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Mr. Gerard Poliquin
Secretary to the NCUA Board
1775 Duke Street
Alexandria, VA 22314

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

Dear Mr. Poliquin:

On behalf of Citadel Federal Credit Union, I am writing to you regarding the National Credit Union Administration's (NCUA) proposed rule governing risk-based capital (RBC). We very much appreciate the opportunity to provide our thoughts on this important regulatory proposal, to express some of our concerns about the potential negative impact of the proposed rule on credit unions if finalized in its current form, and to offer some suggested improvements in the rule for your consideration as you move forward in the rulemaking process.

Citadel was established in 1937 as the credit union for Lukens Steel. Since obtaining our new Community Charter in 2009, we have expanded our member base throughout Bucks, Chester, Delaware, Montgomery, and Philadelphia Counties. Today, we proudly serve over 130,000 households and approximately 400 partner businesses, organizations, and companies. We are one of the largest locally managed financial institutions, exceeding $2 billion in assets, in the greater Philadelphia area.

<u>Legal Authority</u>

The proposal would introduce a new scaled RBC measurement approach for assigning capital classifications for well-capitalized, adequately capitalized, and undercapitalized credit unions. Unlike the current system, which requires that a complex credit union's net worth ratio exceed its risk-based net worth (RBNW), the proposal would require complex credit unions to calculate a different ratio - the RBC ratio. The RBC ratio itself must exceed certain thresholds. Most notably, for a complex credit union to be deemed "well-capitalized," its RBC ratio must exceed 10%. To be deemed "adequately capitalized," a complex credit union's RBC must exceed 8%. As a result, under the proposal, a credit union that is otherwise "well-capitalized" based on its net worth ratio could lose that designation if its RBC ratio falls between 8% and 9.99%, in which case it would be deemed "adequately capitalized."

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We question if the NCUA has the statutory authority to prescribe a separate risk-based capital threshold for "well-capitalized" and "adequately capitalized" credit unions. NCUA Board Member J. Mark McWatters, the dissenting vote on the proposal, called NCUA's lack of legal authority the most "fundamental issue presented before the Board" and offered a lengthy and exhaustive statement to this end.

The *Federal Credit Union Act* (FCU Act) expressly provides that NCUA shall implement a risk-based net worth requirement that "take[s] account of any material risk against which the net worth ratio required for an insured credit union to be *adequately capitalized* may not provide adequate protection." 12 U.S.C. § 1790d (d). The FCU Act *does not* provide NCUA the express authority to implement a separate risk-based net worth threshold for the "well-capitalized" net worth category. Simply put, Congress has not expressly authorized the Board to adopt a two-tier risk-based net worth standard.

Costly and Unnecessary

If finalized, the proposal will impose astronomical costs on the credit union industry. NCUA estimates that this proposal will cost credit unions roughly $5.1 million to read the rulemaking and review it against their current policies. NCUA also projects that it will cost $3.75 million for the agency to adjust the Call Report, update its examination systems, and train internal staff to implement the proposed requirements. If this proposal were to be finalized, NCUA also estimates credit unions would incur an ongoing $1.1 million expense to complete the adjusted Call Report fields.

In addition, analysis completed by NAFCU estimates that credit unions' capital cushions (a practice encouraged by NCUA's own examiners) will suffer a $490 million hit if NCUA promulgates separate risk-based capital thresholds for well-capitalized and adequately capitalized credit unions (a "two-tier" approach). Specifically, in order to satisfy the proposal's "well-capitalized" thresholds, today's credit unions would need to raise an additional $760 million. On the other hand, to satisfy the proposal's "adequately capitalized" thresholds, today's credit unions would need to raise an additional $270 million.

Despite NCUA's assertion that only a limited number of credit unions will be impacted, this proposal would force credit unions to hold hundreds of millions of dollars in additional reserves to achieve the same capital cushion levels that they currently maintain. These are funds that could otherwise be used to make loans to consumers or small businesses and aid in our nation's economic recovery.

The costs associated with the rule are shocking, given how extremely well-capitalized the credit union industry is today. The proposal is an inappropriate use of credit union resources to address concerns about a few credit union outliers. Given that NCUA's budget is funded exclusively by the credit unions it regulates and insures, we are concerned by how much money this proposal will cost the industry.

"Complex" Credit Union

The proposal would change the definition of "complex credit union," for the purposes of NCUA's capital requirements. The FCU Act directs NCUA to base its definition of "complex" credit unions "on the portfolios of assets and liabilities of credit unions." Under the current rule, credit unions are "complex" and subject to the risk-based net worth requirement only if they have quarter-end total assets over $50 million *and* they have a risk based net worth requirement exceeding 6%. The proposal, however, would define the term "complex" credit union using a single asset size threshold of $100 million as a proxy for a credit union's complexity. In other words, the proposal would establish a bright-line $100 million asset threshold to determine whether a credit union is complex for the purposes of NCUA's capital requirements.

The NCUA Board believes there are a number of products and services offered by credit unions with $100 million or more in assets "that are inherently complex based on the nature of their risk and the expertise and operational demands necessary to manage and administer such activities effectively." These products and services include member business loans, participation loans, interest-only loans, indirect loans, real estate loans, non-federally guaranteed student loans, non-agency mortgage-backed securities, derivatives, internet banking, and more.

NCUA notes that "as of June 30, 2014, all credit unions with more than $100 million in assets were engaged in [complex] products and services, with 99 percent having more than one complex activity, and 87 percent having four or more. On the other hand, less than two-thirds of credit unions below $100 million in assets are involved in even a single complex activity, and only 15 percent have four or more."

The definition of "complex" should actually consider a credit union's portfolio of assets and liabilities, rather than an arbitrary asset threshold. Credit unions are distinctly different from one another with regard to the products and services they offer and their level of complexity.

Defining credit unions by an arbitrary asset size risks the danger of bifurcating the industry. The credit union industry has already been bifurcated by the *Dodd-Frank Act* at the $10 billion asset level, which is used to determine whether consumer protection examination and supervision is by NCUA or the CFPB. NCUA's efforts to further divide the industry by asset size is contrary to the best interest of credit unions and ultimately, of the National Credit Union Share Insurance Fund (NCUSIF).

Supervisory Assessment of Capital Adequacy

Proposed new § 702.101(b) will require "complex" credit unions to maintain a comprehensive written strategy appropriate for their level of capital and risk profiles. During the supervisory process, NCUA will assess whether these written plans adequately address a credit union's activities and risk profile as well as risks and other factors that can affect its financial condition. NCUA indicated that its assessment may include a review of the level and severity of problem assets and a credit union's exposure to operational risk, IRR, and significant asset concentrations. In addition to evaluating the appropriateness of a credit union's capital plan, NCUA's supervisory assessment will also take into account the quality and trends in a credit union's capital composition, whether the credit union is entering new activities or introducing new products.

NCUA omitted individual minimum capital requirements (IMCR) from this revised RBC proposal after receiving a legal opinion sought by credit union industry groups, which found NCUA lacks the statutory authority to impose such requirements.

NCUA's attempts to "back-door" an IMCR or substantially similar standard during the examination process may run the risk of violating the agency's statutory authority. While the FCU Act establishes a risk-based net worth requirement for complex credit unions, it does not grant NCUA the authority to impose IMCR. 12 U.S.C. § 1790d(d). Congress authorized specific circumstances that a credit union could be "reclassif[ied]" and subjected to more stringent capital standards, but did not legislate a provision allowing NCUA to prescribe IMCRs for particular credit unions. 12 U.S.C. § 1790d(h). Together with the lack of any express authority, these provisions of the FCU Act suggest that Congress never intended for NCUA to have the power to proscribe IMCRs, either through the rulemaking or examination process.

<u>CUSOs</u>
The proposal would set the risk-weight at 150 percent for investments in CUSOs and 100 percent for loans to a CUSO. The proposal would exclude loans and investments in CUSOs if those assets were already consolidated into the credit union's statement of financial condition under generally accepted accounting principles (GAAP).

While this proposal reduces the investment risk-weighting and accounts for the CUSOs consolidated into a credit union's books, it continues to assign different risk-weights to investments in CUSOs and loans to CUSOs. The agency explains that they are risk-weighted differently because they are treated differently in the event of liquidation or bankruptcy.

While NCUA lowered the risk-weight for investments in CUSOs, the proposed 150 percent risk weight still fails to consider the different types of services provided by a given CUSO. For example, an investment in a CUSO engaged in low-risk activities, such as providing compliance assistance, would be assigned the same risk-weight as an investment in a CUSO engaged in mortgage or commercial loan underwriting. Despite being lowered, the proposed 150 percent risk-weight could still be improved to assess a more meaningful risk distinction between the various types of CUSOs pose. Instead, CUSO investment should be weighted at 100 percent to better align it with loans to a CUSO and more accurately reflect the risk involved with investing in a CUSO.

Although there were a couple of high profile credit union losses partially driven by bad CUSO investments, the reality remains that the overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale, and providing much needed non-interest income to their credit union owners.

Less than 22 basis points of credit union assets are invested in CUSOs and don't represent a systematic risk that could take down the share insurance fund, but this proposed rule could force credit unions to reconsider investments in CUSOs now and in the future. Any exceptions to potential credit union risk should be managed through the examination and supervision process and not by a system-wide capital regime.

- The 150 percent risk-weight for investments in CUSOs is inappropriate because it doesn't reflect the actual risk of investing in CUSOs.
- CUSO investment should be weighted at 100 percent.
- Any exceptions to potential credit union risk should be managed through the examination and supervision process and not by a system-wide capital regime.

Mortgage Servicing Assets
The proposal would set the risk-weight at 250 percent for mortgage servicing assets.

In 2013, NCUA finalized a rule on loan participations that was intended to help credit unions and NCUA better manage the potential concentration risk in loan participations. The loan participation rule is working and should be allowed to continue working instead of higher risk-weights for mortgage servicing assets.

Set the risk-weights for Mortgage Servicing Assets at 150 percent. NCUA could consider whether the loan is a recourse loan and assign those a higher risk-weight. NCUA could then allow an even lower weighting of 100 percent if the loans are sold without recourse, but are still being serviced.

Allow the 2013 loan participation to work and lower the risk-weights accordingly. The 250 percent weight is punitive and indicates NCUA's preference for less loan participations.

- Giving mortgage loan servicing assets a 250 percent risk-weighting is artificially high and excessive.
- Set the risk-weights for Mortgage Servicing Assets at 150 percent.
- Incorporate recourse into the equation when determining the risk-weight and allow a lower weight of 100 percent if the loans are sold without recourse but are still serviced.

Supplemental Capital
The proposed rule does not provide any changes that would allow credit unions the authority to raise supplemental capital.

Currently, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with otherwise healthy growth, such as asset growth resulting from taking in deposits, this can dilute a credit union's regulatory capital ratio and trigger non-discretionary supervisory actions under prompt corrective action (PCA) rules. Allowing eligible credit unions access to supplemental capital, in addition to retained earning sources, will help ensure healthy credit unions can achieve manageable asset growth and continue to serve their member-owners efficiently.

Supplemental capital authority is needed now more than ever considering the restrictions brought on by this proposal. NCUA should call on Congress to pass a legislation solution that modernizes capital standards to allow supplemental capital and directs the NCUA Board to design a risk-based capital regime for credit unions, which would take into account material risks instead of the current proposed rule.

While supplemental capital authority is important for those credit unions that are able to raise it, it is important to understand that supplemental capital authority is not the answer to all of our woes. There is a difference between the authority to raise supplemental capital and the ability of individual credit unions to actually do so. Not every credit union would be able to use that important tool to actually raise significant capital, even if they were given the authority to do so.

- Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule.
- Supplemental capital authority is not the answer to the entire industry's worries about capital, but it is a powerful tool that should be given to all credit unions.
- NCUA should call on Congress to pass a legislation solution that modernizes capital standards to allow supplemental capital and directs the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks instead of the current proposed rule.

<u>Goodwill</u>
The proposed rule would subtract a number of components from the numerator portion of the RBC ratio. These subtractions include goodwill, the NCUSIF deposit, other intangible assets, and identified losses not reflected as adjustments to components of the risk-based numerator. In the case of a supervisory merger or consolidation that occurs before the publication of the final rule, the proposal would allow credit unions to include goodwill in their RBC numerator until December 31, 2024.

Deducting goodwill from the RBC numerator presents two significant issues. First, it penalizes credit unions who have recently gone through a merger. Second, it could disincentive merger activity, which could prevent healthy industry consolidation and the combining of unhealthy credit unions with stronger ones in the future.

The credit union industry has seen significant consolidation in the past few years and this is a trend that is likely to continue. Without goodwill available to help balance out the equation going forward, a healthy credit union is less likely to agree to take on a troubled credit union as a partner (even at the request of NCUA). This is going to make it harder and more expensive for NCUA (and the industry as a whole) to find merger partners for troubled or failing credit unions, which will ultimately lead to more expensive liquidations for the NCUSIF.

- Removing Goodwill will negatively affect credit unions that have had recent mergers by failing to allow them to fully realize the previously accounted for benefit.
- Removing Goodwill will present a disincentive for healthy credit unions to become merger partners for troubling or failing credit unions because of the possible significant negative effect to their risk-based net-worth ratio.
- Goodwill should be added back into the numerator for the risk-based capital ratio.

Interest Rate Risk

Even though this proposal looks better on paper than the original 2014 proposal, almost all of the substantive changes to the risk-weights were made to investments after NCUA removed interest rate risk (IRR). The agency has indicated that it is currently considering an alternative approach to taking account of IRR. With the second risk-based capital proposal, NCUA is specifically requesting advance comments on alternative approaches to IRR. 11

To better control for interest rate risk, NCUA should continue to apply industry-accepted methods as part of a competent supervision and examination process. NCUA already has a number of requirements and guidance regarding interest rate risk that credit unions must comply with, such as the interest-rate risk final rule, a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (14-CU-01).

Banking regulators account for IRR through their annual examination process by ensuring that banks maintain sufficient capital for interest rate risk. NCUA's existing supervisory and examination mechanisms provide it the same authority to ensure that credit unions have enough capital to absorb the level of IRR on their balance sheets. If NCUA were to promulgate a rulemaking on IRR, the agency would hold credit unions to significantly different standards compared to banks. Simply put, NCUA's existing supervisory and examination mechanisms provide the agency the appropriate ability to control IRR at individual credit unions.

Thank you very much for the opportunity to comment on this proposed regulation. The issues we have highlighted above will have significant impact on the credit union industry and our ability to serve our members. We respectfully urge NCUA to address some of the recommended improvements to the proposal contained herein.

If I can be a source of any further information on this comment letter, please do not hesitate to contact me at mariasteffy@citadelbanking.com or by phone at (610) 380-6006.

Sincerely,

Maria F. Steffy

Maria F. Steffy
Chief Financial Officer