Open Board Meeting October 15, 2015

NCUA Vice Chairman Rick Metsger
Statement on the Final Risk-Based Capital Rule

Today, I'd like to respond to some of the most frequent questions we've been asked about this rule, the first of which is:

Are We Acting Too Hastily?

Some have argued that this action is too hasty and that we should, "stop and study" before issuing a final RBC rule—preferably waiting at least until Halley's Comet returns in 2061.

The reality is that our action isn't precipitous. If anything it is too late, not too early. We have "stopped and studied" so many times I'm beginning to get whiplash.

Let's look at the history:

- Federal banking regulatory agencies started implementing risk-based capital rules more than a decade ago.
- International banking regulators are now implementing Basel III, the third version of their risk-based capital rules.
- In 1998, the Congress passed, and the President signed into law, the Credit Union Membership Access Act.

That act established a system of prompt corrective action whose purpose is to resolve the problems of insured credit unions at the least possible long-term cost to the Share Insurance Fund.

The credit union PCA system also has to be comparable to the system established by the FDIC and other banking agencies for commercial banks, and it must take into account the cooperative character of credit unions. The committee report on the law defines "comparable" as, "…parallel in substance (though not necessarily identical in detail) and equivalent in rigor."

To achieve these goals, CUMAA established a leverage requirement for all federally insured credit unions, and directed the NCUA Board to create a risk-based requirement for complex credit unions. That risk-based requirement has to be designed to take into account any—repeat any—material risks against which the net worth ratio required to be adequately capitalized may not provide adequate protection.

A complex credit union cannot be considered well-capitalized unless it meets both the leverage ratio and all requirements of the risk-based requirement.

NCUA staff began work on an updated RBC rule in 2011, before I came to the Board. When we learned that the other federal banking regulators were completing action on their revised rules, we stopped so that we could study and build upon their work.

After the other federal banking regulatory agencies issued their new rules in 2013, we completed our study of them and resumed work on our own rule.

In January 2014, we issued our first proposed rule, then we stopped and waited for comments. The comment period extended a virtually unprecedented 125 days so that all stakeholders would have ample time to study and comment on our proposed rule.

After the comment period, we stopped and studied those comments for almost eight full months, and we held a series of listening sessions across the nation attended by hundreds of stakeholders. We stopped and studied the suggestions that were made at the listening sessions as well as at other meetings we each held with interested parties and then we issued a second proposed rule in January incorporating many of the changes recommended during this nearly year-long first stop and study period.

After issuing that proposed rule, we stopped again and then spent about a half a year analyzing and studying the new comments we received, most of which were form letters saying, “We don’t like the rule” or “We don’t think you have the authority to issue the rule.” We took the substantive comments very seriously and made additional changes that are reflected in the final rule we are considering today. In the preamble to today’s final rule, we have also responded to all of the comments we received—even the form letters.

I’ve lost track of how many times we have stopped and studied during this five-year period. Either those in the industry who continue to ask us to “stop and study” haven’t read our preambles and rules, or they really want us to “stop and bury” not “stop and study.”

Hasn’t NCUA Already Adopted a Risk-Based Capital Rule? If It Ain’t Broke, Why Fix It?

Yes, in 2000 the NCUA board issued a fatally flawed risk-based requirement that it amended in 2002. However, it broken and needs to be fixed.

Among the requirement’s many flaws, it:

- Isn’t comparable to the system for banks;

- Fails to take into account all material risks;
- Is poorly understood. In fact, I defy anyone in the audience to explain it in a way that is comprehensible to someone who isn't familiar with it; and
- Failed to identify credit unions which were undercapitalized and which subsequently became insolvent causing material losses to the Share Insurance Fund that all credit unions eventually paid for.

But Didn't Natural Person Credit Unions Perform Well during the Great Recession? Why Do We Need This?

Natural person credit unions did perform better than banks during the Great Recession, but that is damning with faint praise, and it overlooks two key points:

- First, 27 natural person credit unions with assets over $50 million did fail at a cost to the fund of more than $728 million—costs all remaining credit unions had to pay.
- Second, five corporate credit unions failed. If NCUA had not provided more than $20 billion in liquidity assistance and more than $100 billion in guarantees, and if the Treasury had not lent an additional $5 billion, natural person credit unions would have lost more than $30 billion in uninsured funds. Our staff estimates that as many as 2,500 natural person credit unions would have failed.

But Would This Rule Really Have Made a Difference?

NCUA staff back-tested this rule on the complex credit unions that failed during the Great Recession. Eighty-nine percent of them would have been required to hold more capital if this rule had been in place then, which would have reduced losses to the Share Insurance Fund.

Has the Process Been Fair?

We have bent over backwards to be fair: The first version of this rule was released in January 2014—almost two years ago. As previously noted, the original comment period extended a nearly unprecedented 125 days in order to give all parties ample time to submit comments.

As the Board studied the comments on the first proposed rule, it also held three "Listening Sessions" conducted by the Chairman across the country to receive additional input, and individual Board members each held dozens of additional meetings with stakeholders.

Over the next six months, we stopped and studied the comments on the first proposed rule and the suggestions made at our listening sessions. Staff made revisions to accommodate them, and because the changes were significant, six months later, we issued a second, revised proposed rule in January of this year, again for an extended comment period. We have received more formal comments on RBC than on any other rule the agency has considered. Hundreds of changes have been made as a result of those comments.

With apologies to Winston Churchill, "Never have so many commented on a rule which impacted so few."

Won't This Rule Impose a Terrible Burden on Credit Unions?

No, the rule targets outliers, the relatively small handful of institutions that are gambling with other people's money, and it discourages other credit unions from becoming outliers by requiring them to hold capital commensurate with the risk on their balance sheets.

Unlike the FDIC's RBC rule, which applies to all banks, no matter how small, our rule applies only to credit unions with more than $100 million in assets. Seventy-six percent of all credit unions are exempt from this rule. Zero banks are exempt from their rule. I might point out there are 1,872 banks with less than $100 million in assets that are covered by the banking regulators' RBC rules.

I would note that last month a number of people suggested that we should follow the FDIC's rule and define "small" the same way the FDIC does. "Small is small" they told us. If we followed that principle today there would be no exemption from our RBC rule for credit unions with less than $100 million in assets.

The FDIC and other banking regulators have decided that no institution is too small to be exempt from the RBC process. Instead, this month, like last month, we are taking the cooperative nature of credit unions into account and defining small in the context of the credit union community.

Of the 1,489 complex credit unions that are subject to the rule, only 16—just about 1 percent—will have their PCA category reduced, and not more than one will have its PCA category reduced to undercapitalized.

This is about targeting outliers and preventing small problems from becoming big ones. Remember that the goal of RBC is to resolve problems at the least-possible cost to the Share Insurance Fund.

I'm also surprised that some credit unions don't want to highlight one of their principal competitive advantages over banks. Credit union's relatively high capital levels have insulated them from the massive losses that banks and other financial intermediaries suffered that cost Americans tens of billions of dollars. Why would credit unions want to lose their competitive advantage and instead lobby to adopt the lowest common denominator approach to capital? Credit unions should be champions of capital, not detractors.

But What about the Buffer?

Neither the law nor regulation require credit unions to hold a buffer. Credit unions aren't even required to be well-capitalized; they are only required to be adequately capitalized.

The average RBC ratio under this rule of complex credit unions is 19.2 percent, more than 1,100 basis points above adequately capitalized. That means that the average capital level is already nearly twice what is required to be in the highest capital category.

The real questions credit union members might be asking are:

- Why are credit union capital buffers so large; and
- Why aren't credit unions doing a better job of leveraging their members' capital?

But Why a Two-Tier System? You Don't Have the Authority to Have a Two-Tier System.

This is probably the least understood and most misinterpreted section of the Credit Union Membership Access Act. People who are opposed to a meaningful risk-based capital requirement have asserted again and again that the law does not permit a two-tier system. They think that if they repeat this assertion over and over until they are blue in the face it will be true. They are entitled to their opinion. They are not, however, entitled to their own facts.

Opponents of a meaningful RBC ignore the plain language purpose of the law which under, section 216(a)(1) "is to resolve the problems of insured credit unions at the least possible long-term loss to the Fund." Note in particular the use of the words, "least possible." A two-tier system clearly helps to meet that goal.

Second, opponents of a meaningful RBC rule also ignore the requirement in section 216(b)(1)(A)(i) that the system is, "consistent with this section…." That section defines five net worth categories including well-capitalized and requires a credit union to meet, "***any*** applicable risk-based net worth requirement…." [Emphasis added]

Third, opponents of a meaningful RBC rule gloss over the requirement in section 216(b)(1)(A)(ii) that the system is, "comparable to Section 38 of the Federal Deposit Insurance Act" under which the FDIC has established a two-tier system for banks, even the 1,872 small banks with less than $100 million in assets. Again, I would remind the opponents of a meaningful RBC rule that the Committee Report on CUMAA defines "comparable" as, "…parallel in substance (though not necessarily identical in detail) and ***equivalent in rigor***." [Emphasis added]

Fourth, opponents of an effective RBC rule purposely misconstrue the plain meaning of section 216(d)(2) which says: "The Board shall design the risk-based net worth requirement to take into account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."

The plain language of the statute is that we must design a system that takes these risks into account. The language establishes a floor, or a minimum, of items that must be taken into consideration. These are not necessarily the only things to take into consideration. They are not a ceiling. That's why the statute uses terms like "all material risks" and "may not provide adequate protection."

Congress understood that it was not enumerating, "all material risks" or everything that, "may not provide adequate protection." The Board was specifically delegated the authority to design a system that takes account of all material risks and promotes least cost resolution.

To put it another way: The statute requires the Board to design a system that takes into account any material risks against which the 6 percent statutory net worth ratio is not adequate. But, it doesn't say anything about how many tiers such as system should have.

Is Your Rule Too Tough?

If anything, the rule is not strong enough. In response to concerns raised during the two comment periods, the final rule:

- Does not include interest rate risk;
- Does not include authority for examiners to set individual minimum capital requirements;
- Has fewer, and lower, thresholds for concentration risk;
- Lowers a number of risk weights;

- Establishes a new, lower, risk-weight for “non-significant equity exposures;”
- Provides a lengthy grandfather of supervisory goodwill extending to 2025, four years longer than the original proposal; and
- Extends the implementation period until January 2019, giving the relatively small number of credit unions who are impacted by the rule, more than three years to either raise capital, adjust their balance sheets or some combination of the two.

I am particularly concerned by the reduction in the risk weights and number of tiers for concentration risk. Experience has shown that credit unions that put all their eggs in one basket are least likely to be able to weather economic storms.

Just last month, a state-chartered credit union was conserved by its state supervisor for what the state supervisor called “unsafe and unsound conditions.” That credit union put all its eggs in one basket and would have been subject to the concentration requirements of this rule.

Yet, when the first version of this RBC rule was released the CEO and Treasurer of that credit union assured us that the credit union was safe and sound, and had, “…never suffered a loss…and…never written off a single penny of principal….” He asked to be exempted from the RBC rule and highlighted the credit union’s “…solid financial strength…and the expertise with which we have written these loans….”

That was 16 months ago. Today, NCUA is acting as that credit union’s conservator because its state supervisor found “unsafe and unsound conditions” at the credit union.

Diversification, by sector, product line, length of investment, and geography, all help strengthen the performance of credit unions. A system whose purpose is to, “…resolve the problems of insured credit unions at the least possible long-term loss to the Fund” should promote diversification.

Even after this rule is passed, 79 percent of all complex credit unions will still manage their balance sheets to comply with the 7 percent leverage ratio rather than the new RBC requirement because they are much closer to the 7 percent leverage limit than they are to the RBC requirement.

Only 21 percent of all complex credit unions will have to manage their balance sheets to make sure they continue to meet the 10 percent RBC requirement.

And because 76 percent of all credit unions are exempt from the RBC rule because they have less than $100 million in assets, this really means that only 5 percent of all credit unions in the country will really have to manage their balance sheets to comply with the 10 percent RBC requirement.

The reason why only a few outliers have to manage their balance sheets to the RBC requirement—instead of the leverage requirement—is because unlike the leverage requirement, the RBC requirement applies to credit union's risk-weighted portfolio, and the average risk weight of the assets at complex credit unions is only 59 percent, not 100 percent.

In fact:

- 30 percent of assets have a risk weight of 20 percent or less;
- 52 percent of assets have a risk weight of 50 percent or less;
- 78 percent of assets have a risk weight of 75 percent or less; and
- Only 1 percent of assets have a risk weight greater than 100 percent.

Personally, I find some of the industry lobby rhetoric on this rule disappointing. Here are some of the direct quotes I have read:

- "This is a solution looking for a problem."
- "Millions of dollars will be taken out of play for consumers."
- "This will stifle growth, innovation, and diversification within credit unions."
- "Force credit unions to park capital on their books rather than lending it to their members."

Let's step back a minute, put aside the rhetoric, and look at the facts.

To meet the gold standard of well-capitalized under this proposal a credit union must hold 10 percent capital against its risk-weighted assets. According to the quotations I just mentioned, this would deprive consumers of access to the capital they need to support their families and build their communities.

Yet, when you look at the complex credit unions that are actually subject to this rule, these same credit unions already have, on average, a whopping 19.2 percent capital. By this logic, those credit unions are already depriving their members of the additional leverage and benefits they could obtain from their 9.2 percentage points of excess capital.

Following that logic, if anyone is depriving their members it is the credit unions which already hold massive amounts of excess capital they are not required to hold, either by law or regulation.

If I were to believe the industry rhetoric and I were on the board of one of these credit unions, I would be asking management why they are not doing a better job deploying their members' capital. Why they are taking millions of dollars out of play? And why they are parking capital and stifling growth, innovation and diversification?

Is Your Rule Comparable to the RBC Rules of other Federal Banking Regulatory Agencies?

Other than the exemption for small, non-complex credit unions—for which there is no comparable provision in the banking rules—the structure is comparable, but there are adjustments in the specifics because while we are required to be parallel in substance and equivalent in rigor, we do not have to be identical in detail. The statute also requires the Board to take into account all material risks as well as the cooperative character of credit unions.

This also explains why 76 percent of complex credit union assets have exactly the same risk weight as comparable bank assets, 21 percent have a lower risk weight, and less than 3 percent have a higher risk weight—thanks to abnormally high concentrations of commercial loans and mortgages.

Why Didn't You Include Provisions for Supplemental Capital?

The statute only permits low-income credit unions to count secondary capital towards their leverage requirement. The agency has asked the Congress to amend the statute so that healthy, well-managed credit unions can have similar authority. However, the Congress has not yet granted that authority.

I believe all Board members, in comments that have been made in recent months, have stated that supplemental capital could count towards meeting risk-based capital requirements. And I was prepared to support such an initiative, but then 10 days ago NAFCU urged the Board to consult more closely with stakeholders before issuing a formal rule on supplemental capital.

I agree with NAFCU that issuance of a supplemental capital rule will in their words, "only benefit from additional discourse and debate," and because supplemental capital for RBC isn't needed or even helpful until January 2019, there is no rush to enact it in this rule. It is better to draft such a rule carefully than to enact it in haste—although I hope we can enact it in less than the two or three years it has taken to enact this rule.

Why Isn't the Implementation Period Longer?

This implementation period is significantly longer—almost twice as long—as the original proposal, which was only 18 months. The relatively small number of credit unions with insufficient capital to remain well-capitalized will have until January 2019 to adjust their balance sheets by either raising capital, reducing risk or some combination thereof. These credit unions are clearly outliers when compared to the average credit union, which has more than twice as much risk-based capital as it is required to hold.

This gives these few outliers more than three years to get ready and five full years from the date of our first proposed RBC rule. It also coincides with the implementation of the latest bank RBC rules, making our rules, once again, more comparable to theirs.

I note with more than a little irony that credit unions want us to slow down implementation of the risk-based capital rules, but to speed-up to warp speed implementation of new rules on member business loans.

At least one trade group even came up with the creative suggestion that we should delay implementation until whenever credit unions receive a rebate from the bailout of the corporate credit union system, which is unlikely at least until 2021. They make this request even though there is no real relationship between the credit unions that will receive rebates under that program and the relatively small handful of credit unions that may actually have to raise additional capital.

I assume they are not suggesting that healthy credit unions with low-risk profiles should fund the capital accounts of the few credit unions with high-risk profiles. I expect any day now that the next suggestion will be to delay implementation until impacted credit unions win the Publishers' Clearing House Sweepstakes.

Are You Respecting the Will of the Congress?

I have great respect for the Congress. I, and all the members of the Board, are bound to faithfully execute the laws of the United States, including the Federal Credit Union Act of 1934 as amended by the Credit Union Membership Access Act of 1998. We are implementing those acts as passed by the Congress and signed into law by the President, and which are the prevailing law of the land.

Some people confuse our obligation to faithfully execute the laws of the United States, with a desire to follow the wishes of individual members of Congress. There are 535 members of Congress, and as is painfully obvious these days, they don't always agree with one another. Every year, tens of thousands of bills are introduced, many of which contradict each other, and very few of which are enacted into law.

Even more numerous than the bills that are introduced, are the letters sent by individual members. I think the Chairman receives at least one a week.

Neither the letters, nor bills that are introduced, have the force and effect of law—except for the very rare bill that is passed in identical form by both houses of Congress and signed into law by the President, or even more rarely, passed over the President's veto.

We do take the opinions expressed by members of Congress very seriously, but when they conflict with our oath to faithfully execute the laws of the United States, we have an obligation to follow the laws.

I do want to note that while several hundred members of Congress submitted comments during the comment period on the first draft of the RBC rule, not a single one submitted comments during the comment period for RBC2. I like to think that is because they understood that we did "stop and study" after the first draft and that we either modified the rule to address their concerns or answered the questions they had about it.

One letter we received during the first comment period, sent by the largest group of House members led by Representatives King and Meeks, asked us to do four things.

First, they asked us to: "Take into account the cost and burden of implementing the new risk-based capital requirements beyond the current leverage ratio." We have done that in this third, revised rule. As I have already said, 76 percent of all credit unions will be totally exempt from the rule, and only 16 credit unions will have to raise additional capital or shed risk in order to meet the new RBC requirement, and they will have more than three years to come into compliance. They won't have to raise any capital, if they are willing to drop from "well-capitalized" to "adequately capitalized" which is permitted both under law and under this regulation.

The so-called "cost and burden" of this rule has been greatly exaggerated. The vast majority of credit unions already comply with the new rule. Only a small handful of outliers, who are putting other credit unions' and their members' money at risk, will have to either raise capital, shed risk, or be willing to drop to "adequately capitalized." Moreover, they will have three years to decide what to do.

Second, they asked us to: "Provide justification and more clarity as to why the proposed risk weights differ from those applied to other community financial institutions." Again, we have done that in this rule, and as I have already stated, where our rule differs from the banks' RBC rule it almost always is to the benefit of credit unions and does so to reflect the fact that credit unions' balance sheets are generally less risky than banks, and the unique cooperative nature of credit unions.

That is why this rule only applies to 24 percent of all credit unions, while the banks' rule applies to 100 percent of all banks—regardless of how small they are. It is also why the risk weight for consumer loans is 25 percent less for credit unions than it is for banks. This has always been the heart blood of the credit union system.

The only area where the risk weight for credit unions is higher than the risk weight for banks is at credit unions with abnormally high concentrations of mortgages or commercial loans, and that is because our statute, requires us to take into account, "all material risks" which includes concentration risk. This higher risk weight applies to only a small percentage of the assets at about 200 credit unions and is dwarfed by the much lower risk weight on consumer loans, which benefits virtually all credit unions.

Third, they asked us to: "…give credit unions more time than the proposal's allotted 18 months to come into compliance." Again, we addressed their concern both by issuing a new rule, which had the effect of delaying the compliance deadline, and by extending the deadline to more than three years after the issuance of this final rule.

Fourth, they asked us to: "…give stakeholders more time to comment on this proposal…." Once again, we addressed this concern by issuing a new proposed rule with a second comment period.

Congressmen Fincher, Heck, and Posey have also introduced legislation, H.R. 2769, recently reported out of the House Financial Services Committee, which would require us to "stop and study" four issues prior to enactment of any final RBC rule.

A lot has been made of the passage of this legislation by the House Financial Services Committee, and like all Board members, I have great respect for the Committee and its members. At least four senior NCUA staff, including my own Senior Policy Advisor, are former employees of that committee.

At the same time, I have to note that the Library of Congress' legislative tracking system monitors 97 potential steps in the legislative process between the introduction of a bill and it becoming law. This legislation has reached 4 of those steps, so it has a long way to go before it becomes law. We are obligated to faithfully execute the laws as they are currently written unless and until a new law is enacted.

Even though we are not bound by the requirements of H.R. 2769, we will nonetheless voluntarily fulfill the requirements of the bill by submitting a report to Congress on the four areas the bill asks us to study, which are also addressed in the preamble of the rule we are considering today.

They are:

- **Whether we have, "…the clear legal authority to prescribe separate risk-based capital thresholds for both 'adequately capitalized' and 'well-capitalized' credit unions."** Both our General Counsel and an Independent Counsel retained by the Chairman have confirmed that we have clear legal authority to act. I concur and would add that we also have an affirmative obligation to do so because of the requirement that our risk-based capital standard be comparable, parallel in substance, and equivalent in rigor to the FDIC standard, which has two-tiers.

- **"A discussion of the differences between credit unions and other types of depository institutions and reasons why they should have similar or different risk-weights for their capital requirements."** Again, as I said earlier, we have done that study and the results are in the preamble to this rule:

  - 76 percent of complex credit union assets will have risk weights identical to the banks' risk weights;

  - 21 percent of complex credit union assets will have risk weights that are less than the banks' risk weights; and

  - Less than 3 percent of complex credit union assets will have risk weights higher than the banks because our statute requires us to take into account "all material risks," including concentration risk and about one-quarter of 1 percent of all complex credit union assets—investments in CUSOs and corporate credit unions—have no counterpart in the banking world.

  Our preamble details the reason for each and every one of our risk weights and why it is either identical to or different from the comparable risk weights for banks.

- **"A discussion of the rationale behind the risk-weights assigned in the proposed rule…"** The preamble of the second rule discussed those risk weights, and as just mentioned, the preamble of this third and final rule discusses the rationale behind each and every one of the risk-weights in the final rule.

- **"An analysis of the impact the proposed rule … would have on excess capital above the minimum level for a credit union to be 'well-capitalized' (a credit union's 'capital cushion') including the impact it would have on credit union lending and credit union examinations."** I would reiterate that nothing in law or regulation requires a credit union to hold a capital cushion. In

> fact, neither law nor regulation require a credit union to be well-capitalized. The 200 basis points required to be well-capitalized are totally voluntary and is a capital cushion. Nonetheless this preamble analyzes the impact of the proposed rule on credit union's capital, and it concludes that it will have no impact on the overwhelming majority of credit unions.
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> Remember that 76 percent of all credit unions are totally exempt from the rule, and the 24 percent who are subject to the rule already have an average capital cushion of 920 basis points over well-capitalized and 1,120 basis points over adequately capitalized. They don't need any more capital.
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> Only 16 out of more than 6,000 credit unions in the United States will be required to either raise capital or shed risk. More importantly, however, what we have done is create a capital system that reduces the likelihood that in the next recession credit unions will take on excessive risk. That fulfills the precise purpose of the RBC requirement in Credit Union Membership Access Act, which is to resolve problems of insured credit unions at the least possible cost to the Share Insurance Fund.

All of the questions posed in H.R. 2769 have been asked and answered.

Conclusion

This agency has been working on a new risk-based capital rule for five years: 2011, 2012, 2013, 2014 and now 2015. We have stopped and studied numerous times. We have stopped and studied what other federal banking regulators require in their RBC rules. We have stopped and studied what international banking regulators require in their RBC rules. We have stopped and studied the impact on credit unions.

After five years, two proposed rules, two longer than normal comment periods, after innumerable listening sessions and meetings, and after making hundreds of changes to reflect suggestions made in the comments and listening sessions, the time for studying has ended, and the time to act is now.

This rule targets only extreme outliers, not the vast majority of well-run and well-capitalized credit unions. It fully exempts 76 percent of all credit unions while covering 90 percent of credit union assets, and the vast majority of the 24 percent that are not exempt already comply with the rule without having to take any action. It can prevent credit unions from having to—once again—pay special assessments because a few bad apples gambled with their funds.

It is time, in the words of one of the best-known natives of my home state, to, "Just do it."