RBC2 HOLISTIC AND LEGAL REVIEW

PART 2: THE HOLISTIC ARGUMENT CONTINUED

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The Rule Itself Undermines the Cooperative Nature of Our Charters

Why should this regulation treat all credit unions equally? The industry believes that this rule would undermine the cooperative and diverse nature of our charters by creating a one size fits all over-reaching capital formula. This is a massive flaw of the NCUA's structure as regulator and insurer. This is a myopic view of cooperatives and only considers our equity funding mechanism. A cooperative is a like group of individuals banding together to own a business that is guaranteed to meet their similar financial needs. The arguments and logic of the rule misapplies what is done successfully at a local or institutional level, to an entire system.

At the local level, credit union boards and managers are making numerous decisions about the composition of their balance sheet and capital adequacy based on the needs of their membership and local community. These factors do not just take into consideration the asset type but include the reasons for their charter to begin with, corresponding funding from liabilities, and unique economic needs of the communities they serve. These thousands of local decisions are driven by diverse business priorities, pricing and growth objectives as well as responses to unique local needs. The independent decisions result in varied portfolio strategies which enhance the system's overall soundness rather than a single approach nationwide to risk management.

This proposed rule comprises the essence of why we have a cooperative system and a credit union charter. Credit Unions were to be an antidote; a solution to the excesses and failings of the for-profit financial community; a market based competitor that would show a unique way for member-owned institutions to provide responsive community services in all economic cycles. This rule just pushes the industry further into the banking model and in doing so undermines the foundation of our cooperative strength, which is primarily local decisions managing local funds invested in local loans.

From a cooperative economic standpoint the Rule is actually a tax on members. NCUA themselves state:

> *"While higher levels of capital can insulate depository institutions from adverse shocks, holding higher levels of capital does have costs, both to individual institutions and to the economy as a whole. For the most part, the largest cost associated with holding higher levels of capital, in the long term, is foregone opportunities; that is, from the loss of potential earnings from making loans, from the cost to bank customers and credit union members of higher loan rates and lower deposit rates, and the downstream costs from the customers' and members' reduced spending."*

Although Congress has stated that risk based capital standards must be addressed in a similar fashion as the banking industry, Congress did not wish to create a tax on members and abandon the cooperative principals of credit unions.

Below is NCUA's argument relative to the over-all cost.

> *"Estimating the size of these effects is difficult. However, despite limitations on the ability to quantify these effects, the annual costs appear to be significantly smaller than the losses avoided by*

reducing the probability of a systemic crisis… [I]t is clear that the relatively large potential long-term benefits of holding higher levels of capital outweigh the relatively small long-term costs."

Since the publication in the Federal Register the actual costs associated with this capital tax have been challenged. NAFCU published an estimate that credit unions will need to raise an additional $760 million dollars in capital to achieve their current capital levels. Because credit unions only have one source of earnings, that additional capital tax must come directly out of member's pockets through a reduction in savings rates, increase in loan rates, and potentially changes to transaction fees. NCUA's estimate falls far short of the actual cost to the industry and again focused on the potential risk to the insurance fund rather than those the regulate and ultimately their members.

Legal Argument

While the NCUA could ultimately prevail if challenged in court, there are significant weaknesses in the NCUA's legal arguments. Ultimately, it comes down to two major considerations:

1. In order to conclude the NCUA has the authority to implement a two-tiered RBNW system, you need to stretch the meaning of the statute. The Paul Hastings memo constantly uses terms such as "could", "reasonably", "interpret", "not expressly", and so forth. McWatters, by contrast, is able to point to terms like "plain language", "not … ambiguous" and "holistic."

2. The NCUA has been operating since 2000 under the impression <u>it does not have the authority</u> to institute a two-tiered RBNW, despite its current claims. As McWatters pointed out, the NCUA actually asked Congress to amend Prompt Corrective Action in 2007 because the NCUA did not have the authority to create the two-tiered RBNW system. Congress made no changes to the statute.

Minds can certainly differ on this matter, and agencies do have the ability to change their opinion. However, these are both pretty profound weaknesses in the NCUA's legal arguments.

What's Next?

Urge the NCUA, or more likely Congress, to throw the Rule out and end the debate on the particulars of the weights. The industry as a whole must concentrate on the larger picture and the impacts the Rule will have on the credit union industry's ability to meet the needs of the people we serve. From an overall view of the regulation, to its weak legal underpinnings, the Rule has completely missed the mark and will create more risk in the industry than it is purported to mitigate.

What could be done? If the NCUA truly believes that this rule will uncover the outliers and those credit unions that should operate with higher levels of capital, then make this rule a test similar to those currently being performed like the 17/4. The OCC has numerous ratios and tests which they perform based upon call information such as the canary ratios. These ratios are designed to uncover outliers and direct supervision in these areas to review.

We must stop the debate about the nuances of the rule and convince the NCUA that after outlining the substantial objections, the modeling approach needs to be tested and tried in the examination process as a tool and then the results shared with the industry before suggesting that a model be embedded in a law.