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May 28, 2014 **VIA EMAIL ONLY: REGCOMMENTS@NCUA.GOV**

Gerard Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314–3428

Re: SW&M Comments on Notice of Proposed Rulemaking: PCA—Risk-Based Capital

Dear Mr. Poliquin:

We are writing to comment on the Notice of Proposed Rulemaking Regarding Risk Based Capital (the "Proposed Rule"). We are providing comments herein on specific issues on which we may be able to add value based on our unique perspective. Many other commenters have covered aspects of the Proposed Rule that we believe the NCUA should carefully consider, in particular, the apparent result that credit unions will be required to maintain higher capital levels than banks (despite being unable to raise capital).

As a law firm representing hundreds of credit unions nationwide, and focusing on credit unions for over 30 years, we are privy to trends in examination and enforcement and the private concerns of numerous credit unions. In our relationship with the NCUA over the decades we have always striven for a collegial and constructive relationship, focused on safety and soundness, the stability of the credit union system as a whole, and higher ideals of due process. It is in that spirit that we offer our comments in this letter, and we hope to assist the NCUA in critically examining its own processes to the betterment of the agency and credit unions alike.

From this perspective, we have comments in two areas regarding the effects of the Proposed Rule and the interaction of the Proposed Rule with other areas of credit union operations: (1) the need for consistency in application of expanded powers for examiners, and limitations on those powers; and (2) the relationship between the Proposed Rule and limitations on and reporting of CUSO investments, particularly the methods by which investments in CUSOs can be reduced or eliminated. Additionally, in section 3 below, we wish to pass along comments collected from some of our credit union clients who wish to remain anonymous in their comments.

Re: SW&M Comments on Notice of Proposed Rulemaking: PCA—Risk-Based Capital

1. The Need for Consistent Application of the Rule and Risk Ratings, and Improvements in Due Process

   We have significant concerns about the areas in the Proposed Rule which provide potentially unappealable authority to examiners to influence the amount of reserves required under PCA, and for which automatic consequences will follow. For example, we note examiners' influence in determining acceptability of Net Worth Restoration Plans;[1] the potential for application of 1250% risk weighting under 702.104(c)(2)(x);[2] the ability of examiners to influence "identified losses" and thereby capital levels;[3] and examiners' influence on ALLL methodologies and levels.[4] These concerns arise from our experience with the examination processes at numerous credit unions in multiple regions.

   In 2012, the NCUA issued the National Supervision Policy Manual to "bring[] more consistency and clarity to NCUA's supervisory operations and procedures across the country."[5] Our understanding is that this came in part in response to the development of OIG Report #OIG-12-10 and other OIG reports, as well as continuing industry concern regarding inconsistency in the exam process. OIG Report 12-10 criticized the NCUA in that, despite (in OIG's view) having clear standards and policies and an adequate appeals process, there were inconsistencies in implementation, and operational and organizational deficiencies in the various processes.

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[1] Approval of NWRPs has appeared to us and our clients to be highly subjective from the regional and examiner levels. At times, it appears that NWRPs seem to only be accepted after a trend within the originally submitted NWPR has already established, creating significant additional work for credit unions. We would encourage the NCUA to study how many NWRPs have been accepted on their first (or even second) revisions, and how much the original assumptions of the NWRP changed from version to version.

[2] Such a significant risk weighting should not be based largely on examiner perception. This is particularly the case when small credit unions would like to explore alternative investments. For example, at least one examiner we have dealt with identified municipal bonds at small credit unions as something that was nearly impossible for staff and the volunteers to have a proper understanding of, despite the continued positive performance of the investments. Under the Proposed Rule, those examiners could have forced credit unions into PCA, a system of automatic consequences by changing a risk weighting, rather than negotiating regarding DOR items and appropriate actions to take over a reasonable time period.

[3] Examples noted in the Proposed Rule of "identified losses" can be found in this description: "Examples of items that would be subject to this provision include shortages in the ALLL, underfunded pension accounts, and unsupported valuations of bond claim receivables." 79 Fed. Reg. 11,184, 11,194 (Feb. 27, 2014). Each of these are extremely subjective, and could result in higher PCA hurdles for credit unions based on a subjective standard. Without due process, these standards become arbitrary.

[4] During the financial crisis, pro-cyclical additions to Allowances for Loan and Lease Losses became common, with shifting of methodologies being required to keep the worst of an institution's losses (and sometimes only the worst) in its methodology. The shortening of historical loss periods made sense at the beginning of the crisis, but lengthening them did not make the same sense on the "upswing" from the crisis. We saw such a pattern consistently, despite commentary on NCUA webinars which reflected an agency position against over-funding of ALLLs.

[5] http://www.ncua.gov/News/Pages/NW20121102SuperPolManual.aspx (Nov. 2, 2012).

While the NCUA has made significant efforts toward consistency, there are many areas in which that consistency has not developed, or which do not extend to the level of examiners. After all, examiners are only human—subjective standards enter into their analyses. But examiners (and with them the NCUA in general) appear to have little to no incentive to take or allow credit unions to take even reasonable, well-planned risks that deviate from the agency's established norm. When risks are permitted, then there is an obvious concern of being criticized internally or the target of an OIG report; when risks are not permitted, there are no negative consequences in the near term. Accordingly, our observation is that the fear of consequences leads examiners to excessive risk avoidance.

Excessive risk avoidance can particularly be seen in exam findings, DORs and LUAs regarding Allowance for Loan and Lease Loss calculations, branch sales and other consolidation of facilities, and divestiture from CUSOs after the recession was already over. ALLL calculations, in particular, caused pro-cyclical issues at a number of credit unions which later[6] had to back out their allowances when losses did not materialize. Despite the inclusion of ALLL balances up to 1.25% of risk assets in the measure of capital for RBC purposes, that inclusion would not help credit unions facing severe overfunding due to the subjective concerns of risk-averse examiners.

However, NCUA should take notice that even in the existing paradigm, appeals of individual examination actions and determinations are not pursued for a number of reasons, including the broad definition of safety and soundness combined with the "arbitrary and capricious" standard to which the agency would eventually be held. These make any contest nigh-unwinnable for a credit union. Additionally, despite the agency's reassurances, there continues to persist a real fear of retaliation. We believe this fear comes in part from a largely unused Ombudsman function[7] and a perceived tendency of NCUA to unfailingly support their individual examiners. There is no apparent real internal resource at the NCUA which is charged with advocating for commercially reasonable risk-taking.

With this existing paradigm, the examination environment we continue to observe is not conducive to additional examiner powers without well laid-out checks, balances, and due process. Please keep in mind—Prompt Corrective Action is an <u>automatic and unwaivable</u> set of consequences for credit unions, and has very real effects on business. The application of PCA frequently results in the cessation of income-earning programs while also enforcing asset-reduction at the insistence of NCUA. Neither of these practices help the long term franchise viability of a credit union—once members are driven away, they often do not return.

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[6] Those that survived their ALLL balances and were not forced to merge.

[7] We do note with interest the additional role provided to the Ombudsman in Proposed § 747.2006, and hope that the NCUA will ensure that the position is given sufficient deference and power to ensure that it provides a true balance against other internal agency pressures.

Accordingly, we see highly discretionary and subjective determinations[8] leading to automatic consequences as highly inappropriate. If those subjective determinations are to be included in the PCA rules then, at a minimum, speedy and fair review of any issues with such determinations must also be included in the processes. At present, completion of appeals documentation, often at the same time as taking other corrective action in response to exam issues, then waiting for results while under PCA or similar restrictions, exceeds credit unions' resources and lasts beyond the time where franchise damage could be avoided.

While we are encouraged that the individual minimum capital requirements under proposed Section 702.105 might require NCUA Board action, rather than examiner or Regional action, we believe this provision is not sufficiently clear as to the reasoning under which such determinations would be made and the effects of different triggers for higher capital levels. The OCC's October 2013 Final Rule on Risk-Based Capital[9] clearly provides a statement of the potential effects of different determinations. The same seems to be lacking from the Proposed Rule,[10] and should be included. Additionally, specific reference to Proposed § 747.2006 should be made in Proposed § 702.105 to ensure that credit unions are well informed of their due process rights.

Apart from specific consequences for various problem conditions, we are also concerned about some of the potential reasons higher capital levels may be required in § 702.105—they do not consist of objective standards, and allow for considerable subjective power for examiners. For example, a credit union may receive "special supervisory attention" because of a personality conflict between the CEO and examiners or because of a corporate culture where examiners believe the CEO has excessive control over the Board's rationale. A number of the other potential reasons for higher capital levels are entirely subjective (e.g., inadequate underwriting policies, standards, or procedures), or do not relate to capital levels, but rather asset mix (e.g., poor liquidity).

With the automatic nature of PCA in mind, as well as the numerous tools available to the NCUA, we believe the NCUA has more appropriate methods of answering its concerns about levels of capital being incommensurate with risk activities. Regulations based on safety and soundness without the unavoidable and automatic outcomes of PCA would allow for a more nuanced paradigm. Accordingly, we believe the NCUA should revisit the use of Risk Based Capital as a function of Prompt Corrective Action in its Proposed Rule. The NCUA should also ensure that sufficient due process and objective standards are contained in any regulation to protect against subjective examiner judgments leading to arbitrary and automatic consequences.

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[8] The examination process already has a number of subjective determinations. *See, e.g.*, Letter from Jeb Hensarling, Chairman, House Committee on Financial Services, to Debbie Matz, Chairman, National Credit Union Administration (May 22, 2014).

[9] *See* 78 Fed. Reg. 62,018, 62,158 (Oct. 11, 2013).

[10] *Compare* 78 Fed. Reg. 62,018, 62,158 (Oct. 11, 2013) (enacting § __.1(d)), *with* Proposed Rule § 702.105(b), (c).

2. CUSO Investments

Other commenters have identified that the 250% risk weighting for equity investments in subsidiaries being well beyond corporate exposure or equity exposure risk ratings for banks, especially for subsidiaries of banks reported on a consolidated basis. While we agree, and believe this risk rating should be considerably less, we wish to comment on the manner in which the proposed risk weighting, when combined with current CUSO rules, will cause significant uncertainty for credit unions.

Federal credit unions are permitted to invest up to 1% of unimpaired capital and surplus in subsidiaries. The amount that has been invested has been judged by the NCUA based on "aggregate cash outlay" under the Regulations and Office of General Counsel Opinion Letters. This has come to mean that when an equity investment in a CUSO increases in value, the increase in value does not cause the investment to become impermissible or limit later investments. Unfortunately, however, it is not readily apparent what occurs when the value of an investment goes down, or how an investment can be recouped to decrease the amount of aggregate cash outlay. This is important for FCUs, as they may wish to decrease their CUSO investments in the face of increased reserve requirements.

We understand and agree that an equity investment in a subsidiary should not immediately be permitted again if an investment decreases in value. This makes sense because a credit union may write down its investment in order to pour more money into a failing business. However, this limitation should have a time limit. After all, if a subsidiary goes out of business with zero or near zero value, but the corporation continues to exist, the amount of aggregate cash outlay should not persist for years or decades after. We believe, though, that answers may exist for this dilemma in accounting.

Perhaps just as troubling on an ongoing basis is uncertainty as to what calculation of aggregate cash outlay applies when a FCU wishes to decrease its investment in a subsidiary without a change in value in the underlying securities. We see two potential methods of a FCU and its CUSO actively reducing the FCU's investment absent a sale of equity securities to another investor:

(a) dividends (the income from which could offset the aggregate cash outlay through income); or
(b) stock or membership redemptions (a method by which the CUSO would buy back a proportion of its equity securities).

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The issuance of regular or extraordinary dividends would only be possible under the laws of most states if performed out of the retained earnings. Accordingly, we do not believe this method of decreasing aggregate cash outlay could be used to support a failing subsidiary to the detriment of the investing credit union's financial condition. We have also seen the issuance of dividends reducing aggregate cash outlay be supported by auditors and accountants for credit unions. But for a particularly effective CUSO, dividends may eliminate the aggregate cash outlay for that CUSO (or all CUSOs for a credit union) entirely. Accordingly, it is ambiguous the manner in which this would accounted for. It would need to be considered, also, whether past dividends could be used to offset future cash outlay into new CUSOs or the same CUSO.[11]

With a stock redemption, all states we have investigated similarly treat this as a distribution, and only possible out of retained earnings. However, for a stock redemption, the possibility exists for a mis-match in the value for which a share is redeemed and the proportion of aggregate cash outlay attributable to that share (either by being higher or lower). Accordingly, it remains unclear how a credit union must value its aggregate cash outlay in a stock redemption situation. We would support whatever redemption received reducing aggregate cash outlay, even if not proportional to the original shares purchased and book valuation. But, if the amount received back from the CUSO for a proportion of the issued shares does not match with book value, it raises the question how the NCUA will wish to value the CUSO for the purposes of the investing credit union's balance sheet. This ambiguity should also be resolved.

As can be seen, if the Proposed Rule is adopted as issued, or if any finalized rule investment in CUSOs becomes disincentivized, FCUs may wish to divest of their CUSO holdings or otherwise reduce their book value of CUSO investments. Those FCUs should have clear rules through which to do so in order to properly also reduce their aggregate cash outlay and not jeopardize their future ability to invest in CUSOs.

3. <u>Additional Credit Union Comments</u>

Because some credit unions remain concerned about speaking out from fear of retaliation, we have been asked to pass on some comments regarding the Proposed Rule:

- The design of the risk ratings appears to emphasize shorter loans, higher liquidity, less concentration in real estate and member business loans, and clearly places a severe "penalty" on institutions with longer term investments. This seems to force credit unions into an excessively conservative mode of managing the organization and provides the NCUA with too strong a role in managing risks without proper assessment of such risks.

[11] For example, $100 is invested in a CUSO, taking the investing FCU to its 1% limitation. Over the course of 9 years, $100 is received in dividends reducing aggregate cash outlay to zero. On year 10, credit union received another $5 in dividends. Can in year 10 the credit union invests $105 in another CUSO, or only $100?

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- It is difficult to determine how the NCUA would apply the new risk ratings to each individual credit union, but based upon current ALM assessment practices by NCUA examiners, there will probably be significant "judgment" by individual examiners in determining when circumstances warrant additional examination efforts.
- U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS). This seems designed to avoid government criticism as this risk relates to interest rate risk and liquidity at longer average lives, but they are all treated equally. This is contrary to all other investments in the other categories.
- Category 3 (Risk Weight at 50%) includes the total amount of investments with a weighted-average life of greater than one year but less than or equal to three years and the total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets. An investment of 1-3 years is a conservative allocation of assets and much less risk than a first trust deed of nearly any average life.
- Category 4 (Risk Weight at 75%) includes 3 to 5 year investments and STS loans and concentrations of mortgage loans. It seems inappropriate that an investment of 3-5 years (which is reasonable for most institutions) carries the same risk weight as a concentration in first mortgages, which could have a much higher average-life and carry many additional risks.
- Category 4 (Risk Weight at 100%) carries many issues. Land, buildings and loans held for sale have the same risk as foreclosed and repossessed assets. Non-1st real estate loans are capped at 10%, which is way too low to effectively serve members, and then treated equivalent to a MBL or a foreclosure.
- For Category 7 (Risk Weight at 150%) an investment with an average life of 5-10 years carries the same risk rating as a delinquent credit card loan. This appears aimed at harshly penalizing longer term investments regardless of their effectiveness in financial management of the credit union. Additionally, an agency-backed investment is of notably lower risk than a real estate loan held by an organization with a similar average life.
- The corporate credit union investment risk weight appears in response to the past corporate issues, not a proper reflection of risk, which should be based on the quality of the corporate in which the capital is held.

These various issues have raised as possible unintended consequences the following:

  - Increased fee emphasis – The proposed RBNW requirements will shorten the average maturity of earning assets and will decrease the earnings potential on assets. This could increase the reliance on fees which will increase cost to members and possibly reduce the attractiveness of a credit union membership.

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- Decrease in current Net Income – A shortening of maturities will result in a decrease in current net income. This will have an immediate impact on current earnings and a cumulative affect over the long term. This could also increase rates offered on loans and/or decrease rates offered on deposits
- Possible decrease in deposit growth – Low earnings will first be felt in the payment of dividends and a possible decrease in earnings as there will be fewer assets to invest or lend.
- Possible change in the maturities in the deposit base – Potential decreases in current net income may result in a credit union to change its strategies on deposit structure. A credit union may decide to pay a premium on shorter/longer term deposits to rebalance its assets and liabilities.
- Support of the Corporate Credit Union structure – The higher risk weight applied to both perpetual and non-perpetual capital at Corporate Credit Unions could result in less participation in the Corporate Credit Union system, reducing credit union wide liquidity and services offered by Corporate Credit Unions.
- Decrease in Credit Quality – If a credit union determines that shorter term consumer loans will benefit the RBNW calculation, the credit union may lower credit standards for the approval of new consumer loans to attract additional loans. This could also apply to "loan participations."
- Investment in CUSOs – Not only will a 250% risk weight affect the calculation of the RBNW, but it will certainly bring into question whether a CUSO of any type is far too risky of an investment to participate. The result could be less credit union to credit union cooperation, fewer member service benefits and possibly less earnings.
- Obstacles in terms of beneficial mergers – Credit unions when calculating RBNW for a merger could be either discouraged or denied mergers due to unfavorable combined RBNW ratios. Mergers could be limited even if all parties, including the NCUA would benefit from a merger.
- Board make-up – The new RBNW requirements may signal a change in the requirement of volunteers for the Board of Directors. This new proposal (along with the myriad of other regulatory and legislative requirements) may result in a focus on the recruitment of specific types of new Board members. Historically the Boards of Directors were open to any and all members. The developing organizational complexity and NCUA requirements for more knowledgeable volunteers may result in limitations of who will serve on future Boards of Directors. Instead of open elections for the Board, some credit unions may establish and recruit for "experts" in finance, accounting, investments, information security and technology, auditing and the law. While it can be argued that this expertise is necessary to insure the success of a credit union, it may also lead to a less democratic election practice and a movement away from the foundations of a credit union.

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- Change in "horizon" focus – The majority of the areas addressed in the proposed RBNW focus on the duration of assets. It appears that the movement is toward a shorter duration in the three (3) to five (5) year range. This certainly could be the "safest" approach, but it does ignore macro-economic cycles and potential longer term benefits—longer durations may be lower risk at the top of the market, even though they are verboten now.
- Regional Standards – There exists different focuses by different NCUA Regions. Depending upon those "standards" set in each region, the focus on an examination will determine how the RBNW results impact the direction of the examination and possible "findings" and "DOR's." The result is that through a combination of individual examiner's "judgment decisions," Regional standards and focus differences, and the overall NCUA current areas of concern, an individual credit union's plans for longer periods can become confused, and interpretation of the standards applicable rather arbitrary.

Conclusion

While we agree that some variety of risk-based capital is advisable, and may, if executed properly, bring some predictability to credit unions about examiners' expectations on capital levels for risk assets levels. However, we also believe that the NCUA can do so without the unintended consequences and due process concerns embodied in the current rule. Indeed, the NCUA has tools available to it to encourage the use of low-risk assets without entirely incorporating risk based capital into PCA in the style of BASEL III. The NCUA could:

- define "total assets" to exclude cash, insured deposits, and federal government securities for basic capital requirements;[12]
- institute risk based capital requirements in PCA at levels lower than 7% to correspond with Tier 1 capital requirements for banks; and/or
- separate risk based capital from PCA to ensure that the consequences are not automatically statutorily prescribed, and are more tailored to the risks posed by a credit union's asset mix.

[12] The NCUA has this power because 12 U.S.C. 1790d(o) does not define "total assets," but does define "net worth."

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If you have any questions about our comments, please do not hesitate to call.

Sincerely,

STYSKAL, WIESE & MELCHIONE, LLP

William J. Adler

Timothy I. Oppelt

WJA/TIO/pc