March 13, 2015

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

Re: Comment to the Second Proposed Prompt Corrective Action – Risk-Based Capital (RBC) Regulation

Dear Mr. Poliquin:

The National Association of Credit Union Service Organizations ("NACUSO") is a trade association of credit union service organizations and credit unions. The mission of NACUSO is to strengthen credit unions through collaboration. On behalf of NACUSO, we would like to provide the following official comment letter regarding the NCUA's recently proposed risk-based capital rule.

While we acknowledge some improvements in the risk weights from the original RBC proposal, we remain concerned with the overall regulatory approach taken by NCUA on RBC – including this second proposal. Based on the voluminous comments to the first proposal, it appears that this process in general has been somewhat arbitrary and, in our view, not based in fact. We understand that NCUA, as administrator of the National Credit Union Share Insurance Fund ("NCUSIF"), would desire credit unions to retain as much capital as possible. NACUSO likewise recognizes the need for credit union capital sufficient to offset institutional risk; however, in our view it is just as important to the long-term viability of the NCUSIF for credit unions to be as successful as possible in generating income through growth. In order to grow, credit unions need to free up capital and put it to strategic use. NCUA seems to have ignored the latter point in its approach to RBC. The regulatory process appears to have taken the form of a negotiation where NCUA's first bid was purposefully high with the expectation that through the rulemaking and official comment process the actual numbers would be where NCUA really wants them in a final regulation. This is not a reasonable approach to regulation in general, and certainly not regulation as far reaching as risk based capital.

Built into this perplexing regulatory approach is the lack of any substantive presentation of industry study and quantitative analysis used to support this proposal. As stated in this second proposal, many comments on the first proposal pointed out the commenters' belief that the assigned risk weights of certain assets were arbitrary. Yet, despite these comments, NCUA continues to avoid presenting actual quantitative justifications through empirical data and instead is simply negotiating the numerical risk weights upwards or downwards in hopes of hitting some 'happy median' without clear industry performance data as justification. NCUA's primary resource

for justification seems to be comparison with, and an attempt to mimic as much as possible, the capital rules of the Federal Deposit Insurance Commission ("FDIC").

In our view, this FDIC-based justification for the RBC rule over emphasizes the need for the regulation to be comparable to the other banking agency regulations. Comparability is commendable where there are true comparability of institutions; however, we feel NCUA is missing an opportunity to take a unique approach to the risk based capital regulation of member owned credit unions and to emphasize that credit unions may be financial institutions but they are not banks. In fact, the fundamental structure – both in law and in reality – of credit unions as not-for-profit financial cooperatives is not comparable with the for profit banking system. Member owned credit unions generally have a different risk model than the profit oriented banks, so if anything credit unions should have lower risk based capital requirements than banks.

Credit unions provide an alternative to banks within the financial services industry and this should never be lost or fail to be recognized in the regulation of credit unions. Further research and quantitative analysis of the risks unique to the credit union industry would be required before this structural differential could be incorporated into the final RBC rule. It does not appear from the narrative accompanying this second RBC proposal that such research and analysis has been done or, if it has, that it is to be presented in a transparent manner sufficient to justify the structure of this regulation in its current form.

While we will address several areas of concern with the proposal, we believe that a primary example of this regulatory approach is the counter-productive risk weight assigned to unconsolidated investments in credit union service organizations ("CUSOs"). As we have stated in the past, CUSOs have been used effectively by credit unions for decades to reduce costs and generate income. Yet, NCUA continues to present anecdotal and unsubstantiated references to what it considers "substantial CUSO losses" over the last decade as justification for over burdensome CUSO regulations and now an overzealous risk weight to CUSO investments. No detailed statistics have been provided to justify these losses as substantial, and NACUSO would challenge any such claim as we are not able to substantiate any losses of a significant nature through credit union investment in CUSOs over the past ten years and in fact find that such CUSO investment losses have been largely immaterial. We implore NCUA to investigate the industry benefits of CUSOs and the relatively immaterial level of CUSO investment impact on the NCUSIF before it finalizes the current proposed risk weights for CUSO investments into a final RBC rule.

Even the FDIC Vice Chairman Thomas M. Hoenig believes that risk weights should be prospective and should not be used to either actively or inadvertently discourage investment in any type of asset. By looking back at anecdotal loss information, NCUA is not properly assessing risk to the NCUSIF. As Mr. Hoenig stated at the International Association of Deposit Insurers 2013 Research Conference:

> Despite all of the advancements made over the years in risk measurement and modeling, it is impossible to predict the future or to reliably anticipate how and to what degree risks will change. Capital standards should serve to cushion against the unexpected, not to divine eventualities. All of the Basel capital accords, including the proposed Basel III, look backward and then attempt to assign risk weights into the future. It doesn't work.[1]

[1] See https://www.fdic.gov/news/news/speeches/spapr0913.html for transcript of entire speech.

This approach seeks to reward the insurance fund at the expense of the economic activity the industry needs to survive *and* support the country's economy. NCUA has a moral responsibility to ensure that the risk weights assigned to certain assets do not have a detrimental effect on the communities supported by credit unions. Mr. Hoenig is right that retrospective risk weight schemes "may have inadvertently created a system that discourages the very loan growth we seek, and instead turned our financial system into one that rewards itself more than it supports economic activity."[2]

Comments on the CUSO Investment Risk Rating in General

Our first comment is centered on what we feel is the arbitrary 150% risk weight assigned to unconsolidated CUSO investments. On the one hand, NCUA justifies the risk assessment by noting its lack of enforcement authority over third party vendors and, on the other hand, cites the historic losses to the NCUSIF supposedly related to CUSOs. It would seem the agency cannot have it both ways. Either NCUA has the authority to gather sufficient data about CUSOs through the credit unions it regulates and insures or it does not. If it lacks the ability to gather such data, it would seem disingenuous to quote the amount of supposed substantial losses from CUSOs. If it has such data available, it would certainly bring into question the need for recent regulation to directly regulate and de facto examine CUSOs in order to gain such information.

We have repeatedly asked for evidence of "significant" CUSO losses to the NCUSIF to no avail. NCUA broadly references some losses in its recently approved CUSO rule, all of which were related to lending risk where the credit union losses had nothing to do with CUSO investments and more to do with costly decisions on lending risks. This is operational risk, not investment risk.

We also fail to see why third party vendor authority is relevant to risk based capital regulations. If NCUA is concerned about its lack of third party vendor enforcement authority as part of the justification for the risk weights assigned to CUSO investments, we can only presume that the risk weight is partially – if not totally - based on operational risk. As NCUA notes, CUSOs are in their view similar to third party vendors. However, we cannot find any references in the proposal that would account for the alleged risk posed by non-CUSO third party vendors. Only CUSOs are singled out for their supposed risk. Surely, this is not justification for the risk weight assigned to a CUSO investment.

NCUA goes on to cite FDIC in saying that risk weights should be set based on the risk of loss and not the size of exposure. Yet, even the FDIC agrees that non-significant investment exposures in unconsolidated equity of a privately held company should be risk weighted at 100%. Non-significant is defined as equity exposures that in the aggregate are 10% or less of a bank's capital. As NCUA claims, the FDIC approach does become complex for equity exposures that are "significant." While it is incredibly patronizing to presume that credit unions are not sophisticated enough to handle this complexity, we think it important to look deeper into the FDIC definition of "non-significant" and how this definition translates to unconsolidated CUSO investments. If 'comparability' is to be cited as a justification for the RBC rule in general, 'comparability' should also be considered when looking at the risk weights for non-significant investments.

Federal credit unions and most state chartered credit unions are limited by statute or regulation to a maximum aggregate investment in CUSOs. For federally chartered credit unions, this aggregate

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[2] Ibid.

limitation is 1% of shares minus any regular or special reserves, or essentially assets. In terms of net worth, a well capitalized credit union, (if its CUSO investments were maxed out at 1% of assets) would have aggregate exposures to all CUSO investments in the amount of less than 15% of its total net worth. Based on the 2014 call report data, 97.7% of all federally insured credit unions were well capitalized, over two thirds of all federally insured credit unions had a net worth ratio of 10% or greater, and the weighted average net worth for all federally insured credit unions was over 10%.

These numbers show that the statutory and regulatory structure of CUSO investments make such investments "non-significant" using the FDIC definition, and thereby subject to only a 100% risk weighting.

Furthermore, built into this analysis is the assumption that credit unions will invest the full aggregate CUSO investment cap in unconsolidated CUSO investments. The data also shows that this is not the case. Based on the 2014 call report data, federally insured credit unions in total have only 17 basis points of their assets invested in CUSOs and this number includes fully consolidated CUSO investments. Therefore, the data shows that only in the rarest of cases will a credit union's unconsolidated CUSO exposures exceed 10% of their net worth. According to the FDIC, this is the definition of non-significant investment and we agree.

Instead, NCUA set an arbitrary risk weight of 150% as if this is a gift reduction from the originally proposed 250% risk weight. The only justification for higher than a 100% risk weight would be to capture the outliers in the data referenced above. We believe that arbitrary regulation focused on the outliers of the industry is unreasonable and certainly not in the spirit of reducing regulatory burdens on credit unions. The outliers can be addressed through the supervisory examination process. It is not necessary to punish all CUSO investments through a regulatory risk weight that is not justifiably applied to all. We believe a risk weighting of 100% for unconsolidated CUSO investments is appropriate to the industry, the level of risk to the NCUSIF, and comparable to the FDIC rule.

Collaboration and Appreciation of CUSO Investment Exposure

In the proposal, NCUA will use GAAP standards to determine the reporting basis upon which a CUSO investment will be risk weighted. We agree that this approach will correctly allow consolidated CUSO investments to be incorporated into the overall risk-based capital treatment of the credit union's financial statements. However, using GAAP standards to determine the reporting basis of unconsolidated CUSO investments will create disincentives for both making good appreciable investments and collaborating with other credit unions.

By using GAAP to determine the investment exposure NCUA would penalize the success of a CUSO by requiring that the credit union reach into its pocket and set aside additional capital on the undistributed appreciation of a CUSO investment. This would make good investments costly for credit unions, in terms of capital they must allocate to these profitable growing CUSO investments. Further, this accounting treatment would only affect unconsolidated CUSO investments where credit unions are collaborating to bring efficiencies of scale and innovation to the industry. We strongly believe credit unions should only account for their cash investment in a CUSO and not the appreciation of that investment over time. This approach will incentivize good investment behavior and promote collaboration as a valuable tool for the credit union industry.

We respectfully request that NCUA remove any risk weighting above 100% for CUSO investments and set the reported basis for such investments at the total cash investment. 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.

Capital Restoration Plan Remedy

NACUSO believes, as we are certain the Congress that enacted it as a part of the Credit Union Membership Access Act in 1998 still does, that there is value in the statutory net worth level to be well-capitalized as it was established by law at 7% reserves to total assets. This statutory definition of the amount of net worth required to be considered well-capitalized should be incorporated into the RBC final rule and recognized as more than an outdated one-size-fits-all number that is in need of being replaced by a more sophisticated RBC number. Both must have weight in any RBC rule that is consistent with the statutory net worth requirements.

Therefore, we would recommend that any credit union with over 7% net worth as a percentage of total assets but fails to exceed its required risk-based capital level under this proposed regulation be given consideration in any proposed corrective action required under the risk-based capital regulation. We strongly encourage NCUA to limit the remedy in such cases to a capital restoration plan that allows the credit union a reasonable and appropriate period of time to improve its risk-based capital ratio – even as they maintain their statutory net worth ratio above 7%.

In our view, the draconian measures that can be used by law and regulation in a prompt corrective action are not appropriate when the statutory minimum of 7% net worth is met, even if the risk-based capital ratio should fall below 10%. Any corrective action removing volunteers, dismissing management officials and severely restricting business options is an unwarranted overreach for a credit union with over 7% net worth. The 7% net worth level is a well-established and conservative statutory requirement that has been in place and managed to comply with by credit unions for over fifteen years. Its value, both in statute and in historical credit union strategic management plans, should not be diminished.

Supplemental Capital

The introduction of a risk based capital system requires more options for all credit unions to raise supplemental capital. We encourage NCUA to accelerate the efforts to implement supplemental capital options for all credit unions, in conjunction with the Risk Based Capital Rule implementation, providing an important tool for those credit unions that will no longer be well capitalized as a result of this rule and for others that need strategic options to assist them in managing to the new risk based capital standards. As some commentators have suggested, we believe NCUA has the power to authorize supplemental capital for risk-based capital purposes.

We encourage the agency to include supplemental capital authorization and guidance in the final RBC rule or, in the contrary, to propose a supplemental capital rule that can become final and effective in advance of the date the RBC rules is scheduled to become effective.

Conclusion

The one-size-fits-all nature of the proposed risk ratings is admittedly easier to apply for NCUA than would be a system with credits for historical risk management performance and risk weights that

are documented by empirical data on a large scale basis; however, we feel that such historical risk performance data is essential if the RBC rule is to be considered justifiable and necessary by the credit unions subject to it. In our view, the proposed rule does not reflect a fair assessment of the actual risks of assets held by an individual credit union and should be tabled until data can be analyzed and the resultant analysis provided in a transparent manner to justify the RBC rule and to have it recognized as necessary.

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 an unreasonable and arbitrary regulatory scheme with a regulator more focused on protecting the NCUSIF than the industry it insures. This seems short sighted. The best way to protect the NCUSIF is to protect the safety, soundness and marketplace viability of the credit union it insures.

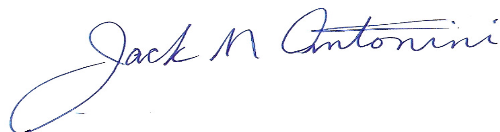
Just as the credit union business model is changing to meet today's economic challenges, so must the approach of their regulator. Growth and the strategic use of capital are what will help this industry grow and, in turn, further protect the NCUSIF. The maintenance of sufficient capital to offset losses is certainly part of the risk management decisions credit union leaders make every day. However, as NCUA's own numbers clearly indicate, credit unions are doing an excellent job of maintaining capital in that nearly all credit unions' net worth ratio is over 7% and over two-thirds of credit unions have a net worth ratio of 10% or more.

If NCUA cannot justify with empirical risk data the necessity of this regulation, it will likely create a big problem for the industry. If credit unions are required to reserve an unjustifiably excessive amount of capital to meet the RBC requirements, the amount of strategic capital needed to invest in member services, net income opportunities and the growth of credit unions will be minimized. Credit unions will suffer in the marketplace without the ability to strategically invest needed capital to remain competitive, while safe and sound long term.

As an organization designed to foster collaborative innovation, risk sharing alternatives through cooperation and return on investment from the CUSO model, NACUSO feels that it is imperative for NCUA to get RBC right and to justify its final rule – or to delay final action until the case for necessity can be effectively made.

Thank you for the opportunity to comment.

Very truly yours,



Jack M. Antonini
President and CEO

cc: Deborah Matz, Chairman
Mark McWatters, Board Member
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