NAVY FEDERAL Credit Union

Office of the President

December 17, 2013

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Notice of Proposed Rulemaking – Capital Planning and Stress Testing

Dear Ms. Rupp,

Navy Federal Credit Union is pleased to provide comments on the National Credit Union Administration's Notice of Proposed Rulemaking (NPR) governing the introduction of Capital Plans and Stress Tests for large Federal Credit Unions (FCUs).

Overall, we support the concept of capital planning and stress testing. We believe stress testing and capital planning to be a vital component of risk management and we have already implemented stress tests comparable to those required of $50+B banks for our own management purposes. We recognize the importance of stress testing to ensure Navy Federal remains a safe, sound and well capitalized financial institution and support NCUA's plan to formalize these requirements within the credit union industry.

We believe NCUA is trying to achieve parity with the banking industry's prudential regulators and we support this direction. However, there are certain areas where NCUA's proposed rule establishes requirements that are more restrictive than those applied to the largest banks. Considering the historical performance of the credit union industry, and in particular the credit unions covered by the proposed rule, we recommend NCUA achieve parity with the banking industry but not require credit unions to adhere to more restrictive requirements. Specifically, we urge NCUA to:

- Limit the internal capital stress test to a planning horizon of nine quarters as opposed to three years;
- Remove the net economic value of equity stress test from this regulation;
- Remove the requirement to run a capital stress test using a 2-year final maturity for core deposits; and,
- Provide more guidance on how the company-run stress tests will be used.

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NCUA has also proposed hiring a 3rd party to perform the supervisory stress tests. Feedback from the banking community indicates significant time and effort is needlessly spent shuttling data between the financial institution and the regulator to run the stress-test model. Instead, we recommend NCUA require covered credit unions to develop their own stress test models. To ensure the integrity of these models, we also recommend NCUA hire an independent 3rd party to validate the covered credit unions' models and assumptions. Based on our experience, the cost to NCUA will be materially less than hiring an outside 3rd party to run the models. Additionally, each of the covered credit unions will gain expertise through the validation process which only further enhances the risk management capabilities of the credit union industry. This approach allows covered credit unions to increase their capital risk management skills while NCUA ensures the stress tests results are accurate and reliable.

We also recommend delaying the proposed rule to allow NCUA and covered credit unions adequate time to develop the models and to perform a "dry-run" of the stress tests to identify implementation issues, and/or unique credit union parameters which could impact the results of tests that were designed for banks. The results of this dry-run should be evaluated before a final rule is published to ensure the stress tests are appropriate for the credit union business model.

Lastly, we support the concept of public disclosure to achieve parity with the banking industry; however, NCUA should delay any decision to publically disclose information for at least two full reporting cycles to ensure adequate time for implementation issues to be resolved.

In summary, Navy Federal supports the concept of capital planning and stress testing. We recommend NCUA achieve parity with the banking regulators so credit unions are not put at a disadvantage relative to the banks. We also recommend NCUA implement the supervisory stress tests using a 3rd party to validate credit union developed models as opposed to using a 3rd party model. Our detailed commentary can be found in Attachment I.

If you have any questions, please feel free to contact either Joel Polster at (703) 206-3501, or, Vince Pennisi at (703) 255-8740.

Sincerely,

Cutler Dawson

Cutler Dawson
President/CEO

Attachment I

This attachment is provided as a supplement to Navy Federal's response regarding NCUA's Proposed Rule for Capital Planning and Stress Tests. It is organized in two sections: first, we provide comments on the proposed Credit Union Capital Planning Analysis, and second, we provide comments on the proposed Annual Supervisory Stress Tests.

CREDIT UNION CAPITAL PLANNING ANALYSIS

1. **Establishing a capital plan**

   The Federal Reserve conducts two types of stress tests within the banking community. The Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act Stress Tests (DFAST) are tools the Federal Reserve uses to ensure financial institutions have robust capital planning processes and that they maintain sufficient capital. CCAR is conducted annually to ensure the largest bank holding companies (e.g., $50+B) have sufficient capital taking into consideration their unique risks (e.g., multiple complex business units, international exposure, investment banking operations, etc.). Similarly, DFAST institutions (e.g., $10B+ to $50B) conduct stress tests to ensure these large, but less complex, institutions maintain sufficient capital to weather adverse economic conditions. Additionally, the CCAR and DFAST institutions submit company-run stress tests to supplement the supervisory stress tests which are run by the Federal Reserve.

   NCUA has proposed Natural Person Credit Unions (NPCUs) with $10B+ of assets be subject to similar capital planning and stress testing requirements to ensure these "covered credit unions" maintain capital adequacy. NCUA states these requirements align with the Federal Reserve's expectation that large financial institutions have robust systems and processes that incorporate forward-looking projections of revenue and losses to ensure they maintain adequate capital under a variety of stressful economic conditions. NCUA considers the Federal Reserve's approach to be best practice and the proposed rule is designed to achieve parity with the prudential banking regulators[1]. Broadly speaking, Navy Federal supports requirements to ensure a financial institution maintains sufficient capital to remain safe and sound under adverse economic conditions.

   As NCUA considers the proposed capital planning requirements, it is important to remember the Federal Reserve's stress tests are a direct result of the poor financial performance and high leverage exhibited by some of the large financial institutions, where some of the capital actions taken by these institutions during the financial crisis were contrary to the goals of conserving capital and maintaining safety and soundness. By contrast, the credit union industry has a long history of stable performance supported by strong capital levels. Additionally, unlike many of the large banks, the credit union industry performed extremely well during the financial crisis which is further evidence of the lower levels of risk on the credit union balance sheet when compared to the large bank. For example, NPCUs do not have investment banking or trading businesses which can quickly erode capital. In essence, even though the covered credit unions have assets greater than $10B, their business model is simply that of a large retail financial institution.

[1] The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)

Even though the credit union business model is less risky than many of the large financial institutions, and even though credit unions performed well during the financial crisis, Navy Federal believes it is important for all financial institutions to adopt best practices and perform robust capital stress tests to ensure safety and soundness. Equally important, credit unions must maintain parity with the banks by ensuring our capital stress tests are no more restrictive than those applied to the banking industry.

As we evaluated NCUA's proposal, we identified certain areas where the proposed rule is more restrictive than the rules applied to the banks even though the covered credit unions have less risky business models and performed better during the financial crisis.

Specifically, we recommend NCUA consider the following changes to the proposed rule to achieve parity with the prudential banking regulators:

a. **Capital plan horizon**
Under NCUA's proposed rule, covered credit unions will be required to submit capital plans showing projections of revenue, losses and capital for at least three years[2]. Although the Federal Reserve provides three years of forecasts for key economic variables as part of their supervisory stress tests, the 3rd year's data is only provided to enable banks to estimate their Allowance for Loan and Lease Losses for the second year[3]. To achieve parity with the other prudential regulators, we recommend NCUA's capital plan requirements align with those of the Federal Reserve which is nine quarters (e.g., the current quarter plus two years).

b. **Using +/- 300bp rate shocks in the capital plan**
Navy Federal supports regulatory parity with the Federal Reserve's DFAST capital stress tests. In a deviation from the banking industry's practices, NCUA's proposed rule requires covered credit unions to perform an analysis of the net economic value of the credit union using interest rate shocks of at least +/-300bp. Typically, rate shock scenarios are used to measure interest rate risk, and while there is a theoretical correlation between current changes in net economic value and future reported net worth, this requirement is not consistent with other regulatory requirements for capital stress testing. Should NCUA require this analysis to evaluate the degree of interest rate risk, we recommend NCUA require credit unions to perform this test as part of the annual examination process and not include this requirement in the capital plan regulation.

Should NCUA decide to move forward with this requirement, we recommend NCUA eliminate the specific +/-300bp requirement and replace it with a requirement to use "interest rate shocks consistent with current economic conditions".

[2] The proposed rule requires covered credit unions to submit capital projections over the planning horizon. The planning horizon is defined as a period of at least three years.
[3] For example, the 2014 CCAR guidance provides economic data through 2016 but forecasts are only required through 2015. The 2016 data is used to estimate the ALLL for 2015.

c. **Using a 2-year final maturity assumption for core deposits**

The proposed rule requires covered institutions to model the net economic value of the credit union assuming all non-maturity shares have final maturities of two years or less[4]. We have several concerns with this requirement.

As noted above, net economic value is typically used to measure interest rate risk, not capital adequacy; as such, we recommend NCUA remove this requirement from the capital regulation and require credit unions to provide the information as part of the annual examination process.

Should NCUA decide to maintain the net economic value metric in the final rule, we object to NCUA specifying how a financial institution should model their assets or liabilities. This approach is not consistent with banking regulations and is far more restrictive than the standards applied to the banks. More specifically, codifying this requirement as part of NCUA's capital planning regulation creates several issues, most notably it nullifies the value of the credit union value proposition which is inherent to the industry's business model and it contravenes best practice guidance from the prudential banking regulators for large financial institutions. Further, we are not convinced that the underlying assumptions stand the test of time because their impact varies under different economic conditions.

i. **Nullifies the credit union value proposition**

A large component of the credit union business model is to build loyalty and stability through member service and value-added financial services. Our entire industry is built on the premise that credit unions treat their customers as members and these members reward the credit union with their loyalty. Every credit union works hard to build relationships with its members that surpass those of the banking community. Requiring a credit union to model its core deposits using a 2-year final maturity assumption not only strips away the value of the credit union business model, it can erroneously make the credit union look more "risky" than its banking counterparts.

A 2-year final maturity assumption means a credit union's non-maturity deposits only have a weighted average life of about one year. This assumption also means all non-maturity deposits perform the same way; for example, savings accounts perform the same way as jumbo money markets. Historical studies show both of these assertions to be false. For example, savings accounts have significantly longer weighted average lives than money market accounts. Additionally, regular money market accounts have longer weighted average lives than jumbo money market accounts.

Applying a one-size-fits-all approach to non-maturity deposits eliminates any benefit a credit union may have received from building a member relationship and diversifying its sources of deposit funding. In other words, NCUA's assumption means members who have checking accounts with direct deposit and use the credit union as their primary financial institution have the same proclivity to withdraw funds as a member

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[4] Non-maturity shares include: savings, checking, and money market accounts.

who only has a jumbo money market account and no other relationship with the credit union. Historical studies of banks and credit unions alike have proven this false.

Historical studies of banks and credit unions also show savings and checking accounts have weighted average maturities well in excess of one year. For example, it is common to find banks with checking accounts that have weighted average maturities in excess of 5 to 7 years. Considering the credit union business model, it is easy to see how credit unions can have core deposits with weighted average lives well in excess of their banking peers. Our research shows credit union attrition rates can be half that of a large bank's, which means credit union deposit lives can be twice a bank's[5]. As a result, the NCUA mandated assumption of ~1 year is vastly different from the actual performance of these deposits. In essence, the NCUA assumption implies credit union deposits are less stable than those of the banking industry, which is inconsistent with the value proposition of credit union membership: loyalty, stability, and customer service.

ii. Contravenes banking regulators best practices

Specifying a uniform assumption for core deposits as part of a regulation, is not consistent with the regulatory requirements of the banking community. The prudential banking regulators do not identify these types of assumptions as part of their rules; instead the banking regulators recognize these assumptions are institution specific and need to be addressed on a case by case basis. For example, the average life of deposits for a large-scale national bank can differ quite substantially from those of a smaller regional or community bank.

The OCC requires its regulated institutions to demonstrate the ability to model core deposits, validate these assumptions through back testing, and perform scenarios around these assumptions to highlight the impact if baseline assumptions are wrong. According to the OCC's comptroller handbook:

> *"The OCC does not dictate which assumptions or methods banks must use to assess the interest rate sensitivity of their deposits. Instead, the OCC encourages bank management to study the behavior of the bank's deposit accounts and develop assumptions and treatments based on how these deposits will perform under various interest rate scenarios.... Examiners should determine whether the bank has analyzed its depositor base, and formulated and documented assumptions that are reasonable given the bank's past performance and its current marketing, funding, and pricing strategies."*

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[5] We recommend NCUA use an attrition rate assumption rather than limiting deposit cash flows to a specific final maturity assumption. Using a final maturity assumption negatively impacts interest rate risk analytics such as key rate duration.

The OCC also goes on to say:

> *"Because the expected performance of these deposits will vary with a bank's competitive market, its position in that market, and its customer base, examiners should not expect every bank to treat its deposit balances the same."*

The OCC does not apply a standard approach to core deposit modeling. Instead, it recognizes the average life of core deposits is an institution-specific assumption which must be supported by strong analytical skills and robust back-testing. NCUA's approach is not consistent with the banking industry's best practices.

iii. The assumption does not stand the test of time

Since NCUA has expressed concerns about credit union's abilities to withstand a rising rate environment, we believe it has chosen a 2-year final maturity assumption to highlight the impact of a rising rate environment. Choosing a short final maturity assumption reduces the average lives of the deposits so they will reprice sooner; this creates margin compression in a rising rate environment. Since NCUA expects a rising rate environment to be a challenge for credit unions in the future, assuming a short deposit life increases the modeled level of interest rate risk (i.e., it makes the institution look riskier so corrective action must be taken sooner).

Our view, however, is that this assumption is not durable and should not be part of a regulation. In the future, interest rates will likely return to levels where there is a reasonable probability rates will either increase or decrease. This "normal" rate environment has been part of every rate cycle for the past several decades and only recently (as a response to the financial crisis), do we find ourselves in a rate environment where there is an asymmetrical likelihood of rising interest rates. Under a normal rate environment, a short deposit assumption can actually hide risk. For example, in a falling rate environment, a shorter deposit life assumption provides a benefit because deposits reprice more quickly than assets resulting in improved margins. As a result, what appeared to be a conservative assumption under one rate environment is actually an aggressive assumption under a different rate environment.

Overall, we recommend NCUA remove the net economic value test from the capital planning regulation. The test is primarily an interest rate risk test and it is inconsistent with the capital tests used by the banking regulators for large financial institutions. Additionally, should NCUA require credit unions to perform specific interest rate risk scenarios, it has the authority to require these scenarios as part of the current examination process. For example, NCUA could require covered credit unions to perform net economic value stress tests using a variety of core deposit and interest rate shocks. This enables NCUA to evaluate interest rate risk on a case-by-case without codifying the requirement in the capital planning regulation.

d. **Use of capital stress tests**
The proposed rule does not identify how the company-run capital stress tests will be used by NCUA nor does the rule provide guidance regarding what minimum thresholds NCUA considers appropriate. By comparison, the NCUA identifies a specific threshold for the supervisory stress tests. We recommend NCUA provide greater guidance on how the company-run capital stress tests will be used.

ANNUAL SUPERVISORY STRESS TESTS

1. **Implementing the supervisory stress test using a 3rd party model**
Similar to the capital planning requirements, Navy Federal supports the concept of regulatory parity with respect to the supervisory stress tests applied to DFAST financial institutions. NCUA also sought commentary on whether to require covered credit unions to conduct their own stress tests in a manner consistent with the requirements of the banking regulators. Navy Federal believes that to be consistent with the banking regulators, it would be appropriate for NCUA to require covered credit unions to perform and submit their own stress tests using the Federal Reserves' supervisory scenarios.

NCUA has stated it plans to hire an outside 3rd party to run the stress tests. While this appears to be inconsistent with the Federal Reserve's approach, we understand the limited number of covered credit unions makes an investment by NCUA in the resources to run these tests in-house an uneconomical choice at this time. However, we have concerns with NCUA's plan to hire a 3rd party to perform the stress tests.

We believe NCUA wants to ensure the results of the stress tests are accurate and that the results can be validated. We believe there is a better approach which not only meets the needs of NCUA, but also enhances the covered credit unions' risk management capabilities and reduces the cost to the credit union industry. We recommend NCUA:

a. Require covered credit unions to develop their own supervisory stress test models, and,
b. Hire an independent 3rd party to validate the credit union's models and assumptions

We believe this is a better approach because each credit union will be required to develop the in-house expertise to run these models. Navy Federal has already invested significant resources in developing these models and we understand the benefits of developing and maintaining these models, namely; enhanced risk management capabilities, and, improved capital planning processes and oversight.

This approach also satisfies NCUA's need to ensure the models are objective and accurate. Based on our experience with model validation, the cost to NCUA will be materially less than the cost of hiring an outside 3rd party to run the models.

Finally, we believe each of the covered credit unions will gain additional expertise through the validation process which only further enhances the risk management capabilities of the credit union industry. In other words, under this approach the covered credit unions increase their capital management skills while NCUA ensures the data it receives from the covered credit unions is accurate and reliable. Based on feedback from the banking industry, we believe this approach is better than relying on a black box approach from a 3rd party vendor.

2. Timing of Implementation

Implementing capital stress test models is a significant undertaking. There are numerous data elements that must be coded, key assumptions that must be validated, and business practices that need to be interpreted and modeled. Our experience, corroborated by the experience of the banking industry, suggests NCUA should delay implementation of the supervisory stress tests for at least one year to allow for the development of assumptions, models and processes.

We recommend delaying the proposed rule to allow NCUA and covered credit unions adequate time to develop the models and to perform a "dry-run" of the stress tests to identify implementation issues, and/or, unique credit union parameters which could impact the results of tests that were designed for banks. The dry-run should be performed using current credit union data and should be completed and vetted as part of each credit union's annual examination. Lastly, the collective results of these dry-runs should be evaluated by NCUA before a final rule is published to ensure the stress tests are appropriate for the credit union business model.

3. Public Disclosure

We understand the banking regulators have adopted disclosure requirements. These requirements vary based on whether the institution is a CCAR or DFAST institution; but over time, the results of the stress tests will be disclosed by the banking regulators. Navy Federal supports the concept of public disclosure to achieve parity with the banking community. However, we do not believe it is necessary for NCUA to include this requirement in the final rule. NCUA has the authority to determine at a future date whether to disclose these results once they have been vetted and proven to be stable, valid and indicative of a NPCU's capital adequacy. We do not believe it is necessary for NCUA to put a disclosure requirement in the rule which could inadvertently force disclosure before it is appropriate. We recommend NCUA delay any decision to publically disclose for at least two full reporting cycles to ensure adequate time for implementation issues to be resolved.