BLACK HILLS FEDERAL CREDIT UNION
A Member-Owned, Not-For-Profit Cooperative
PO Box 1420, Rapid City, SD 57709-1420

May 28, 2014

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

Email: regcomments@ncua.gov

RE: Comments on Proposed Rule: Prompt Corrective Action; Risk-Based Capital

Dear Secretary Poliquin and Members of the NCUA Board:

On behalf of the Board of Directors and Executive Management Team of Black Hills Federal Credit Union (BHFCU), I am writing in response to NCUA's request for comment on the proposed rule regarding risk-based capital (RBC) requirements. Black Hills Federal Credit Union is a community chartered, low income designated credit union serving members in the South Dakota counties of Pennington, Meade, Fall River, Custer, Lawrence, Haakon, Hughes, Stanley, and Butte. We also serve the Cheyenne River Indian Reservation in South Dakota, consisting of Dewey and Ziebach counties. BHFCU currently serves 58,976 members and has assets of approximately $986 million.

Under NCUA's current regulation, BHFCU ended the first quarter of 2014 with a net worth ratio of 10.70%, resulting in a "well capitalized" level. Our capital cushion compared to the minimum "well capitalized" level of 7.00% was 370 basis points or $36,911,856 as of March 31, 2014. Under the proposal as it stands today, BHFCU would see its cushion over "well capitalized" shrink by 171 basis points, which is equivalent to $17,104,873. The cushion over "well capitalized" would decline to 199 basis points, and the capital cushion decline would equate to nearly all of our earnings from the past three years.

Risk-Based Capital Proposal Should Be Abandoned

This risk-based capital proposal is not justified and should be abandoned. We disagree that a credit union should have to meet both capital requirements. It seems over complicated that we would have to meet both the net worth ratio of 7.00% and a risk-based capital ratio of 10.50% in order to be considered well capitalized. Credit unions weathered the Great Recession well under the current Prompt Corrective Action (PCA) regulation. During that time, the PCA requirement worked as it was meant to and protected the credit union system and National Credit Union Share Insurance Fund (NCUSIF) from losses incurred from natural person credit unions.

If it is the NCUA's desire to have a risk-based capital program, then we strongly recommend the NCUA produce a well-thought through and fair risk-based capital program. We strongly disagree with NCUA's RBC proposal, as there are considerable flaws and negative implications that have not been considered or taken into account by the NCUA. The design of the proposal seems arbitrary and, without question, will stifle credit union growth and viability going forward. The number of credit unions continues to decline due to regulatory burdens, and consequently, if adopted as it stands, this rule will further exacerbate an already troubling trend and outlook for credit unions as a whole.

While we understand the goal of the RBC proposal is to protect the system, we believe much more damage than good will be done. The NCUA has not provided adequate support or rationale for the random risk weightings proposed for each category. We believe that many of the risk weightings make little sense and will have unintended consequences by restricting growth across the credit union industry. The proposed risk weightings are perplexing and difficult to understand when compared to the less onerous Basel III (Basel). Bankers are likely celebrating this gift from NCUA that will put credit unions at such an unfair competitive advantage!

Again, we recommend the NCUA abandon this proposal and maintain the current PCA Net Worth regulation and not require that both capital requirements be met. Specifically, we recommend that only the current PCA regulatory minimum net worth ratio of 7.00% be required to be well capitalized.

Risk Weights of Investments

The risk weights proposed are attempting to capture interest rate risk, concentration risk, and credit risk, yet the bank's requirement in Basel focuses strictly on credit risk. By including interest rate risk and concentration risk in the proposed rule when credit unions already have to abide by rules and regulations for these risk areas, additional and unwarranted competitive disadvantages are imposed on credit unions compared to banks under Basel. Additionally, interest rate risk cannot be adequately assessed without looking at liabilities.

If a 30-year Treasury investment has a 0% risk weight, overnight money at the Federal Reserve Bank should not be weighted at 20%. It is difficult to understand why a Federal Reserve Bank deposit would be risk weighted when NCUA has designated it as a source of emergency liquidity. We keep over $100 million in overnight liquidity at the Federal Reserve and find no justification for a risk weight higher than 0%.

The weighting of securities and investments in government-sponsored enterprises (GSEs) by the five weighted average life tiers is way too severe compared to Basel. Government sponsored enterprises such as Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Federal Farm Credit Banks (FFCB), and Federal Home Loan Banks (FHLB) are common investments found in many credit union portfolios because of the implicit guarantee from the United States government. The implicit guarantee states the government will not allow such important institutions to fail or default on debt. The implicit guarantee has already been tested and proven during the worst mortgage crisis in history when the government bailed out and put into conservatorship Fannie Mae and Freddie Mac. Because of the implicit guarantee of GSE's, the risk weighting applied in Basel adequately and wisely weights GSE investments of all durations at 20%. We do not understand why the NCUA did not risk weight accordingly.

Currently, BHFCU's investment portfolio holds approximately $193 million in GSE securities over varied durations, some of which are greater than 5 years. Over the past few years, we have seen our investment portfolio increase and our loan-to-share ratio stay at a relatively moderate level. While we could have taken on additional interest rate risk and held 30-year mortgages over the last four years, we instead saw our mortgage portfolio decline from 16% of assets to 11% of assets as we have helped members take advantage of record low interest rates and refinance their mortgages to the secondary market. In an effort to offset some of the lost income from the mortgage loans that paid off or refinanced to the secondary market, we invested in securities that took advantage of the steepness of the yield curve, captured some additional yield, and had less overall interest rate risk.

Under the proposed rule, credit unions are penalized with a risk weight of 150% for investing in a 7-year GSE bond rather than keeping a 30-year mortgage in the portfolio that is risk weighted at 50%. The 7-year GSE bond carries some interest rate risk and very little credit risk, but definitely less than a 30-year mortgage. We recommend a more reasonable approach to risk weighting GSE investments and believe the Basel risk weighting of 20% would be a more appropriate level.

Additionally, we recommend the NCUA change the risk weights for all municipal general obligation bonds and municipal revenue obligation bonds. The risk weights proposed are exactly the same risk weights as what is proposed for GSE securities. We disagree with this approach and favor the risk weighting implemented by Basel which has all municipal general obligations risk weighted at 20% and municipal revenue obligations at 50%. We believe this is a fair approach that captures the credit risk correctly.

Risk Weighting of Investment in CUSOs

The 250% risk weighting for investments in CUSOs lacks sufficient rationale and could seriously curb collaboration among credit unions. The actual risk of investing in CUSOs is much less than what the proposed risk weighting implies.

Although Credit Union Service Organizations of all types exist, their one common goal and premise is to serve members and credit unions. Unfortunately, the proposed risk weighting will reduce collaboration and cooperation among credit unions, as it will result in credit unions using riskier third party vendors. The proposed risk weight will create another competitive disadvantage for credit unions and penalize them for investing in businesses that will help members as well as their credit unions.

We are part owner of a business lending CUSO, Midwest Business Solutions, and majority owner of an insurance agency, BHFCU Insurance Services. These two CUSOs strive to provide excellent member service, but also help provide additional income to participants and owners. Midwest Business Solutions facilitates meeting member business loan and agricultural loan needs, as well as provides credit unions additional interest income through participation loans. Midwest Business Solutions also reduces operating costs for credit unions as they originate and service loans for credit unions for a nominal fee. Also, BHFCU Insurance Services has enabled us to meet our member's insurance needs by providing a convenient and low cost solution. Although BHFCU Insurance Services has only been in operation for five years, we have been able to generate a positive net income over the past three years.

We have additional concerns with the proposed risk weighting for CUSOs, as it does not address the retained profits earned by a CUSO. For example, our equity investment in BHFCU Insurance Services continues to appreciate because of the positive net income and return over the past three years. We have not taken a distribution at this time; however, a risk weight this high, without rationale and clarification, will certainly dictate that we take distributions. We have serious concerns including the profits the CUSO has generated as part of the calculation, as it will only force credit unions and investors to take distributions and weaken the equity position of CUSOs. We recommend the NCUA clarify the CUSO risk weighting and exclude profits generated by CUSOs and only risk weight the actual amounts invested.

CUSOs have demonstrated the ability to make millions of dollars for credit unions through costs savings, additional interest income, and fee income. In addition to helping the net income for credit unions, CUSOs help credit unions offer expanded and better member service. As an example, we are members of and utilize CO-OP Financial Services for their cost-saving shared branching and ATM networks. CO-OP's services have helped us serve not only our members throughout the United States, but members of other credit unions from all over the country.

At a recent BHFCU Board meeting, we presented a CUSO investment opportunity that would enable us to provide a much needed service to more members while enhancing net income. Because the proposed risk weighting for CUSOs is so punitive to credit unions, our Board asked whether additional investments in CUSOs were prudent. If our Board is already discussing the negative consequences of investing in CUSOs, you can be assured other credit union officials are doing likewise. The unfortunate thing about this discussion is that a reduction in CUSO investments will result in credit unions not providing additional affordable services to members to the delight of the for-profit financial industry, while also having a detrimental economic impact on credit unions.

With the headwinds and regulatory burdens that credit unions face today, operating costs are constantly on the rise and growth in earnings is imperative. CUSOs help mitigate the headwinds by providing a low-cost solution and/or additional income. It is apparent this risk weighting is out of fear and is a classic example of managing by exception! Overall, CUSOs make credit unions better. If the NCUA's desire is to have a blanket weight for all of the various CUSOs, then we recommend this be risk weighted more reasonably at no more than 100%.

Risk Weighting of Member Business Loans

The risk weightings for member business loans are too severe when compared to Basel. Given the restriction most credit unions face on the percentage of member business loans at 12.25% of assets, implementing harsher risk-based guidelines only exacerbates the challenge credit unions face to stay competitive. Although we agree with NCUA's proposed risk weighting for SBA loans at 20%, not all of our business loans have SBA backing and receive a reasonable risk weighting. Regardless of concentration, Basel risk weights all business and agriculture loans at 100%, while the NCUA proposal tiers the risk weight by concentration. We do not agree with creating tiers of member business loans based on concentration of assets.

Although we are a low-income designated credit union and can go beyond the asset limitation of 12.25% for member business loans, it is apparent we are being penalized for our low-income designation. The restriction and penalty we receive by going beyond 15% of assets, as proposed, only hurts the small businesses and communities that rely on affordable, quality business and agricultural lending from their credit union.

The reason we have the low-income designation and the ability to surpass the 12.25% of assets level is because of the need to serve these important businesses and members who live in underserved areas. Black Hills Federal Credit Union continues to live by the credit union motto of "Not For Profit, Not For Charity, But For Service." As an example, we merged with a credit union on the Cheyenne River Indian Reservation in September 2012. The two counties we merged in were severely underserved and were also the two most impoverished counties in the country. The low-income designation is supposed to help credit unions serve the underserved, not penalize them for it!

In an effort to combat the relatively moderate loan-to-share ratio and low interest rate environment we have experienced over the past few years, we have focused on increasing income through thoughtful and careful growth of our business loan portfolio that is within BHFCU's tolerance for risk. We anticipate that with our low-income designation, we will be reaching or surpassing the 12.25% MBL limitation on assets within three years. We project that within five years our MBL portfolio will likely reach the 15% of assets level and be subjected to the punitive risk weighting of 150%, as proposed, for every loan beyond 15% of assets.

As an example of how we have affected businesses in our communities, we have won the Small Business Administration (SBA) award for most loans originated in South Dakota three times since 2008. In addition, this past year one of our senior business lenders was recognized as SBA's lender of year for South Dakota. Our average business loan is approximately $100k, and we take great pride in providing service to small business owners.

Although many other institutions, mostly banks, took large losses in business loans during the recession, we did a great job of underwriting our loans and incurred relatively low losses. Since 2008, our business loans (including small purpose business loans) have only caused us losses totaling $442,995. We do not agree with NCUA's approach to tier the risk weights based on concentration in MBL's and believe this diminishes the purpose of having a low-income designation and hurts small businesses and farmers. We believe a flat risk weight for Member Business Loans of 100% is more appropriate and does not cause undue harm to those credit unions trying to serve underserved members and communities.

Risk Weighting of Residential Mortgages

As addressed previously, over the past few years we have seen our residential mortgage loan portfolio decline from 16% of assets to 11% of assets and our loan-to-share ratio stay at a relatively moderate level. We have worked diligently to put other high quality earning assets on our balance sheet. In an effort to do so, we have grown business loans as mentioned previously, and we have also targeted different mortgage strategies. Some of the strategies we have targeted and implemented over the past few years for mortgages were 5/1, 6/1, 7/1, and 10/1 ARM promotions, as well as fixed 8-, 10-, and 12-year mortgages. We've also offset the interest rate risk of 30-year mortgages with a longer-term certificate promotion. In addition, we have contemplated a borrowing strategy from the FHLB to finance fixed-rate mortgages.

As we try to bolster our loan portfolio, we are always targeting a safe and effective way to grow income and loans. Our top priority in growing mortgage loans is to minimize the impact of interest rate risk and concentration risk, and we have succeeded by utilizing these various strategies and options. It is important to note that we have not concentrated on one type of mortgage over the others; rather we have balanced our focus with variable ARM or HELOC mortgages, short-term fixed rate mortgages, and long-term fixed rate mortgages. If we were to see a peak in mortgage loan demand again, much like we did a couple years ago, we might consider or weigh the possibility of financing long-term fixed rate mortgages with long-term fixed rate borrowings rather than selling the loans to the secondary market. However, this rule and risk weight for first mortgages over 25% of assets and for second mortgages greater than 10% of assets penalizes credit unions as it is out of line with Basel. This is especially true if the credit union has taken appropriate steps to manage and monitor interest rate risk, credit risk, and concentration risk.

Unfortunately, the risk weightings as proposed are again tiered by concentration and do not factor in any risk-mitigating factors the credit union might have in place such as fixed rate long-term borrowings or variable re-pricing. The proposed rule also does not address the specifics of the mortgages. For example, the rule does not consider if the mortgage is variable or re-pricing, short-term fixed rate, or long-term fixed rate. The risk of a residential mortgage is determined by the type of loan, loan-to-value, debt-to-income, duration, geography, demographics of a market, etc. We recommend the NCUA eliminate the concentration and tier-based risk weights and factor in a flat risk weight of 50% for non-delinquent first mortgage loans and 100% for second mortgages.

NCUSIF Capitalization Deposit

The deduction of the NCUSIF Capitalization Deposit from capital essentially says our money and deposit paid is worthless! The Capitalization Deposit has value and subtracting it from both the capital and risk-weighted total assets is equivalent to writing off the deposit. We recommend not deducting this deposit from the numerator and the denominator as this is a valid asset.

Allowance for Loan Loss Limitation

The limit to the amount the Allowance for Loan Loss can add back to the numerator of 1.25% of risk assets should be removed. The NCUA mandates that credit unions abide by Generally Accepted Accounting Principles (GAAP) and reserve for their future loan losses through provision expenses. The possibility of accounting rule changes in GAAP and estimating the allowance, which would require additional reserve allocation, only increases the pain being inflicted on credit unions.

The Allowance is funded by what would have normally been an increase to earnings or capital and is set aside for credit risk. If the goal of the proposal is to capture credit risk, it is illogical to limit the reserves set aside for one of the exact risk exposures this proposal is designed to address. To propose a 1.25% limit of risk assets is unwarranted for what should be considered capital available. We recommend the Allowance for Loan Loss Limitation of 1.25% of risk assets be removed entirely.

Examiner Authority

The ability and authority for an examiner to impose additional capital based on the examiners judgment and on a case-by-case basis is not justified. This amount of discretion, subjective judgment, as well as inconsistent interpretation, may lead to an abuse of power and could lead to significant and unfair ramifications for credit unions. There is no logical reason for such a rule to be allowed, and we recommend examiner authority to impose additional capital requirements be completely eliminated.

Implementation and Compliance Timeline

The compliance timeline of 18 months is way too short. Banks were given nine years to comply with Basel. Although the NCUA has stated this rule, as it is today, only impacts the capital requirements of 199 credit unions right now, but in reality it impacts every credit union regardless if they are larger or smaller than $50 million in assets. The time to correct and strategically change a balance sheet cannot happen in just 18 months without significant harm to the credit union and its members, as there would have to be an immediate transformation of the credit union. As we stated earlier, this rule will eliminate more credit unions and stifle growth. Unlike banks, credit unions can only generate additional capital through earnings and do not have the ability to go to investors for injections of capital. Because credit unions can only generate capital one way, the extremely short timeline only reinforces the competitive advantage banks have over credit unions. Much more time is needed to afford credit unions time to change their balance sheets with minimal impact to their bottom line and to the members. We recommend a compliance timeline of at least nine years to provide credit unions a reasonable time to restructure balance sheets and generate capital.

Summary

The proposal as it stands guides credit unions to avoid risk, shorten portfolios, and reduce net interest income and net income. The proposal calls into question credit union viability. It is important for the NCUA to consider that credit unions did not cause the recession, yet the risk weightings being imposed are far worse than what was implemented for the institutions that did cause it. As historical data has proven, credit unions, in most cases, have been very conservative and have taken on less risk than their competitors. Credit unions were not the problem, yet we are the ones continuing to get beaten down and penalized for the risks and losses taken on by others!

The RBC proposal comes at a time when all credit unions are trying to get back on their feet following years of NCUA assessments, in addition to operating with compressed net interest margins caused by low interest rates. The environment over the last five years has been extremely difficult. Implementing such a harsh rule within such a short timeframe and without proper regard would be devastating.

This risk-based capital proposal is not justified and should be abandoned. If the proposal is not abandoned, we recommend the NCUA address, at a minimum, the following items:

- We recommend the NCUA stay with the current PCA Net Worth requirement and not require that both capital requirements be met. Specifically, we recommend that only the current PCA regulatory minimum net worth ratio of 7.00% be required to be well capitalized.
- We find no justification for a risk weight higher than 0% for an overnight deposit at the Federal Reserve Bank and recommend the 20% risk weight be removed.
- We recommend a more reasonable approach to risk weighting GSE investments and believe the Basel risk weighting of 20% would be a more appropriate level.
- We disagree with the risk weightings applied to municipal general obligation bonds and municipal revenue obligation bonds. We recommend and favor the risk weighting implemented by Basel which has all municipal general obligations risk weighted at 20% and municipal revenue obligations at 50%. We believe this is a fair approach that captures the credit risk correctly.
- If the NCUA's desire is to have a blanket weight for all of the various CUSOs, then we recommend this be risk weighted more reasonably at no more than 100%.
- We recommend the NCUA clarify the CUSO risk weighting and exclude profits generated by CUSOs and only risk weight the actual amounts invested.
- We believe a flat risk weight for Member Business Loans of 100% is more appropriate and does not cause undue harm to those credit unions trying to serve underserved members and communities.
- We recommend the NCUA eliminate the concentration and tier-based risk weights and factor in a flat risk weight of 50% for first mortgage loans and 100% for second mortgages.
- We recommend not deducting the NCUSIF deposit from the numerator and the denominator as this is a valid asset.
- We recommend the Allowance for Loan Loss limitation of 1.25% of risk assets be removed entirely.
- We recommend examiner authority to impose additional capital requirements be completely eliminated.
- We recommend a compliance timeline of at least nine years to provide credit unions a reasonable time to restructure balance sheets and generate capital.

Credit unions already face many undue regulatory burdens and currently have rules and regulations that address interest rate risk and concentration risk. If the intent is to bring our risk-based capital requirements more in line with Basel, then the interest rate risk and concentration risk considerations and components should be left out of the proposal. Based on all of our aforementioned recommendations, it would be wise if the NCUA abandoned their risk-based capital proposal and continue with the Prompt

Corrective Action regulation that served credit unions so well during the Great Recession.

We thank you for the opportunity to comment and for your time and consideration. We encourage you to make the best decision for credit unions and the members they serve.

Respectfully,

Roger R. Heacock
President & CEO

cc: Senator Tim Johnson
Senator John Thune
Representative Kristi Noem
Credit Union Association of the Dakotas