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April 21, 2015

Mr. Gerard Poliquin
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria VA 22314

Re: Proposed Rule on Risk Based Capital RIN 3133-AD77

Dear Mr. Poliquin:

The Pennsylvania Credit Union Association (PCUA) appreciates this opportunity to comment on the National Credit Union Administration's (NCUA) second proposed rule on Risk Based Capital (RBC2). PCUA is a state-wide advocacy organization that represents a majority of the credit unions located in the Commonwealth of Pennsylvania.

PCUA consulted with its Regulatory Review Committee and State Credit Union Advisory Committee (the Committees) in order to provide comments on RBC2. The Committees consist of credit union CEOs and senior management staff. Members of the Committees also represent credit unions of all asset sizes. The comments contained in this letter reflect the input of the Committees and PCUA staff.

We acknowledge that RBC2 represents improvements over the 2014 proposed rule. However, RBC2 remains an onerous regulatory scheme that will alter the management decisions of complex credit unions and those credit unions that are growing and may soon reach the threshold for complex credit union. It is imperative that, should NCUA adopt a final rule, it strike an appropriate balance between safety and soundness and the compliance burdens, leaving adequate discretion in the hands of the management teams of credit unions to operate in a manner that serves the best interests of the membership.

Summary of Comments

- Pennsylvania's credit unions are financially sound, questioning the need for RBC2.
- NCUA does not have legal authority for a separate standard for a credit union to be well capitalized.
- The proposed definition of "Complex Credit Union" is arbitrary and should focus on more than asset size.
- We support the removal of Individual Minimal Capital Requirements and oppose the proposed rules for a capital adequacy plan.
- Supplemental capital offers protection to the NCUSIF and should be included in the RBC ratio.
- We support including the entire amount of the allowance for loan loss as capital.
- We support including goodwill in the RBC ratio and it should not sunset.

- The 1% NCUSIF deposit protects the NCUSIF, is a unique attribute of credit unions, and should be included in RBC ratio.
- The revised risk weights remain unduly complex and should address historic performance of those assets.
- We support the removal of interest rate risk provisions, further regulation in this area unnecessary.

Need for RBC2

As a matter of public policy, we question the need for a rule such as RBC2. NCUA's record does little to support the overhaul of credit union capital standards or Prompt Corrective Action (PCA) in such a complex manner. To the contrary, the current net worth criteria for federally insured credit unions served consumers of Pennsylvania very well. In 2008, the average net worth of Pennsylvania's credit unions was 11.36%. In the wake of the Great Recession, Pennsylvania experienced a modest decline in average net worth in 2009 and 2010 to 10.83% and 10.72% respectively. Despite that decline, the National Credit Union Share Insurance Fund (NCUSIF) continued to be protected by a health capital cushion from Pennsylvania's credit unions. By year end 2013 and 2014 average net worth in Pennsylvania credit unions climbed to 11.31% and 11.42%.

NCUA has indicated that it has concerns about "outliers" within the system that might present undue risk to the NCUSIF. The Federal Credit Union Act (FCUA) and the current PCA regulatory scheme provide the NCUA with a broad array of supervisory enforcement powers to address those situations. The proper use of supervision, aimed at actual risk is infinitely more preferable and wiser public policy than a sweeping regulation that has the potential to reduce services available to members.

In the preamble to the proposed rule, NCUA states that it has a legal mandate to adopt a regulatory system of PCA and risk-based capital (RBC). The FCUA requires a system of prompt corrective action that is comparable to that established by the Federal Deposit Insurance Act. 12 USCA § 1790.d. The FCUA also mandates:

The Board shall design the system required under subparagraph (A) to take into account that credit unions are not-for-profit cooperatives that – (i) do not issue capital stock; (ii) must rely on retained earnings to build net worth; and (iii) have boards of directors that consist primarily of volunteers. 12 USCA § 1790.d(b)(1)(B).

In light of the clear language of the FCUA, if NCUA is determined to finalize such an RBC rule, the agency should strike a better balance in terms of recognizing credit unions as non-profit cooperatives. The regulation need only be comparable to rules developed for banks. Any final rule does not have to track the rule for banks in terms of structure or content. For example, simplification of the risk weighting would go a long way toward recognizing that credit unions are cooperatives that do not issue capital stock. NCUA is well aware that net worth is built through retained earnings. The risk weights put pressure on a credit union's ability to earn income. Therefore, as we will discuss further in this letter, additional liberalization of the risk weights is necessary to comply with the FCUA in terms of fashioning a final rule. Also, inclusion of the 1% NCUSIF deposit in the RBC ratio would also be more in line with the FCUA, taking into account that credit unions are unique, vastly different from banks.

NCUA Legal Authority

NCUA's legal authority to structure RBC2 in its current form is an issue that carries over from the 2014 proposed rule. Specifically, the issue is whether NCUA has legal authority to create a risk-based capital standard for a credit union to be well capitalized. We maintain that the FCUA does not confer such authority on NCUA.

The FCUA directs the NCUA to:

Design the risk-based net worth requirement to take account of any material risks against which the net worth ratio for an insured credit union to be adequately capitalized may not provide adequate protection. 12 USCA § 1790(d)(2) (emphasis added).

NCUA's limits on its authority are clear. The FCUA permits a standard for complex credit unions to be adequately capitalized in terms of risk-based net worth. A separate standard to be well capitalized as proposed in RBC2 is outside the scope of NCUA's rulemaking authority pursuant to the FCUA.

Definition of Complex Credit Union

RBC would apply to "complex" credit unions which the proposal defines as federally insured credit unions greater than $100 million in assets. The original proposal established the threshold for complex credit union greater than $50 million. The increase in asset size is appreciated and is reform headed in the right direction; however, we maintain that asset- size criteria, alone, is an arbitrary measure for defining a credit union as complex.

The maintenance of capital to satisfy the proposed capital ratios and standards for RBC2 will be a daunting task. It requires careful planning and an enormous amount of staff time. Compliance with the rule will inevitably impact services to members and the composition of a credit union's balance sheet. Accordingly, the definition of complex credit union must be designed to protect the share insurance fund from real risk. Asset size alone is not a sufficient indicator of risk. A well-considered rule would increase the asset threshold and take account of the balance sheet of the credit union. In Pennsylvania, many credit unions with assets greater than $100 million have conservative balance sheets. Members of the Committees indicated they do not engage in derivatives, hedging or have overseas exposure. The final rule should emphasize the assets and the portfolio in determining whether a credit union is complex.

Individual Minimum Capital Requirement/Capital Adequacy

PCUA supports the removal of the Individual Minimum Capital Requirement (IMCR) from RBC2. As explained in PCUA's 2014 comment letter, the examination process is too informal a setting for a prudential regulator to mandate the retention of additional capital.

IMCR appears to have been replaced, however, by new provisions on capital adequacy. Proposed section 702.101 requires a complex credit union to maintain capital commensurate with the level and nature of risk to which it is exposed and have a process for assessing its overall capital adequacy in relation to its risk profile including a written strategy for maintaining an appropriate level of capital. 80 F.R. 4431.

This so-called capital adequacy provision is redundant and creates compliance undue burdens and should be removed from the proposed regulation.

PCA, by defining the capital standards and corresponding supervisory enforcement actions, establishes capital adequacy. Capital adequacy is defined as a matter of law. For example, a credit union is well capitalized if its net worth ratio is 7% or greater and risk based capital of 10% or greater. 80 F.R. 4432. Further, the risk weighting scheme represents the fundamental policy decisions enforcing the maintenance of capital commensurate to risk. RBC, itself, negates the need for individual credit unions to prepare yet another policy.

Also, NCUA should not restate basic management principles in a regulation. In addition to the regulation, credit unions provide for capital adequacy through existing policies and strategic plans. Through its business or strategic plan, a credit union charts its course for growth, new services, branches, and maintaining appropriate net worth consistent with regulatory requirements. Credit unions maintain asset-liability management and liquidity policies which further ensure capital adequacy.

The proposed capital adequacy rule, without further refinement, confers too much discretion on the agency at the examination level to second guess business and management decisions rendered by a credit union. We anticipate that an examination team could criticize any written strategy for capital adequacy despite a credit union's net worth or RBC ratios. RBC will be difficult enough to manage and it builds more than enough of a capital cushion to protect the NCUSIF. RBC can achieve safety and soundness ends without the additional requirement of capital adequacy. Further, should the final rule include capital adequacy rules, credit unions should be afforded a robust and independent appeals process for review of determinations or commentary offered by NCUA at any level.

Supplemental Capital

The Committees unanimously support the development of a system of supplemental capital. Further, supplemental capital should be included in the RBC ratio. The FCUA is very clear that a system of prompt corrective action must take into account that credit unions rely on retained earnings to build net worth. 12 USCA 1790.d(b)(1)(B). As a matter of good public policy and to carry out the mandate of the FCUA, NCUA should include supplemental capital in the RBC ratio. Given the exacting standards of PCA and RBC, credit unions must have additional mechanisms available to achieve compliance with the capital standards. Too much stress is imposed on retained earnings alone, especially if RBC2 is adopted and finalized.

Supplemental capital can, indeed, offer realistic protection to the NCUSIF. In 2010, the NCUA issued the *Supplemental Capital White Paper*, prepared by its Supplemental Capital Working Group. The White Paper acknowledged that affording credit unions the ability to raise supplemental capital that is included in net worth is an appropriate policy consideration. The White Paper also acknowledged that supplemental capital may add protection for the NCUSIF provided it is structured and utilized in an appropriate manner.[1]

Accordingly, the White Paper should be used as the basis for future discussions on the terms and conditions for use of supplemental capital as net worth. The White Paper advanced three key principles that would be applicable to any form of supplemental capital which we support:

[1] National Credit Union Administration, Supplemental Capital White Paper, April 12, 2010. p.18.

1. Preservation of the cooperative, mutual credit union model;
2. Robust investor safeguards; and
3. Prudential safety and soundness requirements.[2]

Allowance for Loan and Lease Losses (ALLL)

The original proposal capped ALL at 1.25% of risk assets in the RBC ratio. RBC2 eliminates that cap and the entire amount of ALLL is included to cover losses. We support this change and applaud the regulatory relief afforded to credit unions.

Goodwill

RBC2 permits the inclusion of goodwill or intangibles recorded from supervisory mergers or combinations completed prior to publication of a final rule. A credit union's ability to include goodwill sunsets in 2025. We support the inclusion of goodwill in the RBC calculation. It is a recognized accounting treatment and should benefit or assist a complex credit union with RBC compliance. Goodwill should be recognized or included for such time as Generally Accepted Accounting Principles permit. The regulation should not sunset inclusion of goodwill.

1% NCUSIF Deposit

NCUA continues to exclude the 1% NCUSIF deposit from the RBC ratio. NCUA argues that the 1% deposit is not an asset and cannot be counted as system equity that protects the NCUSIF. We disagree. The 1% deposit is unique to the cooperative structure of credits unions and the funding of the NCUSIF. Consistent with the FCUA's mandate that a system of PCA takes into account that credit unions are not-for-profit cooperatives, inclusion of the 1% deposit is appropriate.

Pursuant to section 202 of the FCUA, each insured credit union shall pay and maintain with the NCUSIF a deposit of one percent of insured shares. 12 USCA § 1782(c). Further the deposit may be used by the NCUSIF to meet its expenses and credit unions can be required to replenish it. Therefore, as a matter of law, the 1% deposit is a funding mechanism and protection for the fund. The deposit and premiums, when assessed are part and parcel of a system of share insurance that is unique to credit unions. This further distinguishes the credit union system from banks. It follows, then, that in developing a system of PCA/RBC that is comparable to yet recognizes the unique features of credit unions as cooperatives, it is appropriate and consistent with the FCUA to include the 1% deposit in the RBC ratio. We appreciate that the accounting is difficult. With so much as stake from the consequences of this proposed rule, NCUA must make every effort to accommodate what is unique about credit unions and the structure of the NCUSIF.

Risk Weights

We appreciate that NCUA lowered the risk weights assigned to many of the risk-based assets in RBC2. Credit unions and NCUA can realize the safety and soundness goals of RBC2 by further simplification of the risk weighting. Though improved, the new proposal remains complex, particularly with respect to real estate loans and member business loans. Additionally, the new risk weighting, similar to the original proposal, will require significant changes to the Report of Financial Condition. This will cost the NCUA and credit unions money and time.

[2] Id. p. 15.

a. Residential Real Estate

Focusing on residential real estate loans, the risk weighting scheme is too intricate. A less complex approach is warranted, mainly, because significant losses in connection with real estate loans do not exist movement wide. Pennsylvania has not experienced volatility in real estate values. Underwriting by Pennsylvania credit unions is conservative and such underwriting standards are reinforced by Regulation Z criteria regarding qualified mortgages and the ability-to-repay rules.

NCUA's approach to risk weighting residential real estate loans skews heavily toward concentrations. If the aim is to address material risk, the rule should take account of historical loss, loan-to-value ratio or loss ratio by product or lien type. One risk weight should apply to the entire portfolio of first lien loans, especially if the loan is fully secured. In the case of junior liens, we assert that the proposed risk weight is just too high and there is insufficient discussion in the background and summary to RBC2 to rationalize it. By taking a more historic look at the performance of junior liens, the risk weight could be well below 100%.

b. Member Business Loans/Commercial Loans

The revised risk weighting for one-to-four family non-owner occupied first or junior-lien loans would receive the same treatment as residential real estate loans. This is a significant improvement that we support. In light of this significant regulatory relief in the context of RBC, NCUA should give due consideration to amending Part 723 of its Rules and Regulations and remove one-to-four family non-owner occupied first or junior-lien loans from the definition of member business loan. Removing these loans from the scope of member business lending does no harm to safety and soundness.

Absent additional relief regarding the treatment of non-owner occupied loans, the regulatory scheme creates a strange dichotomy when accounting for such loans on a Report of Financial Condition or Call Report. In sum a credit union will treat these types of loans as a consumer loan and a member business loan in separate sections of the Call Report. This is not an appropriate result. Credit unions and borrowers will be better served if non-owner occupied first or junior lien loans would be viewed as residential real estate and excluded from the definition of member business loan.[3]

The risk weighting for member business loans, otherwise, remains a complicated exercise. NCUA's approach emphasizes concentrations. While perhaps not intended, the focus on concentrations of MBL to arrive at risk weighting overlooks the exacting standards of Regulation 723. NCUA addressed the asset cap in the background and summary. However, the requirements established in Part 723 for the loan-to-value, personal guarantees, loan policies and the experience of credit union personnel mitigate risk in the business lending portfolio. With this in mind, we assert that risk weights for member business lending should be less than 100% across the board.

c. Corporate Capital, Loans to and Investments in CUSOs.

Corporate credit unions and credit union service organizations (CUSOs) are part of the unique, cooperative nature of credit unions. Like natural-person credit unions, corporate credit unions are member owned cooperatives that provide vital payments systems services and other services to credit unions. CUSOs meet a variety of needs. Whether a credit union extends a loan to or makes an equity

[3] NCUA should amend Regulation 723 in a manner that is consistent with the Credit Union Residential Loan Parity Act, H.R. 1422.

investment in a CUSO, it has a degree of control over that CUSO. Control mitigates risk. Therefore, in light of the unique role played by corporate credits unions and CUSOs, the risk weights for corporate capital and CUSO activity should be less than 100%.

Interest Rate Risk

We note and support NCUA's removal of the five weighted average life (WAL) tiers that applied to investment risk weights. As RBC is a capital adequacy tool, it is appropriate that interest rate risk be addressed separately. NCUA has issued significant guidance and regulations on interest rate risk and those mechanisms are sufficient.

The NCUA 2015-2016 Annual Performance Plan, however, indicates that NCUA will pursue new policies and regulations addressing interest rate risk. The Plan outlines four significant goals connected to interest rate risk:

- An interest rate risk proposal for complex credit unions;
- Examiner and industry guidance and policy on quantitative risk measurements for interest rate risk;
- Supervisory guidance on interest rate risk sensitivity methods; and
- An interest rate risk sensitivity component of CAMEL.

NCUA expects to issue such rules or guidance by December 31, 2015.

In recent years, many members of PCUA have experienced micromanagement by NCUA examination teams over interest rate risk and related policies. These members have expressed frustration that while the examination team may indicate that asset-liability management and similar policies are satisfactory, the NCUA wants to see certain ratios achieved, particularly with respect to net economic value. Such suggestions or "moral suasion" compel a credit union to alter is balance sheet and forego income.

As a result of these types of supervisory experiences and because of the anticipated burdens and complexities of RBC, any such rules must be accompanied by a robust appeals process. The evaluation of balance sheet decisions is subjective. Therefore, credit unions must have meaningful recourse to challenge or seek reversal of a supervisory decision, be it formal or less formal. Appeals should be conducted by an independent administrative law judge or an independent hearing panel. The proceedings should be conducted pursuant to the rules of evidence. Decisions should be delivered in writing and supported by findings of fact and conclusions of law.

Conclusions

RBC2 as proposed is not warranted by the safety and soundness track record of credit unions. Further, NCUA can take additional steps to recognize important distinctions between banks and credit unions and craft a regulation that is less cumbersome. The proposed capital standard for a complex credit union to be well capitalized exceeds NCUA's authority. NCUA should suspend further consideration of RBC2 until a system of supplemental capital can be developed and included in the RBC ratio. Such a step would further recognize the unique character of credit unions and would be more consistent with the FCUA. The proposed capital adequacy provisions should be removed because they are redundant.

The rule's inclusion of goodwill and ALLL in the RBC ratio are positive steps and consistent with the structure of credit unions. The 1% NCUSIF deposit is a very unique characteristic of credit unions which provides protection to the share insurance fund. Therefore, it should be included in the RBC ratio. Additional adjustments to the risk weights are appropriate. The rule should take actual risk into account as opposed to concentrations. We support the removal of interest rate risk provisions. We advocate the creation of an appeals process for review of supervisory determinations related to balance-sheet decisions.

We would be happy to discuss the comments contained in this letter at your convenience.

Sincerely,

PENNSYLVANIA CREDIT UNION ASSOCIATION

Richard T Wargo

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Executive Vice President/General Counsel

RTW:llb

cc: P. Conway, President & CEO
PCUA Board of Directors
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