Open Board Meeting Jan. 15, 2015

NCUA Chairman Debbie Matz
Statement on Newly Proposed Risk-based Capital Rule

First, my deep gratitude to the multitude of staff that has spent the past year poring over comment letters and rewriting this proposed rule. I also want to thank the 2,056 commenters who took the time to read the first proposed rule and send a comment letter. These letters were invaluable to us in reevaluating the first proposal and developing an alternative rule. I think you will agree that we carefully read each letter and have responded to each comment. The vast majority of the changes we made were directly attributable to the comments we received.

Why We Need This Rule

As I have articulated over the course of the past year, I believe there is a compelling need for this rule in addition to our legal obligation for it. Throughout the past year, credit union officials often asked me: "Since credit unions did not cause the financial crisis, why do we need a new rule on risk-based capital?" The short answer is: This rule is required by law.

The Federal Credit Union Act requires NCUA to update risk-based capital standards to be "comparable" with the federal banking agencies. The FDIC, OCC and the Federal Reserve issued new risk-based capital rules in 2013—so we have already fallen more than a year behind.

In addition, both the Government Accountability Office and our Inspector General found that the existing NCUA rule on risk-based net worth failed to prevent credit union losses as a result of the financial crisis. The GAO concluded that NCUA should propose "additional triggers for PCA that would require early and forceful regulatory action…"

The Inspector General noted NCUA needs a PCA framework that will identify increasing risks on a timely basis, well before losses occur. However, even if we were not compelled to do so by law, by the GAO, or by the Inspector General, requiring complex credit unions to hold sufficient capital to offset their risk is good public policy.

Ensuring Capital Adequacy

Simply put: Addressing the problem of capital inadequacy of high-risk outliers protects the entire credit union system. Let's not forget, while credit unions did not cause the financial crisis—they were deeply affected by it.

During the crisis, NCUA had to extend $26 billion in liquidity to prevent the credit union system from collapsing. Without an infusion of $20 billion from NCUA's Central Liquidity Facility and an additional $6 billion from NCUA's line of credit at the U.S. Treasury, the credit union system—as we know it—would probably not have survived. As we know, natural-person credit union losses resulting from the crisis reached three-quarters of a billion dollars—losses that had to be paid by all surviving credit unions.

Many people may assume that natural-person credit unions failed during the crisis because they held less than 7 percent capital. While that may seem like a logical conclusion, it is not correct. To learn more about failed credit unions, and so as not to skew the results based only on crisis failures, I asked the staff to review the failures of natural-person credit unions from before the crisis, through the crisis, to after the crisis.

What they found was eye-opening.

In the last 10 years, 192 credit unions failed. Yet 24 months before they failed, their average net worth ratio was over 12 percent. Officials in those credit unions likely believed they had more than enough capital to offset their risks. But clearly, holding net worth more than 500 basis points above the statutory 7 percent still wasn't enough.

Today, credit unions hold average net worth of 10.9 percent. For those who believe today's credit union system has too much capital because the average net worth ratio is 390 basis points over the statutory 7 percent, they're potentially in for a rude awakening.

Now don't get me wrong: I'm not saying each credit union needs to have net worth ratio over 12 percent. I am saying each credit union needs to have enough capital to offset its own risks.

A well designed risk-based capital rule would do exactly that. It should also be flexible and forward-looking so credit unions can choose to concentrate in high-risk assets; that's fine—but, their risk-based capital requirements should match those risks in order to prevent losses. Had the risk-based capital rule been in place before the crisis, it would have reduced losses to the Share Insurance Fund which surviving credit unions all had to pay.

As we consider this proposed rule, it is important to note that this rule would require 27 complex credit unions with high-risk portfolios to bolster their capital base. In the future, as more credit unions attain complex status, this rule will prevent even more costly failures—and save surviving credit unions from paying for their losses.

Seeking Comments on Supplemental Capital

As I mentioned, the agency has adopted many of the changes proposed in the comment letters. One issue we did not change was supplemental capital; and we are specifically inviting comments on changes we could make in the future.

As many stakeholders know, I have long supported legislation to authorize healthy credit unions to raise supplemental capital for the purposes of strengthening net worth. However, such authority raises complicated issues that would need to be addressed through changes to other NCUA rules—including consumer protections and amending Share Insurance Fund payout priorities.

To gain insight and the benefit of stakeholder experience, the preamble to the proposed risk-based capital poses six questions about supplemental capital for commenters to consider. I encourage commenters to offer suggestions about how NCUA could address those issues in subsequent rules.

Confirming NCUA's Legal Authority

Another issue that was raised during the comment period for the previous proposed rule on risk-based capital was NCUA's legal authority to promulgate this rule. Several commenters claimed that unlike the banking agencies, NCUA only has authority to design a single risk-based requirement to be adequately capitalized—without a higher tier to be well-capitalized.

Because this issue is so fundamental to the risk-based capital framework, I concluded that the agency should not move forward with a rule until we received an independent legal opinion from an outside counsel analyzing our authority.

This past summer, I solicited 11 law firms around the country that specialize in financial services statutes and regulations. I solicited the independent legal opinion in order to perform my own due diligence. I ultimately chose the Global Banking and Payment Systems practice of Paul Hastings, based in Washington, DC.

Paul Hastings' partners have years of experience on legal issues related to PCA, from the perspectives of financial institutions as well as from the perspective of a federal agency. In preparing the scope of work, I made it clear that I wanted their unbiased legal opinion on the issue, and that NCUA would not influence or pre-determine the legal opinion in any way. If the opinion found that NCUA did not have legal authority to propose different risk-based thresholds to be well-capitalized and adequately capitalized, then we would have redrafted the proposed rule accordingly.

The firm researched every legal issue in the proposed rule for several months, during which outside counsel reviewed all 2,056 comment letters, plus any additional letters we received that questioned NCUA's legal authority. In October, a team from Paul Hastings presented an oral legal opinion to the NCUA Board. The oral legal opinion maintained that while certain parts of the Federal Credit Union Act are arguably ambiguous, it did support our proceeding with a two-tier risk-based capital framework comparable to the banking agencies—with one threshold to be adequately capitalized and a second threshold to be well-capitalized.

During the oral briefing and in the weeks that followed, my Board colleagues and I had opportunities to ask the outside counsel any questions we had about NCUA's legal authority. While some lawyers may present conflicting opinions about NCUA's legal authority, the fact that there are different statutory interpretations clearly demonstrates that reasonable minds may differ on this issue. Even if the law is determined to be ambiguous, deference is given to the agency—unless the regulation is "arbitrary, capricious, or manifestly contrary to the statute."

In our case, the proposed thresholds of 8 percent to be adequately capitalized and 10 percent to be well-capitalized are certainly not "arbitrary, capricious, or manifestly contrary to the statute." In fact, we've clearly established that these thresholds are comparable to the banking agencies as required by the statute. I am very confident that we are moving forward on solid legal ground with this proposed rule.

The cost of Paul Hastings' legal work included $100,000 for the oral opinion and multiple consultations with Board members, plus $50,000 for a written opinion.[1] I should note that this is not a new budget request; it was paid in 2014 from our Office of General Counsel's line item for Contracted Legal Services.

My intent was to release the written opinion at the meeting. This week, however, the Board received a letter from the law firm refusing to reverse their policy on the confidentiality of written legal opinions. We have asked the firm to reconsider, and we hope to be in a position to release the written opinion in the near future.

[1] The Board received an oral opinion from the Paul Hastings law firm, which provided support for our decision to proceed with the two-tiered approach. Subsequent to the oral opinion, the firm provided a privileged, substantive written opinion. My statement during the open meeting on January 15, 2015 clearly and deliberately referred to the oral opinion. Regretfully, Board Member McWatters quoted directly from the firm's written opinion during the open meeting and, in so doing, violated the firm's policy regarding the confidentiality of that opinion.

Providing a Reasonable Board Timeline

Finally, I once again want to thank the NCUA staff for their incredibly hard work to improve this rule over the past year—and for providing a reasonable timeline for the Board to make informed decisions.

Just to provide a sense of what occurred behind the scenes: Staff logged every issue raised by 2,056 comment letters and prepared extensive summaries for the Board. After the comment period, staff kept track of ideas raised at my Listening Sessions around the country.

By November, staff presented each Board member with 22 white papers on every major issue raised by commenters. Each white paper described detailed pros and cons of various options to address commenters' concerns. Each Board member was invited to ask questions and make recommendations on which options to pursue and why. Staff provided draft after draft and as many briefings as each Board member requested.

Then in December while most people were enjoying the holiday spirit, the staff was drafting the preamble, responding to Board member concerns, and achieving a target of getting the complete preamble and rule text to the Board before the end of the year.

In the Interest of Transparency

There will be a 90-day comment period which will begin when the proposed rule is published in the Federal Register.

I think we have demonstrated that we consider every comment very carefully. I urge stakeholders to once again provide us with your insights.

To be as transparent as possible and to assist with understanding this complex rule, we have prepared a number of summary documents which will be on our website.

These summary documents include:

- Comparison charts highlighting key provisions of the current proposal versus the January 2014 proposal
- Risk weight comparisons to FDIC's final rule
- Answers to frequently asked questions.

In addition, on Wednesday, January 21, at 2 p.m. Eastern, staff will be holding a webinar to explain the rule and answer questions.

And because we are concerned that credit unions will need time to adjust to the new rule once it is finalized, we are planning an implementation period of more than three years. Again, this was in response to comments requesting ample time for credit unions to review their business plans and develop new policies consistent with rule.

In closing, I am confident this rule fulfills our statutory responsibility while exempting most credit unions, targeting only high-risk outliers, and most importantly, protecting the credit union system into the future.