NASCUS
National Association of State Credit Union Supervisors

May 28, 2014

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: NASCUS Comments on Proposed Rulemaking for Parts 700, 701, 702, 703, 713, 723, and 747, Prompt Corrective Action; Risk-Based Capital

Dear Mr. Poliquin:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the following comments in response to the National Credit Union Administration's (NCUA's) proposed changes to NCUA Rules and Regulations Parts 700-703; 713, 723, and 747 regarding prompt corrective action (PCA) and risk-based capital. This proposed rule would incorporate a system of minimum risk-based capital requirements into the current prompt corrective action framework for credit unions with assets of more than $50 million.

Application of a risk-based capital ratio could add depth to NCUA's capital adequacy analysis that is beneficial and appropriate given the development of the credit union industry and the financial regulatory landscape. Assigning capital requirements based on the perceived risk of assets can establish a baseline of capital adequacy theoretically tailored to the risk-profile of each institution.

However, the utility of a risk-based capital ratio is limited. It assigns static determinations of risk and is therefore ill suited to address sources of variable risk in the marketplace. For example, although interest rate risk is a primary concern for credit unions in this rising-rate environment, NCUA's efforts to control that risk exposure through risk-weights is short-sighted. Eventually, when interest rates stabilize or decline, a risk-weight system built with rising rates in mind will cripple the industry's ability to adjust to those market variations.

Furthermore, NCUA must appreciate that risk weightings, as a sweeping value judgment of balance sheet composition, will likely drive which products and services are offered by credit unions. This in turn presents the risk that the regulator ultimately makes wholesale business decisions *for* the industry as industry manages to the regulation rather than to the market. NASCUS appreciates the deliberation that NCUA put into the proposed rule, however, we feel that there is still a significant amount of refinement that should take place before the rule is finalized.

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.

Given the inherent uncertainty of both the effectiveness of risk weightings and the market reaction to such weightings, it is incumbent that any final risk-based capital rule be the product of careful deliberation and comprehensive dialogue with stakeholders. Years after the first introduction of BASEL to the banking system, questions remain as to the efficacy of bank risk weightings. The credit union system has the opportunity to learn from the shortcoming of each of the three BASEL Accords and craft a more streamlined, focused, and modest approach.

Our comments focus on ensuring that the rule is right-sized for the credit union industry, reflects a reasoned judgment of the actual risks, maintains predictable standards that support credit union growth and innovation, and cements the current commitment by NCUA to consult and coordinate with state regulators when taking action against state-chartered credit unions under the PCA framework. We value the opportunity to contribute to the development of this important rule, and we look forward to working with NCUA to perfect its application to the credit union system.

Safety and Soundness Benefits Must Outweigh Regulatory Burden

As a regulators' professional association, NASCUS understands that "regulatory burden" alone cannot stand as dispositive of the validity of any given regulation. However, it is incumbent upon regulators to consider and, as appropriate, balance the burden of a regulation with its supervisory benefit. As discussed in more detail below, there are several elements of NCUA's risk-based capital proposal that should be amended to better balance supervisory benefit with regulatory burden. Given the magnitude of this proposed rule and its dramatic impact on the credit union system, more consideration should be given to refining the application of the risk-based capital requirements.

NCUA should provide stakeholders with a more thorough discussion of how this rule will fit into the new regulatory fabric woven by the agency over the past eighteen months. NCUA has finalized rules regarding liquidity, interest rate risk, and stress testing and capital planning. Now as NCUA proposes a broad rule to risk weight balance sheets, the agency should explain its view of how all of the rules fit together to provide an appropriate supervisory framework without unnecessary regulatory burden. For example, credit unions with assets in excess of $10 billion must comply with detailed interest rate risk and liquidity rules that seek to mitigate the risk of a sustained change in rates. Those same credit unions must also conduct enterprise wide capital planning and undergo NCUA administered stress testing of their balance sheets to determine if they have sufficient capital and liquidity to withstand market downturns. Now, those same credit unions will risk weight their balance sheets to determine if they have sufficient capital to withstand market downturns. Although this example focuses on the largest credit unions, the need for streamlined regulation only intensifies for smaller institutions. As NCUA adds another level of regulation, it should ensure that unnecessary redundancies are eliminated. The agency's articulation of how all of its rules work together would be consistent with the announced goals of the 2011 “Regulatory Modernization” initiative.[2]

The Applicability Threshold Should Be Raised to $500 Million

Although NASCUS agrees that many credit unions now provide a wide array of products and services that might make a risk-weighted measure of their balance sheet valuable, we do not

[2] November 7, 2011, Letter to the Office of Management and Budget by NCUA Chairman Debbie Matz.

believe that $50 million in assets is the correct threshold to capture “complex” activities. We are also unconvinced that a $50 million credit union rises to the level of complexity intended by Congress. We recommend NCUA raise that threshold to $500 million.

In authorizing a risk-based capital structure, Congress explicitly directed NCUA to consider more than just asset size in defining complexity. The Federal Credit Union Act (FCUA) directs the NCUA to develop risk-based capital requirements for "complex" credit unions as defined "by the Board based on the portfolios of assets and liabilities of credit unions."[3] Congress could have just as easily directed NCUA to develop risk-based capital requirements for all credit unions and then exempted small credit unions. Rather, Congress clearly sought a more thoughtful and exclusive standard, hence the use of "complexity" rather than assets as a threshold.

If NCUA is committed to maintaining a pure asset size threshold, it should err on the side of setting that threshold high. Given the significant burden that would be imposed by this rule and the potential for unintended consequences it would be wise to phase-in the application of the rule slowly. By starting with credit unions with assets of $500 million or more, NCUA would be able to ensure smooth implementation of the rule without threatening the viability of smaller institutions. Once the full effects of the risk-based capital ratio are known, NCUA can always adjust the applicable threshold as necessary. Certainly, there is precedence for establishing $500 million as a threshold for application of the rule.

We note that NCUA requires federal credit unions with assets of $500 million or greater to obtain an annual financial system audit.[4] In the 2012 liquidity and contingency funding proposed rule, NCUA also requested comments on applying Basel III liquidity measures to credit unions $500 million or greater.[5] Given that this risk-based capital system is also based on Basel III international standards, NCUA should likewise limit its initial application to the larger institutions in the credit union system.

<u>Within NCUA’s Authority to Include Supplemental Capital</u>

That NCUA has declined to include supplemental capital for non-low income consumer credit unions within its proposed risk-based regulatory framework is unfortunate and disappointing.[6] NCUA's contention that it lacks the authority to include supplemental capital for the risk-based capital ratio is an unnecessarily narrow reading of the FCUA. That NCUA has chosen to so narrowly construe their legal authority in this instance is puzzling given the agency has taken a generous interpretation of the FCUA both within this rulemaking and in previous rulemakings.

NCUA's interpretation of the FCUA is articulated not in the proposed rule, but rather in a letter to Congress.[7] NCUA cites 12 U.S.C. 1790d(0)(2) as limiting what may be counted as net worth in a non-low income credit union. However, §1790d(0)(2) addresses ***net worth*** for purposes of calculating the statutorily required ***net worth ratio.*** Neither of these terms, and hence the cited

[3] 12 C.F.R 1790(d)(1).
[4] 12 C.F.R 715.5(a).
[5] 78 FR 64880 (Oct. 30, 2013).
[6] NCUA does include supplemental capital for low income credit unions in the proposed §702.2 definition of net worth as it is currently included under existing regulation. *See* 79 FR 11211 (Feb. 27, 2014).
[7] NCUA Letter to the Honorable Jeb Hensarling and the Honorable Maxine Waters (April 9, 2014).

statutory definition, are dispositive for risk-based capital. As proposed by NCUA, credit unions will be required to meet two standards: the explicit statutory net worth ratio and then the proposed risk-based "capital ratio."

The term "capital ratio" appears nowhere in the current statutory construction cited by NCUA as limiting its ability to broadly include supplemental capital. Put more simply, NCUA is introducing a new capital measure into the PCA construct. Because Congress did not speak directly to what may constitute the capital ratio, NCUA need not be limited by §1790d(0)(2) in defining what constitutes the ratio elements. Such an interpretation of the FCUA is well within both the "reasonableness" and "rightness" standards by which an agency's interpretation of its authorizing statute is judged.[8] As discussed elsewhere in this letter, some have questioned NCUA's authority to issue this rule at all given what might be read as limiting language in §1790d(d).[9] NCUA has chosen to read the applicable provisions broadly for its authority to issue this rule, and it should read the authority to include supplemental capital in the same permissive light. Ultimately, this proposal is designed to bolster the safety and soundness of the credit union system. As NCUA has itself acknowledged, supplemental capital has a role to play in that equation.[10]

Required Capital Levels Should be Restructured

The FCUA directs NCUA to implement capital standards for credit unions that are comparable to Federal Deposit Insurance Corporation (FDIC) standards but that take into account the unique characteristics of the credit union system.[11] As non-profit cooperative financial institutions, credit union balance sheets can differ significantly from banks in several respects.

Credit unions generally operate as portfolio lenders, making and holding high-quality consumer and residential real estate loans that serve their members and improve their communities. Credit unions often carry significantly less exposure to volatile products lines such as acquisition development and construction (ADC) loans, commercial real estate, and complex derivatives products. Credit unions also face stringent regulatory restrictions on their investment powers.[12] As a result, natural person credit unions fared substantially better during the recent financial crisis than many other entities. An appropriate risk-based capital requirement would reflect these important differences with a streamlined program that recognizes credit unions as strong counter-cyclical lenders while bolstering safety and soundness through meaningful benchmarks and access to supplemental capital.

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[8] See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 104 S. Ct. 2778 (1984) and *Securities Indus. Ass'n v. Board of Governors*, 104 S. Ct. 2979 (1984).

[9] 12 C.F.R. 1790d(d)(2) reads, "The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth required to be adequately capitalized may not provide adequate protection."

[10] In a May 2, 2013 letter to Congressman Peter King supporting legislation that would allow credit unions to use supplemental capital in their **net worth ratio** calculation, Chairman Matz noted that "this additional capital buffer in credit unions would also reduce downstream risks to the National Credit Union Share Insurance Fund (NCUSIF) to absorb losses."

[11] Public Law 105–219, 112 Stat. 913 (1998).

[12] Federal credit unions are limited to 1% investment in CUSOs. Federally insured credit unions are limited in their ability to hold non federal government obligations. Credit unions in general also face restrictions on their abilities to hold securities, equity investments and to engage in derivative transactions.

Congress Intended an Adequately Capitalized Floor
The FCUA directs the NCUA Board to "design 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."[13] A strict interpretation of the statute suggests that risk-based capital was intended as a floor for capital adequacy. In fact, former United States Senator Alfonse D'Amato, who chaired the Senate Banking Committee when this language was adopted, recently wrote to NCUA saying just that. Senator D'Amato noted that "had [Congress] intended there should also be a separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so."[14] Although Senator D'Amato's views are not dispositive of NCUA authority, his insights into the congressional intent behind the risk-based capital system for credit unions should not be lightly disregarded.

Comparatively, the applicable bank statute unambiguously provides authority to set dual capital standards for each capital category: "Each appropriate Federal banking agency shall, by regulation, specify for each relevant capital measure [leverage limit and risk-based capital requirement] the levels at which an insured depository institution is well capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized."[15] It is true that the credit union statute provides NCUA with broad authority to make credit union regulations comparable to banks. However, in exercising its authority, NCUA is obligated to remain faithful to discernible congressional intent.

Reliance on Capital Conservation Buffer Concept is Misplaced
As currently drafted, the proposed rule requires credit unions to maintain at least 7% net worth and 10.5% risk-based capital to be considered well-capitalized for prompt corrective action (PCA) purposes. In comparison, banks need only 5% net worth and 10% risk-based capital to achieve a well-capitalized PCA classification. NCUA settled on 10.5% as an appropriate threshold by way of comparison to 8% Total Risk-Based Capital plus 2.5% capital conservation buffer (CCB) from the FDIC rule.[16] There are several flaws with this comparison.

First, the 2.5% CCB is not part of the PCA framework for banks.[17] A bank can be well-capitalized for PCA purposes while failing to satisfy the CCB requirement.[18] A bank that fell into this category would face some restrictions on capital distributions and discretionary bonus payments, but would not have slipped any closer to an "undercapitalized" PCA designation. By incorporating the CCB directly into the PCA framework, NCUA disadvantages credit unions by making them more vulnerable to downgrades in their PCA capital classification level. In fact, the FDIC specifically declined to incorporate the CCB directly into PCA: "Because the capital conservation buffer is designed to absorb losses in stressful periods, the FDIC believes it is appropriate for a depository institution to be able to use some of its capital conservation buffer

[13] 12 U.S.C. 1790d(d)(2) (Emphasis added).
[14] Hon. Alfonse D'Amato Letter to NCUA, May 7, 2014.
[15] 12 U.S.C. 1831o(c).
[16] 79 FR 11192 (Feb. 27, 2014).
[17] 78 FR 55354 (Sept. 10, 2013).
[18] *Id.* at 55356.

without being considered less than well-capitalized for PCA purposes."[19] NCUA should explain why credit unions should not be afforded this same flexibility.

Second, the CCB is being phased-in slowly over a five year period for the banking system, with the full 2.5% requirement taking effect in 2019.[20] NCUA has proposed an 18-month implementation period for the full 10.5% requirement. This not only results in credit unions being held to higher capital standards than banks, but also stresses the ability of credit unions to meet those higher standards with pure retained earnings in a compressed time frame. If NCUA insists on retaining the 10.5% requirement, credit unions should be given until at least 2019 to fully implement it so as not to disadvantage them relative to the banking industry. Even if most credit unions are already at or above the 10.5% threshold, most will need to reevaluate their balance sheets in light of the new regulation. Credit unions should not lose valuable adjustment time because most have chosen to operate with conservative capital levels well above the current standards.

Finally, NCUA only applied the CCB to the well-capitalized classification. For adequately capitalized credit unions, NCUA applies the 8% total risk-based capital ratio used by the other federal banking regulatory agencies' without amendment. In the interest of consistency, NCUA should remove the 2.5% CCB from the well-capitalized credit union standard and adjust the other levels accordingly or, at a minimum, allow credit unions an equivalent five year implementation period to build their capital reserves without sacrificing member services or dramatically increasing fees.

Risk-Based Capital Ratio

NASCUS generally supports NCUA's proposed calculation for the risk-based capital ratio, but believes that a few of the exclusions and limitations built into the numerator are misguided. Several of these provisions were adopted from the banking regulation without adequate consideration of the differences between the banking and credit union industries that justify the differences in capital treatment. NASCUS encourages NCUA to revisit the below exclusions and adjust them to better suit the credit union system.

Allowance for Loan and Lease Losses Should Not be Limited

Generally, regulators should not create incentives to keep loss reserves low. The allowance for loan and lease losses (ALLL) account is, in its purest form, capital set aside to absorb losses. In the event of an economic downturn, the full balance of this account would be immediately available to bolster the credit union. Limiting the ALLL will have minimal practical effect on the way credit unions underwrite loans or record losses, but it could create a disincentive to hold higher reserves. For banks, the 1.25% limitation prevents the use of the ALLL as a means to control taxable revenue by maintaining excessive reserves. Credit unions have no incentive to manipulate the reserve in that manner. Given that the primary motivation for limiting this account does not apply to credit unions, NASCUS urges NCUA to include the full ALLL balance in the risk-based capital ratio numerator.

The NCUSIF Deposit Should Count Toward Regulatory Capital

[19] 78 FR 55361 (Sept. 10, 2013).
[20] *Id.* at 55394.

Here also, the reasons for excluding this provision on the bank side do not translate to the credit union system. Although banks expense their deposit insurance, credit unions treat the deposit as an asset. This accounting difference is already captured as part of the higher leverage ratio for credit unions as compared to banks: "Congress established a capital level two percentage points higher [than banks], a level recommended by Treasury, because one percent of a credit union's capital is dedicated to the NCUSIF and another one percent of the typical credit union's capital is dedicated to its corporate credit union."[21] If NCUA excludes the NCUSIF deposit it will not "even the playing field" between banks and credit unions, as NCUA suggests, but will instead disadvantage credit unions by adjusting for the deposit twice. Maintaining consistent treatment of the NCUSIF deposit with this rule is the simplest way to ensure that the congressionally devised correlation between the two systems remains intact.

NCUA Should Consider the Implications of Excluding Goodwill

Given that goodwill is not immediately available to absorb losses in accordance with the intended purpose of regulatory capital, NASCUS agrees that it should be excluded from the risk-based capital calculation. However, its exclusion could have a negative impact on merger incentives in the industry. In order to avoid unintended consequences, we must carefully consider how this might affect a credit union's willingness to acquire troubled institutions in times of stress; a practice which has minimized losses to the NCUSIF in the past. NCUA should model the impact that this treatment would have had on the profitability of mergers during the crisis and include a plan for alleviating any negative side-effects before finalizing this rule.

On Balance Sheet Risk-Weightings

NASCUS has concerns with the general structure, as well as some of the specific proposed risk-weights of this section. We recommend NCUA reevaluate its interpretation of statutory language, remove the concentration risk-weights, and adjust some of the proposed risk-weights to better reflect historic asset performance.

The Risk-Based Capital Ratio Cannot Replace Supervisory Oversight

As currently drafted, the proposed rule attempts to incorporate controls for all of the material risks that are facing the credit union system into the risk-based capital calculation. NASCUS believes this effort is misplaced and counterproductive. Risk-based capital can be an effective tool for obtaining a high-level picture of a credit union's balance sheet relative to other credit unions and relative to a specific set of assumptions. But risk-based capital is not necessarily an effective tool to mitigate every risk facing the credit union system.

Although the FCUA specifies that the risk-based capital system should "take account of any material risks against which the net worth ratio . . . may not provide adequate protection," it cannot and should not attempt to address all areas of potential risk. The statute does not require incorporation of all material risks but merely recognizes that the net-worth ratio is limited, and that risk-based capital (as conceived and applied on the bank side) offers some additional insights into capital adequacy based on the credit risk of the assets held. Instead of reimagining the risk-based capital ratio, NCUA should use the ratio for the purposes for which it was designed: to ensure that credit unions with higher-risk assets are holding capital commensurate with that risk; and to capture off-balance sheet exposure in the capital adequacy calculation.

[21] U.S. Department of the Treasury. 2001. 11 *Comparing Credit Unions with Other Depository Institutions.*

Beyond those goals, the ratio becomes heavy-handed. It sets uniform standards in areas where credit unions must retain the flexibility to innovate in order to meet their members' needs and generate returns. Credit unions, and all financial institutions, are successful when they take on risk and manage it effectively. Regulators are successful when they promulgate rules that are nimble enough to address problem credit unions without encumbering the entire industry. As currently drafted, this rule does not rise to that standard.

Concentration Weightings Should be Removed from the Rule

As discussed above, the risk-based capital calculation is not an effective means of addressing concentration risk. In fact, as currently drafted, the rule does not mitigate concentration risk in the traditional sense at all. It does not account for over-exposure to a specific obligor, or industry, or geographic location. It only captures exposure to a particular product line as a percentage of the overall balance sheet. As such, these risk-weight buckets are actually designed primarily to combat exposure to interest rate risk in credit unions with a large percentage of assets in long-term investments.

If NCUA is in fact using the concentration measure to control interest rate risk, NASCUS has several concerns with that approach. First, the rule does not account for the use of derivatives and other asset and liability management (ALM) strategies to mitigate the interest rate risk associated, for example, with a high concentration of real estate loans. Second, this system penalizes credit unions with specialized expertise in a particular area, such as MBLs, without regard to the success of those credit unions in managing the specific risks of their markets. Finally, the rule only accounts for risk in a rising-rate environment, and does not contemplate the effects of falling rates on credit union portfolios. Although we are undoubtedly facing a rising-rate environment, interest rates will inevitably fluctuate. It is precisely that variability that makes other supervisory tools, such as pointed regulations and timely guidance a more effective means of addressing interest rate risk. A one-size-fits-all regime is not capable of providing a focused response to the risks that interest rate fluctuations present to the system. If NCUA intends to address true concentration risk, it would need to collect more detailed information. NCUA indicated, and NASCUS agrees, that such a reporting structure would be overly burdensome.

Non-Delinquent First Mortgages Should be Risk-Weighted at 50%

NASCUS urges NCUA to eliminate the proposed concentration buckets and risk-weight all non-delinquent first mortgage real estate loans at 50%. As outlined in the previous section, concentration risk-weights are an ineffective method of controlling risk. In reality, this structure could increase risk in the system by encouraging credit unions to swap out first mortgages for riskier investments that they may not have the necessary expertise to manage properly. For example, a credit union with over 35% of its assets in first mortgages would be better off from a capital adequacy standpoint if it shifted toward unsecured loans and vehicle loans. That would be true regardless of the credit union's delinquency rates and risk mitigation strategies.
As drafted, this provision penalizes well-run institutions that have chosen to specialize in a particular product area. NCUA has not provided any empirical evidence that the designated concentration thresholds represent "tipping points" of balance sheet risk, even in well-managed institutions.[22] If the problem is with poor management or inadequate risk-mitigation when

[22] For example, the preamble to the proposed rule seems to indicate that NCUA designated the concentration thresholds based on the average percentage of mortgages held by credit unions. 79 FR 11197 (Feb. 27, 2014). This

coupled with these thresholds, NCUA should target the problem credit unions directly through supervisory action.

There is a great deal of differentiation across mortgage products and NCUA faces a difficult challenge in determining the best framework to identify those higher-risk mortgages without instituting an untenable reporting requirement. Given the delicate balance between regulatory burden and meaningful reporting, NASCUS recommends that NCUA maintain the proposed definition for non-delinquent first mortgage real estate loans and risk-weight everything at 50%. This would provide parity with the banking system and obviate the need for more onerous reporting. NCUA should adopt a similar approach for other real-estate secured loans by eliminating the concentration buckets and risk-weighting everything at 100%. Of course, there are other reasonable methods of setting the risk-weight for this asset class, including incorporating some additional underwriting criteria into the reporting and requirements. Whatever path NCUA decides to pursue, it should provide the industry with a quantitative analysis of the costs and benefits driving the chosen approach.

Treatment of Member Business Loans Does Not Target True Risks

The proposed risk-weight for member business loans (MBLs) is unnecessarily high and the concentration buckets do little to address the true source of risk with this type of product. If NCUA wants to differentiate between MBLs, they should do so by considering the relative risk of the loan provisions and underlying collateral. MBLs cover a wide range of products, including any loan over $50,000 that is used for commercial, corporate, agricultural, or business investment purposes. By tying risk-weights to the underlying collateral of the loan, NCUA would capture a more accurate risk-profile of the affected credit unions.

As drafted, the rule would have a chilling effect on lending at specialized credit unions that have been specifically exempted from MBL limitations to support important public policy objectives.[23] NASCUS is concerned that the proposed MBL weightings could have a dramatic negative effect on credit unions and members located in rural, underserved, and agriculture dependent communities. NCUA should reconcile the possible effect of these proposed weightings with its support of credit union service to underserved rural communities.

Treatment of CUSOs May Undermine Gains From Existing Regulations

The proposed rule singles out credit union service organizations (CUSOs) as a unique risk to credit unions. CUSOs serve a special role in the credit union system and we are not convinced that the treatment afforded to them under the proposed rule serves the long-term interest of the credit union system, or regulators.

It is clear that NCUA is concerned about CUSOs. In November 2013, NCUA finalized a CUSO regulation that dramatically expanded NCUA oversight over those entities. That rule cited several prominent losses to the NCUSIF related to operational and due diligence problems in CUSOs and addressed "material risks that CUSO operations pose to the credit union industry" by creating registry and reporting requirements focusing on "complex or high-risk" CUSOs. The

methodology does not appear to be based on any inherent risk analysis; it simply homogenizes the industry for ease of regulation.

[23] 12 C.F.R §723.17.

risk-based capital proposed rule on the other hand, focuses on the risk presented by the actual cash outlay to the CUSO, which the rule assigns the second-highest possible risk-weight of 250%. The proposed rule does not differentiate between types of CUSO activity.

From a technical perspective, this makes sense. One rule tackles credit, strategic, and reputational risks arising from operations. The other rule addresses the investment risk associated with CUSO ownership. But from a risk-management perspective, these two rules seem to be working against each other. If the primary risk posed by CUSOs is tied to the services they provide, then attaching an arguably punitive risk-weight to CUSO investments will only drive that activity into third-party service providers, that may be, from NCUA's perspective, more opaque than CUSOs. As a result, credit unions would face higher operational costs (because investing in a cooperative cost-saving platform would be rendered unattractive by the excessive capital surcharge), and NCUA's extensive reporting system would be undermined (because it lacks direct statutory and regulatory authority over third-party service providers). NCUA should provide a cohesive explanation of how these regulations fit together to address the varying risks presented by CUSOs.

Finally, the analogy of an "unsecured equity investment in a non-publicly traded entity" from the bank system is ill-suited to the true relationship between credit unions and CUSOs and should be abandoned.[24] The FCUA explicitly grants NCUA the flexibility to take the cooperative character of credit unions into account when prescribing the system of prompt corrective action.[25] Given the unique position of CUSOs in the credit union system, NCUA should exercise that authority to craft a solution that supports the framework of existing regulation while maintaining the viability of CUSOs as cooperative cost-saving business structures.

Treatment of Mortgage Servicing Assets Could Produce Unintended Consequences

Many credit unions depend on mortgage servicing assets to supplement their income. If the 250% risk-weight is maintained, NCUA should, at a minimum, adopt the 5 year phase-in of this provision that was provided on the bank side. It is also worth noting that this excessive risk-weight may be driving mortgage servicing out of the banking industry and into third parties. Such a migration of this activity could have a profound long term effect on the banking system. NCUA should consider whether this designation may have similar unintended consequences for the credit union system.

For many credit unions in particular, maintaining the personal member relationship throughout the life of a transaction is of strategic importance. If the practical effect of a regulation is to force the sale of a mortgage or the servicing rights, the supervisory necessity of such a regulation must be unquestionably clear.

The 1,250% Risk-Weight Should be Altered or Removed

NASCUS has several concerns with the provision that allows for a 1,250% risk-weight. The proposed rule gives NCUA broad discretion to require dollar-for-dollar capital on asset-backed investments for which NCUA feels the credit union is unable to demonstrate a comprehensive understanding. While we agree that such an investment may represent a significant safety and

[24] 79 FR 11197 (Feb. 27, 2014).
[25] 12 U.S.C. 1790d(b)(1)(B).

soundness concern, we feel that an elevated capital requirement is not an appropriate means of addressing that risk.

If a credit union does not understand an investment on its books, the regulator should work with the credit union through the supervisory process to rectify that situation. Although this provision was adopted in the bank rule, use of these types of products is more limited in the credit union industry and risks can and should be addressed through examinations. At a minimum, NCUA should endeavor to minimize the regulatory burden of this provision by limiting the proposed reporting requirements to investments identified during the supervisory process as a potential concern.

Furthermore, the provision does not require the NCUA to coordinate with the applicable state regulator when assessing a state-chartered credit union with a 1,250% capital surcharge. As the primary regulator with the most on-site contact, state regulators are well-positioned to evaluate a state-chartered credit union's understanding of its investments. NCUA does not typically perform annual on-site reviews for all state-chartered credit unions that fall within the proposed definition for a complex institution. NASCUS strongly believes that NCUA should be required to perform an on-site evaluation and reach a joint determination with the state regulator before recommending a 1,250% risk-weight on a state-chartered institution. The final rule should also clarify the administrative level within NCUA at which this determination will be made. NASCUS believes that such a finding could have a dramatic impact on a credit union's PCA classification and major implications for that credit union's balance sheet and management structure. As such, a decision to assess a 1,250% risk-weight should be made through joint consultation between the state regulator and the applicable NCUA Regional Director. Furthermore, the final rule should specify that a 1,250% risk-weight constitutes a material supervisory determination and that is subject to appeal.[26]

Off Balance Sheet Risk-Weightings

NASCUS agrees that capturing off-balance sheet activities is essential to an effective capital adequacy program. In general, the method of multiplying the face value of off-balance sheet items by a credit conversion factor and then by the applicable risk-weight is a functional method of recognizing contingent liabilities. However, the proposed definition of a "limited recourse loan" must be amended to represent the true risk associated with that product. The proposed definition mirrors the Call Report field and includes the "total principal balance outstanding of loans transferred . . . for which the transferor credit union retained some limited recourse." Although we appreciate NCUA's efforts to align defined terms with existing Call Report fields, that practice proves problematic in this instance.

Contingent liabilities should be taken into account only to the extent the credit union retains contractual and legal liability on the exposure. On partial recourse loans, the credit union only retains a small fraction of the liability and is not exposed on the total principal balance. For example, if a credit union sold $10 million in loans to a Federal Home Loan Bank (FHLB) under a program that requires 2% recourse liability, the credit union would only be liable for $200,000 in losses under the worst case scenario. Under the proposed rule, the credit union would be

[26] 12 U.S.C. 1790d(k). NCUA should add this risk-weighting to the list of determinations that are appealable to the Supervisory Review Committee under IRPS 11–1.

treated as holding the full $10 million as a contingent liability. This is a significant misrepresentation of the risk and it creates a disincentive for credit unions to utilize limited recourse loan sale relationships.

Those relationships provide credit unions with a valuable option in managing liquidity and interest rate risk, while still incentivizing the credit union to make high-quality loans. The proposed rule would penalize credit unions that have utilized these programs prudently and effectively as part of a safe and sound asset management program. This definition and the corresponding Call Report field should be amended to reflect the true recourse exposure of the credit union.

Derivatives

This section of the proposed rule is difficult to decipher. In particular, NCUA needs to clarify the process by which a credit union can recognize the risk-mitigation benefits of holding financial collateral and how investments in state-chartered credit unions that are not permitted in federal credit unions will be treated under the rule. NCUA should include example calculations so that credit unions can see how this system would work and which Call Report items are implicated. Overall, NASCUS recommends that NCUA amend the proposed rule to track the banking risk-weights for derivatives as closely as is practicable.

Individual Minimum Capital Requirement (IMCR)

NASCUS has serious concerns with the theoretical and operational elements of this section and urges NCUA to remove it from the proposed rule. As currently drafted, this provision provides NCUA with complete discretion, unchecked by consultation with the credit union's primary prudential regulator, to demand higher capital levels from any credit union at any time. Although we can appreciate the benefits of expediency in capital retention authority in times of crisis, we believe agency discretion should be controlled by clear standards, delineated administrative processes, and a robust appeals process.

Agency Discretion Should be Tempered

The expansive circumstances which could justify the imposition of an individual minimum capital requirement (IMCR) leave this provision susceptible to arbitrary application. Even if executed properly, the potential for misuse will create uncertainty in the industry, which will slow growth and impede innovation.

Credit unions must be able to pursue business and development plans with a clear understanding of regulatory expectations. But the considerations on which NCUA may rely to demand an IMCR are so broad that no credit union in the industry could be confident that it was not at risk. Although there may be instances where loss could have been avoided if NCUA had had this sprawling authority, the overall cost to the industry will surely outpace the safety and soundness gains in the long run. NCUA should resist the urge to over-correct in the shadow of the financial crisis and instead allow the natural dynamic tension between industry innovation and supervisory circumspection to create a safe and sound (but profitable) middle ground in which credit unions can operate without fear of regulatory interference.

Additionally, a credit union cannot predict what new capital level NCUA might require when setting an IMCR. There is no ceiling to the IMCR and no defined system of adding percentage points to the already high 10.5% requirement. While NASCUS agrees that regulators need flexibility to address supervisory concerns in varying situations, the lack of discernible standards or predictable outcomes under this system will do more to undermine growth than to promote safety and soundness.

The IMCR is Unnecessary and Duplicative of Existing Authority
Under current regulations, NCUA already has the authority to reclassify a credit union into the next lower capital category based on the existence of an unsafe or unsound condition or practice at the credit union.[27] This existing authority provides NCUA with the tools it needs to mandate additional capital retention under exceptional circumstances. But it also provides credit unions with comparably clear standards for invocation (safety and soundness violations) and a definite framework for possible agency action (downgraded one capital classification level). The IMCR creates substantial uncertainty without appreciably improving NCUA's ability to address material risk and, consequently, it should be eliminated from the proposal. If despite these significant concerns NCUA decides to retain the IMCR, it should, at a minimum, strengthen the operational framework and improve transparency surrounding its use.

Stronger Appeals and Coordination Framework is Needed
The administration of the IMCR would be codified in new Part 747.2006. As proposed in §747.2006(a), NCUA would "serve on the credit union reasonable prior notice of the proposed IMCR" once NCUA has determined an IMCR might be appropriate. The proposal never specifies at what level within NCUA this initial determination is to be made. Given that NCUA acknowledges in the preamble that this is a material supervisory determination pursuant to Section 216(k) of the FCUA, the rule should specify that the notice come from the NCUA Regional Director.[28] The provision also does not specify that NCUA's notice shall be in writing, but ***does*** specify in proposed §747.2006(b)(4) that the credit union's response be in writing. For consistency, the rule should specify that NCUA's initial notice be in writing as well.

One of our most significant concerns with §747.2006 as proposed is the lack of proffered cooperation and coordination with state regulators when the IMCR determination involves a state-chartered credit union. The proposed rule provides that in the case of a state-chartered credit union, NCUA shall "forward a copy" of the notifying letter to the appropriate state regulator.[29] This is insufficient. NCUA has a statutory mandate to consult and cooperate with state regulators when applying prompt corrective action to state-chartered credit unions.[30] Given the substantial impact an IMCR would have on the operation of a credit union, the spirit of the law would suggest a more integrated approach between regulators would be appropriate, and the rule should carry forward that spirit.

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[27] 12 U.S.C. 1790d(h).
[28] 79 FR 11207 (Feb. 27, 2014) and 12 U.S.C. 1790d(k).
[29] 79 FR 11225 (Feb. 27, 2014). Existing NCUA Rules and Regulations Part 747 applies to federally insured state-chartered credit unions by incorporation in 12 C.F.R. 741.213.
[30] 12 U.S.C. 1790d(l)(1).

Furthermore, state-chartered credit unions often have investment and operating powers that differ in some ways from their federal counterparts. State regulators would be valuable in helping NCUA understand how federally insured state-chartered credit union activities are governed and monitored at the state level.

We commend NCUA for including within the proposed rule elements of a third party review process. However, as noted above, given both the subjective nature of the IMCR and the substantial impact upon a credit union's balance sheet and operations of complying with an IMCR, the review process as proposed is inadequate.

Pursuant to proposed §747.2006(b)(4), a credit union has 30 days ***or less*** to respond to an NCUA determination that the credit union should be subject to an IMCR. In its response, the credit union must affirmatively seek a recommendation from the NCUA Ombudsman on the matter. At that point, the credit union's response is presented to the NCUA Board for determination. Leaving aside the fact that the credit union is appealing the decision to the very NCUA Board that presumably already determined that an IMCR was appropriate, the process is at odds with the NCUA Ombudsman's own characterization of its role in the supervisory process.

The Ombudsman's page on the NCUA website notes that the office "assists in resolving problems by helping the complainant to define options and by recommending actions to the parties involved."[31] The 30 day or less timeframe for a credit union's formal response, coupled with the fact the formal response is what triggers the involvement of the Ombudsman, does not appear to leave any opportunity for the Ombudsman to have any meaningful dialogue with the credit union as to its options. We also note that the Ombudsman's web page states that the office does not handle any matter subject to formal review as set forth in NCUA Regulations or IRPSs.[32] Proposed Part 747.2006 establishes a formal review which would seem, on its face, to be in conflict with the Ombudsman's authority. It is clearly within NCUA's purview to promulgate this exception to that principle, and we note it here only to flag an issue the agency should clarify to reduce confusion.

The entire proposed rule establishes a detailed, comprehensive and complex framework to measure capital adequacy. That a credit union subject to such a requirement could go through the hours of monitoring its balance sheet to compliance and make consequential business decisions based on the established expectations, only to have NCUA determine that an otherwise unknowable standard is determinative, is extraordinary. As such, it should be accompanied by meaningful due process by which both a credit union subject to an IMCR may seek review of the supervisory action, and the credit union system as a whole may monitor its use.

The review process established by proposed §747.2006 should be amended to provide sufficient time for a credit union subject to an IMCR to consult with the NCUA Ombudsman ***prior*** to facing the deadline for submission of the mandatory response. This way, the credit union has an opportunity to receive the benefit of the Ombudsman's perspective in formulating its response to NCUA's notice. Furthermore, because the credit union's response will likely be specifically tailored to the contents of NCUA's notice, the review process must allow the credit union to

[31] Available at http://www.ncua.gov/about/Leadership/Pages/page_omb_bio.aspx.
[32] *Id*.

provide additional information should the NCUA Board, in its deliberation, seek or receive additional information from NCUA staff not included in the proposed §747.2006(b) notice. Likewise, the applicable state regulator should also be given the opportunity to respond should the NCUA Board seek or receive additional information during its deliberation that was not part of the formal notice to the credit union.

Concerns regarding the exercise of IMCR authority would also be mitigated by increasing transparency regarding the review process. Proposed §747.2006 should be amended to include a requirement that NCUA, or the Ombudsman, report at the end of each year the number of times NCUA sought to impose an IMCR, the number of times the imposition of an IMCR was challenged through the review process, and the disposition of those challenges. We anticipate that the imposition of an IMCR would only occur in extraordinary circumstances. Providing statistics to the credit union system on its use, presumably bearing this out, would be a constructive change to the proposed rule.

Furthermore, the changes recommended to the review process proposed in §747 are wholly consistent with the Regulatory Modernization Initiative announced by NCUA in September of 2011. Our recommended changes represent modest yet effective concessions to legitimate concerns regarding the imposition of an IMCR while in no way inhibiting the necessary ability of regulators to respond expeditiously to an imminent material risk.

Drafting Error in Proposed §747.2006(a)

Finally, it appears proposed §747 contains a drafting error. NCUA's proposed Prompt Corrective Action - Risk-Based Capital rule is intended to apply exclusively to federally insured natural person credit unions.[33] However, as published in the *Federal Register*, proposed §747.2006(a) states that NCUA will forward a copy of the letter notifying a FISCU of a pending IMCR to the state regulator in cases involving a state-chartered ***corporate credit union***.[34] This reference should be changed to a state-chartered ***natural person credit union***.

Implementation Period

NCUA proposes to delay the effective date of the final rule for 18 months.[35] It is commendable that NCUA acknowledges the complicated nature of the proposal and anticipates that credit unions will need an extended period of time to adjust. However, 18 months is insufficient to provide credit unions meaningful lead time to make adjustments to balance sheets, polices, procedures, and operations. As but one example, as discussed above, NCUA's risk weighting of CUSOs might cause some credit unions to divest their CUSO investments. Eighteen months is not enough time for a credit union to conduct due diligence to end its ownership of a CUSO, identify a new service provider (if needed) and transition operations.

As noted previously in this comment letter, NCUA should provide credit unions an implementation period commensurate with that of BASEL III, (2019). At a minimum, credit unions should be given 36 months to come into compliance with the final rule.

[33] 79 FR 11184 (Feb. 27, 2014).
[34] *Id*. at 11225.
[35] 79 FR 11208 (Feb. 27, 2014).

Developing risk-based capital requirements for credit unions is a complicated undertaking. Given that the final construct of this rule will have an enormous impact on how credit unions operate, the products and services available to members, the types of information sought by regulators, and the costs of compliance, it is incumbent on NCUA to judiciously consider all of the comments and concerns raised by stakeholders. We are confident the agency will do so, regardless of how long this process takes. NASCUS remains committed to working with NCUA to ensure any final rule is carefully calibrated to achieve the supervisory goal of improving capital standards without unduly burdening the credit union system. NASCUS will be pleased to assist the agency in its efforts.

Sincerely,

Mary Martha Fortney
NASCUS President and CEO