The Wisconsin Credit Union League
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Submitted via email: regcomments@ncua.gov

April 24, 2015

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

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

Dear Mr. Poliquin:

On behalf of Wisconsin's credit unions® and their 2.6 million members, the Wisconsin Credit Union League welcomes the opportunity to comment on the National Credit Union Administration's (NCUA's) second proposed Risk Based Capital rule (RBC2).

We want to thank the NCUA for considering credit unions' concerns over the original RBC proposal (RBC1) in 2014. Credit unions nationwide expressed serious misgivings over RBC1, offering their critiques during a series of NCUA listening sessions and submitting roughly 2,000 comment letters. The NCUA's RBC2 proposal includes approximately 25 key improvements, and The League offers its sincere appreciation for the NCUA's willingness to work with credit unions toward finding a workable solution. We hope that cooperative spirit will continue, because RBC2 remains seriously flawed, despite all of the positive changes in the new proposal.

We respectfully ask that the NCUA withdraw its RBC2 proposal, which is fundamentally unsound in several respects:

- RBC2 is unnecessary. It would impose a substantial burden on credit unions but yield few tangible benefits to the National Credit Union Share Insurance Fund (NCUSIF). Even if RBC2 had been in place before the recent financial crisis, analysis shows that it would have done little to reduce insurance losses.

- RBC2 exceeds the NCUA's legal authority. The Federal Credit Union Act (FCU Act) only allows the NCUA to establish a *single* risk-based net worth requirement for complex credit unions – the standard that a credit union must meet to be classified as "adequately capitalized." It does not allow the NCUA to set a higher risk-based capital tier for a credit union to be well-capitalized.

- RBC2 ignores the unique nature of credit unions. The FCU Act requires the NCUA to design a system of capital requirements that 1) is comparable to the FDIC's and that 2) makes allowances for the cooperative nature of credit unions. RBC2 disregards the second prong of that requirement.

While we would prefer that NCUA scrap the notion of risk-based capital rules altogether, if this proposal is going to be finalized in some form, we respectfully ask the NCUA to consider making certain significant changes, including the following:

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- Set credit unions' risk weights at levels equal to or less than comparable risk weights for banks.

- Include goodwill and other intangible assets (for either previous or future mergers) in the RBC numerator if they meet Generally Accepted Accounting Principles requirements, without time limitations.

- Increase the proposed $100 million threshold for credit unions to be considered "complex" to $500 million (indexed for inflation), and exempt credit unions with an NCUA Complexity Index below 17.

- Drop any additional capital adequacy provisions.

- Delay implementation until 2021.

Finally, we believe that potential future rulemaking on interest rate risk is unnecessary in light of existing NCUA guidance and that examiners can use supervisory review to identify credit unions with particular interest rate risk concerns.

RBC2 is Unnecessary

We continue to question whether a system of risk-based capital reserves is even needed for federally insured credit unions.

Federal agencies have a responsibility to show that the benefits of their proposals justify the costs, which seem quite substantial in the case of RBC2. Credit unions already face heavy, and growing, regulatory burdens, and RBC2 would simply add to the load. It would further stress credit unions, by requiring more capital and tying their hands as they work to serve their members. It would constrain healthy growth in the credit union industry as a whole.

Are those costs worth the perceived benefit? Would RBC2 prevent such losses to the NCUSIF as to justify the burdens and expenses it would impose on credit unions? No. Given the strong performance of credit unions and the NCUSIF during the recent recession – especially in comparison to banks and the FDIC – the NCUA has failed to show a need for such a broad new RBC regimen. There is no evidence that credit unions are under-capitalized or that NCUSIF losses during the recession would have been reduced had an RBC system been in place. As CUNA explained in its recent comment letter, RBC2 "would not have noticeably reduced insurance losses during the recent financial crisis had it been in effect. … Of the 26 credit unions with more than $80 million in assets just before the crisis … a total of just three would have been demoted to being undercapitalized by RBC2, and therefore subject to net worth restoration plans. And the amount of capital they would have been required to obtain to become adequately capitalized is only $7 million, as compared to the (NCUSIF) insurance losses of over $700 million."

The necessity of implementing RBC2, as proposed, simply escapes us, especially 1) given the historic safety and soundness of credit unions, and 2) given that credit unions' high net worth leverage ratio requirement already demands higher capital levels than similarly sized banks.

Given the questionable benefits of RBC2 and the obvious burdens it would impose, the proposal should be withdrawn.

RBC2 Exceeds the NCUA's Legal Authority

The NCUA continues to propose a two-tiered RBC system that it has no legal authority to enact.

In §301 of the Credit Union Membership Access Act (CUMA), Pub. L. No. 105-219, 12 U.S.C. § 1790d Congress granted NCUA authority only to establish a *single* risk-based net worth requirement for complex credit unions – the standard that a credit union must meet to be classified as "adequately capitalized." CUMA unequivocally says:

> The Board shall design the risk-based net worth requirement to take account for any material risk against [which] the net worth ratio required for an insured credit union *to be adequately capitalized* may not provide adequate protection.

Congress did not grant the NCUA the power to promulgate a separate risk-based standard for a credit union to be classified as "well capitalized."

As CUNA has repeatedly pointed to, several members of Congress who were responsible for CUMA, along with the former chairman of the Senate Banking Committee, have explained that the language Congress approved means exactly what it says: The NCUA is to set a single risk-based system to measure adequate capitalization. Congress did not intend for the NCUA to set a separate risk-based requirement for credit unions to be well-capitalized (in addition to the 7% net worth ratio for adequate capitalization).

Despite Congress' explicit mandate, RBC2 continues the NCUA's push for a two-tiered system. RBC2, if finalized, would be plainly unlawful and subject to legal challenge. It should be withdrawn.

RBC2 Ignores the Unique Nature of Credit Unions

In response to criticisms of its RBC proposals, the NCUA points out that the FCU Act §1790d(b) requires the agency to prescribe a system that is comparable to the FDIC's system for banks. That may be so, but the NCUA all but ignores the remainder of that statutory mandate, which requires the NCUA's system to make allowances for the unique nature of credit unions:

> The Board shall design the system required … 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.

It is a mystery to us how the RBC2 proposal makes any allowances for the unique, cooperative nature of credit unions. For example, Basel III uses lower risk weightings in certain categories than RBC2 would (as discussed more in the next section of this letter). Does the unique nature of credit unions somehow account for this disparate treatment? The proposal does not explain it. If anything, credit unions' risk weights should be lower than banks' risk weights. Why? Because credit unions, as not-for-profit, member-owned cooperatives, have unique incentives to avoid excessive risk in order to maximize savings and benefits for their members. For-profit banks, on the other hand, have more incentive to pursue risky strategies in order to maximize returns for their investors. Furthermore, the proposal fails to address how credit unions are expected to increase their capital revenues when, unlike banks, credit unions do not have capital stock and cannot seek equity from outside investors to shore up capital ratios.

The NCUA should withdraw RBC2 until it can issue a proposal that clearly considers the unique nature of credit unions. Short of that, the NCUA should at least expand on and explain how it has applied the mandate of the FCU Act to its RBC2 proposal, and it should revise its proposal to realistically reflect the credit union movement's cooperative nature.

Significant Revisions Are Needed if RBC2 is to be Finalized

Despite all of the fundamental faults that plague RBC2, it seems clear that the NCUA intends to move forward with an RBC proposal in some form. We would prefer that NCUA scrap the notion of RBC rules altogether, but if this proposal is going to be finalized, we respectfully ask the NCUA to consider making at least the following revisions.

Risk weights

Much of The League's RBC1 comment letter focused on that proposal's troubling risk weighting system. To its credit, the NCUA made a number of positive changes to this area in its RBC2 proposal. For example, RBC2 would:

- Remove weighted average life components from risk weights for investments;
- Change the risk-weight escalation for higher concentrations of real estate and member business loans;
- Remove interest rate risks from the risk weights;
- Reduce the top risk weight for commercial loans from 200% to 150%;
- Treat loans that are secured by vehicles manufactured for personal use as consumer loans, not business loans (unless used for a fare-based business); and
- Designate 1-4 family, non-owner occupied mortgage loans as residential loans, subject to lower risk weightings than member business loans.

Despite these enhancements, several of the proposed credit union risk weights would still be higher than the risk weights in place for banks. In particular:

- A credit union's share-secured loans would be risk-weighted at 20%, but similar bank loans have a 0% risk weight. Credit unions should not be required to hold capital against share-secured loans, which are of such negligible risk as to warrant 0% treatment.
- Current first lien residential mortgage loans over 35% of assets would have a risk weight of 75% for credit unions, higher than the 50% risk weight for banks.
- Junior residential real estate loans over 20% of assets would have a 150% risk weight for credit unions, but 100% for banks.
- Credit union commercial loans over 50% of assets would have a risk weight of 150%, while the risk weight for bank commercial loans over 50% of assets could be as low as 100%.

Credit unions should not be treated less favorably than banks, and no explanation was given for imposing higher requirements on credit unions. At the very least, all of the risk-weight discrepancies between credit unions and banks should be equalized, since credit unions face no higher risk levels from holding these assets.

In fact, credit unions' risk weight should be lower than comparable banking risk weights for assets such as mortgage loans, member business loans, servicing and certain investments. Lower risk weightings for credit unions are appropriate because 1) credit unions, as not-for-profit, member-owned financial cooperative have different incentives to manage risk than banks do, and 2) credit union have lower loss histories than banks do. Lowering these risk weights would be one way the NCUA could show that its system takes into consider the unique nature of credit unions.

RBC2 includes fair treatment of consolidated credit union service organization (CUSO) investments and loans; however, the risk weight for unconsolidated CUSO investments is excessive. It should be the same as proposed for CUSO loans (100%).

The 250% risk weight for mortgage servicing, which was unchanged from RBC1 and is the same as for banks, is too high and should be significantly lower in any final RBC2.

The 300% risk weighting for publicly traded equity investments should be lowered. Credit unions would be unduly limited in their investments for employee benefit funding under RBC2.

The NCUA should assign a risk weight of no more than 100% to charitable donation account investments. This would help encourage credit unions to continue supporting charitable endeavors, such as the Wisconsin Credit Union Foundation, a 501(c)(3), non-profit organization that helps to promote credit union development, educate credit union staff and volunteers, and support financial literacy programs. RBC2 should not hinder credit unions in their support of such charities.

Finally, The League endorses CUNA's recommendations concerning the Mortgage Partnership Finance (MPF) Program. To quote CUNA's recent RBC2 comment letter:

> As proposed, the definition could be construed as limiting the benefits of the risk based capital treatment only to those credit unions that service their MPF loans, but not those that choose to sell the loans servicing-released. Whether or not credit unions service their mortgage loans does not alter their credit enhancement obligation in any way. We urge NCUA to remove the words, "and servicing them" from the definition of the MPF Program. We also recommend adding language to clarify that the definition of the MPF Program does not apply to the Mortgage Purchase Program (MPP), a secondary market alternative offered by certain Federal Home Loan Banks that achieves credit enhancement by creating a contingent asset for the credit union participant, in contrast to the contingent liability obligation created under the MPF Program. Since the purpose of the risk based capital requirements for off-balance sheet activities is to ensure credit unions hold capital against recourse risk, and MPP loans do not have such risk, MPP loans should fall outside of the definition of the MPF Program.

<u>Goodwill</u>

We remain concerned about the proposal's treatment of goodwill and other intangible assets (OIA). They would be permitted in the RBC2 calculation, but only when they arise from "supervisory" mergers (meaning assisted mergers, emergency mergers, or mergers where the NCUA or state supervisory authority selected the surviving credit union). Goodwill and OIA could be retained in the RBC2 numerator only until 2025.

This is a step in the right direction, since RBC1 would have excluded goodwill altogether, but it does not go far enough. A well-managed and well-capitalized credit union may rely on goodwill as an incentive for merger. If its ability to do so is limited, it may no longer be able to justify the business decision to merge, forcing NCUA to step in and negatively impacting the NCUSIF. Discouraging well-managed and well-capitalized credit unions from participating in mergers cannot be the NCUA's intention.

Instead, all goodwill and OIA should be included in the numerator if they meet Generally Accepted Accounting Principles requirements (i.e., they are subjected to annual goodwill impairment testing). We also believe that goodwill from both previous and future mergers should be counted, without a time limitation. At a minimum, non-supervisory goodwill from future mergers should be retained in the numerator over a 10-year phase out period (i.e., reduced by 1/10 each year for ten years), assuming it satisfies regular impairment testing, while all previous supervisory goodwill should be grandfathered without time limit. These steps would give well-situated credit unions an incentive to absorb struggling credit unions and reduce insurance losses to the NCUSIF, without being penalized after the fact for previous mergers.

<u>"Complex" credit unions</u>

RBC2 would raise the asset size threshold for a credit union to be considered "complex," from $50 million under RBC1 to $100 million. This is a positive change, since $50 million was far too low. As a result, RBC2 would apply to far fewer credit unions. Regardless, we believe that $100 million is still not the appropriate threshold and that the change sidesteps a key underlying issue: Should asset size alone be used as a proxy for complexity? No. The FCU Act requires the NCUA to define "complex" based on the "portfolios of assets *and liabilities* of credit unions." RBC2 ignores the second prong of Congress' explicit requirement.

To address both assets and liabilities, we join CUNA in recommending that the NCUA increase the proposed $100 million threshold to $500 million (indexed for inflation) and that the threshold be used in combination with actual operational complexity as measured by the agency's Complexity Index. Only federally insured credit unions with assets above $500 million and an NCUA Complexity Index (discussed in the Supplementary Information to RBC1) value of 17 or higher should be subject to a new RBC regime.

This more tailored definition of "complex" would ensure that RBC2 only applies to credit unions that pose extraordinary risks, beyond routine loans and investments, for which their adequately-capitalized-level net worth does not provide adequate protection. This approach is consistent with the FCU Act. In addition, two-thirds of NCUSIF insured shares are in credit unions with $500 million or more in assets, so this approach would pose little danger to the credit union system. And NCUA would of course retain the authority to adjust the definition as needed going forward.

<u>Capital adequacy</u>

While the NCUA has dropped the RBC1 proposal for individual additional minimum capital, RBC2 still would require some credit unions to retain extra capital – above and beyond the RBC2 ratio requirements for "well-capitalized" credit unions. This new capital adequacy provision should be cut from RBC2.

RBC2 would require a covered credit union to maintain capital commensurate with the level and nature of all its risks. To that end, each covered credit union would have to develop a "comprehensive written strategy" to maintain "an appropriate level of capital." The credit union could then be required to set aside capital over and above the 7% net worth and 10% RBC requirements. The credit union's plan and amount of additional capital would be subject to examiner review.

Examiners' concern about the credit unions they supervise should be addressed on an individual basis, not through overarching new rules that would impose onerous new requirements on all "complex" credit union, however well-managed they are. Credit unions should be allowed to conduct their own, internal, strategic capital planning. They should be free to set their own long-term goals for capital ratio as they see fit, depending on their own assessments of potential risks. Their plans may well include buffers of additional capital to stay above regulatory requirements, but that does not mean that examiners should be authorized to force credit unions to meet those internal goals.

In addition, this aspect of the proposal exceeds the NCUA's legal authority. Congress did not provide for credit unions to be subject to higher capital requirements than the FCU Act directs. The FCU Act does not set "minimum" capital requirements and give the NCUA free reign to force credit unions to retain more capital. If a credit union meets the net worth and RBC capital requirements to be well-capitalized, the sufficiency of its capital should not be a regulatory issue.

For these reasons, the NCUA should drop any additional capital adequacy provisions from RBC2.

<u>Implementation date</u>

We believe that credit unions would be best served by delaying the implementation of RBC2 until 2021, when the corporate stabilization fund will terminate and credit unions will receive refunds. As needed, credit unions could then use those refunds to increase capital levels in compliance with RBC2.

Future Rulemaking on Interest Rate Risk is Unnecessary

The NCUA has asked for commenters' input about potential future rulemaking on interest rate risk (IRR). We strongly believe that such a new rule is unnecessary in light of existing NCUA guidance and that it would only serve to add more compliance load on already over-burdened credit unions.

Over the last several years, the NCUA has issued numerous rules and letters addressing IRR, all of which can be accessed via the agency's "Interest Rate Risk Resources" webpage. For example, since Sept. 30, 2012, the NCUA has required certain federally insured credit unions to develop and adopt a written policy on interest rate risk management and a program to effectively implement that policy, as part of their asset liability management responsibilities. Appendix B to Part 741 of the NCUA regulations provides guidance on developing an IRR policy and an effective implementation program based on generally recognized best practices.

That rule, the accompanying guidance, and the NCUA's various Letters to Credit Unions and other resources are sufficient to guide credit unions and examiners on IRR concerns. Examiners are well-equipped to guide individual credit unions, depending on the specifics of the credit union being examined. Examiners have the flexibility to consider each credit union's unique circumstances. We encourage the NCUA to continue to address IRR concerns through the examination process.

A broad new set of IRR rules is unnecessary, and any attempt to regulate in this area is likely to be unwieldy, given the various IRR factors at play and specific to each credit union. The NCUA is certain to face substantial difficulty in crafting a standardized, quantified IRR rule that can be applied to a broad spectrum of credit unions.

Instead, we support CUNA's suggestion that NCUA form an advisory group consisting of a broad cross-section of credit unions. This advisory group should be tasked with developing a call-report-based model for identifying the small number of credit unions that might be considered IRR "severe outliers." These credit unions could be subjected to varying degrees of enforcement actions and examiner review. Such an approach would be similar to the supervisory review process used by banking regulators to identify institutions of particular concern.

Conclusion

In summary, we believe that the NCUA should withdraw its RBC2 proposal, which is fundamentally unsound, unnecessary, burdensome, beyond the legal authority of the NCUA to enact, and blind to the unique nature of credit unions. If the NCUA does insist on moving forward to finalize RBC2, it should include a number of significant revisions, such as:

- Reducing several risk weights,
- Including goodwill and other intangible assets without time restrictions,
- Increasing the asset size threshold for credit unions to be subject to the rule,
- Considering additional factors to determine whether a credit union is "complex,"
- Dropping the proposed capital adequacy provisions, and
- Delaying implementation until 2021.

Finally, we believe that potential future rulemaking on IRR is unnecessary in light of existing NCUA guidance. Instead, examiners can use supervisory review to identify credit unions of particular IRR concern.

Thank you.

Sincerely,

Paul Guttormsson
Legal Counsel
The Wisconsin Credit Union League