RBC2 HOLISTIC AND LEGAL REVIEW

PART 1: THE HOLISTIC ARGUMENT

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From History to the Future

"As I have articulated over the course of the past year, I believe there is a compelling need for this rule in addition to our legal obligation for it. Throughout the past year, credit union officials often asked me: "Since credit unions did not cause the financial crisis, why do we need a new rule on risk-based capital?" The short answer is: This rule is required by law."

The Hon. Debbie Matz, NCUA Chairperson, January 15 2015

The NCUA has published a revised set of Risk Based Capital rules ("RBC2"). These revisions are touted by the NCUA as a rewrite of the original rule with major changes. The agency goes on to say that these changes will lessen the burden of the rule, affect fewer credit unions, give more time to morph balance sheets and all while providing a tool to protect the insurance fund.

While there is no question the NCUA did make changes in the RBC rule with respect to such items as the definition of "complex" credit unions, eliminating IRR, and extending the implementation timeframe, the impact to the industry if RBC2 is passed remains highly suspect and likely detrimental. Although the proposal was 450 pages, far too many were reviews of the comments and the NCUA's rebuttal or disregard of them. In a vacuum, the changes accepted by the NCUA would appear good but in fact are designed to draw credit union leadership away from impact of the Rule as a whole. RBC will increase costs to members, expand the right of the NCUA to interfere in the governance of credit unions through Prompt Corrective Action ("PCA"), and threaten the financial stability of the industry long term.

Credit unions should consider resisting the Rule on holistic grounds, its questionable legal authority, and the detailed changes in the Rule itself. RBC should not become law. Credit unions should continue to provide comments to the NCUA and to Congress, maintaining that RBC2 is harmful to the industry and decrying the NCUA giving the Rule the force of law.

What History Has Taught Us

This rule could potentially have a similar outcome from the Basel Formula used by banks? Specifically, this Rule will lead to less diverse credit union portfolios and create potentially dangerous concentrations caused by credit union adherence to the standards being proposed. By virtue of every complex credit union following these weights, credit unions will be less likely to maintain a diverse asset structure and concentrate their portfolios in identical asset types with lower risk weights. Even the head of the FDIC stated that this inflexible weighting of risk led to the demise of international banks during the great recession by virtue of having lower weights on international debt and real estate backed securities.

"It turns out that the Basel capital rules protected no one: not the banks, not the public, and certainly not the FDIC that bore the cost of the failures or the taxpayers who funded the bailouts. The complex Basel rules hurt*, rather than helped the process of measurement and clarity of information."*

Thomas Hoenig, Vice Chairman of the FDIC, September 14 2012

The rule and debate during the board meeting concentrated specifically on the particulars of the Rule's impact on net worth but failed miserably on addressing the differences between banks and cooperatives. As a matter of fact, there are dozens of citations in the rule commentary where the NCUA equates this rule to the one designed by the FDIC. Congress's legal intent was not to establish an elaborate evaluation of capital as the FDIC/Basel models have done (remember Basel started before full PCA), but rather to certify using the minimum risk based net worth approach, a second single test of capital adequacy along with the simple leverage 7% ratio. There is an inbuilt regulator bias and instinct to make simple goals very complex and bureaucratic.

Also, the Rule penalizes credit unions for specific activities such as real estate lending, member business lending, and credit unions chartered to assist the un-bankable by placing a capital tax on the resulting assets of low income or poor credit lending. The end result will be thousands of homogenous balance sheets in 2025 that they can easily understand from a supervisory perspective. However, this current risk posture of the agency cannot fail but to lead credit unions to shy away from diversity or cooperative reason for the charter and field of membership. Will this not force the industry into potential areas of investment and lending the credit union lacks experience with or industry wide concentrations that could be impacted by similar economic variables? In and of itself, this rule creates more risk than it proposes to control.

No One Can Predict the Future

Is it obvious that NCUA will be required to change the weights as the economic environment changes? The proposed asset weights are based upon what NCUA believes is the best way to manage the risk to capital and ultimately the Share Insurance Fund. However, no-one can predict the relevancy of these weights years into the future and what might prompt the next economic bubble.

The existing weights of greater than 100% are to a degree based upon the asset structure of balance sheets from 2007. This is evidenced by the weights associated with real estate loans, member business loans, and investments in corporates to name a few. The economic risks of the past do not dictate the risks in the future and based upon that fact the rule will need continuous revision. If the NCUA makes no changes in the Rule, industry balance sheets will be stuck in a perpetual 2007. If the NCUA makes changes, this moving target will be highly disruptive to credit union long range planning and balance sheet management. What is acceptable today and tomorrow may not be so ten days from now.

Also, as stated during the board meeting and depicted in the proposal, over 40% of failures were the result of fraud—all of us have been following the St. Paul Croatian FCU's fraud loss which cost the insurance fund $170 million dollars to date. Economic policy had nothing to do with many of these losses, regardless of the shape of credit unions' balance sheets. The idea that passing a rule—the typical government reaction—can stop fraud, eliminate mismanagement and prevent external circumstances from decimating a credit union's market environment is wrong. Hoenig's critique of the Basel rule's effectiveness is just one example of this mistake.

Effective supervision is not rule making; it is intelligent supervision and patient reorganization when problems arise. This is lacking in our CU regulatory community today.