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Indiana Credit Union League Comments on Proposed Rule - PCA Risk-Based Capital

1 message

John McKenzie <johnm@icul.org> Fri, May 23, 2014 at 4:22 PM
To: regcomments@ncua.gov
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Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Indiana Credit Union League Comments on Proposed Rule - PCA Risk-Based Capital

Dear Mr. Poliquin:

The Indiana Credit Union League (ICUL) appreciates the opportunity to submit comments on the National Credit Union Administration's proposed rule addressing risk-based capital under the Prompt Corrective Action section of NCUA's rules & regulations. The ICUL member credit unions represent 97% of assets and members of Indiana's credit unions, with those memberships totaling more than two million consumers.

The ICUL supports the concept of risk-based capital. We believe that a much broader overhaul of the capital regulations should occur that replaces the existing leverage and risk-based capital ratios with one risk-based ratio that is appropriately designed to recognize both the risk and the unique cooperative structure of credit unions. We recognize that the current proposal does not accomplish this, and therefore respectfully recommend that NCUA table the proposed rule until such time that NCUA, in conjunction with credit union input, can develop an acceptable risk-based capital system.

That being said, we do have major concerns with the proposed rule itself. These concerns include:

- NCUA has not sufficiently demonstrated the need for this proposed rule.
- Through various aspects of the proposal, NCUA is treating credit unions as being inherently more risky than other financial institutions.
- The risk-weights being applied to certain asset categories are onerous, unnecessary, and will place credit unions at a strategic disadvantage relative to community banks.
- NCUA is trying to address multiple risk categories with one regulation that in other industries focuses only on credit risk.
- The proposal focuses only on the asset side of the balance sheet and does not account for any asset liability management offsets on the liability side of the balance sheet.
- Under the proposal, NCUA could assign a higher individual risk-based capital requirement to a credit union based on very subjective criteria.
- The NCUSIF one percent deposit and goodwill are deducted from capital in the calculation.
- CUSO investment risk weighting is too high and does not distinguish between the differences in risk between various types of CUSOs. Some of the financially strongest and most important organizations supporting the entire credit union system are CUSOs.
- The 10.50% well capitalized rate is too high and not supported by any legislative or regulatory authority.
- NCUA has underestimated the impact this regulation will likely have on credit unions. It is not just about how this proposed rule would impact CUs in the near-term; it is about how it would hinder growth, service options and strategic decisions over the longer-term.

- 18 months is not nearly long enough to implement a revised risk-based capital rule.
- It appears that through this regulation NCUA is "managing" credit union operations and strategic planning rather than "regulating."

The following provides additional detail on the bullet points listed above.

NCUA has not demonstrated the need
Credit union capital has withstood the most challenging five-year economic turmoil that we have ever seen. Credit union capital on average is almost at the same, very strong level as it was before the severe economic downturn that began in 2008 and after absorbing the corporate CU capital write-downs as well as the assessments for the Corporate Stabilization Fund (a good portion of which now appears to have been unnecessary) during the past five years. The tenor of the proposal is that credit unions are not adequately positioned to manage risk. Existing regulations that require credit unions to establish an allowance for potential loan losses, stress test their balance sheets, understand the various risks in different aspects of the credit union operations, etc. have adequately enabled credit unions to manage risk very well.

Treats credit unions as inherently more risky
Through developing a proposed risk-based system that attempts to address multiple types of risk, and applying much higher risk weights to various asset categories, NCUA is inferring that credit unions are inherently riskier than other financial institutions. We could not disagree more with this position. Credit unions have historically been much more conservative in lending and investing than other financial institutions. Loan losses at credit unions have been lower than at other financial institutions as a result of this more conservative approach. Existing capital standards for credit unions are higher than for banks. The information provided in NCUA's supporting narrative does not provide sufficient information to justify why first mortgages, member business loans (MBLs), long-term investments and CUSO investments are such a higher risk at credit unions than similar assets at banks. BASEL III risk weights for these asset categories, regardless of concentration, are generally much lower than what NCUA proposes for credit unions. NCUA has not provided sufficient detail from any analysis that has been completed to justify this significant and onerous difference in risk weights as compared to community banks.

Risk weights are onerous, unnecessary and result in a strategic disadvantage
As mentioned above, the risk weights being applied in various asset categories and incremented based on concentrations are onerous, unnecessary and would place credit unions at a strategic disadvantage relative to other financial institutions for no apparent reason. In particular we believe NCUA has not provided sufficient justification for the following:

- Investments with a weighted average life of one year or more (50%-250% vs. 20% for all under BASEL III), in particular investments that are guaranteed or insured by the federal government.
- Member business loans based on percent of assets (100%-200% vs.100% for all under BASEL III)
- First & second mortgages based on percent of assets (0%-100% for first mortgages, 100%-150% for seconds, compared to 50% for all under BASEL III)
- Delinquent consumer loans (150% vs.100% under BASEL III)
- Investment in CUSOs (250% vs.100% under BASEL III)
- Mortgage servicing assets (250% for all vs. under BASEL III 100% up to 15% of capital , then 250% on amounts over 15% of capital)
- Corporate perpetual capital (200% vs. 100% under BASEL III)

One component of pricing involves risk. If credit unions are required to apply these significantly higher risk weights, and therefore have to increase the risk component in their pricing to cover this perceived risk, the end result is higher pricing that is less competitive in their market. This could easily result in a credit union deciding not to offer a certain product, thus reducing the availability to the consumer. We firmly believe that through the application of these risk weights, NCUA is inferring greater risk in credit unions for these asset categories. A negative consequence of this approach is that NCUA would be managing the investments and loan services that credit unions can offer to their members by punishing credit union participation through unreasonably higher risk weights than those required by BASEL III for community banks.

We are very concerned that NCUA's unrealistic risk weighting of member business loans will force many credit

unions to significantly reduce making these types of loans. The unintended consequence of this would be fewer options available for small businesses and many farm operations, and in some cases no options for these entities. Credit unions that are located in small to medium-sized communities are often the primary option for small businesses and farmers. As a direct result of the risk weights for business loans, one agricultural based credit union in Indiana would end up with more risk assets than total assets. This credit union has been very successful in agriculture lending and has not experienced any significant losses in this area, yet the proposed rule would treat the credit union as an extremely high risk institution. We do not believe this is appropriate.

When NCUA announced its proactive efforts to identify credit unions that qualified for the low income credit union (LICU) designation, NCUA touted regulatory flexibility in certain areas as one of the benefits of having the LICU designation. Included in the regulatory flexibility was relief from the member business lending cap. The risk weighting applied to MBLs through this proposed rule would indicate that while LICUs could exceed the cap, NCUA is effectively reinstating the cap by applying risk weights of 150% and 200% on loans that exceed the cap. We believe that this would nullify any regulatory flexibility that came with the LICU designation.

The risk weights associated with mortgages may have the same impact on consumers - fewer options. Members have come to rely on their credit unions as trusted resources for mortgage lending. Credit unions have demonstrated a willingness to work with their members in a safe and sound fashion to make home ownership a reality. By placing unreasonable risk weights on mortgages based solely on concentration, NCUA could force credit unions to have to limit this service to their members; the end result would be fewer and likely more expensive options for members.

Addressing multiple categories of risk with one regulation/Asset focus of proposed rule

In the write-up for the proposed rule, NCUA states that the risk weights are necessary to offset various categories of risk, including interest-rate risk, credit risk, concentration risk, transaction risk, etc., while BASEL III is focused primarily on credit risk. The proposed regulation also focuses solely on the asset side of the balance sheet. Many of the risks that NCUA is addressing in the proposed rule and associated risk weights are addressed through asset liability management practices and various credit union policies (loan, investment, ALM, MBL, interest rate risk, liquidity, concentration, etc.) and other NCUA rules and regulatory guidance, which are totally ignored in the application of this proposed rule. NCUA has required these policies over time to specifically address many of the categories of risk that the proposal also addresses. We do not believe that this duplication is necessary, and encourage NCUA to take an approach similar to BASEL III should they move forward with this proposed rule.

Ability to assign a higher individual risk-based capital percentage

The proposed rule would give NCUA the authority to require a higher individual risk-based capital ratio requirement to a credit union based on subjective analysis by the examiner. We are adamantly opposed to the inclusion of this individual credit union mandate in the proposal. The reasons given for this to be applied to a credit union by an examiner are too subjective in nature. If NCUA develops a risk-based capital proposal that is well thought out and supported by valid empirical data (which this is not), an individual risk-based capital requirement would not be necessary. NCUA currently has other regulatory options available at its disposal if there are safety and soundness concerns. Today, examiners "require" higher net worth ratios, well above the 7% well capitalized ratio, based solely on the examiner's subjective opinion on the level of capital that a credit union should hold. In multiple cases, examiners have "required" through the examination report findings that credit unions should maintain leverage net worth ratios higher than 10%. There is no regulatory basis for this, only the examiner's opinion. With this approach already being used with the leverage ratio, we are very concerned with how this individual credit union mandate would be implemented.

Deduction of NCUSIF deposit and goodwill from capital calculation

Under the proposed rule the NCUSIF 1% deposit is deducted from the capital calculation and also deducted from the total risk-based assets. While this appears as an equal trade-off, it does not function that way. By deducting the NCUSIF deposit from both sides of the equation, the net effect is a lowering of the risk-based capital ratio by over 1 percent in some instances, resulting in the credit union falling below the 10.50% versus being above 10.50%. We recommend that NCUA not deduct the NCUSIF deposit from either side of the balance sheet, but leave it as an asset with a 100% risk weight.

Deduction of goodwill from both sides of the equation will have a similar effect. The definition of goodwill is the

excess market value of assets compared to the book value brought over in a merger. It is a GAAP requirement. Again, we would recommend that goodwill also be risk weighted at 100% and not deducted from the capital calculation.

CUSO Investment 250% risk-weighting is too high

We do not believe that NCUA has fully recognized a primary purpose of CUSOs in this proposed regulation. This is evident by the 250% risk weight applied. A key reason many CUSOs are established is to help mitigate or share risk across multiple organizations. The benefits that credit unions see are not only based on the CUSO paying a dividend to the credit unions involved. Quite often, there are significant cost savings to the credit union that are not directly evident in an evaluation of risk assets. The assumption in the proposed rule is that all CUSOs are the same. This again is an area where we feel NCUA needs to spend time doing a more thorough analysis before promulgating a risk-based capital rule. There needs to be differentiation in types of CUSOs and the associated risk to the credit union. All CUSO investments should not be risk weighted at 250%. PSCU for example, has consistently paid a patronage dividend to the credit unions involved. This is only possible as a direct result of the economies of scale generated by the participating credit unions, reducing the overall risk to this group. A portion of this dividend is reinvested as additional capital in PSCU and increases the CUSO investment on the credit unions' financials. Under the proposed rule, this increased investment would also be risk weighted at 250%. Punishing credit unions by requiring excessive net worth based on the success of a CUSO, which ultimately reduces the risk profile of the credit union, does not make sense to us. In addition to PSCU, some of the financially strongest and most important organizations supporting the entire credit union system are CUSOs. They would be affected negatively by this unnecessarily high risk weighting.

Credit unions have also expressed concern that there is the possibility of "double dipping" on risk weighting of CUSO assets. Credit unions report CUSO activities in a consolidated manner within the credit union financials. If NCUA looks at the CUSO individually from the credit unions, and then also risk weights the assets that may be represented in the credit union's financials, this would have the potential to effectively risk-weight these assets 500%. Should NCUA proceed in promulgating a rule in this area, it needs to make sure that assets are only risk weighted once.

10.50% well capitalized rate is too high

In the proposed rule, NCUA established an arbitrary 10.50% risk-based capital ratio to be considered well capitalized. We do not believe that there is any legislative or regulatory basis for establishing this rate. NCUA has not provided any supporting data sufficient to indicate why this rate is proper. Banks are not subject to the same level of capital that credit unions currently are, and certainly nowhere near what credit unions would have to meet in the proposed rule. This is another example where NCUA infers that there is higher risk in credit unions than in other financial institutions for certain asset categories. This is absolutely not true, and is borne out in the loss ratios for various financial institutions. Credit union loss ratios have historically been lower, and certainly do not support this level of capital requirement.

NCUA has underestimated the impact of this proposed rule

In its write-up, NCUA states that fewer than 200 credit unions would be impacted by this proposal. Its definition of impacted is that the credit union would be demoted at least one category, such as from well capitalized to adequately capitalized. The greater impact of this proposal is the loss of an estimated $7.3 billion dollars in the capital cushion that thousands of credit unions have today relative to the well capitalized threshold. In examinations, the examiners consistently challenge credit unions when their net worth ratio is declining; focusing on how much cushion they have to being well capitalized. As stated before, many examiners set higher capital expectations than the 7% well capitalized standard, and in the examination write-ups point out how the credit union's capital is declining, even though they have a significant cushion above being well capitalized. We are concerned that examiners would utilize this decline in the cushion to the 10.50% arbitrary risk-based capital requirement to further limit what a credit union can do strategically. It is not just about how this proposed rule would impact CUs in the near-term; it is about how it would hinder growth, service options and strategic decisions over the longer-term.

18 months is not nearly long enough to implement the rule

We believe that NCUA is not being realistic in expecting 18 months to be sufficient time for "credit unions to make adjustments to internal systems, balance sheets and operations" in advance of the effective date of any final rule. When banks were at a similar point in the process of BASEL III being developed and implemented, they

had had nine years to fully implement the revised rule. It is inconceivable to us how NCUA could expect credit unions to make all the necessary adjustments, particularly to their balance sheets in such a short window without exposure to losses that could occur from selling investments, participating out loans, etc., that may be required adjustments to the balance sheet. We encourage NCUA, should a final rule be developed, to allow a much longer time frame to fully implement the final rule, similar to what the banking industry had. The vast majority of credit unions can only increase capital by generating net income. A short implementation time frame would force credit unions to consider liquidating assets to adjust the balance sheet since there would not be enough time to generate net income to grow capital sufficiently.

One additional approach NCUA should consider would be to allow greater access to secondary capital by all credit unions. This would support a faster option to build capital than exists today.

As stated above, the ICUL supports the concept of risk-based capital. We believe that a much broader overhaul of the capital regulations should occur that replaces the existing leverage and risk-based capital ratios with one risk-based ratio that is appropriately designed to recognize both the risk and the unique cooperative structure of credit unions. The current proposal does not accomplish this and we respectfully recommend that NCUA table the proposed rule until such time that NCUA, in conjunction with the credit union community's input, can develop an acceptable risk-based capital system.

Thank you for the opportunity to comment on the proposal. If you have any questions about our letter, please do not hesitate to give me a call at (317) 594-5320.

Sincerely,

John McKenzie
President, Indiana Credit Union League