NAFCU

3138 10th Street North
Arlington, VA 22201-2149
P: 703.842.2234
F: 703.522.0594
chunt@nafcu.org

National Association of Federal Credit Unions | nafcu.org

**Carrie R. Hunt**
Executive Vice President of Government Affairs
and General Counsel

July 11, 2016

The Honorable Rick Metsger, Chairman
The Honorable J. Mark McWatters, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

**RE: Credit Union Capital**

Dear Chairman Metsger and Board Member McWatters,

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association focusing exclusively on federal issues affecting the nation's federally-insured credit unions, I am writing to urge NCUA to reassess the implementation of the Risk-Based Capital (RBC) rule until a number of regulatory, legislative, policy and economic issues fully unfold.

Credit unions and the National Credit Union Share Insurance Fund (NCUSIF) performed very well during the financial crisis, and since RBC was first proposed, the health of the credit union industry has only continued to improve. In fact, as of March 2016, the number of CAMEL code 4 and 5 credit unions has fallen from 409 in December 2011 to 218. Likewise, the number of CAMEL code 3 credit unions has fallen to 1,212 from a total of 1,741. As a result, over 92 percent of the industry's assets are held in CAMEL 1 or 2 credit unions. Given the continued health of the credit union industry under the status quo, as well as continued pressure on earnings, NAFCU still has concerns with going forward with implementing NCUA's risk based capital rule.

Multiple financial experts and economists have conducted in-depth examination of rules similar to RBC, and have found them to be failed experiments. Most recently, at a July 6, 2016 event, Federal Reserve Board Governor Daniel Tarullo acknowledged that risk-based capital requirements are not appropriate for smaller banks and credit unions, noting that the requirements are too complicated. He stated, "when it comes to smaller institutions... any institution under $10 billion, I think we can and should have a substantially simpler capital system."

Similarly, researchers at the Mercatus Center and Heritage Foundation have found that risk-based capital requirements will likely impede economic growth without reductions in systemic-risk, especially considering the fact that risk-based standards proved inadequate during the financial crisis because they included subjective assessments of risk.

Additionally, Thomas Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, has also criticized the complexity of Basel-like rules. In a September 2012 speech, he asserted that regulators should develop better alternatives to Basel-like capital rules, especially considering that risk-based capital rules failed to help banks avoid the effects of the financial crisis.

**Forthcoming Regulatory and Legislative Developments**

As the agency explained in the rule's preamble, RBC was developed, in part, to identity risk outliers that posed potential threats to the NCUSIF. In the months since RBC has been finalized, though, there have been several regulatory developments that more adequately confront the risks that RBC was initially intended to address. One of these risks was interest rate risk (IRR). Thankfully, the agency removed IRR provisions from the final rule, electing instead to address IRR through the use of a tool during examinations.

The IRR examination tool will provide NCUA with increased clarity around the actual levels of market risk in the system, and will allow NCUA to generate more precise methods to measure and address risk at individual credit unions. While the IRR tool will be a minimally invasive procedure allowing NCUA to focus on risk outliers, NAFCU believes that the RBC rule is a blunt instrument that is not as precise, effective, or useful. The IRR tool stands in stark contrast to the RBC rule. Unfortunately, RBC's implementation will unintentionally ensnare healthy credit unions in the attempt to identify outlier risk.

In addition to NCUA developments that address risks, other regulators have also developed new rules since RBC was first proposed. As recently as June 2016, the Financial Accounting Standards Board (FASB) released a final accounting standards update (ASU), which is intended to address the need for a more predictive model for the financial reporting of credit losses on loans and other financial instruments held by lending institutions.

The ASU establishes a "current expected credit loss" (CECL) model for financial institutions that would require credit unions to immediately increase their Allowance for Loan and Lease Loss (ALLL) balance and reduce capital. Again, this is a rule that will address the risks that RBC was initially intended to address, and as such, create a redundant regulatory environment. Now that such significant threats are being addressed independent of the RBC rule, the agency's stated need for this rule is no longer essential, and the rule no longer serves the agency's stated purpose.

On the legislative front, other alternatives to Basel-like capital rules are currently being considered, including the recently unveiled *Financial CHOICE Act*. The *Financial CHOICE Act* is designed to enhance U.S. financial market resiliency and promote economic growth by offering well-managed, well-capitalized financial institutions – those with a simple leverage ratio of 10 percent – an "off ramp" from RBC's complexity. As Chairman Jeb Hensarling wrote in support of the bill:

> "The leverage ratio used to assess capital adequacy under the Financial CHOICE Act is more stringent than the risk-based capital regime traditionally favored by global banking regulators and embodied in the successive iterations of the Basel capital accord. Unlike Basel's risk-weighted capital requirements, a leverage ratio measures a bank's capital against its total assets, without incorporating subjective regulatory judgments about the relative riskiness of those assets."

The *Financial Choice Act* creates a new approach, but would also have to be tailored for credit unions.

Ultimately, NAFCU believes comprehensive capital reform for credit unions, such as allowing credit unions to have access to supplemental capital sources, and making the statutory changes necessary to design an appropriate capital system for credit unions, requires further study and debate. The work that the NCUA Board and staff has performed relative to risk based capital to date has been substantial and not without controversy. NAFCU recognizes all the hard work that has been done on this issue, but believes there is more work to be done so that credit unions may continue to have a positive impact on our economy.

Should you have any questions or would like to discuss these issues further, please do not hesitate to contact me at chunt@nafcu.org, or (703) 842-2234.

Sincerely,

Carrie R. Hunt
Executive Vice President and General Counsel