the derivatives authority for larger credit unions.

Transition Period for Credit Unions That Reach the $50 Million Threshold

Another way this proposal impacts credit unions more broadly than acknowledged by NCUA, is its impact on credit unions that are approaching the $50 million threshold. Since there is no phase-in period for these credit unions, they have to be deciding today how they are going to comply with an RBC framework. There is at least anecdotal evidence indicating that some of these credit unions are considering slowing growth to avoid RBC requirements. To make sure that existing credit unions are not already being impacted by RBC reform and to make sure that credit unions in the future are not deterred from growing simply to avoid the RBC requirements, the final regulations should provide that, for credit unions not yet at or above the threshold, the compliance date will be four years from the date they grow to $50 million in assets as reflected in their most recent call report.

Effective Date

NCUA is proposing that credit unions have only 18 months to comply with this regulation once it is finalized. This timeframe is entirely too short for several reasons. Credit unions -- irrespective of their capital classifications -- will have to train staff, develop new policies and procedures, reevaluate growth plans and acquire new software with which to model compliance with whatever framework emerges. In fact, there are already well-capitalized New York credit unions that have put off investments and building plans in response to this proposal.

In addition, for those credit unions that will need additional capital either to replenish depleted buffers or become well capitalized, the challenges posed by this regulation are vexing. To comply with capital requirements, these credit unions will either have to reduce their lending portfolio, reconfigure their investment strategies, or grow capital, most likely without the benefit of secondary capital. Considering that banks are being given up to four years to comply with Basel III requirements, have already been

complying with a sophisticated RBC framework, and have access to shares, credit unions should be given at least this much time, if not more, to comply with whatever capital framework ultimately emerges from NCUA's proposal. Recently, Chairman Matz indicated that the compliance date for RBC reform is not set in stone and it is my hope that NCUA already recognizes the need to give credit unions as much flexibility as possible to comply with these mandates.

Conclusion

The implementation of a more advanced risk-based capital system presents both opportunities and challenges to NCUA and the industry as a whole. All credit unions, irrespective of their size and how much they intend on growing, have a stake in a system that is positioned to maximize assets to address member needs, keep liquidity within the system and, of course, withstand future economic downturns. The Association believes that an RBC system more narrowly focused on those risks which represent dangers to the system as a whole, as opposed to risks reflecting the mistakes and misfortunes of individual credit unions, should be the focus of RBC reform. Such a system should not be designed to prevent credit unions from making mistakes but should rather be designed to allow credit unions to manage risks consistent with the unique attributes of the industry and the circumstances of a particular credit union. The Association believes that the suggestions we have provided to you on behalf of the credit unions of New York State can help design a capital framework that both strengthens capital and allows credit unions to manage risk.

However, much more needs to be done before a final regulation is put in place. Consequently, I applaud Chairman Matz's decision to hold a series of discussions with credit unions throughout the summer to further refine this proposal. I would request, however, that NCUA reopen its comment period on this regulation so that these discussions can be made an official part of the record and interested stakeholders can submit additional comments based on the insights offered at these meetings. The Association and NCUA both believe that a more advanced risk-based capital framework can and should be developed and we hope that the insights offered by this letter will help in reaching that shared goal.

Sincerely,

William J. Mellin
President/CEO