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National Association of Federally-Insured Credit Unions

July 25, 2019

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

RE: Delay of Effective Date of the Risk-Based Capital Rules (RIN 3133-AF01)

Dear Mr. Poliquin:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to you regarding the National Credit Union Administration's (NCUA) proposed delay of the effective date for its risk-based capital (RBC) rules. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 117 million consumers with personal and small business financial service products. NAFCU appreciates the NCUA Board's commitment to evaluating the appropriateness of the 2015 RBC final rule in light of other regulatory developments, including asset securitization and subordinated debt, and to providing more time to prepare for the rule's implementation. NAFCU and its member credit unions support the NCUA Board's proposed two-year delay of the effective date and thank the Board for holistically evaluating the rule's impact on the credit union industry. Below are several recommendations for the Board to consider as it evaluates a community bank leverage ratio (CBLR) analog for credit unions as well as how to proceed with asset securitization and subordinated debt. NAFCU has also included recommendations regarding certain aspects of the 2015 RBC final rule that could be improved to facilitate a more effective risk-based capital framework. The NCUA should also work with Congress in the future to amend the *Federal Credit Union Act* (FCU Act) to achieve comprehensive capital reform.

Summary of Regulatory Improvements

NAFCU maintains a number of concerns about the RBC rule and recommends the following issues be reviewed and regulatory improvements be made to reduce regulatory burden on an already extremely well-capitalized industry:

- *Definition of "Complex" Credit Union*: The size of an institution does not determine its complexity. Rather than an arbitrary $500 million asset threshold, a "complex" credit union should be defined as one that is engaged in higher-risk assets or liabilities.
- *CBLR Analog*: A CBLR analog should be regarded as an alternative measure of capital adequacy that supplements the definition of "complex," whether that term is modified to reflect an activities-based approach, as NAFCU proposes, or remains asset-based. A

CBLR analog could function as an off-ramp for credit unions already subject to the RBC rule.

- *Risk-Weight Categories*: The NCUA should recalibrate risk-weights for credit union service organization (CUSO) investments, corporate paid-in capital, and mortgage servicing assets, and remove concentration risk thresholds for mortgages and commercial loans, to more appropriately mirror requirements for similar investments by banks.
- *Goodwill*: Goodwill should not be deducted from the sum of the capital elements of the RBC ratio numerator.
- *Additional Considerations for Capital Relief*: The NCUA should issue guidance for credit unions on permissible asset securitization activities and issue a rule on supplemental capital to permit efficient capital planning and ease compliance with RBC.

General Comments

NAFCU and its member credit unions support a fair capital system for all federally-insured credit unions that both provides true risk-based capital and access to supplemental capital. In October 2015, the NCUA adopted the RBC rule for federally insured, natural-person credit unions to create a two-tier risk-based capital system. The rule made significant changes to the NCUA's capital adequacy rules and was to take effect on January 1, 2019. In October 2018, the NCUA finalized a rule amending its 2015 RBC rule to delay the implementation date by one year to January 1, 2020 and increase the threshold level for coverage under the RBC requirements from $100 million to $500 million by amending the definition of a "complex" credit union.

The NCUA now proposes this rule to delay the effective date of both the 2015 and 2018 final rules until January 1, 2022 to allow the agency more time to consider whether to: (1) develop regulatory and supervisory standards to address asset securitization; (2) propose and finalize a rule to allow certain forms of subordinated debt to qualify as capital for risk-based capital purposes; and (3) integrate the equivalent of a CBLR into the NCUA's capital standards. In any risk-based capital regime, NAFCU has one key tenet that needs to exist: capital must be sufficient to protect the institution, but not so restrictive as to provide a competitive disadvantage or curtail lending.

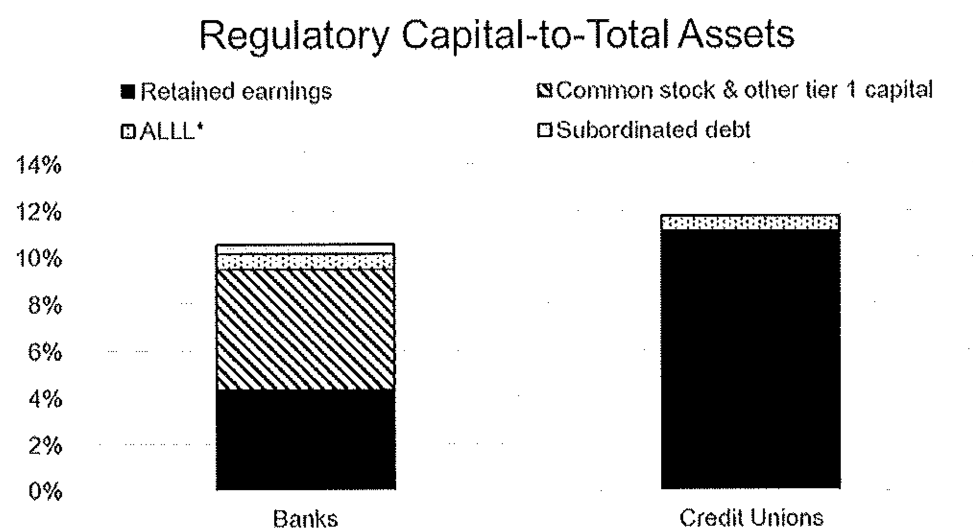
Credit Union and Bank Capital

As the Board considers different ways to moderate the effects of the RBC rule, it should take into account the totality of new regulation imposed since the financial crisis, much of which has sought to improve the safety and soundness of the financial sector as a whole. For example, all credit unions must now have a plan to access a contingent liquidity source, all credit unions will soon be subject to the current expected credit loss (CECL) standard, most are subject to new interest rate risk management expectations, and most credit union lending activities are subject to greater scrutiny and restrictions than existed prior to the financial crisis. Furthermore, large credit unions now undergo regular capital planning and stress testing. The cumulative effect of these regulations has greatly enhanced the resiliency of credit unions to future economic shocks or liquidity risks. In such an environment, the NCUA should focus on opportunities to develop an appropriately tailored and competitive capital framework that reflects the overall strength of the credit union system today.

Other regulators have recognized that the capital strengthening sought by post-crisis reforms has already been accomplished. In recent testimony before the House Financial Services Committee, the Federal Reserve's Vice Chair of Supervision, Randal Quarles, remarked that for banks, "the capital-building phase of the post-crisis era is now complete." Credit unions, like other financial institutions, responded to the financial crisis by adopting new risk management policies, rebuilding capital, and improving internal capital planning processes—whether or not they were subject to formal rules or enhanced supervision. Advancements in technology, forecasting, and approaches to risk management have also made the credit union system stronger and this industry-wide process of maturation should weigh in favor of more flexible capital rules.

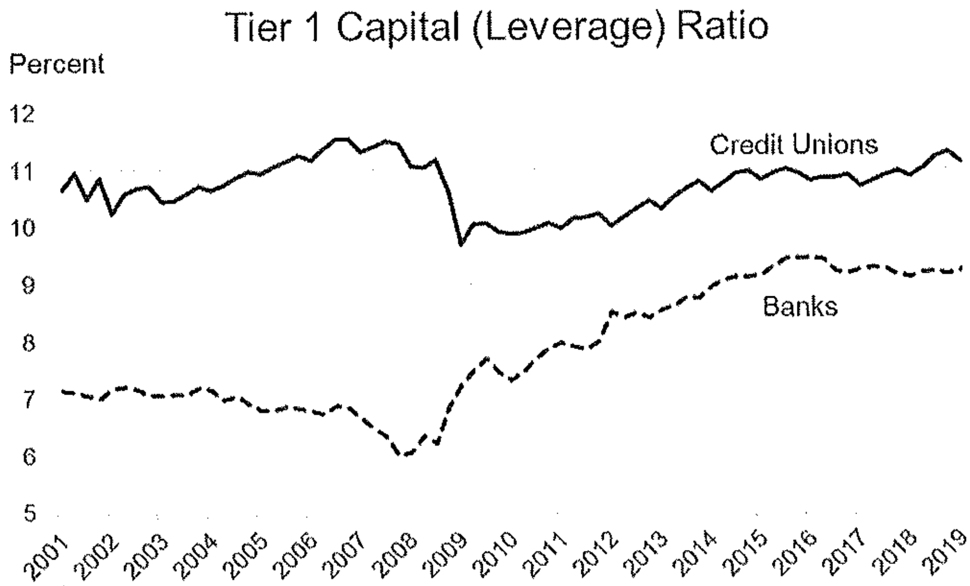
The Board should also recognize that credit unions are fundamentally different from banks and face unique restrictions that tend to promote more conservative business practices and capital planning. A natural aversion to risk taking is largely the consequence of credit unions being reliant on retained earnings in order to build net worth. Credit unions cannot issue stock or avail themselves of different tiers of equity capital like banks, so the consequences of a loss that eats into retained earnings will be felt much more acutely in the long term. The vast majority of credit unions, recognizing such risk, already maintain capital levels above what is necessary to be considered well-capitalized.

As shown in the first chart below, credit union risk-based capital consists almost entirely of high quality retained earnings and, as a share of total assets, exceeds the equivalent regulatory capital held by banks. To the extent the Board feels that credit union capital rules have not kept pace with those imposed on banks, this table should serve as a reminder that credit unions already maintain a stronger capital position.



* ALLL = Allowance for Loan and Lease Losses. Banks and CUs have different thresholds for allowable ALLL; figures reflect entire ALLL account.
Sources: Bank and credit union call reports

The NCUA should also review the performance of credit unions during and after the financial crisis. As shown in the chart below comparing leverage ratios, credit unions maintained significantly more high-quality capital than banks through the crisis and up to today (+200 bps) despite substantial capital infusions at banks.



Sources: Federal Reserve Bank of New York, NCUA

The higher leverage ratio maintained by credit unions (measured by the ratio of aggregate capital to total assets), despite banks receiving $313 billion of Troubled Asset Relief Program (TARP) funds during the financial crisis, demonstrates that they are capable of maintaining capital resiliency in the absence of prescriptive regulation. The Board should also note that the regulatory leverage limits for banks and credit unions are calculated differently (with banks benefiting from a more expansive range of qualifying capital). Before the Board entertains any decision to achieve "parity" with bank-specific capital rules—or contemplates adjustments pursuant to its authority under Section 216(c)(2)(A) of the FCU Act—it should consider whether credit unions' capital framework is truly competitive.

Definition of "Complex"

In response to the 2015 RBC final rule, NAFCU's Board of Directors approved a set of recommended changes, upon which the recommendations in this letter are based. NAFCU supports reform of the RBC rule, including an activities-based complexity ratio versus a static threshold of total assets as is currently required under the rule. Section 216(d)(1) of the FCU Act authorizes the NCUA to develop a definition of "complex" based on the portfolios of assets and liabilities of all credit unions. The definition the NCUA has created, although more favorable in the 2018 final rule, is still overly simplistic and not in line with the approach other financial regulators use to determine complexity.

For example, the Basel Committee considers complexity and size as separate categories in determining whether an institution is a global systemically important bank (G-SIB). The Basel Committee has also focused its discussion of complexity on the difficulties in resolving complex banks when they fail and the higher level of losses entailed. The NCUA should adopt a similar approach and identify as complex those products and services associated with increased losses to the National Credit Union Share Insurance Fund (NCUSIF) instead of just focusing on the size of a credit union. Such a customizable risk-based approach could allow the NCUA to better identify credit union risk exposures and their individual risk profiles. Accordingly, NAFCU does not support a bright-line asset threshold in determining complexity and encourages the agency to move away from this conservative approach to truly risk-based capital requirements. The definition of complex should take into consideration the factors the NCUA evaluated when formulating the complexity ratio in its 2018 final rule.

CBLR Analog

NAFCU understands that the Board is not formally proposing a CBLR at this time; however, the NCUA should consider several issues as it decides whether such an option would be desirable for credit unions. NAFCU does not support a CBLR analog that replaces or limits the existing definition of a complex credit union. Although NAFCU disagrees with the conceptual basis for the current asset-based definition of complex, it provides a more reasonable threshold for coverage than an 8-10 percent leverage ratio by itself, which could subject even the smallest credit unions to the RBC rule. Accordingly, any CBLR analog should serve as an alternative measure of capital adequacy, operating alongside NAFCU's proposed, activities-based definition of complex, or—in the alternative—supplementing the current definition of complex.

In general, NAFCU supports a CBLR option because it provides an off-ramp from the RBC rule. Nonetheless, NAFCU encourages the agency to evaluate such a potential capital rule option through the lens of fair competition with other financial institutions. To appropriately tailor a CBLR analog for credit unions, the NCUA should develop its own qualifying criteria rather than strictly rely on what has been adopted by the other banking agencies. The CBLR proposed by the other banking agencies in February 2019 includes four qualifying factors (off-balance sheet items, trading assets, mortgage servicing rights, deferred taxes) in addition to a $10 billion cutoff. The qualifying factors disqualify only a handful of community banks and were clearly designed to accommodate the vast majority of banks under $10 billion in total assets.[1] As a result, the more meaningful bar for eligibility is the 9 percent leverage ratio test.

For credit unions, the qualifying factors present a different story. As asset size increases, off-balance sheet (OBS) exposures become a limiting factor, and a much larger share of credit unions than community banks ultimately exceed the 25 percent limit. The stronger correlation between asset size and OBS exposure is likely due to credit unions' heavier emphasis on consumer lending

[1] *See* NPRM, Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations, 84 Fed. Reg. 3062, 3064 (Feb. 08, 2019) ("[T]he CBLR framework is intended to be available to a meaningful number of well capitalized banking organizations with less than $10 billion in total consolidated assets."). The banking agencies, including the Federal Deposit Insurance Corporation, have scheduled a final rule on CBLR in their Spring Unified Agendas for this summer.

as compared with community banks, which results in more uncommitted lines on credit cards and home equity lines of credit. For the median credit union under $10 billion in assets, those two items make up 2.5 percent of total assets. For community banks, the median is 0.9 percent. To ensure that credit unions' commitment to consumer lending is not unfairly penalized, the NCUA should either adopt a higher OBS exposure limit or eliminate this qualifying factor from a future CBLR analog.

Based on the most recently available credit union call report data, introducing a CBLR analog would exempt 92 percent of the industry if the option were identical to what has been proposed by the other banking agencies. It should be noted, however, that the current definition of complex already exempts approximately 90 percent of the industry. Accordingly, a potential CBLR would provide relief for credit unions that maintain strong capital and present minimal risk, but would not dramatically alter industry coverage under the 2018 Supplemental Rule.

A CBLR analog that functions as an off-ramp for credit unions already subject to the RBC rule must be carefully designed to ensure compatibility with the FCU Act's directive that the NCUA apply a risk-based standard to all complex credit unions. Potentially, a CBLR may be implemented by creating a two-step test for determining whether a credit union is complex. For example, using the current definition, the NCUA could provide that a complex credit union is one that exceeds $500 million in total assets and <u>does not</u> elect an alternative measure of capital adequacy under a simplified leverage ratio test. Permitting voluntary adoption of the CBLR would be similar to the framework adopted by the other banking agencies. Furthermore, structuring the definition of complex in this way would avoid the challenges associated with developing different risk-based standards for credit unions that are already deemed complex.

Risk-Weight Categories

NAFCU remains concerned that the RBC rule continues to maintain risk-weights that exaggerate the risks associated with certain assets and investments. NAFCU continues to believe that these risk weight categories should be reconsidered as the NCUA considers various capital relief options. NAFCU's recommends several amendments to the RBC rule that would modify the calculation of the risk-based net worth (RBNW) ratio. These include: (1) reducing the risk weight for investments in CUSOs from 150 percent to 100 percent; (2) reducing the risk weight for corporate paid-in capital from 150 percent to 125 percent; (3) reducing the risk weight for mortgage servicing assets from 250 percent to 150 percent; (4) removing the higher risk weight for higher concentrations of real estate and commercial loans; and (5) not deducting goodwill from the numerator of the ratio.

The table below shows the estimated changes across RBC categories by asset class under the current RBC ratio calculation and using the NAFCU proposed changes. The differences are minimal, with only a handful of credit unions migrating to higher capital categories.

Asset Class	Using NCUA Proposed Risk Weights			Using NAFCU Proposed Risk Weights		
	Under 8%	8%-10%	10% or more	Under 8%	8%-10%	10% or more
$500M-$1B	0	2	244	0	1	245
$1B+	1	0	283	0	0	284
Total	**7**	**19**	**1,530**	**4**	**20**	**1,532**

Despite the small adjustments, NAFCU believes that reconsideration of the risk weights will improve complex credit unions' capital cushion and relieve pressure on certain types of investments or growth options. For example, there is no reason to assign a high risk weight to CUSO investments when total industry investment in these entities is insignificant (22 basis points) and individual investments are already limited to 1 percent of a federal credit union's total assets. Adopting a risk-weight category for CUSOs that is analogous to what the Federal Deposit Insurance Corporation (FDIC) uses for equity *investments exceeding 10 percent of a bank's capital* fails to consider regulatory constraints on CUSO investments as well as low aggregate exposure.

Grandfathering Goodwill

NAFCU requests the Board permanently grandfather "excluded goodwill" and "excluded other intangible assets" in the RBC calculation. Currently, these amounts may be included in a credit union's RBC ratio calculation until January 1, 2029, at which point the 2015 final rule requires that both goodwill and other intangible assets be deducted from the numerator of a credit union's RBC ratio. Permanently grandfathering goodwill and other tangible assets would result in several benefits to the credit union industry.

Changing the treatment of these balances would likely: (1) reduce regulatory burden on an already extremely well capitalized industry; (2) avoid penalizing credit unions that engaged in mergers, which in many instances benefitted the NCUSIF; and (3) not discourage such mergers from taking place in the future to the detriment of all insured credit unions. Several of NAFCU's members have indicated that if the grandfathering of goodwill sunsets, they are likely to face substantial impacts on their capital positions should they undertake a merger with another credit union. NAFCU urges the NCUA to evaluate capital requirements based on a credit union's individual risk profile and evaluate the issue of goodwill during the supervisory process instead of prohibiting the entire industry from incorporating goodwill into their RBC ratios.

Additional Considerations for Capital Relief

NAFCU supports a robust capital framework that allows credit unions to maintain an appropriate level of capital for their unique risk profiles. NAFCU supports the NCUA's evaluation of asset securitization and subordinated debt during the delay of the RBC rule and views both as mechanisms for credit unions to attain higher levels of capital and ease compliance with RBC. Below are NAFCU's recommendations for the agency as it continues to evaluate the best approach to asset securitization and subordinated debt.

Asset Securitization

NAFCU and its member credit unions have been actively involved in conversations regarding asset securitization after the NCUA first proposed a rule in 2014 to explicitly authorize this activity. In June 2017, the NCUA issued a legal opinion letter explaining that a proposed rule is unnecessary because a federal credit union already has the requisite authority to issue and sell securities as part of its incidental powers under the FCU Act. Although federally-insured, state-chartered credit unions can rely on state laws and regulations governing asset securitization, NAFCU requests the NCUA develop regulatory and supervisory standards for asset securitization so that those federally-insured, federally-chartered credit unions wishing to securitize assets are aware of the scope of permitted activities before issuing securities. Such activities have the potential to expand credit unions' access to capital, reduce liquidity risk, and facilitate compliance with RBC.

As the NCUA decides whether to provide guidance for all federally-insured credit unions, it should consider the following: (1) expanding the eligibility of loans beyond those originated by the securitizing credit union, in particular, by permitting the use of purchased loans needed to complete a pool as well as allowing the aggregation of loans by CUSOs; (2) providing flexibility in the levels of residual and retained interests in securitized assets that a credit union may hold; (3) authorizing credit unions to have special purpose vehicles with the authority to enter into derivative transactions; and (4) providing additional clarifications on the types of securitization transactions in which credit unions may engage. NAFCU appreciates the NCUA's attention to this and is hopeful that a holistic evaluation of how potential securities structures fit into the RBC requirements would prove beneficial for the credit union industry.

Subordinated Debt

NAFCU has long supported subordinated debt as a capital option for credit unions and appreciates the NCUA evaluating this as it considers it during the proposed delay of the RBC rule. As described in the NCUA's 2017 advanced notice of proposed rulemaking, subordinated debt may serve as a form of regulatory capital—or supplemental capital—that can be included in the numerator portion of the RBC calculation. The ability to issue subordinated debt would provide important relief by permitting more efficient capital planning and could ease the transition to full compliance with RBC. Subordinated debt offers a straightforward approach to introducing a form of regulatory capital that is fully compatible with the FCU Act and the cooperative structure of credit unions. Subordinated debt would not convey voting rights and restrictions on covenants (similar to what exists for secondary capital) would easily limit interference with a credit union's governance and business planning.

In general, the ability to issue supplemental capital would help credit unions adjust to changing economic conditions more effectively. When a credit union's economic outlook fluctuates, either as a result of asset growth or declines in capital resulting from losses on loans or other assets, it must rely on retained earnings to satisfy regulatory capital requirements. Because retained earnings accumulate slowly, the present cost of ensuring future financial stability may necessitate less than desirable tradeoffs. For example, a credit union may need to offer less attractive rates in order to build retained earnings that will support future growth and guard against unexpected downturns.

Supplemental capital would make this process of capital planning and adaptation more cost-effective and predictable, giving credit unions the ability to quickly raise capital when the need or desire arises. NAFCU anticipates that supplemental capital will grant credit unions the peace of mind necessary to pursue longer-term, growth-oriented plans that require a greater capital buffer than retained earnings alone can provide. NAFCU encourages the NCUA to continue its work developing a proposed rule for supplemental capital.

Conclusion

NAFCU appreciates the opportunity to provide comments on this proposed delay of the RBC rules and looks forward to working with you both now, and in the future. If you have any questions or require additional information, please do not hesitate to contact me or Ann Kossachev, NAFCU's Director of Regulatory Affairs, at 703-842-2212 or akossachev@nafcu.org.

Sincerely,

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