FIRST SOURCE
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Michael J. Parsons | President/CEO
mparsons@fsource.org

MAY19'14 PM 2:01 BOARD

May 15, 2014

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

Dear Mr. Poliquin:

Re: Comments on NCUA's Risk Based Net Worth Proposal

On behalf of First Source Federal Credit Union, I would like to provide the following comment letter regarding the National Credit Union Administration's proposed risk-based capital rule recently approved by the NCUA Board. We appreciate the opportunity to express our concerns about the potential negative impact of the proposed rule on credit unions if finalized in its current form and to offer some suggested improvements in the rule for consideration as the NCUA moves forward in the rulemaking process.

During the financial crisis, the overwhelming majority of natural person credit unions weathered the economic downturn very well and continued to provide much needed lending and financial services to the communities we serve. As you know, credit unions did not engage in the types of risky lending practices that led up to the crisis and nearly all maintained their well-capitalized position - even during the worst economic crisis since the Great Depression.

In short, credit unions demonstrated their ability to manage their financial condition under very adverse economic circumstances and continue to effectively manage and mitigate risk as evidenced by an industry-wide average Net Worth of nearly 10.80% as of December 31, 2013. Despite this performance versus the most demanding capital standards in place for any sector within the financial services industry, the NCUA's proposed risk-based capital proposal imposes an even higher risk-based requirement on top of the 7% leverage ratio we are currently required to maintain to be considered well-capitalized.

Since the industry has a limited ability to raise capital other than through retained earnings and because the financial crisis did not provide evidence pointing to the need for greater capital reserves, we believe the one-size-fits-all categorical approach

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outlined in this proposal is both burdensome and inequitable. While First Source FCU is supportive of a Risk Based Net Worth regime for credit unions, we do not believe this proposal is appropriately balanced or equitable. If credit unions with riskier balance sheets are required to maintain more capital, then credit unions with more conservative and less risky balance sheets – as well as those that have proven their ability to manage the risk in the balance sheet - should benefit by having a lower required risk-based capital level.

We believe there would be several unintended consequences of the risk-based net worth proposal in its current form such as, but not limited to, higher lending costs, lower dividends to consumers and forcing credit unions to curtail mortgage and member business lending activities. The proposed rule in its current state may very well produce long-term adverse effects on credit union growth, forcing many credit unions to realign their balance sheets when it is not justified by solid asset-liability risk management considerations and significantly alter their strategic objectives.

Higher capital requirements beyond those justified by the balance sheet risk will inevitability reduce the availability of funding for credit unions to invest in strategic growth initiatives. Capital reserves currently available for branch expansion, technology, new products/services and investment in innovation will no longer be available for credit unions as these dollars will have to remain in reserves. When credit unions lose access to their additional capital reserves and are required to operate under a regulatory mandate that effectively defines how their balance sheet must be structured, all credit unions (regardless of their risk profile) will be adversely impacted.

In short, in our view the proposed rule will put credit unions at a competitive disadvantage which will ultimately negatively impact consumers and small businesses across the country. Credit unions are already at a competitive disadvantage to the banking industry in terms of capital requirements and this proposed rule magnifies that disadvantage by requiring credit unions to unnecessarily hold additional capital. It will, in its current form, adversely impact the value of the credit union charter.

The following provisions cause us the greatest concern:

<u>Risk Weightings</u>

The risk weightings, including those based on higher loan concentration levels, are considerably higher than those applied to the banking industry. This will put many credit unions at a competitive disadvantage and, as noted above, may cause credit unions to curtail needed and well-managed mortgage and member business lending. This will not only hurt credit union earnings that build capital, it will also cause consumers, small businesses and communities to suffer.

We understand from reports that many larger asset credit unions have calculated their risk-based capital standards under the Basel III capital standards for community banks and, generally, the risk-based capital ratios of these credit unions are better under the

Basel III formula than under NCUA's formula. Consequently, we fear as a mid-size credit union that the industry could see an exodus of some of our largest credit unions converting to a banking charter regardless of the benefit of our tax exemption. This will hinder our ability to grow and remain competitive under the credit union charter if the industry faces the reputation risk of massive conversion from the credit union charter. While this conversion activity may or may not happen under the final rule, certainly the not-for-profit credit union industry should not fair worse under the proposed NCUA risk based capital standards than does the for-profit banking industry under Basel III.

Member Business Loans

First Source FCU recently introduced Member Business Services into our product set offering and will not be negatively impacted by this provision of the rule at the present time; however, we do have concern for the future as the proposed rule factors concentration risk into the proposed risk-weighting for Member Business Loans by setting the risk-weight to correspond with the percentage of assets held in the MBL portfolio.

We believe that concentration risk for credit unions should be controlled through the examination process and not a one-size-fits-all capital requirement that causes credit unions to hold more capital without allowing credit unions with less risk to hold less capital.

NCUA has failed to address the different risks based on the types of Member Business Loans by category. As a former commercial banker I've seen firsthand how some business loans carry more inherent risk than other loans. For example; agricultural loans, construction and development loans, and floor plan loans to automobile dealers carry more inherent risk than equipment term loans or small commercial real estate loans. NCUA should consider different risk-weightings based on empirical and historical data on various types of Member Business Loans.

Investments

The proposed rule appears to reflect a bias towards lending and against investments. First Source FCU has historically maintained a healthy Loan-to-Share Ratio; however, many credit unions struggle with growing their loan portfolios and have no other option but to purchase investments to improve their interest income to boost their overall earnings.

The proposed rule is but another one-size-fits-all requirement to hold more capital for almost all types of investments as a means to control interest rate risk. This is evidenced by the differences in proposed risk-weights for investments based upon the maturity level of those investments. Credit unions already monitor and control for interest rate risks through their Asset Liability Management and Interest Rate Risk policies. These policies and a credit union's implementation thereof is regularly reviewed during the NCUA examination and supervision process. Indiscriminately requiring more capital regardless of the asset-liability management strategy of the credit union only serves as a disincentive to invest in some needed investments; it does not provide the in-depth analysis that can come about through the examination process. The determination of an effective asset-liability management strategy should be judged through the examination process; not through a one-size-fits-all system of risk weights.

NCUA should consider comparability of its proposal to the FDIC requirement for risk-based capital. For those investments credit unions are permitted to make, the FDIC does not incorporate interest rate risk into the investment risk-weights for community banks.

If NCUA keeps interest rate risk built into investment risk-weights, First Source FCU would urge the Agency to not penalize credit unions for short or medium term investments as the potential interest rate risk is mitigated by shorter maturities. First Source FCU suggests a risk-weight assignment of 20 percent for investments with a maturity of 0-5 years; allowing NCUA to maintain a higher risk-weight for long-term investments that pose greater potential interest rate risk. Investments of five years and more should not be weighted above 100 percent because the reasonable maximum loss on an investment, in even the worst case of scenarios, would be the total amount originally invested.

<u>CUSOs</u>

While First Source FCU has not invested significant resources in Credit Union Service Organizations, we believe in the CUSO model for collaboration and efficiency. There is a greater need in our industry for economies of scale and operational efficiency that can be gained via a CUSO. We believe the proposed risk-weighting at 250% discourages credit unions from seeking these cost savings by participating or investing in a CUSO.

While there have been less than a handful of high-profile credit union losses caused in part by improperly managed CUSO investments, the overwhelming majority of CUSOs are performing very well, earning needed income and generating considerable savings through economies of scale. The proposed rule very well may force credit unions to reconsider current and future investments in CUSOs and drive them to other sources outside the industry where there is considerably more risk - again putting credit unions at a competitive disadvantage that could ultimately lead to potential safety and soundness concerns.

The risk-weighting for a CUSO investment appears to be particularly arbitrary and may not at all reflect the actual risk of investing in a particular CUSO. Consideration should be given to the function of any given CUSO and an appropriate risk-rating assigned based on a validated risk assessment. For example, a CUSO developed to reduce back office operational expenses and allowing credit unions to share in those costs savings, should be less risky than a CUSO developed for higher risk ventures. We believe the best approach would be to weight all service and operational CUSO investments at 100% and lending CUSO investments at 125%.

Individual Minimum Capital Requirement

The proposed rule provides NCUA with the ability to require a higher minimum risk-based capital ratio for an individual credit union where NCUA determines the circumstances indicate that a higher minimum risk-based capital requirement is appropriate. This means NCUA may establish increased individual capital requirements upon its determination that the credit union's capital is, or may become, inadequate in light of the credit union's circumstances - regardless of the actual risk-based capital ratio of the credit union.

This provision giving the NCUA the authority to subjectively increase a credit union's capital requirement above the 10.50% of risk based assets is especially troublesome and should be eliminated from the final rule. If adopted in its current form, this provision would make it practically impossible for a credit union to make sound business decisions relative to its portfolio mix, leading to uncertainty for credit unions. The final rule must establish capital requirements that a credit union can manage effectively. An arbitrary, movable "goal line" is virtually impossible for a credit union to utilize as an effective management criteria.

Supplemental Capital

The proposed rule does not provide any changes that would allow credit unions the authority to raise supplemental capital. Any consideration to changes in capital requirements for credit unions is incomplete without this discussion. Supplemental capital in the form of subordinated debt is needed now more than ever considering the restrictions that will occur if the risk-based proposal is adopted in its current form. NCUA should call upon Congress to pass a legislative solution to modernize capital standards and directs NCUA to design a risk-based capital regime that takes into account material risks. In the meantime, NCUA should count and appropriately weight supplemental capital as part of the risk based capital structure for those low-income designated credit unions authorized to have supplemental capital.

Implementation Period

The proposed 18-month implementation timetable is insufficient for a rule as complex and impactful as this proposed rule. The proposed revisions to the well-established and current Net Worth requirements that have been in place since passage of the Credit Union Membership Access Act in 1998 will affect a credit union's decision making enormously, and it will take time for a credit union to adjust its balance sheet relative to this new rule. Credit unions will be faced with difficult decisions about their future and may, in fact, be forced to significantly alter the strategic direction of their balance sheet decisions - a major undertaking at best.

First Source FCU would urge NCUA to consider an implementation period of no less than three years after the passage of any final rule. Credit unions will need at least that long to make safe and sound business decisions to effectively implement the final rule.

Conclusion

Thank you for the opportunity to comment on this proposed regulation. Again, we support the efforts of the NCUA to pursue a balanced risk-based capital system that requires additional capital for truly higher risk credit unions while rewarding those credit unions with proven risk management evident in a lower risk balance sheet.

First Source FCU urges NCUA to withdraw the proposed rule and work with the industry and Congress to modernize capital standards for the credit union industry. While we do not believe the current proposal is sufficiently balanced and should be withdrawn if it cannot be perfected, we respectfully encourage NCUA to consider some of the recommend improvements to the proposal in the event the agency determines that it is not prudent to withdraw the proposal in its entirety. It is absolutely crucial for the long term viability of the credit union industry and the value of the credit union charter that NCUA do everything reasonably within its power to make sure this final rule is balanced and appropriate to the risks reflected within its capital structure.

Very truly yours,

Michael J Parsons

Michael J. Parsons
President/CEO