CU Revest

April 23, 2015

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

Re: Comment to the Proposed Amended Risk-Based Capital Regulation

Dear Mr. Poliquin:

CU Revest is a credit union service organization that collaborates nationally with credit unions to restore capital lost to charged-off consumer assets and to help rehabilitate the members associated with those assets. The mission of CU Revest is to strengthen credit unions and the credit union movement by increasing the tangible, financial recoveries from charge-off assets as well as the intangible recovery of members who can once again contribute cooperatively to the underlying spirit of the movement. Toward these ends, we would like to provide the following official comment letter regarding the NCUA's recently proposed risk-based capital rule.

Our primary comments relate to the proposed risk weighting of 150% assigned to investments in CUSOs. We assert that this is still arbitrarily high and not supported by empirical data. Such a risk weighting, we believe, will potentially prove counter-productive to the credit union movement by discouraging the collaborative risk mitigating model that CUSOs represent. In general, CUSOs have been and are being used effectively by credit unions to reduce costs and generate income. We encourage NCUA to revisit the risk weighting proposed for CUSO investments so as not to encourage unintended consequences that could potentially serve to make credit unions less safe and sound, not more.

As we stated in last year's comment letter, while there have been a handful of CUSO investment losses that have attracted the attention of the agency and contributed to a perceived lack of confidence in CUSOs, there are hundreds of others that have performing splendidly over the past several decades. We would encourage the agency to take the time to fully appreciate the overwhelming positive impact CUSOs have had on credit unions. In addition to what CU Revest is working to accomplish, we would like to provide additional specific examples of the considerable value CUSOs bring to credit unions—value that may be discouraged by the proposed risk weighting. Further, the discussion below illustrates the vast differences between CUSOs and the absurdity of treating each of them the same for risk weighting purposes.

Capital Recovery CUSOs

CU Revest is the credit union industry's sole material capital recovery CUSO. The purpose of the CUSO is to recover capital, using a non-abusive, fair and compliant, member-centric approach. We encourage the member to repay 100% of the charge off balance in order to requalify and return to the credit union as a member in good standing. Our process of recovery takes two significant forms. The first, and most tangible, is the increase in financial recoveries from these assets. These recoveries are denominated in dollars and cents and memorialized on the 5300s as recoveries or increases in the ALLL. The second, very important recovery are the people. The rehabilitation of disenfranchised and under-banked credit union members to good standing is an essential part to recovering the financial health and wellbeing of our Nation. The underlying fundamental to our success is bad things can happen to good people and given the opportunity to recover their membership privileges and dignity, they will.

It is important to note that our participating credit unions assign their off-balance sheet charge-offs to CU Revest in lieu of a traditional capital contribution, and therefore the specific risk weighting of the investment is largely immaterial. What is important, however, for smaller or potentially less sophisticated credit unions is what the 150% risk weighting says about NCUA's attitude toward CUSOs in general and those credit unions best positioned to benefit from CU Revest may be discouraged from doing so as to not complicate discussions with examiners. This is precisely the unintended consequence of the rule—discouraging a credit union from doing something that would ultimately make it more financially sound.

Operational Services CUSOs

The purpose of operational services CUSOs is to pool resources to reduce operational costs by achieving economies of scale they cannot achieve on their own and to be able to provide a higher level of services. Credit unions use a CUSO to leverage the money they spend on operational services and while not designed to make a profit, these CUSOs generate savings which contribute to net income.

The proposed regulation implies that unless the CUSO pays a cash dividend to the credit union owners, there has not been a return on the investment and, consequently, the investment is at risk. However, credit unions that are receiving annual returns of 100% to 200% on their investments through cost savings (at a higher level or service, no less) than they could otherwise achieve on their own, see the CUSO investment risk and return quite differently than NCUA. These are precisely the collaborations that NCUA should be encouraging, not discouraging which the proposed 150% risk weight clearly does.

To further the theme or unintended consequences, operational costs credit unions incur are internal expenses and no capital reserve is required. These costs can and are being reduced via the CUSO, but since the shared operational costs are called "investments" in the CUSO, they become subject to the capital reserve. These monies would have to be spent regardless and the key difference is that in a CUSO the costs are less. By adopting the proposed rule, NCUA would be penalizing credit unions for saving money and, as such, there should be zero capital risk for operational services CUSOs under these circumstances.

Fee Generating CUSOs

There are also CUSOs that generate fee income for their credit union owners. In one instance, a CUSO has paid more than $30 million in distributions to the owners and more than $1 billion in other fees. This equates to average annual returns (based on the current offering price) of approximately 12% over the past ten years with early investors receiving 70%-80% annual returns (based on their original investment). For one credit union, these fees alone offset its losses from a poorly performing lending portfolio.

It is important to note that generating fee income generally takes much less capital than generating interest income. In order for the credit union owner to generate $11 million in gross interest income over the same ten-year period at a 5% interest rate, the credit union would have had to lend $22 million per year with the attendant credit risk.

We do not see any justifiable reason to assign a high capital risk to financial services CUSOs as the amount that can be invested under the regulation is not material and additional revenue streams should be encouraged not discouraged. Non-interest income tends to be less cyclical than loan demand and provides a steady source of income. Credit unions are not penalized for making internal investments in costs to launch a new credit union product to generate income and serve their members. Credit unions should also not be discouraged from making an investment to launch a financial product within a financial services CUSO – a decision that can both generate fee income and also help them better serve their members' financial needs.

Loan Origination CUSOs

A small number of CUSOs originate and fund business loans, mortgage loans and credit card loans. There is no difference in the credit risk of a credit union making these loans versus a CUSO making the loans but under the proposed rule, the risk rating would be materially different. The investments in these CUSOs should be analyzed on the credit risk of the underlying loans and should be the same risk rating as if the credit union made the loan. Anything different is, in our view, arbitrarily punishing the credit union for loan origination through a CUSO versus through the credit union – again, a deterrent to the collaborative risk sharing model that serves both credit unions and NCUA well.

Comments on the CUSO Investment Risk Rating

The CUSO risk rating is the markedly disproportionality to other risk ratings. In an extreme example, consider this: If a credit union has $1 million to invest in either a CUSO which it thinks is well conceived and very safe or a pool of consumer debt over sixty days past due, it would incur better risk based treatment from doing the latter despite it being clearly a poor business decision. The CUSO may be anticipated to be profitable and the debt will surely have substantial losses, but since the debt is risk rated at 150% it requires only 60% of the capital, according to NCUA, the debt is the superior alternative. Following the same logic, delinquent first lien mortgage debt would be even better as it is risk rated at 100% and would require only 40% of the capital required for the CUSO. Clearly, NCUA would not actively agree with the conclusions above, but its rules do in fact suggest that it would.

All CUSOs are not alike and as a result, a single, arbitrarily high risk rating is not appropriate. In order to identify the proper risk rating NCUA should weigh, among other things, (i) what types of services are being provided, (ii) whether the investment represents necessary operational expenses that would be otherwise incurred, (iii) whether the amount invested is material, (iv) whether the CUSO has a history of profitability, and (v) whether the investment amount has already been fully recovered (through either savings or income). Even if there is a risk assessment for the initial CUSO investment, there is no reason to continue to have a risk assessment if the amount of the investment has been fully offset by net income or cost savings for the credit union that was generated by the CUSO.

Importance of Encouraging Prudent CUSO Investment

There is a real sustainability risk in credit unions today. The traditional credit union model was sustained in the past on the net interest margin. Net interest income was sufficient to pay the operating costs, build reserves and sometimes make special dividend payments to members. That model is under extreme stress today due to interest rates being at record low levels and operational costs (especially in areas of personnel costs, compliance and technology) increasing exponentially.

Coupled with the challenges most credit unions are experiencing in generating quality loans, the average net interest margin in the industry is very thin and in some credit unions the net interest margin is even negative. Many credit unions are slowly depleting their capital in what could amount to a slow liquidation of those credit unions or, at the very least, a steady slide toward the need for forced mergers that drains capital from the continuing credit unions.

We lose 3% of our credit unions every year and that rate could increase when the full impact of the new regulatory compliance onslaught overwhelms credit unions. At the very time that CUSOs are needed to help sustain credit unions, we are greatly concerned that NCUA may be creating a regulation that will be a disincentive for investments in CUSOs. The true risk is not the investment or loan to a CUSO, rather it is *not* investing in a CUSO to share risk, reduce costs and increase income.

We respectfully request that NCUA remove any risk weighting above 100% for CUSO investments and loans due to the already established CUSO investment and loan regulatory limits in place and the fact that disincentive to collaboration and risk sharing models such as CUSOs is inconsistent with the long term best interest of the credit union industry – and, frankly, its regulator and insurer as well. We further recommend that NCUA make it a priority to better understand the positive impact CUSOs have as a collaborative tool for credit unions to manage their sustainability risk.

Conclusion

1. CU Revest believes most credit union movement participants support a truly well-balanced risk-based capital system that replaces the current standards. We further believe, however, that any new standard must incorporate both benefits and penalties based upon the structure and management of balance sheet risk. In our estimation, and particularly as it relates to CUSOs, this proposed rule has a considerable number of improvements needed to accomplish that purpose.

This proposal supplements the current one-size-fits-all net worth system with a revised (and more complicated) one-size-fits-all risk based capital version. While the one-size-fits-all nature of the proposed risk ratings is admittedly easier to apply than a system based on historical performance and empirical data on a large scale basis, we feel that it does not reflect a fair assessment of the actual risks of assets held by a particular credit union, especially in the assertion that all CUSO investments should not be rated as high-risk.

If regulations unnecessarily serve to discourage or prevent necessary adaptations in the business model, the credit union industry will be put at risk. Credit unions cannot generate sufficient net income in today's economic and regulatory climate if they are shackled to a regulatory scheme that is designed to regulate the credit union industry as if it were the 1980's. Just as the credit union business model is changing to meet today's economic challenges, so must the approach of the regulator. Safety and soundness is not sacrificed but how credit unions operate to meet the economic challenges is modified. CUSOs are a big part of those necessary modifications.

There is certainly a danger to credit unions not having enough capital to cover the risks credit unions pose to the share insurance fund. However, there is also a danger to the sustainability of credit unions if an unnecessary amount of capital must be reserved in proportion to an individual credit union's balance sheet risk. If credit unions are required to reserve an excessive amount of capital, member services, net income opportunities and the growth of credit unions will suffer.

Thank you for the opportunity to comment.

Very truly yours,

Michael A. Joplin
President/CEO

cc. Deborah Matz, Chairman
J. Mark McWatters, Board Member
Richard Metsger, Vice Chairman