Open Board Meeting April 30, 2015

Board Member J. Mark McWatters
Statement on Regulatory Relief for Corporate Credit Unions

Although I will vote to approve the Corporate Credit Union (Corporates) final regulations and proposed regulations pending before the Board today, I wish to offer my observations regarding additional regulatory relief for the Corporates that is not currently before the Board.

While I fully appreciate the financial turmoil and economic pain suffered by the broader credit union community in bailing out the misguided and ill-advised investment activity of the Corporates, I am concerned that the regulatory pendulum has nevertheless swung too far the other way. The Perpetual Contributed Capital (PCC) limitations placed on the regulatory capital of the Corporates that are scheduled to trigger in 2016 and 2020 appear punitive in nature when viewed *today* on a prospective basis. These rules will mandate that the regulatory capital of each Corporate drop in 2016 and 2020 even though the GAAP capital of the Corporates has slowly, yet steadily, increased due to the accumulation of retained earnings.

It is my understanding that PCC includes interests of a Corporate that are perpetual, non-cumulative dividend accounts, are available to cover losses in excess of RE, are not insured by the Share Insurance Fund, are considered a form of equity under GAAP, and are the regulatory equivalent of non-cumulative perpetual preferred stock. It is also my understanding that no other financial regulator requires the full exclusion of PCC-type capital, including non-cumulative perpetual preferred stock or other similar permanently contributed capital, from an institutions calculation of core capital.

On page six of his comment letter to the proposed Corporate rules, Mr. Lee C. Butke, President and CEO of Corporate One Federal Credit Union, offers an interesting example of the consequences presented by the PCC rule as in effect today. In his example, although one Corporate holds $89 million of additional PCC over another Corporate, both Corporates report identical regulatory capital ratios. As expected, the Corporate with the additional PCC reports a materially higher GAAP capital ratio than the other Corporate. NCUA has created a truly surreal world where $89 million of PCC simply disappears for regulatory capital purposes.

With this example in mind, it’s challenging to understand why the Corporates should suffer such a dramatic step-down in regulatory capital in today's low interest rate environment that inhibits their ability to generate retained earnings. It’s equally difficult to appreciate why NCUA would champion a regulatory protocol that so adversely differs from GAAP capital and other well-recognized measures of regulatory capital employed by financial regulators. By adversely affecting regulatory capital the Corporates may receive less favorable pricing on third-party contractual arrangements that may inhibit their ability to generate retained earnings and contribute to higher fees and interest rates charged to their members and customers. Since third parties—such as the Federal Reserve, financial institutions, creditors, contractual counterparties, business partners, among others —often look to regulatory capital, instead of GAAP capital, for due diligence and underwriting purposes, Corporates with PCC in excess of the 2016 and 2020 limitations are placed at a competitive disadvantage with financial institutions permitted by their regulators to include PCC-type investments in the calculation of regulatory capital. A better approach must surely exist to balance the safety and soundness goals of NCUA and the legitimate, rational business objectives of the Corporates.

I acknowledge that capital is a sensitive issue for NCUA and the Corporates, but I am concerned that NCUA is in effect making fundamental policy, as well as day-to-day operational and business decisions, for legal, legitimate Corporates by denying them access to their PCC—or at least a meaningful portion of their PCC—that clearly qualifies as capital under well-recognized and respected GAAP standards. I understand that the regulatory capital rules applicable to the Corporates were enacted during the financial crisis and that some reasonable restrictions on the use of PCC may appear appropriate even in today's much-improved economic environment so as to motivate the Corporates to build retained earnings. That said, it seems that the current rules act as little more than rough justice when a more thoughtful, nuanced approach is preferable.

Here's the problem: NCUA should regulate the Corporates and natural person credit unions in a more nimble manner and modify its regulations to fit the facts and circumstances on the ground and not a revisionist perspective where the agency remains condemned to relive the past as a regulatory sequel to Groundhog Day. Times change and the rules of the road must also change in a thoughtful, reflective manner. I'm certainly not advocating for an “anything goes” regulatory regime for the Corporates, as that approach would ignore the valuable lessons learned from the recent financial crisis and the bailout of the Corporates by the credit union community. NCUA should, however, loosen the regulatory stranglehold the agency has on the ability of the Corporates to count PCC as regulatory capital.

While, understandably, natural person credit unions may feel little sympathy for the Corporates and their checkered history of knuckleheaded business and investment decisions, they should remain mindful of the broader implications of NCUA's refusal to acknowledge that the economic times have changed and that the capital shackles impeding the economic viability of the Corporates should be loosened in a methodical, trust—but verify—manner. It's easy for NCUA to “just say no” to regulatory relief for the Corporates as members of an unsympathetic class in today's credit union world. Natural person credit unions should remain mindful, however, that NCUA might—equally unwisely—advocate a similar approach to their regulatory relief.

It's easy for NCUA to call for regulatory relief, but yet another to delivery on the promise. The devil is in the details and any proffered overtures of regulatory relief will ultimately correlate with the willingness of the agency to roll up its sleeves and get to work on progressive solutions that are relevant on a prospective basis. This is a teaching moment for the community as NCUA's problematic approach to addressing a controversial and vexing issue has surfaced yet again. Times change, economic reality changes, and regulatory regimes should follow. If, indeed, the Corporates have reformed—and please tell me if you believe they have not—NCUA should modify the existing rules in favor of steady-handed rehabilitation so as to encourage the Corporates to better serve their members and customers.

Some may argue that my perspective is naïve as I was not involved with the restructuring of the Corporates and, as such, do not appreciate the extent of the economic havoc they wreaked on the broader credit union community. I would remind those that I served as a member of the TARP Congressional Oversight Panel and invested much energy in understanding the causes of the recent financial crisis and the best practices necessary to keep another crisis from emerging. In addition, as a practicing attorney I am aware that it’s possible to rehabilitate economic basket cases into viable going concern businesses. Successful business reorganizations are seldom accomplished with nothing but the relentless blows of a hammer. After a turn-around patient is stabilized it is necessary to shift to a more nuanced approach that allows for greater latitude in the exercise of independent business judgment by the reorganized entity under the watchful monitoring of the firm’s directors, officers and employees and, as appropriate, regulators. While the Corporates may not have recovered their full economic viability, it’s important to acknowledge that much progress has ensued since the dark days of 2008 and 2009. NCUA should recognize these changes and rework its regulations accordingly.

With these thoughts in mind, I recommend that the Board consider in the near future a limitation on the use of PCC as regulatory capital only to the extent PCC exceeds two-to-three times a Corporate’s retained earnings. Another reasonable approach would remove any cap on the availability of PCC to serve as regulatory capital, yet require each Corporate to grow retained earnings at a fixed rate of 10 to 20 basis points per annum or pursuant to a more customized, yet transparent formula.

In addition to modifying the PCC rules, the proposed 180-day cap on the term of any indebtedness incurred by a Corporate seems far too restrictive relative to a sound, prudent business model for the Corporates to follow on a going forward basis. A longer borrowing term will permit the Corporates to serve the seasonal and systemic liquidity needs of their members and customers which, as the recent financial crisis clearly demonstrated, may exceed 180-days. With loan demand exceeding deposit growth in a recovering economy, credit unions may also seek to extend the term of their borrowings from the Corporates so as to enhance their cash management programs. Further, a longer borrowing term will allow the Corporates to match-fund loans and hedge against interest rate risk (IRR).[1] As such, I recommend that the Board consider in the near future a cap of 12- to 18-months on the term of any indebtedness incurred by a Corporate.

These proposed changes would respect NCUA's stated goal of ensuring the safety and soundness of the Corporates' operational systems for the benefit of the credit union community, while providing the Corporates with enhanced flexibility in executing on their business models and earning an appropriate return on their assets in today's economic environment.

Thank you.

[1] Since NCUA has identified IRR as perhaps the ultimate risk facing credit unions today it is ironic that the agency would support a rule that incorporates an IRR component. I will nevertheless vote for the rule because a Corporate borrowing with a term of 180-days should incorporate less IRR than a Corporate borrowing with a term of 30- or 120-days on an offsetting Corporate loan of 12- to 18-months, although more than a true match funded Corporate borrowing and loan each with a term of 12 to 18-months. The proposed rule, although far from ideal, represents the lesser of two unfortunate choices.