May 28, 2014

To: regcomments@ncua.gov

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

RE: Comments on Proposed Rule: PCA - Risk-Based Capital

Dear Mr. Poliquin:

First Heritage Federal Credit Union (FHFCU) appreciates the opportunity to comment on the National Credit Union Administration (NCUA) Board's proposal to revise Prompt Corrective Action related to Risk-Based Capital. FHFCU has a community charter and serves 30,700 members in Steuben and Chemung Counties in New York and Tioga County in Pennsylvania. The Credit Union currently has $395 million in assets. FHFCU agrees there may be a need to modernize capital standards to identify excessive risk in credit union balance sheets. However, management feels the current Proposed Rule will have negative effects on FHFCU members and discourage investments in long term strategies necessary to the survival of the credit union. FHFCU is asking the NCUA to consider revising risk weightings to more reasonably assess interest rate risk and to better align the proposed risk-based well capitalized requirements to existing net worth requirements. This could force management to reshape the credit union's business model as it relates to long term investment, lending and expansion strategies which will negatively impact the member experience and make the credit union less competitive with banks and other competing financial institutions. The Proposed Rule, in its current state could inhibit FHFCU's growth and discourage the credit union from investing in branches and new technology.

The modernization of NCUA rules defining minimum capital requirements and Prompt Corrective Action appears to be timely given the 2007-2009 recession and Basel III. We believe that any such modernization should take into consideration the unique characteristics and qualities of credit unions, the need to identify credit unions with excessive risk, and the need to create a risk-based standard that is comparable to Prompt Corrective Action systems that are employed by other Federal Banking Regulatory Agencies. There is no evidence that risk based capital requirements, utilized by the banking regulators, work any better than the net worth requirements currently imposed by the NCUA. The CUNA analysis of NCUSIF losses vs. FDIC losses from 2007 to 2013 shows the banking loss rate, with risk-based capital standards in place, was 8.8 times higher than the credit union experience. During this period the FDIC loss rate per $1,000 of deposits was $2.30 vs. the credit union loss rate of $0.26 per $1,000 of deposits. Banks have had risk-based capital requirements for nearly 25 years and

Main Office
110 Village Square
Suite 101
Painted Post, NY 14870
607.936.4667
ATM on site

Addison
11 Steuben Street
Addison, NY 14801
607.359.2275
ATM on site

Corning
23 West Market Street
Suite 102
Corning, NY 14830
607.962.4691

Elmira
1100 Clemens Center Pkwy.
Suite 6
Elmira, NY 14901
607.734.0231
ATM on site

Elmira Heights
218 Prescott Avenue
Elmira Heights, NY 14903
607.733.4624
ATM on site

Elmira Southport
1707 Cedar Street
Elmira, NY 14904
607.734.6280
ATM on site

Horseheads
501 Gardner Road
Horseheads, NY 14845
607.796.2671
ATM on site

Mansfield
1550 South Main Street
Suite 1
Mansfield, PA 16933
570.662.1220
ATM on site

Wellsboro
17 East Avenue
Wellsboro, PA 16901
570.724.5331
ATM on site

Call toll-free 800.833.3338
SMART Line: 888.936.8402
Web site: www.fhfcu.org

these requirements neither prevented the latest crisis in 2007 nor stopped significant failures in the banking system.

Natural person credit unions came through the worst recession in history with few problems, so it appears that this proposal could end up harming an industry that is not currently in need of strong corrective actions. Most credit union failures, including the Corporates, were due to high concentration levels of assets with poor credit quality, which this proposal seems to treat as a secondary characteristic rather than as a primary focal point.

Below are the comments that FHFCU is asking the NCUA to consider in developing the final version of the Risk-Based Capital Rule.

FHFCU General Comments:

1. **Several of the risk weightings under the Proposed Rule appear to be too general or excessive. Under the Proposed Rule, credit union risk weights would be higher than that of banks requiring credit unions to hold more capital than banks for the same assets. This is a major concern to FHFCU as it would place credit unions at a competitive pricing disadvantage in an already highly competitive marketplace. In addition, risk weights in the loan portfolio are defined solely by relative concentration of a specific asset class, without consideration of maturity or repricing characteristics. This is an unbalanced approach, which completely ignores sound ALM practices.**

Cash Held at the Federal Reserve

FHFCU has been holding cash at the Federal Reserve as an alternative to short term investments and as a source of liquidity should there be an increase in the utilization rate on unfunded lines of credit or an outflow of non-core deposits currently held by our members in this historically low rate environment. Under the Proposed Rule, cash balances being held at the Federal Reserve are given a 20% risk weighting. Given that the Federal Reserve has been designated as a source for emergency liquidity for the entire credit union industry, there appears to be little risk in holding cash balance at the Federal Reserve. Under Basel III, central bank reserves are deemed to be highly liquid assets during a time of stress and carry a 0% risk weighting. FHFCU believes cash balances being held at the Federal Reserve should be given a 0% risk weighting in the final version of the Rule.

Investments

Under the Proposed Rule, investment risk weightings for credit unions are significantly higher than that of banks. The NCUA risk weights appear to be inconsistent when compared to banks thus putting credit unions at a disadvantage. For example, all securities guaranteed by the full faith and credit of the US Government and those securities guaranteed by the NCUA or FDIC carry a 0% risk weight, regardless of the maturity. However, securities issued by Government Sponsored Entities (GSE's) carry almost no credit risk, but they are risk weighted based on weighted average life time buckets. Investments with weighted average lives greater than 5 years are given punitive risk weights of 150% for 5 to 10 year average lives and 200% for average lives greater than 10 years. This compares to 20% risk weightings for similar securities in the banking model. It is apparent that the NCUA is concerned with longer term assets and duration mismatch on the balance sheet, but these risk weightings are harsh, do not give credit for sound ALM practices, and almost force credit unions to maintain all of their investments in anything with a maturity of less than three years, which can hurt overall profitability.

Another weakness of the proposal is the lack of uniformity when assigning risk for very similar assets. For example, a 30 year conforming mortgage on FHFCU's balance sheet would carry an arbitrary risk weighting of 50%, however, if we securitize the same loan into a 30 year Mortgage Backed Security (MBS) through Fannie Mae or Freddie Mac, and then purchase it back, the risk weighting somehow increases to 150%. This higher risk weighting makes absolutely no sense because the MBS has no credit risk to the credit union and enjoys enhanced liquidity as it can be sold on the secondary market very quickly, but the proposal, in its current form, ignores these enhancements in favor of strictly assigning a risk weight based on maturity.

Finally, the rule completely ignores sound ALM practices. As of March 31, 2014, FHFCU has an average maturity on the investment portfolio of 5.2 years. Many of the investments are asset-backed pools, which will provide monthly cash flows of principal and interest, which are reinvested into member loans or back into investments at current market rates. Also, 90% of the credit union's loans mature in 15 years or less, and the average life of the entire portfolio is just 3.6 years. Additionally, the average life of the credit union liabilities is 7.7 years, which is derived through careful analysis of member behavior over the preceding 10 years. Based on this analysis, the credit union is not taking excessive risk with a longer investment maturity structure. Under the current proposal, the credit union will be penalized for holding longer term investments even though the analysis supports the balance sheet as currently structured.

FHFCU believes the final version of the Rule should more closely mirror bank risk weightings for investments so as not to create such a competitive disadvantage. FHFCU also believes there should be no risk weightings on investments greater than 100%.

<u>Real Estate Loans</u>

Under the Proposed Rule, no distinction is made on the risk weightings assigned to mortgage loans of various maturity and repricing terms. A 30 year fixed rate mortgage gets the same risk weight as a 1 year adjustable rate mortgage and a 30 year fixed rate home equity loan gets the same risk weight as a variable rate home equity line of credit. As opposed to implementing risk-based capital standards that unfairly lump all mortgage loans together with the focus being placed on relative concentration, there should there be more attention paid to repricing and maturity structures. This will ensure that credit unions continue to utilize sound ALM principles when making lending decisions.

<u>Member Business Loans</u>

The NCUA Proposed Rule creates a bias in favor of consumer loans as opposed to other assets such as member business loans. Consumer loans are assigned a 75% risk weighting while member business loans are subject to risk weights based on relative concentration of loan balances, similar to member mortgage loans. Credit Unions are a valuable resource in their markets with respect to these loans, and this proposal, in its current form, could cause a decrease in lending to small businesses, simply because of the adverse impact on capital.

This is not a sound way to make business decisions, but the current proposal may have this specific impact.

2. FHFCU has concerns about the NCUA being able to arbitrarily decide that the credit union needs a higher capital ratio, even if the calculation indicates the credit union is well capitalized (individual minimum capital requirements).

The Proposed Rule gives the NCUA subjective authority to require a higher minimum risk-based capital ratio for individual credit unions based on NCUA examiner discretion. This could lead to inconsistent interpretation and application of the Rule across the country. A well-designed model will allow the NCUA to determine an appropriate level without including subjective reasoning. By leaving this loophole in the regulation, the entire model is open to interpretation and examiner bias. FHFCU strongly recommends the elimination of minimum capital ratios which deviate from the published matrices from the final version of the Rule.

3. The proposed allowance for loan loss limit of 1.25% is too low in light of impending changes from FASB.

FASB's proposal to move towards a Current Expected Credit Loss (CECL) model will most likely increase normal allowance for loan loss reserves by an estimated 30% to 100% at some credit unions. FHFCU believes that more of this required allowance should count towards capital should the higher standard be adopted in the near future.

4. Investments in CUSOs should be risk weighted at 100% as opposed to 250% under the Proposed Rule.

FHFCU is not currently a member of any CUSOs, but we do understand the important role that they play within the credit union industry. CUSOs allow credit unions to share expenses and risk in order to offer additional products and services to the membership. FHFCU is very concerned that the inflated risk weighting on CUSO investments may hinder the cooperation among credit unions at a time when such collaboration is vital to the future progress of the industry, and as such, FHFCU believes CUSO investments should be risk weighted at no more than 100%.

5. Consideration should be given to permit federally insured credit unions to offer supplementary capital.

Credit unions remain the only financial institutions that do not have access to sources of capital beyond retained earnings. If higher capital standards are to be imposed on the credit union industry under the Proposed Rule, affording credit unions the ability to raise supplementary capital which counts towards net worth requirements seems to be an appropriate policy consideration.

In summary FHFCU feels the current Proposed Risk Based Capital Rule has too many inconsistencies and all but ignores sound business decisions by the Board of Directors and

Management. The Proposed Rule, in its current form, will most likely reduce the risks to the NCUSIF but at a significant cost to credit unions and their members through reduced returns and higher-cost residential and member business loans. In addition it will place credit unions at a competitive disadvantage as it would require far more capital than what is required for banks, especially when considering a credit union's inability to raise supplemental capital. FHFCU feels that with modifications to the Proposed Rule based on objective criteria, the final version of the Risk-Based Capital Rule could in fact be a significant improvement over current Risk Based Net Worth.

Thank you for the opportunity to comment on the Proposed Rule and for listening to FHFCU's concerns. Please feel free to contact me with any questions or comments regarding FHFCU's comments on the Proposed Rule.

Sincerely,

Frank D. Vassallo, CFA
Chief Financial Officer