Pentagon Federal Credit Union

Office of the President

November 14, 2013

BY: E-MAIL (regcomments@ncua.gov)

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

SUBJECT: Comments on Proposed Rule-
Capital Planning & Stress Testing

Dear Mr. Poliquin:

Pentagon Federal Credit Union (PenFed) hereby provides its observations regarding the subject above.

PenFed has long been a consistent supporter of a strong National Credit Union Administration (NCUA), an agency that is focused on maintaining the safety and soundness of credit unions regardless of the external economic environment. If we have learned nothing else as a society over the last decade we should have been educated to the fact that safety and soundness is not simply credit union officials' fiduciary responsibility to our members; it is a responsibility to the nation as well.

Understanding the foregoing, we unequivocally state at the outset that we enthusiastically support stress testing of America's largest credit unions. Indeed, we support stress testing of all financial institutions to ensure their financial integrity. Although such depositories may not have systemic relevance they are the custodians of individual's financial assets and accordingly, have responsibility for being prudently operated. Analogously, one does not drive a vehicle with faulty brakes; similarly one should not operate a financial institution that is unprepared for difficult times.

Thus, the nature of our comments concerning the instant proposal do not revolve around whether or not stress testing should

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occur. Rather, they are focused on one technical element of the proposed rule; that being the requirement of a two year final maturity for non-maturity shares (NMS)(the Rule).

We suspect that the Rule was derived from a 2001 study NCUA engaged, The Evaluation of Credit Union Non-Maturity Deposits (the Study), the focus of which was centered on how to manage NMS maturity measurements for *small* credit unions and whose accuracy with regard to *large* credit unions has no basis in fact.

We do not argue that asset liability models should not be stressed. In this connection, PenFed has been applying a 700 to 800 basis point shock to its balance sheet model for nearly two years now. This action has been taken to ensure that the credit union is prepared to confront the most historically severe rise in rates to which it might be subject. Importantly, there is a historical basis for choosing that data point.

To understand the nature of our concern requires a historical review of ALM management with regard to credit unions. As noted in the introduction of the Study, "[t]he NCUA was particularly interested in the question of what effective maturity may reasonably be assumed for NMSs in simple methods that do not explicitly model NMS cash flows."

It is in the Study that one can find recommendations regarding a two year final maturity (Appendix 1). Importantly, however, the authors initially observed that, "for credit unions that wish to base NMS valuations on actual (discounted) cash flows, but not use the complex state of the art methods, we provide an illustrative simple present value model, which can produce durations comparable to those estimated in the literature."

Critically, in our opinion, the authors also caveated their model with the following disclaimer, "[we] do not recommend that any credit union (or NCUA examiner) blindly adopt this model, or even this type of model, without careful consideration of whether the assumptions make sense for a particular institution."

Notably, the reporters stated on page 49 of the Study:

> We must keep in mind that many credit unions are small organizations and many have limited experience or expertise in the arena of financial modeling. All these factors tend toward a conclusion that most credit unions will be quite

adequately served by using simple methods for valuing NMSs, as long as they are used in a careful manner, consistent with the specific circumstances of their institution. *The key question then becomes at what point does a credit union become too large or too sophisticated to use simple valuation methods."* (emphasis supplied)

That question has neither been asked, considered, nor debated in a transparent manner between the agency, the credit union community and the current practitioners of relevant ALM modeling and stress testing. Instead, it would appear that NCUA has simply chosen to apply a twelve year old study metric that was clearly not intended for credit unions greater than $10 billion.

To the contrary, the Study authors suggested to NCUA that it commission a statistical study of credit union deposits in order to obtain a more accurate fact based assessment of NMS behavior. The authors insightfully noted,

> To the extent that the credit union is investing a significant portion of its balance sheet in mortgages, or other loans or securities with embedded options, it should consider adopting a more complex method of valuing its deposits. This is because such assets have very different interest rate risk than other possible investments; this in turn means that the valuation of the deposits *must be undertaken in a more comprehensive manner to determine the institutions' interest rate risk.* (emphasis supplied)

That was then. This is now. In January 2010 joint interagency guidance, Advisory On Interest Rate Risk Management, was issued with regard to measuring and managing interest rate risk, which NCUA adopted (the Guidance). The Guidance mandated "[c]omprehensive systems and standards for measuring IRR, valuing positions and assessing performance, including procedures for updating IRR measurement scenarios and key underlying assumptions driving the institution's IRR analysis."

Moreover, the Guidance provided that "...current computer technology allows even some smaller, less sophisticated institutions to perform comprehensive simulations of the potential impact of changes in market rates on their earnings and capital....Institutions are encouraged to use the full complement of analytical capabilities of their IRR simulation models."

Credit unions with assets of $10 billion and greater are neither small nor lacking in expertise with regard to ALM or financial modeling. All such institutions have access to outside consulting firms with state of the art capabilities with regard to all ALM capabilities as well as NMS maturity calculations. NCUA equally shares this capability.

The firm NCUA has engaged for stress testing is one of a number in the country that can and does calculate NMS maturities. What was rare in credit unions in 2001 is readily available to many credit unions today and certainly to all of the credit unions $10 billion and above.

But, why such concern over one assumption? The Guidance addresses that in specific:

> *Proper* measurement of IRR requires *regularly assessing* the reasonableness of assumptions that underlie an institution's IRR exposure estimates. The regulators remind institutions to document, monitor and regularly update key assumptions used in IRR asset prepayments, *non-maturity price sensitivity and decay rates* and key drivers for each interest rate shock scenario. *Assumptions about non maturity deposits are critical*, particularly in market environments in which customer behaviors may not reflect long term economic fundamentals, or in which institutions are subject to heightened competition for such deposits. (emphasis supplied)

The Guidance reiterates that, "[f]inancial institutions should perform historical and forward looking analyses to develop supportable assumptions and models relevant to their market and business plans. Proper measurement of IRR also requires sensitivity testing of key assumptions that exert the greatest impact on measurement results."

But NCUA has not applied the Guidance in proposing a two year final maturity data point for NMS. In lieu, it is relying upon a twelve year old study that, by the authors' professional assessment, was never intended for large complex institutions.

NCUA's examination teams would not countenance nor permit a credit union to use twelve year old data and assumptions. Similarly, neither should the proposed rule. The Guidance states that, "[l]arge and complex institutions or those with significant IRR exposure may need to perform more in depth validation procedures of the underlying mathematics."

The fact is that in today's world financial institutions of $10 billion and greater, to include credit unions, can and should know and understand their actual NMS decay rates and maturities. The fact also is that numerous vendors have the analytical tools and professional resources to enable them to provide this service for an institution with great accuracy.

These vendors include NCUA's choice of contractor for stress testing. Undeniably, stressful scenarios must be tested that change decay rates so that boards, management officials and NCUA examiners have a strong understanding of a credit union's actual embedded risk in a credit union's balance sheet.

But, to be meaningful we urge that such assessment must begin with real data and be modified from there in some realistic ratio that reasonably reflects past performance in difficult economic environments.

We are not aware that the Federal Reserve or the Federal Deposit Insurance Corporation are superimposing a definitive final maturity points for their regulated institutions. Instead, these agencies are expecting that those institutions use modern methods and technology to arrive at actual data and then stress test from there as closely mirroring maturity performance in prior periods of stress as possible.

The foregoing regulatory action considered in relation to the Study and the Guidance should be the basis upon which NCUA establishes a requirement related to the matter of NMS. At bottom, the agency should adopt a "rule of reason", that is, all facts considered.

Finally, we would observe that requiring credit unions to be assessed on a two year NMS standard will place the institutions at a competitive disadvantage. It may well reduce credit unions' key role in providing mortgages to its members based upon the erroneous assumption at the same time other financial institutions are limiting their roles in making mortgages available.

NCUA has additionally sought comments concerning the establishment of a requirement for credit unions to self-stress test and the extent to which, if at all, stress test results should be made public. In connection with these requests we offer the following observations:

* All covered credit unions should be mandated to perform stress testing in accordance with government guidelines that are the same or very similar to all financial institutions of similar size. It would place credit unions at a material competitive disadvantage to use testing guidelines that have no basis in fact or are not suitable for institutions of like size.

* Public disclosures should be required. One or two rounds of stress testing should initially take place to resolve any issues with the testing process. At bottom, large credit unions should be just as transparent as banks.

I would welcome the opportunity to amplify the foregoing thoughts or otherwise respond to any questions the NCUA staff may have in connection with them.

Thank you for your consideration.

Very truly yours,

Frank R. Pollack
President/CEO

FRP/kld

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