Open Board Meeting October 15 2015

NCUA Chairman Debbie Matz
Statement on the Risk-Based Capital Final Rule

First, let me express my sincere gratitude to the NCUA staff for their incredibly hard work over the past two years to substantially improve this rule.

And I would like to acknowledge the thousands of stakeholders, including many Members of Congress, who provided thoughtful input throughout this two-year process.

We received more than 2,000 comment letters on both proposed rules, and welcomed hundreds of participants at each of my Listening Sessions, which I scheduled across the country between comment periods. Public input was invaluable to us, as we made major changes to the first proposal, and as we made even further changes from the second proposal to get to this final rule.

Earlier this month, the House Financial Services Committee passed a bill titled the Risk-Based Capital Study Act of 2015. Should the bill eventually become law, it would require NCUA to study and report to Congress on four issues:

- "whether NCUA has the clear legal authority to prescribe separate risk-based capital thresholds for both 'adequately capitalized' and 'well capitalized' credit unions";

- "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";

- "a discussion of the rationale behind the risk weights assigned in the proposed NCUA rule"; and

- "analysis of the impact the proposed rule would have upon excess capital above the minimum level for a credit union to be 'well capitalized'…"

Since these are such important issues, NCUA staff has already studied each of them very carefully. Our analysis of the legal authority, risk weights, bank comparisons, and average risk-based capital surpluses are included in the preamble to this final rule.

However—whether or not the bill becomes law—I have committed to provide a report to the House Financial Services Committee addressing these issues. The report will also include additional analysis of any projected impact on credit union examinations, as the pending legislation would require. I anticipate that the report will be sent to the Committee within the next few weeks.

In addition, on Tuesday I received a letter from the House Financial Services Committee Chairman, the Honorable Jeb Hensarling, expressing his disappointment that we are considering this rule today. Chairman Hensarling requested that his letter be read into the record. Reading a letter from a Member of Congress into the record of an NCUA Board meeting would be unprecedented.

However, because Chairman Hensarling is a leader on a committee of jurisdiction, I am prepared to make an exception today. Therefore, after my statement, I will ask the NCUA Board Secretary to read the full text of Chairman Hensarling's letter of October 13, 2015, into the official record of this open Board meeting.

I respect the House Financial Services Committee, including Chairman Hensarling and the members who voted on the risk-based capital bill. I also have the highest regard for the legislative process and the laws it produces.

As such, this Board has a responsibility to follow the current law. And current law, according to the Federal Credit Union Act, requires the NCUA Board to design a risk-based capital system that is "comparable" with the federal banking agencies.

Why This Rule is Necessary

The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve Board issued new risk-based capital rules in 2013. So, by law, we are required to update our risk-based capital rule as well—and that is why we have spent two years working on this rule.

In addition, both the Government Accountability Office and NCUA's 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. GAO concluded that NCUA should propose "additional triggers for Prompt Corrective Action that would require early and forceful regulatory action." The Inspector General noted that NCUA needs a PCA framework that will identify increasing risks on a timely basis, before losses occur.

However, even if we were not compelled to do so by law, or by the GAO, or by the Inspector General, there is another compelling reason why we need this rule: It will protect the entire credit union system.

Those who dispute this are also challenging the expertise of financial regulators in the United States and around the world who have already implemented risk-based capital.

Requiring those credit unions that are high-risk outliers to hold sufficient capital to offset their risks will minimize systemic losses. And putting safeguards in place before the next financial crisis occurs is simply good public policy and good common sense.

Let's not forget: After the last financial crisis began in 2007, credit unions paid a staggering cost. Due to a relatively small number of corporate credit unions taking excessive risks, the credit union system lost $5.6 billion in capital and paid $4.8 billion in assessments. In case anyone needs reminding, five corporate credit unions nearly brought down the entire credit union system.

Adding to that, consumer credit union failures resulting from the crisis cost the system another three-quarters of a billion dollars. Those losses had to be paid by all surviving credit unions through the Share Insurance Fund.

The fact is, the 7 percent statutory net worth requirement for consumer credit unions was not designed to recognize the difference between low-risk and high-risk assets. That's because the net worth ratio is a lagging indicator. It is based on historical performance.

To put this in perspective, I asked the staff to analyze the 192 consumer credit unions that failed over the last 10 years. They found that 24 months before those credit unions failed, their average net worth ratio was 12.1 percent. Officials in those credit unions believed they had more than enough net worth to account for their risks. But clearly, for those failed credit unions, holding net worth 510 basis points above the statutory 7 percent was not enough.

And when examiners urged them to shed some of the risky assets or hold more capital, a common response was: "Show us the regulation."

Today, surviving credit unions hold average net worth of 10.9 percent. So if history repeats itself, those who believe today's credit union system has "too much capital" will see more high-risk credit unions fail the next time there is a major downturn in the economy.

Now let me be clear: I'm not saying each credit union needs to have net worth over 12 percent. What I am saying is that each credit union needs to have sufficient capital to cover its own risks. A well designed, risk-based capital rule should do exactly that.

Unfortunately, NCUA's risk-based net worth rule is outdated. It has not been updated since 2002; so it has not kept up with the growing sophistication of credit union assets over the past 13 years. Even during the crisis, the outdated rule required only two credit unions to hold more capital.

A modernized risk-based capital rule will help more credit unions avoid capital losses—and reduce the losses to the Share Insurance Fund which all credit unions have to pay.

NCUA's Legal Authority is Well Established

Another issue raised by commenters was NCUA's legal authority to structure this new rule similar to the banking agencies. The banking agencies maintain a two-tier risk-based structure—with a 10 percent tier to be "well capitalized," and a lower tier to be "adequately capitalized." Yet there are those who continue to claim that NCUA only has authority to design a single risk-based requirement to be adequately capitalized—without the higher tier to be well capitalized.

This issue is so fundamental to the risk-based capital framework, I requested an independent legal opinion from an outside counsel to analyze NCUA's authority. I personally solicited 11 law firms that specialize in financial services statutes and regulations. I ultimately chose the Global Banking and Payment Systems practice of Paul Hastings in Washington, D.C. Paul Hastings' partners have years of experience on legal issues related to prompt corrective action, 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 the legal opinion in any way. If the opinion found that NCUA did not have legal authority to propose a risk-based threshold to be well capitalized, then we would have re-proposed the rule accordingly.

However, the Paul Hastings opinion stated that the statute "does not prevent NCUA from imposing higher requirements on 'well capitalized' credit unions to provide greater protection against risks." Thus the opinion determined that NCUA's proposed rule "would withstand a court challenge."

Paul Hastings acknowledged that other lawyers may present conflicting interpretations of the statute. Therefore Paul Hastings noted that this demonstrates the statute is "ambiguous with respect to the statutory authority of the NCUA to implement a two-tier risk-based net worth requirement for complex credit unions, as the language can be interpreted in multiple ways." And wherever the statute is ambiguous, Paul Hastings concluded that the agency's rules "will be given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."

In NCUA's case, Paul Hastings found the proposed thresholds of 8 percent to be adequately capitalized and 10 percent to be well capitalized are not "arbitrary, capricious, or manifestly contrary to the statute." In fact, it has been clearly established that these thresholds are comparable to the banking agencies, as required by the statute.

So, we are finalizing this rule on solid legal ground.

Supplemental Capital to Be Added

As the presenters described in great detail, this final rule includes many other changes suggested by commenters. However, there is one more key provision we plan to include, but we cannot adopt yet: supplemental capital.

As part of modernizing risk-based capital, we are committed to counting supplemental capital. So, in the second proposed risk-based capital preamble, we asked a series of questions about how supplemental capital could be treated.

However, under the Administrative Procedure Act, before we can include supplemental capital in a final rule, we are required to issue a separate notice of proposed rulemaking with specific criteria and requirements.

So, we plan to address supplemental capital as soon as possible in a new proposed rule. The new proposed rule will present stakeholders with a specific outline of our plans to count supplemental capital, and provide opportunities for further comments...

The effective date of a final supplemental capital rule would coincide with the effective date of risk-based capital in 2019.

Impact of This Final Rule

Now it's important to put the impact of this final risk-based capital rule into perspective. For the vast majority of credit unions, this final rule will have no impact. That's because 76 percent of all credit unions are exempt, as their assets are below $100 million—unlike the banking industry, where all banks are required to comply with risk-based capital.

And even among the complex credit unions that are covered by the rule, based on their current balance sheets, nearly 99 percent would remain well capitalized. In addition, the vast majority of covered credit unions will see their capital buffers actually increase.

If the rule took effect today, only 16 credit unions would fall into a lower capital category. Based on the current risks on their balance sheets, those outliers would have a combined capital shortfall of $67 million.

But, of course, the rule will not take effect until 2019. So, capital outliers will have more than three years to plan their strategies. Those outliers will have three strategic choices:

- Reduce the risks on their balance sheets;
- Raise capital to cover those risks; or
- Plan a combination of both strategies by 2019.

Executing any of these strategies will not only strengthen the safety and soundness of individual credit unions; it will strengthen the safety and soundness of the entire credit union system. That's because even though the capital outliers represent a small number of credit unions, they still pose a large threat to the system. In fact, the 16 outliers hold combined assets of nearly $10 billion—or almost as much as the entire Share Insurance Fund.

If any one of those outliers were to fail, all credit unions would have to pay for their losses. The average complex credit union has assets of $679 million. Thus if this rule prevents the failure of only one credit union with more than $600 million in assets, it will be well worth the costs of $2 million in paperwork costs to credit unions and $2 million in implementation costs to NCUA.

Further, this rule will require credit unions with more than $100 million in assets to develop a capital adequacy plan. This will ensure the safety and soundness of the credit union system well into the future.

We will also be providing guidance about the capital adequacy plan that will be required for credit unions with assets over $100 million. Field staff report that many complex credit unions already have capital plans that would comply with this requirement.

To be fully transparent and assist with understanding this complex rule, we're releasing a host of risk-based capital resources today:

- Significant changes from the proposed rule;
- Risk weight comparisons to FDIC's final rule;
- Risk-based capital estimator for each credit union to calculate their current risk-based capital ratio and project future ratios;
- Impact summary; and
- Answers to frequently asked questions.

Staff will also be scheduling a webinar to further explain the rule and answer questions.

My intent is for risk-based capital to be the last significant safety and soundness rule change for the foreseeable future. Contrary to some reports, we are not planning any new rule on interest rate risk.

In the coming months, we do plan to propose several new rules that will provide regulatory relief to thousands of credit unions.

In the end, the risk-based capital 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.