VERMONT FEDERAL
CREDIT UNION

April 27, 2015

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

Re: NCUA's Risk Based Capital Proposal RIN 3133-AD77

Dear Mr. Poliquin:

Vermont Federal Credit Union (VFCU) appreciates the opportunity to submit comments to the National Credit Union Administration (NCUA) Board's request for comments on the NCUA's second proposed risk based capital rule (RBC2). While RBC2 represents an improvement over the original proposal NCUA issued last year, we still have some concerns with the current proposal which are noted below:

I. NCUA Should Better Calibrate RBC2's Risk Weights

RBC2 makes a number of positive changes to RBC1's proposed risk weightings. Improvements include the removal of weighted average life components from risk weights for investments and changes to risk-weight escalation for higher concentrations of real estate and member business loans. Other examples of improved treatment under RBC2 include the designation of 1-4 family non-owner occupied mortgage loans as residential loans, subject to lower risk weightings than if NCUA had categorized the loans as member business loans. There still appears to be some inconsistencies in the risk weights within some on the loan categories. Using the consumer loan risk weights, which we agree with, as a basis; the risk exposure for real estate loan categories with current junior liens <20% of assets and current junior liens >20% of assets pose no more risk than the current consumer secured and unsecured categories, respectively. This would especially be true in light of the fact that consumer loans are more likely to be collateralized by depreciating assets and therefore would be more likely to pose more collateral risk in the event of repossession than a secured real estate loan with a junior lien. This would especially be the case if the

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institution were to require mortgage insurance where the loan-to-value ratio exceeds 80% as we do. The risk weight is also the same for non-current consumer loans as they are for non-current junior lien real estate loans regardless of the concentration as a percentage of assets. For all of the above reasons, risk weights for current junior lien real estate loans <20% of assets and >20% of assets should be the same as the current consumer secured and unsecured categories of 75% and 100%, respectively, as opposed to the proposed respective weights of 100% and 150%. This would also be more consistent with the rationale in both categories of a higher risk weight for a non-current loan.

Using these same rationales, commercial loans secured by real estate <50% of assets and >50% of assets should be reduced to risk weights of 75% and 100%, respectively. These new weights would still be higher than the current first lien real estate categories and no less than the revised weights that we proposed above for the real estate junior lien positions. This would also be consistent with the rationale in all three loan categories of having a higher risk weight for a non-current loan.

While we acknowledge and appreciate many improvements in the risk weights from the original RBC proposal, including reducing the risk weighting on wholly owned CUSOs to 100%, we remain concerned with a 150% risk weighting on CUSOs that are owned by several credit unions. The CUSOs that are owned by more than one credit union are providing much needed economies of scale, helping to obtain levels of expertise that any individual credit union could not afford or obtain on their own, while helping to share/spread risk and lower costs. Assigning an unjustifiably high risk weighting to these multi-credit union owned CUSOs, which are important collaborative tools for our industry, is not reflective of the actual systemic risk CUSOs pose. Overall, based on the 2014 data, federally insured credit unions in total have only 17 basis points of their assets invested in CUSOs, and this number includes the fully consolidated CUSO investments! Clearly CUSO investment is not a systemic risk to the NCUSIF.

NCUA's 150% risk weight on CUSOs that are owned by several credit unions also applies to the accumulated and undistributed earnings of these CUSOs under GAAP, which we feel is inappropriate. By utilizing this approach, NCUA is requiring credit unions to set aside additional capital, beyond what they initially invested, to cover retained earnings to support future growth of these CUSOs. We recommend that IF NCUA doesn't reduce the CUSO risk weight to 100%, that only the initial cash investment by a credit union be risk weighted, not the appreciation in that investment over time.

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II. The Proposed Capital Adequacy Plan Imposes Systemically Significant Financial Institution Stress Testing Requirements on Well-Capitalized and Significantly Smaller Credit Unions

We are very concerned about NCUA's proposed additional provisions regarding capital adequacy. Potentially, these provisions could be among the most problematic for credit unions in RBC2 because they would grant examiners considerable latitude to determine whether a credit union needs more capital even if it is well-capitalized according to standard net worth and risk-based capital ratio requirements.

Under RBC2, complex credit unions would be required to develop a capital adequacy plan to assess the sufficiency of their capital on an ongoing basis, and set aside capital that is over and above the 7% net worth and 10% RBC requirements. The credit union's plan, assessment, and amount of additional capital set aside would all be subject to examiner review.

These requirements are not necessary for the vast majority of complex credit unions based on their management, risk profiles, and current levels of capital. If NCUA examiners have concerns regarding the credit unions they supervise, those situations should be addressed on an individual basis and not through rulemaking that would apply universal requirements to all complex credit unions, regardless of how well managed they may be. Credit unions and the NCUSIF have functioned well without these provisions and NCUA has not provided sufficient justification to support their imposition now.

In recognition of the unique characteristics of credit unions and their lower risk profile, Congress did not intend for credit unions generally to be subject to higher capital requirements than what the FCU Act directs. We reject the notion that the thresholds for a credit union to be well-capitalized as established by Congress are in any sense "minimum" capital requirements. If Congress had intended that to be the case, it would have described the classification as minimally capitalized. Well-capitalized means well-capitalized, plainly and simply. If a credit union meets the net worth and risk-based capital requirements to be well-capitalized, the sufficiency of its capital should not be an issue in terms of any rule that could require it to hold additional capital to be considered well-capitalized.

Even if NCUA had sufficient authority to establish higher capital requirements beyond thresholds that Congress authorized it to implement by regulation, a requirement for even more capital beyond what RBC2 anticipates would be overkill.

We urge NCUA to delete the capital adequacy provisions from the RBC2 proposal.

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III. A Separate Interest Rate Risk Rule Is Unnecessary Because Examiners Have Sufficient Tools to Supervise Interest Rate Risk

NCUA's revised RBC proposal contains what is essentially an implied Advance Notice of Proposed Rulemaking (ANPR) on interest rate risk (IRR)—suggesting that a separate IRR rule is needed. NCUA believes such a standard should be based on a comprehensive balance sheet measure, like net economic value, that takes into account offsetting risk effects between assets and liabilities (including benefits from derivative transactions). The stated intent of this measure would be to assess IRR consistently and transparently across all asset and liability categories, to address both rising and falling rate scenarios, and to supplement the supervisory process with a measure calibrated to address those institutions deemed by supervisory authorities to be severe outliers.

We strongly disagree with the notion that a separate IRR standard is needed to reasonably account for IRR at credit unions. Over the last several years, NCUA has issued numerous rules and letters addressing the issue of interest rate risk. For example, on September 30, 2012, the NCUA Board's final interest rate risk rule took effect. The rule imposes different requirements on federally insured credit unions depending on their asset size. Such requirements include the development and adoption of a written policy on IRR management and a program to effectively implement that policy as part of their asset-liability management responsibilities.

The guidance provided in the appendix to the IRR rule describes best practices for credit unions to consider as they write their IRR policy and construct IRR management programs. It deals with the responsibilities of boards and management, addresses IRR measurement and monitoring, internal controls, and the integration of IRR results into a credit union's decision making. The guidance also provides additional considerations if a credit union is large with complex or high-risk balance sheets. This alone should be the basis of NCUA's efforts to manage IRR concerns.

There is absolutely no need to burden the overwhelming majority of credit unions—those that are clearly not severe IRR outliers—with a new and complicated one-size-fits-all IRR approach. Instead, NCUA's focus should be squarely on the exceedingly small number of institutions that might be considered severe outliers. NCUA can easily identify severe outliers in the supervisory process—and undoubtedly has done so already. Due to the unique issues that cause each institution to be viewed as severe outliers, NCUA should concentrate resources on them separately in the supervisory process.

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To this end we suggest that NCUA—prior to releasing a proposed IRR rule—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 "severe outlier identifier model." Using mostly existing call report data, the model would serve as an identification tool that evaluates each credit union's

assets, liabilities, and all hedging positions that assist in managing risk exposures. Any credit union that "passes" using the model's identification rubric would be deemed to have only low-to-moderate IRR exposure and would not be subject to a standard comprehensive balance sheet model in the supervisory process. In these cases, each credit union's existing approach to IRR would be considered totally sufficient. As noted above, we expect the overwhelming majority of complex credit unions would not be selected by the designated model.

Importantly, a credit union that fails to pass using the tool's selection rubric would automatically be viewed as a "potential severe outlier." In these cases, the identification model would simply raise a "yellow flag" – requiring more detailed analysis and dialogue with supervisory authorities within the examination process. In essence this would be a resource allocation tool which would engage NCUA's Capital Markets/ALM specialists who would more closely evaluate each potential severe outlier.

Following this process, an even smaller net number of actual "severe outliers" would be identified. These credit unions could be subjected to varying degrees of enforcement actions until they no longer were identified as severe outliers, or otherwise demonstrated to examiners that their interest risk was appropriately measure and managed.

This approach would be consistent with that which has been adopted by the banking regulators. The banking industry's Basel requirements use a "three pillars" approach. Banking regulators address IRR in the "second pillar"—within the supervisory review process—in recognition of the fact that IRR is best addressed through policies, procedures and robust measurement systems. Banks are not subject to a standardized, quantified IRR rule—instead bank regulators essentially use the supervisory process to identify institutions of particular concern. In any case, complex credit unions should not to be subject to layers of new IRR regulation disproportionate to their exposure to this risk.

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IV. NCUA Should Permit the Use of Supplemental Capital for the Purposes of this Proposal and Should Strongly Advocate for Statutory Capital Reform that Includes Supplemental Capital for the Purposes of Prompt Corrective Action

As discussed below, NCUA has the authority to permit supplemental capital for RBC purposes, and we believe NCUA should include such a provision if a final RBC2 rule is approved. While supplemental capital cannot be included in net worth for most credit unions without a change in federal law, there is nothing in the FCU Act or GAAP that prevents NCUA from including supplemental capital in the numerator of the risk-based capital ratio for RBC, which already includes items that are not part of net worth.

We do not think NCUA needs to be overly prescriptive in permitting supplemental capital for RBC purposes. NCUA has already authorized certificates of indebtedness, which have been treated as loans from holders to their credit unions, generally with an interest rate paid to the holders. NCUA should reference the use of these instruments to meet RBC requirements for federal credit unions and, where permitted, for state chartered credit unions. Adequate disclosures should be provided by the credit union to the holder before the proceeds are accepted, but the timing or content of the disclosures need not be complicated. The disclosures should be clear and simple, to help ensure the members' interests are protected and should focus on plainly describing the nature and terms of the instruments. In addition, suitability requirements may be appropriate.

Further, we strongly encourage NCUA to aggressively pursue the enactment of legislation that would authorize the use of supplemental capital as net worth for the purposes of prompt corrective action. NCUA has long supported such legislation and we encourage the Board to actively advocate for its enactment.

V. The Treatment of Goodwill and Other Intangible Assets Needs Additional Improvement

In the original proposal, goodwill and other intangible assets (OIA) would have been excluded from the numerator of the risk-based capital ratio. In RBC2, a subset of goodwill and OIA could be retained in the numerator of the RBC ratio until 2025. That subset would be limited to goodwill and OIA that arise from "supervisory" mergers prior to one month after publication of the final rule. Supervisory mergers would be broadly defined as assisted mergers, emergency mergers, or mergers where the NCUA or state supervisory authority selected the surviving credit union.

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The retention of goodwill and OIA in the RBC numerator until 2025 is an improvement over the original proposal, but does not go nearly far enough. We believe a strong case can be made for the inclusion of all goodwill and OIA in the numerator so long as these intangible assets meet Generally Accepted Accounting Principles (GAAP) requirements, i.e., are subjected to annual goodwill impairment testing. The exclusion of non-supervisory goodwill from the numerator will discourage some well managed and well-capitalized credit unions from participating in mergers, and many mergers serve to benefit the members of both the surviving and non-surviving credit union. Similarly, mergers can also have a favorable influence on safety and soundness – producing institutions that in combination have stronger financials and are able to weather more extreme economic swings. In some cases such mergers undoubtedly serve to head off what might ultimately become a supervisory combination.

In recognition that goodwill and OIA may not be available to cover losses in the event of a liquidation, but also accounting for the fact that GAAP goodwill is very unlikely itself to cause a credit union to fail, as an alternative, the final rule might limit the retention of non-supervisory goodwill and OIA in the numerator of the RBC ratio for those credit unions that are well capitalized on the basis of the net worth ratio.

At a minimum going forward non-supervisory goodwill that meets annual impairment testing should be retained in the numerator over a ten-year phase out period. In other words, after any future merger, the amount of any resulting goodwill or OIA that could be included in the numerator of the RBC ratio would be reduced by one tenth each year for ten years.

Regardless of whether or not non-supervisory goodwill is permitted in the numerator, we believe that all previous supervisory goodwill should be grandfathered without time limit, subject to regular impairment testing. There are three reasons for this. First, those credit unions that engaged in such transactions almost certainly reduced insurance losses to the share insurance fund, and should not be penalized after the fact. Second, they did so with an understanding of current rules at that time. Many of these transactions would likely not have occurred had the proposed rules been known, i.e., no longer counting this goodwill at some point in the future would be changing the rules midstream. Considering future growth, supervisory goodwill will decline in proportion to net worth and assets going forward, and grandfathering it would protect those credit unions that in the past reduced NCUSIF resolution costs, from a cliff reduction in their RBC ratios in the future.

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VI. Implementation Should Be Delayed to 2021 to Coincide With the Termination of the Corporate Stabilization Fund.

We appreciate that NCUA has proposed a significant delay in the implementation of RBC2, but we encourage the agency to delay implementation even further—until 2021—to coincide with the termination of the corporate stabilization fund, at which time credit unions will receive refunds. The refunds will be important to those credit unions that will need to increase capital levels in order to comply with RBC2.

Thank you very much for the opportunity to comment on this important proposed rule. Although a great improvement from RBC1, we feel that this proposal still has some significant flaws and would encourage the NCUA to make substantial improvements to the proposal consistent with the above comments.

Sincerely,

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