WCLA Credit Union

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Gerard Poliquin,
Secretary of the Board
National Credit Union Administration
1775 Duke Street
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Subject: Comments on Proposed Rule: PCA—Risk-Based Capital

A risk based capital rule can be a step forward for credit unions, providing better risk mitigation for the system as a whole and moving our capital regulatory framework towards financial industry best practices. However, the aphorism "the devil being in the details" applies here as well. A risk based capital systems requires that we accurately (or at least adequately) identify and quantify risks. The proposed rule comes up short in several areas. We are opposed to the rule as it is currently proposed.

The following illustrates the impacts of the proposed rule on this credit union. I highlight some of the rules deficiencies as experienced from this credit union and offer some suggestions of improvement.

WCLA Credit Union is located in (the other) Washington. It is a state-chartered credit union, organized in 1984 to serve members of the Washington Contract Loggers Association (WCLA). It specializes in financing logging equipment and was $31 million in assets at year end 2013. Shortly after the advent of the Credit Union Membership Access Act in 1998, WCLA Credit Union was grandfathered to a less restrictive Member Business Loan limit because of its original charter purpose and its history of commercial purpose lending. It is a specialty lender in a niche market. The Proposed Rule: PCA-Risk Based Capital is an existential threat to this credit union.

Will the Proposed Rule impact WCLA Credit Union?

The rule as proposed defines a "complex" credit union as one exceeding $50 million assets. An extension of WCLA CU's historical growth rate of the past 5 years will place the credit union over that threshold in 2016.

Additionally, the proposed rule allows NCUA to require an individual, federally insured natural person credit union to hold higher levels of risk-based capital to address "unique supervisory concerns." Having experienced several exam cycles during my 10 year career at WCLA Credit Union, I have a high degree of confidence that WCLA Credit Union's concentration in MBLs will prove to be a "unique supervisory concern" regardless of the amount of total assets. Probably sooner, but at least later, the proposed rule will impact

WCLA credit union and result in a significantly diminished capacity for lending to its membership.

(An aside: Call Report data does not identify WCLA CU as being impact by the proposed rule as it is 1) less than $50MM in assets, 2) not being subject to current RBC rules, the MBL portfolio is placed on the Call Report as "Other Loans" and not MBLs. Hence, NCUA's discussions of the proposed rule's impacts on credit unions does not identify WCLA CU as among those effected.)

How will the Proposed Rule impact WCLA Credit Union?

WCLA Credit Union is a specialty lender in the logging equipment market. Its assets are nearly 70% MBLs. The application of the proposed rule to the credit union's 12/31/2013 balance sheet results in a Risk Based Capital (RBC) ratio of 7.09% as compared to its nominal capital ratio of 11.21%. The RBC ratio is far below the proposed rule's 10.5% benchmark for a Well Capitalized institution. In order to meet the Well Capitalized benchmark, WCLA Credit Union could:

- **Freeze:** Pursue a "no growth" strategy while it waits for future earnings to build capital. Assuming WCLA Credit Union's 2013 ROA performance of 240 basis points, the credit union would be able to resume growth after 3 years. Such a hiatus in growth would be a terrible disservice to the membership, as well as a risky business strategy, if the credit union hopes to survive beyond those 3 years.
- **Shrink**: Reduce the MBL portfolio on balance sheet to achieve an RBC of 10.5%. This approach would require eliminating nearly 50% of the MBL portfolio. Without an ability to replace those earning assets, the credit union's annual earnings would decline 56%. At that reduced level of earnings the credit union would require 3.5 years to regain its 2013 scale. This "stay small" approach extends the period of time where the credit union must cover its fixed costs on a very small asset base. Small is expensive. It is difficult to support the requisite depth of expert staff with such a limited budget.
- **Dilute:** Reduce the MBL concentration by expanding the balance sheet via asset types with smaller RBC weights. This approach would require the credit union balloon its balance sheet approximately 400%. The resulting nominal capital ratio of 2.5% would legitimately cause PCA concerns of the nominal capital ratio from the existing PCA rule.

It is apparent from these scenarios that the proposed RBC rule will force WCLA Credit Union to merge out of existence, become a wholly different organization than originally chartered, or change its credit union charter to one more accommodating of its membership's needs.

Deficiencies of the Proposed Rule and implementation. Possible improvements.

1. **No access to capital**: The proposed rule requires credit unions to increase capital without providing the means of acquiring capital. This is contrary to the congressional directive to consider the unique nature of credit unions as directed in section 216 of the Federal Credit Union Act. An RBC approach to macro prudential regulation requires a balanced approach of determining appropriate amounts of capital, as well as the means of obtaining that capital. Both congressional directive and mere prudence require that adequate regulation of an institution's capital requirements should involve access to capital, as well as the capital levels required. The lack of access to capital is a serious and fatal flaw in the roll out of this proposed rule.
2. **The proposed rule is pro-cyclical**: Without an ability to raise capital outside of earnings capacity, credit unions will be forced to restrict service to membership during a systemic earnings shock to the financial system. This will contribute to the greater economic downward spiral. Thus, the proposed rule increases systemic risk to the insurance fund. This is opposite of NCUA's stated goal.
3. **The objectives of the rule are overly broad**: NCUA identifies 9 areas of business risk that credit union's face. The proposed rule hopes to address at least 4 of them: credit, concentration, liquidity, and Interest Rate Risk (IRR). The result is a blunt force approach to managing risk. Liquidity risks and IRR are particularly difficult to mitigate by capital levels. Better risk management tools exist for these areas and must be employed. The proposed rule's attempt to address these risks via capital is a misapplication of the tool and brings with it too many unintended consequences. It is the application of a hammer when a screw driver is needed.
4. **Time to implement**: As illustrated above, increasing capital requirements while restricting access to capital leaves this credit union with an untenable business model. More time is needed for credit unions to adapt their balance sheets to such a significant change in regulation. Absent a clear and present danger, I hope the NCUA board can agree it is more important for improvements in capital regulation to be done correctly rather than quickly.
5. **Credit unions covered by the rule**: The $50 million threshold to decree a credit union as complex is a flawed metric. A credit union's complexity must rightly be a qualitative assessment, not a quantitative one. While size is a contributing factor, this is too simple an approach for such a sophisticated rule. Applying an RBC requirement based on asset size alone simply misses the mark. The credit union system deserves better.
6. **Systemic risk is increased**: An objective of the proposed rule is protection of the NCUSIF and the pursuit of stability for the credit union system. One result of the system's supervisor forcing the same RBC rule on to all credit unions will be a herding behavior resulting in lack of diversity across the system. This will increase systemic risk, not decrease it.
7. **Disparate impacts to small organizations:** The proposed rule will have disparate impacts on credit unions along the asset size continuum. A smaller credit union has fewer tools and is less

able to adapt to the imposition of this rule. It is a reality of the market place that smaller credit unions can be economically viable only by becoming an expert in a market niche. The specialized institution will have greater concentration risks. The (fear based?) Risk Weights of the proposed rule make such a business model untenable. Realistic Risk Weights and access to capital are necessary for the small credit union to survive beyond this change in rule.

Since their origins, credit unions have served a membership with a common bond. Particularly for smaller credit unions, forcing them to dilute their common bond membership will result with an entirely different type of institution. Providing access to better tools (supplemental capital) and allowing smaller credit unions to address their heightened concentration risks via individual risk mitigation practices is necessary for their survival.

8. **Dilution is not the only solution.** Quality, rather than dilution, can also serve to mitigate concentration risk. An RBC rule taking allowance of quality underwriting, ALM practices, and management is necessary for the small credit to survive. As the credit union landscape continues to diverge into The Large and The Small, an RBC rule that can apply equally well to both ends of the spectrum is necessary.
9. **MBL definition and risk weights**:
    a. **MBL threshold is out of date**. As currently defined in regulation, Member Business Loans are a diverse lot ranging from a multi-million dollar apartment complex to a lawn care company's pickup truck. Increasing the MBL size threshold to $250,000 would be a significant improvement of the RBC rule's fit to the marketplace of 2014. Provision in the regulation for the threshold to adjust periodically (5 years?) would be even better.
    b. **MBL Category is too broad.** The proposed rule takes an exceedingly simplistic approach in placing Commercial Real Estate (CRE), Construction and Development (C&D), and Commercial and Industrial (C&I) in the same category, while making no allowance for the individual institution's expertise or history in the genre. This places the $50k pickup truck loan originated by the small rural credit union in the same risk category as the several million dollar apartment building project in a large metropolitan area. The proposed rule does not recognize the differing risk characteristics of these types of loans, nor the individual credit union's ability in underwriting those risks.
    c. **The 200% RBC weighting is excessive.** The proposed 200% RBC weight for MBLs is twice the Basel requirement for Small Banks. Further, there is no recognition of the individual credit union's expertize in this type of lending. The newly started business services program is handled the same as an established program that has operated safely through several business cycles. This appears to be an attempt to regulate to the lowest common denominator. Credit union members that have previously been served successfully by their credit unions will be unjustifiably restricted from obtaining this service in the future.

d. **Is the MBL 200% RBC weighting the right tool?** Is the 200% RBC weighting attempting to address the risk of credit, liquidity, or IRR? Such a large weight to address credit risk is not supported by evidence, at least no support has been offered. An MBL program requiring such a large capital buffer has weaknesses that cannot be fixed by capital alone. Concerns about liquidity risks presented by MBLs are much better addressed by other means and those tools are available. Similarly with IRR, other more appropriate means of managing IRR are available and should be employed. Merely increasing the MBL RBC weighting does not adequately address any of these risks and brings with it a host of unintended and undesirable consequences.

10. **Examiner has authority to require additional capital beyond the RBC rule.** A well-crafted rule will allow for a certain flexibility and provide the regulator with an ability to address a presently unforeseen or future evolving circumstance. It must also constrain the well-meaning, but overzealous examiner from straying beyond their sphere of expertise. A credit union's stay of execution pending appeal (and remaining internal to the NCUA chain of command, at that) is not the optimal safeguard. The imposition of higher capital requirements should carry a high standard of accountability.
11. **"Regulatory relief" is not the answer**. A vibrant and progressive credit union system requires better regulation, not relief from bad regulation.
12. **Beyond Risk Based Capital**. The espoused objective of the proposed RBC rule is to provide for stability of the credit union system, as well as protect the NCUSIF from losses which must be borne by all credit unions. 80% of the systems assets are held in a minority of credit unions. The entire credit union system will be well served by an increased regulatory focus on risks that impact the credit union system over risks that impact individual institutions.

Conclusion

While well intentioned, the proposed rule misses the mark in several key areas. The implementation of the rule as proposed will result with decreased service to credit union members, a closing window of viability for small credit unions, and a credit union system that has increased risks of systemic instability. For WCLA Credit Union, implementation of the rule will likely put it out of business or at least into another charter of organization. Addressing the rule's weakness will require significant revisions to the proposed rule. Obtaining input from the regulated while developing the revisions will aid in crafting an effective rule while avoiding unnecessary and unintended consequences. We all share the goal of a safe and sound credit union system.

Best regards,

Brian Bahs, President/CEO
WCLA Credit Union