MICHIGAN CREDIT UNION LEAGUE & AFFILIATES

April 27, 2015

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: RIN 3133-AD77 - Comments on Proposed Rule – Risk Based Capital

VIA ELECTRONIC MAIL: www.regulations.gov

Dear Mr. Poliquin,

The Michigan Credit Union League (MCUL), the statewide trade association representing 98% of the credit unions located in Michigan and their 4.7 million members, appreciates the opportunity to comment on the NCUA's revised proposed rule addressing Risk-Based Capital. The MCUL applauds the NCUA's efforts to provide an amended proposal reflective of comments and concerns expressed by credit unions nationwide. As such, we are pleased to see significant amendments from the original proposal.

As expressed in countless letters to the various regulatory agencies, including the NCUA, credit unions have borne the weight of undue burden over recent years since the financial crisis and the passage of Dodd-Frank. The MCUL was pleased to see Chairman Matz address the issue of regulatory burden during her speech at the Credit Union National Association's Government Affairs Conference in March. The Chairman's statement that 2015 is to be the "Year of Regulatory Relief" is welcomed with open arms, given the onslaught of new and amended regulations impacting credit unions of all size.

In the vein of regulatory burden and the need for regulatory relief the MCUL believes the NCUA is attempting to provide regulatory relief with the revised Risk Based Capital Proposal, specifically in seeking comments regarding access to Supplemental Capital, which we will discuss in greater detail throughout this letter. However, we have also identified areas of regulatory burden remaining in the proposal.

The MCUL has identified the following critical components of the NCUA's Risk Based Capital Proposal (RBC2):

- The need for access to supplemental capital;
- The new requirement that every credit union develop a Capital Adequacy Management Plan; and
- The high risk weightings for CUSO Investment and Mortgage Servicing Assets.

In an effort to provide the NCUA with constructive feedback to the above issues, we respectfully provide the following comments.

Supplemental Capital

Credit unions are unique as the only depository institutions in the U.S. without the ability to issue some form of capital instrument to augment retained earnings in order to build capital. A credit union's only source of capital is the retention of earnings. The requirement to maintain a higher capital ratio can only be accompanied by asset growth if there is sufficient net income. Increasing a net worth ratio requires even higher levels of net income or slower growth rates. This issue would not be of such concern if retained earnings could be enhanced to some degree if credit unions had access to alternate or supplemental capital.

Credit unions who hold a Low-Income Designation from the NCUA can offer secondary capital accounts and can accept non-member deposits from any source. In many situations credit unions have experienced very strong balance sheet growth over the last few years. Due to the low interest rate environment, capital growth has not kept pace with asset growth. Loan growth has remained strong in many instances, yet with rates remaining low, loans do not generate sufficient interest income to maintain and increase capital. If interest rates continue to remain low over the long term, it will have a negative impact on the capital ratio of credit unions as assets continue to increase. Additionally, continued loan growth, while necessary, can cause a significant strain on liquidity and cash flow, hence the necessity for access to supplemental capital.

The NCUA has asked if supplemental capital should be included in the risk-based capital numerator and how including such capital would protect the NCUSIF from losses. The answer to this question is yes. While supplemental capital cannot be included in net worth for most credit unions without a change in federal law, there is nothing in the Federal Credit Union Act or GAAP that would prevent the NCUA from including supplemental capital in the numerator of the risk-based capital ratio for RBC, which already includes items that are not part of the net worth.

The NCUA is also seeking comment if certain forms of certificates of indebtedness were included in the risk-based capital ratio numerator, what specific criteria should such certificates reasonably be required to meet to be consistent with GAAP and the FCUA. To echo CUNA's comments, the NCUA already authorized certificates of indebtedness, which have been treated as loans from holder to their credit unions, generally with an interest rate paid to the holders. The NCUA should reference the current use of such instruments to meet RBC requirements for federal credit unions and where permitted, for state chartered credit unions. Appropriate disclosures should be provided by the credit union to the holder before the proceeds are accepted, but the timing or content of the disclosures should not be complicated. The disclosures should be clear and simple, to help ensure the members' interests are protected and should focus on plainly describing the nature and terms of the instruments. Additionally, suitability requirements may be appropriate.

There are a number of capital instruments to be considered as viable options if supplemental capital authority is granted. Henceforth the NCUA should call on Congress to pass a legislative solution that modernizes capital standards and allow supplemental capital authority as well as direct the NCUA Board to design a risk-based capital regime for credit unions that ultimately takes into account material risks instead of the current capital proposal.

As identified in a white paper prepared by CUNA other financial institutions, such as our banking counterparts, have access to a number of forms of capital, in addition to retained earnings. [1]However, not all forms available to our counterparts would be available to credit unions due to their unique cooperative structure. Alternative or supplemental capital would need to be created to work in harmony with this structure. The NCUA is requesting comment as to what investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital if permitted for credit unions.

The development of supplemental forms of capital would need to adhere to certain principles. As previously stated, credit unions offer a cooperative ownership structure, unique to credit unions. The ownership of the credit union must remain in the hands of its members, regardless of whether they have provided any supplemental capital (i.e. additional membership shares). In the event supplemental capital is provided by non-members, it can confer no ownership rights. Therefore, common stock would not be a source of supplemental capital for credit unions and without common stock, no debt or hybrid instrument could be convertible to common stock.

Governance of the institution must continue to be driven by one member, one vote, with no additional voting rights for providers of supplemental capital. In the event supplemental capital is issued to non-members of the credit union, it should not be granted governance or voting rights.

Additionally, because credit unions would not want supplemental capital to in any way jeopardize their not for profit status, supplemental capital would need to be authorized and implemented in a way that has no adverse effect on the not for profit status of credit unions. This would be accomplished, in part, by meeting the previous criteria on ownership and governance. The preservation of the not for profit status would best be reinforced by a statement in enabling legislation that such capital does not in any way change not for profit status of credit unions.

Additionally, supplemental capital instruments should include protection of the National Credit Union Share Insurance Fund. Disclosures to investors in credit union supplemental capital must provide a clear picture of any risks. Supplemental capital must be practical for credit unions to acquire and not a one-size fits all approach. There must be vehicles for smaller credit unions to reasonably gain access to alternate capital if they wish to do so. Finally, supplemental capital should be optional for credit unions. For those credit unions who are willing and able to operate with only retained earnings, there should be no requirement to acquire alternative forms of capital.

The MCUL again commends the NCUA Board on their commitment to working with the credit union industry to expand the available opportunities for access to supplemental capital for all credit unions, with or without the low-income designation. With this much needed resource, credit unions could infuse cash into their balance sheets, subsequently supplying funds for continued loan growth without the need to use long term borrowings from the Federal Home Loan Bank (FHLB) for example. In addition, the infusion of such cash flow would result in an immediate increase in capital and therefore a credit union's net worth ratio. This would allow credit unions to increase their assets and continue lending without deterioration to their capital ratio.

[1] http://www.cuna.org/supplemental-capital.aspx

Supplemental capital would allow a credit union to stabilize its capital while continuing to serve its membership. Over time, the growth will level out and capital will naturally increase with retained earnings. Supplemental capital would help maintain capital ratios in a period of growth while allowing a credit unions capital to naturally catch up.

Risk Weight Concerns

While the MCUL is pleased to see the NCUA has proposed a reduction in a number of risk weightings concern remains in to areas of the proposal, specifically the risk weightings assigned to CUSO Investments and Mortgage Servicing Assets.

Mortgage Servicing Assets

The risk weighting for Mortgage Servicing Assets remains excessively high at 250%, as set in the initial proposal. In 2013, the NCUA finalized a rule on loan participations that was intended to assist credit unions and the NCUA better manage the potential concentration risk in loan participations. The loan participation rule is working and should be allowed to continue working instead of imposing higher risk weights for mortgage servicing assets. [2]

With the current risks posed by holding first mortgages on a credit union's balance sheet, many institutions may be looking to sell such loans to remove potential risk. While this may make sense from a regulatory capital perspective, given the fact that a significant portion of the cause of the financial turmoil was due to the misalignment of interest inherent in non-portfolio lending, this outcome is not desirable from a public policy standpoint. Portfolio lenders, who have large financial stake in the successful outcome of the loan transaction (as they ultimately bear the consequences of poor underwriting decisions) should not be disadvantaged if they can demonstrate that they effectively mitigate their risk.

In the right type of sale, the sale of mortgage loans assists an institution's balance sheet by effectively removing a great deal of credit risk, liquidity risk, interest rate risk and market risk. While removing such risk from an institution is a useful risk mitigation tool, most institutions would prefer to retain the servicing on sold mortgage loans. Not only does the retained servicing assist the credit union in earning non-interest income in the form of servicing fees, it also allows the credit union to retain relationships with their members, as credit unions are a trusted source for their membership. Credit union members understand and appreciate that they are "not just a number" to their credit unions. Properly valued and managed servicing rights pose minimal risk to a credit union and are risk weighted excessively high.

CUSO Investments

As stated in our initial comments to the NCUA addressing the first Risk Based Capital Proposal, CUSOs play an integral role for credit unions of all sizes and complexity. For decades, credit unions have effectively utilized CUSOs to assist in reducing costs, generating income and providing services to members through collaboration which they may not otherwise have been able to individually. Investments in CUSOs have allowed credit unions the ability to access services and expertise at a far more reasonable cost than hiring experts internally or contracting with other, more expensive service providers. While the MCUL is receptive to the NCUA's reduction in the CUSO risk weighting from 250% to 150% we believe this number is still too high considering the benefits CUSOs provide.

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[2] http://www.ncua.gov/Legal/Documents/Regulations/FIR20130625LoanParticipations.pdf

The NCUA's CUSO regulation requires an attorney opinion that the risk to the credit union is limited to the credit union's investment. The risk weighting of 150% for investments in CUSOs fails to consider the different types of services provided by a given CUSO. For example, an investment in a CUSO engaged in low-risk activities such as providing compliance assistance would be assigned the same risk weight as an investment in a CUSO engaged in mortgage or commercial loan underwriting. Despite the reduction in risk weighting the proposed 150% could still be improved to assess a more meaningful risk distinction between the risks various types of CUSOs pose. Instead, the MCUL feels the CUSO investment should be weighted at 100% to better align it with loans to a CUSO and more accurately reflect the risk involved with investing in a CUSO.

Although there were a handful of high profile credit union losses partially driven by bad CUSO investments, the reality remains that the overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale and providing much needed non-interest income to credit unions. With the need for regulatory relief at a critical level for credit unions, CUSOs provide assistance to credit unions that they otherwise could not provide, coupled with appropriate third-party due diligence standards in place CUSOs pose minimal risk in comparison to the reward provided to their credit union owners.

Additionally, less than 22 basis points of credit union assets are invested in CUSOs and do not represent a systemic risk that would pose a threat to the share insurance fund. The proposal's approach would ultimately penalize the success of a CUSO by requiring the credit union to set aside additional capital on profits earned by the CUSO. This would ultimately deter credit unions from investing in additional CUSOs and potentially force credit unions to exit exiting CUSO relationships, ultimately impacting products and services offered to members. Any exceptions to potential credit union risk should be managed through the examination and supervision process as part of safety and soundness and not by a system-wide capital regime.

Supervisory Assessment and Capital Adequacy Management Plan

While the MCUL understands the NCUA's concern regarding credit unions involving themselves in activities they may not fully understand, we feel strongly that having arbitrary and subjective determinations of increased Risk Based Net Worth requirements based on supervisory assessments and capital adequacy management plans are not appropriate. Proposed new 702.101(b) would require a "complex" credit union to maintain a comprehensive written strategy appropriate for their level of capital and risk profiles.

During the examination process, the NCUA will assess whether a credit union's written plan adequately addresses the credit union's activities and risk profile, as well as risks and other factors that can affect its financial condition. The NCUA has indicated that its assessment may include a review of the level and severity of problem assets and a credit union's exposure to operational risk, interest rate risk and significant asset concentrations. In addition to evaluating the appropriateness of a credit union's capital plan, the NCUA's assessment during the examination will also take into account the quality and trends in a credit union's capital composition, whether the credit union is entering new activities or introducing new products.

The NCUA has omitted individual minimum capital requirements from the revised proposal and now it appears with this revised proposal the agency is attempting to "back-door" an individual minimum capital requirement or substantially similar standard during the examination process. By requiring credit unions to develop a comprehensive written strategy regarding desired levels of capital, as well as strategies to maintain such levels, and then utilizing such goals and benchmarks in examinations, provides examiner subjectivity on a different level, permitting an individual examiner to disapprove a single credit union's plan, thus requiring higher levels of capital for an individual credit union.

Definition of "Complex" Credit Union

The proposal would change the definition of "complex" credit union for the purposes of capital requirements. The Federal Credit Union Act directs the NCUA to base its definition of "complex" credit unions on the portfolio of assets and liabilities of credit unions. Under the current rule, credit unions are considered complex and subject to risk-based net worth requirements only if they have quarter-end total assets over $50 million AND they have a risk based net worth exceeding 6%. The proposal would define the term complex using a single asset size threshold of $100 million as a proxy for a credit union's complexity.

The NCUA Board believes there are a number of products and services offered by credit unions with over $100 million in assets that are "inherently complex based on the nature of their risk and the expertise and operational demands necessary to manage and administer such activities. These activities include member business loans, indirect loans, mortgage loans, and internet banking to name a few.

While the MCUL appreciates the NCUA's consideration in increasing the asset threshold to define a "complex" credit union as a credit union with $100 million or greater in assets. The problem remains in the fact that the definition of "complex" should consider a credit union's portfolio of assets and liabilities rather than an arbitrary asset threshold. Credit unions are distinctly different from one another with regard to the products and services they offer and their level of complexity. Defining credit unions by an arbitrary asset size runs the danger of bifurcating the industry. The credit union industry has already been divided by the Dodd-Frank Act at the $10 billion asset threshold used to determine whether a credit union is subject to the CFPB's examination process as well as the NCUA, without regulatory relief. The NCUA's efforts to further divide the industry by asset size is contrary to the best interest of credit unions.

Goodwill

Deducting goodwill from the RBC number remains an issue in this proposal presenting two significant areas of concern. First, as discussed in the MCUL's original comments to the NCUA, it would penalize credit unions who have recently gone through a merger and second, it could disincentive merger activity, which would prevent healthy industry consolidation and the combining of troubled credit unions with stronger, healthy credit unions in the future.

The credit union industry as a whole has seen significant consolidation in the past few years, and Michigan is no stranger to this with the number of credit unions in Michigan falling from over 300 to 268 over the course of 5 years. This is a trend that is likely to continue. Without goodwill available to help balance the equation going forward, a healthy credit union is less likely to agree to take on a troubled credit union as a merger partner (even at the request of the NCUA). This will result in higher costs to the NCUA and provide for significant difficulty in finding merger partners for troubled or failing credit unions which will ultimately lead to more expensive liquidations for the NCUSIF.

The MCUL strongly encourages the NCUA to reconsider this aspect of the proposal, and not create disincentive for healthy credit unions to proactively assist troubled credit unions. Failure to correct this could have detrimental results to the industry and the NCUSIF.

Interest Rate Risk

The revised RBC proposal contains what is essentially an implied Advanced Notice of Proposed Rulemaking on Interest Rate Risk (IRR). While the new RBC proposal looks substantially better on paper, removing IRR from RBC the MCUL believes a separate rule addressing IRR is unnecessary altogether. To better control IRR the NCUA should continue to apply industry-accepted methods as part of a competent supervision and examination process.

The NCUA already has a number of requirements and guidance regarding IRR that credit unions must comply with, such as the interest rate risk final rule[3], a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (14-CU-01).

The guidance provided in the appendix to the IRR rule describes best practices for credit unions to consider as they write their IRR policy and construct IRR management programs. It deals with the responsibilities of boards and management, address IRR measurement and monitoring, internal controls, and the integrations of IRR results into a credit unions decision making. The guidance also provides additional consideration if a credit union is large with complex or high-risk balance sheets. This alone should be the basis of NCUA’s efforts to manage IRR.

Given Chairman Matz’ comments and the 2015 CUNA GAC indicating 2015 will be the “year of regulatory relief,” subjecting credit unions to yet another rule is unnecessary and results in undue burden, especially provided that sound guidance and regulation already exists and is being utilized effectively and efficiently. NCUA’s focus should be squarely on the exceedingly small number of institutions that may be considered severe outliers. The NCUA can easily identify such severe outliers during the examination process, and undoubtedly has done so already. Due to the unique issues in such an institution, the NCUA should concentrate resources to them separately during the examination process.

Conclusion

The Michigan Credit Union League truly commends the NCUA Board for the positive revisions made to the Risk Based Capital proposal. The revised proposal represents the Board’s commitment to the credit union industry and the NCUA’s openness in seeking comments addressing supplemental capital and the need for such vehicles.

Sincerely,

Ken Ross
Executive Vice President & Chief Operating Officer

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[3] http://www.ncua.gov/Legal/Documents/Regulations/FIR20120126InterestRateRiskProg.pdf