

Open Board Meeting

Jan. 15, 2015

**Board Member J. Mark McWatters
Statement on the Proposed Risk-based Capital Rule**

Legal Authority for Two-Tier Risk-Based Net Worth Rule

The fundamental issue presented before the Board today is whether NCUA has the legal authority to establish a separate Risked-Based Net Worth (RBNW) requirement for each of “well capitalized” and “adequately capitalized” credit unions that are designated as “complex.” Section 216(d) of the Federal Credit Union Act (FCUA) addresses the RBNW requirement for “complex” credit unions.

Section 216(d)(2) provides:

The Board shall designate the risk-based net worth requirement to take 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. (Emphasis added.)

A plain language reading of this section indicates that Congress did not authorize the Board to adopt a two-tier RBNW standard. If Congress had intended a two-tier system, the drafters would not have included the words “to be adequately capitalized” in the section. The inclusion of this phrase indicates that Congress intended to limit the RBNW standard to a single-tier system and any attempt by the Board to read section 216(d)(2) as a “baseline” or “minimum” standard contradicts a plain reading of the text. If Congress had sought to design a two-tier system for credit unions, the drafters of the statute would not have undertaken to accomplish this goal by *only* referencing the “adequately capitalized” standard in section 216(d)(2). Instead, Congress would have included a reference to both the “adequately capitalized” and “well capitalized” standards so as to reflect a two-tier RBNW system in a clear and transparent manner. The crafting of a two-tier standard would not have presented any technical or tricky drafting issues for Congress. By omitting a reference to the “well capitalized” standard in section 216(d)(2), Congress created an unambiguous single-tier RBNW standard.

Sections 216(c)(1)(A) and (B) provide:

- (A) Well capitalized. – An insured credit union is “well capitalized” if –
 - (i) it has a net worth ratio of not less than 7 percent; and
 - (ii) it meets any applicable risk-based net worth requirement under *subsection (d) of this section*.
- (B) Adequately capitalized. – An insured credit union is “adequately capitalized” if –

- (i) it has a net worth ratio of not less than 6 percent; and
- (ii) it meets any applicable risk-based net worth requirement under subsection (d) of this section.

(Emphasis added.)

That the “net worth ratio” (Leverage Ratio) requirement differs for “well capitalized” and “adequately capitalized” credit unions does not necessitate that the RBNW requirement must *also differ* for “well capitalized” and “adequately capitalized” credit unions. Instead, the statute merely provides that the RBNW determination for “well capitalized” and “adequately capitalized” credit unions must satisfy the requirement established under section 216(d). As noted above, a reasonable, plain language, interpretation of section 216(d)(2) mandates that the Board adopt a single-tier standard. Since the Leverage Ratio requirements for credit unions provided in sections 216(c)(1)(A)(i) and (B)(i) exceed the Leverage Ratio requirements for banks, it is entirely rational and reasonable that Congress would have sought to offset the enhanced Leverage Ratio burden placed on credit unions by adopting a single-tier RBNW system based upon the “adequately capitalized” standard.

I appreciate that some may argue that NCUA’s RBNW rules should follow a two-tier system comparable to that of the FDIC. Section 216(b)(1)(A) of the FCUA provides that the Board shall, by regulation, prescribe a system of prompt corrective action (PCA) for insured credit unions that is (i) “consistent” with section 216 of the FCUA and (ii) “comparable” to the rules adopted by the FDIC. Under basic principles of statutory construction, a general provision must give way to a specific provision. As such, the specific RBNW rules tailored by Congress for credit unions in section 216(d) of the FCUA must trump the general mandate that NCUA formulate its rules in a manner comparable to the rules adopted by the FDIC. The Board may not seek to piggyback the FDIC’s RBNW rules by ignoring the statutory provisions specifically prescribed by Congress for credit unions.

Interestingly, an NCUA White Paper, dated April 2007, concludes in part, “In relation to the risk-based net worth requirement, the statute *precludes* a distinction between Well Capitalized and Adequately Capitalized...” (Emphasis added.)¹ The Board also received testimony from a senior NCUA officer in June 2007 that “the statute specifically limits the application of the risk-based requirement to adequately capitalized and the undercapitalized PCA categories, which does not allow us to put more emphasis on the risk-based requirements since we can’t apply it to well-capitalized credit unions...So that also precludes [us] from mirroring how the FDIC PCA system works, as well.”² Apparently, over the past year, NCUA had taken a 180-degree pivot away from a single-tier interpretation of section 216 of the FCUA in favor

¹ National Credit Union Administration, Revisions: Prompt Corrective Action Reform Proposal, April 2007, Appendix 2.

² Open Board Meeting Transcript 22-23 (June 21, 2007).

of a two-tier system of RBNW even though Congress has not acted to revise the statute. It is entirely possible that NCUA undertook to justify in a formal manner the legal basis for a two-tier RBNW standard only *after* receiving numerous written comments challenging the legal underpinnings of the RBNW regulations proposed by the Board and published in the Federal Register on February 27, 2014.

It is worth noting that a well-known law firm has rendered an opinion to the Board regarding the legal authority of the Board to establish a two-tier RBNW system. Regrettably, I am apparently not permitted to disclose the opinion letter itself or discuss “the substance, analysis or conclusions” provided in the opinion letter, even though NCUA and, as such, the credit union community has committed to pay \$150,000.00 to date for the legal services rendered. If you are troubled by this misallocation of limited credit union resources and the complete absence of transparency, trust me, you are not alone.³

It is also worth considering that another well-known law firm retained by CUNA has questioned the legal authority of the Board to propose a two-tier RBNW regulatory system under the *Chevron* doctrine.⁴ This firm concluded:

NCUA’s approach is contrary to the express language of [section 216(d) of the FCUA]. Were NCUA so ill-advised as to adopt in its Final Rule the proposed dual-based capital standard approach that simply ignores the language of multiple parts of the statutory structure that Congress actually adopted, that provision would be highly vulnerable to being overturned as unlawful by a reviewing court.⁵

³ During the January 15, 2015 Board Meeting, the Chair discussed “the substance, analysis and conclusions” of the Paul Hastings legal opinion and in order to clarify the record I remarked as follows:

It is worth noting that a well-known law firm has rendered an opinion to the Board stating that a court “could” conclude that NCUA has the legal authority under the *Chevron* doctrine to establish a two-tier RBNW standard. As a practicing attorney, I have served on the legal opinions committee of large cross-border law firms and note that a “could” opinion represents a relatively modest standard of assurance. In the obscure, arcane and highly technical and nuanced world of legal opinions, key words such as “could,” “would,” “should,” and “more likely than not” truly matter. The recipient of a legal opinion prefers to know that a court “will” or “should” or, at a minimum, “more likely than not will” uphold the legal actions of the recipient. An opinion letter merely noting that a court “could” uphold the actions of the recipient, although not entirely unhelpful, offers limited comfort to the recipient.

⁴ *Chevron, USA, Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984). In a nutshell, the *Chevron* doctrine holds that a regulation is presumed valid if the underlying statute is ambiguous or silent on the matter presented, and the agency’s interpretation of the statute is reasonable. The second prong of the *Chevron* doctrine does not apply since, in my view, the FCUA is not ambiguous or silent regarding a two-tier v. one-tier structure.

⁵ I encourage CUNA to release this opinion letter to the public.

Further, yet another well-known law firm retained by NAFCU has questioned the legal authority of the Board to prescribe an “individual minimum capital requirement” (IMCR) protocol under section 216 of the FCUA. Although, after receipt of the NAFCU commissioned opinion letter, NCUA removed the IMCR provision from the proposed rules that are before the Board today, any attempt by NCUA to “back-door” an IMCR or substantially similar standard during the examination process may very well run the same risk of violating the FCUA as would a formal IMCR rule.⁶

Although not dispositive unto itself, but indicating the intent of Congress, it should be noted that former Speaker of the House Newt Gingrich and former Senate Banking Committee Chair Alfonse D’Amato, both of whom held their positions in Congress when the credit union RBNW rules were enacted, have stated that it was not the intent of Congress to permit the Board to issue two-tier RBNW regulations. Speaker Gingrich stated in a letter to NCUA,

It was our intent to direct NCUA to apply risk-based requirements for a credit union’s capital at the adequately capitalized level... If Congress wanted a different result, we would have indicated that. In fact, in other banking statutes, we did exactly that.⁷

Based upon my 30-plus years of experience as an attorney who has worked on many intricate issues of statutory and regulatory interpretation, I am of the view that NCUA does not possess the legal authority under the FCUA to adopt a two-tier RBNW regulatory standard. Section 216 of the FCUA, while perhaps inartfully drafted, does not appear fatally ambiguous on its face and, accordingly, the *Chevron* doctrine should not apply, as a holistic, plain language reading of the statute in support of a single-tier RBNW standard should prevail over any regulatory interpretation or wishful thinking to the contrary. While one may certainly argue that the Board *should* have the authority to issue two-tier RBNW regulations as a matter of prudent public policy, those debates are best left to Congress as the source of the Board’s regulatory authority. If Congress acts, the Board may follow, but without modification of the statute, the Board lacks the legal authority to issue two-tier RBNW rules and should not seek to invoke the *Chevron* doctrine so as to resolve in its favor a forced or strained ambiguity in the statute.

Please note that I do not offer this analysis without some reservation or caveat. Reasonable minds may and will differ on this issue. I respect those who present well-reasoned, principled arguments to the contrary and note that, in my opinion, the better interpretation of section 216 of the FCUA precludes a two-tier RBNW standard.

⁶ Along these lines, I encourage members of the credit union community to reflect on the proposed RBNW “capital adequacy” rule and its applicability to the cooperative business model.

⁷ Letter dated May 23, 2014 from former Speaker of the House Newt Gingrich to the NCUA commenting on NCUA’s proposed RBNW rules.

“Complex” Credit Unions

Section 216(d)(1) of the FCUA provides that the Board may only adopt RBNW rules for “insured credit unions that are *complex*, as defined by the Board based upon the portfolios of assets and liabilities of credit unions.” (Emphasis added.) Instead of following the clear and unambiguous language of the statute, the proposed RBNW regulations define “complex” by reference to a credit union’s gross asset size as a “proxy” for “the portfolios of assets and liabilities” of the credit union. Although such an approach is not wholly unreasonable, I would strongly prefer that the proposed RBNW regulations follow the express language of the statute and designate credit unions as “complex” only after an analysis of each credit union’s “portfolios of assets and liabilities” as specifically required by the statute.

Secondary (Supplemental) Capital

I am also dismayed that the Board would consider adopting a rigorous set of RBNW regulations without also providing members of the credit union community with the option of at least partially satisfying the requirements of the rule through the issuance of properly structured secondary (supplemental) capital. It is clear from section 216(o) of the FCUA that, other than for Low-Income Credit Unions, a credit union’s “net worth” may not include secondary capital for purposes of satisfying the Leverage Ratio of section 216(c) of the FCUA. I am not aware, however, of any similar limitation that applies to the determination of “net worth” for purposes of the RBNW requirement,⁸ provided the secondary capital is structured in such a manner as to “take account of any material risks” as required by section 216(d)(2) of the FCUA, otherwise complies with applicable law, and ensures the safety and soundness of the NCUSIF.⁹ Accordingly, I encourage the Board to initiate the process that will lead to the promulgation of rules permitting properly structured secondary capital to qualify as “net worth” under the RBNW regulations as ultimately enacted. I appreciate that such an undertaking is not without its unique challenges regarding an array of vexing issues, including, without limitation, (i) the ability of secondary capital to absorb credit union losses, (ii) the “permanence” of secondary capital, (iii) member v. non-member secondary capital, (iv) the availability of secondary capital for state v. federal chartered credit unions, (v)

⁸ The definition of “risk-based net worth” used in the numerator of the proposed RBNW rule differs materially from the definition of “net worth” employed in the numerator of the Leverage Ratio. The Board, pursuant to section 216(d)(2) of the FCUA, establishes the former, and the latter is defined in section 216(o)(2) of the FCUA.

⁹ In an NCUA White Paper on Supplemental Capital, dated November 18, 2014, NCUA’s OGC concluded on page 2, “While the Board cannot redefine the statutory definition of Net Worth, OGC did determine the Board has broad authority in establishing what can be included in the numerator when defining Risk Based Capital (RBC). This could include expanding the inclusion of secondary capital by all FICUs, and not solely the LID FICUs, into the numerator of RBC.” It is also worth noting that a well-known law firm retained by CUNA has issued a memorandum concluding, subject to certain caveats, that there are “strong legal arguments” in support of including secondary capital in the numerator of the RBNW ratio.

consumer protection for purchasers of and investors in secondary capital, (vi) securities regulation of secondary capital issuances, (vii) NCUSIF payout priorities and subordination of secondary capital, (viii) capital contribution limitations of secondary capital as “net worth” for RBNW purposes, and (ix) the contractual terms of, the market demand for, and the cost of secondary capital.

These issues should not have a chilling effect on the willingness of the Board to grant to the credit union community a workable methodology by which to raise properly structured secondary capital for purposes of partially satisfying the RBNW requirement. I recently read an article in *CU Insight* by Brian Branch, President and CEO of the World Council of Credit Unions, describing an array of secondary capital initiatives employed in the international credit union community. Instead of fretting and hand wringing, NCUA, like its international counterparts, should take the leadership role in solving the secondary capital conundrum. Like long overdue modifications to the field of membership and member business lending rules, NCUA should actively endeavor to craft secondary capital regulations that will benefit the credit union community while maintaining the safety and soundness of the NCUSIF. It is beyond ironic that the Board would seek to raise the capital requirements for credit unions without also affording the community a viable means by which to raise secondary capital. A thoughtful, prudently constructed secondary capital rule would afford the credit union community with a heightened opportunity to extend job creating small business loans thereby strengthening the economic viability of the Main Street business community.

Interest Rate Risk Rule

I am pleased that the proposed RBNW rule no longer incorporates an interest rate risk (IRR) component. Although it is my understanding that the Board will consider a separate and distinct IRR rule, I encourage the Board to seek input from the credit union community regarding any proposed rule by issuing an Advance Notice of Proposed Rulemaking. It is absolutely critical that the Board receive timely comments from those who will incorporate the IRR rule into their business plans and econometric models. Such input will enhance the efficiency, effectiveness and transparency of the regulatory drafting process and speed the implementation of the fully vetted IRR rule.

Dissenting Vote on Proposed Risk-Based Net Worth Rule

Since I am of the view that the Board does not possess the legal authority under the FCUA to adopt a two-tier RBNW standard, I will not support the RBNW regulations as currently proposed. Further, it is problematic that I would support a single-tier RBNW standard unless the rule permits the inclusion—or at least acknowledges a good faith undertaking to investigate the viability—of properly structured secondary capital in the calculation of the RBNW ratio to the fullest extent permitted by applicable law.

Cost of the Risk-Based Net Worth Rule

It is also worth noting that in accordance with the requirements of the Paperwork Reduction Act of 1995, NCUA staff estimates that the total non-recurring compliance cost of the proposed RBNW regulations (i) for both “complex” and “non-complex” credit unions totals approximately \$5.1 million,¹⁰ and (ii) for NCUA totals approximately \$3.7 million.¹¹ NCUA staff did not undertake a formal estimate of the recurring compliance costs of the proposed regulations. I anticipate that some, if not many, credit unions may argue that these projections materially underestimate the actual cost of complying with the proposed RBNW regulations. Regrettably, this additional burden falls on a financial services sector that is not too-big-to-fail and was in no manner responsible for the recent financial crisis.

NCUA has dedicated a significant portion of its institutional resources over the past 18 months to revising the proposed RBNW regulations with the ultimate goal of ensuring the safety and soundness of the NCUSIF. While I certainly concur with this objective, I disagree with the approach. If NCUA had issued an Advance Notice of Proposed Rulemaking regarding the anticipated rewrite of the RBNW regulations, there’s little doubt that the overall vetting process of the proposed regulations would have progressed in a much more efficient, effective and transparent manner. The allocation by NCUA of the cost savings generated from an expedited RBNW rulemaking process to fighting fraudulent activity within the credit union community and assisting the management of credit unions with the development of vigorous and resilient internal control systems and procedures would have further enhanced the safety and soundness of the NCUSIF without increasing NCUA’s overall budget and placing any additional financial burden on an already overstressed credit union community and its members.

Thank you.

¹⁰ NCUA Proposed Risk-Based Capital Rule, January 15, 2015, pages 360 – 363.

¹¹ NCUA Board Action Memorandum, January 6, 2015, page 1.