NASCUS
National Association of State Credit Union Supervisors

December 31, 2013

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

Re: NASCUS Comments on Proposed Rule - Capital Planning and Stress Testing

Dear Mr. Poliquin:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the following comments in response to the National Credit Union Administration's (NCUA's) proposed changes to NCUA Rules and Regulations, Part 702, currently Prompt Corrective Action, but to be renamed "Capital Adequacy" pursuant to the proposal. This discretionary rulemaking by NCUA is intended to translate stress testing and capital planning that Congress mandated for the largest banks (but not for credit unions) to the credit union system.

Section 165 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required banks with more than $10 billion in assets to conduct annual stress tests.[2] The provision makes no mention of credit unions. Nevertheless, NCUA believes a forward looking stress test of the capital vulnerabilities of the very largest credit unions is an important risk mitigation tool. We do not disagree. A properly developed, thoughtfully implemented, and carefully evaluated stress testing program for very large credit unions could benefit the credit union system. However, as discussed in detail below, the stress testing rule as proposed by NCUA is in need of refinement in several key regards.

In addition to stress testing, NCUA has also proposed that credit unions with assets of $10 billion or greater be required to develop and maintain capital plans and to submit those plans annually to NCUA for validation. Capital planning is an essential element of the prudent management of any financial institution. As with stress testing, NASCUS agrees that a more formal regulatory requirement regarding capital planning may carry supervisory benefits for some very large credit unions, as it does on the banking side for some very large banks. Yet, our review of the proposal leaves us concerned that NCUA has failed to "right size" the regulation. NCUA notes that the Board of Governors of the Federal Reserve System (Federal Reserve) requires very large bank holding companies to submit capital plans to the Federal Reserve.[3] However, the Federal Reserve requirement applies only to bank holding companies with total consolidated assets of $50 billion or more.[4] Our comments address these proposed provisions in more detail below.

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.
[2] Public Law 111-203, 124 Stat. 1376 (2010).
[3] 78 FR 65583 (Nov. 1, 2013).
[4] 76 FR 74631 (Dec. 1, 2011).

NASCUS • 1655 North Fort Myer Drive, Suite 650. Arlington, Virginia 22209 • P: (703) 528-8351 • F: (703) 528-3248 • www.nascus.org • offices@nascus.org

Capital Planning and Analysis

NCUA should limit the requirement for a federally insured credit union to submit a formal capital plan to a threshold more comparable with the Federal Reserve capital plan submission threshold of $50 billion.

In the preamble to the proposed rule, NCUA cites the concentration of National Credit Union Share Insurance Fund (NCUSIF) exposure in the four natural person credit unions that would be covered by the proposed rule, noting that the combined assets held by the four was currently $108.5 billion (nearly half of which are in the largest credit union of the four) versus an equity of $11.2 billion in the NCUSIF. Certainly we can appreciate, and share, the concern such a concentration occasions, but those concerns should be measured against the equity of maintaining a consistency across regulated entities. Simply put, requiring submission of capital plans by credit unions with assets that are $10 billion or greater disadvantages credit unions in the $10 billion to $49 billion assets size in relation to a like-sized bank. Such a lower threshold for credit unions also seems contrary to the Dodd-Frank Act mandate that federal bank regulators issue "consistent and comparable" regulations when implementing the very requirements that NCUA seeks to "borrow" for the credit union system.[5]

We do not suggest that a competitive disadvantage alone should be the decisive factor in whether a regulation should be promulgated. However, we do believe that when NCUA engages in discretionary rulemaking in an area where Congress acted as part of comprehensive reform of the financial services system, and chose not to include credit unions, NCUA owes the system's stakeholders a more thorough discussion of the issues involved; in this instance, why NCUA is deviating from the framework and choosing a lower regulatory threshold for application to the credit union system. Comparing NCUA's rulemaking to the bank side is imperfect, particularly in this instance where the submission of a capital plan for banks is not a requirement of the FDIC (the deposit insurer) but rather of the Federal Reserve. Furthermore, the bank requirement is not designed to protect the FDIC's fund, but rather to protect the overall financial system of the United States.[6] These inconsistencies between NCUA's stated goals and the goals of the regulations being modeled suggest a more thorough discussion and consideration of these issues is warranted.

NCUA should reconsider the $10 billion threshold for application of a capital planning submission rule. At a minimum, NCUA should discuss why $10 billion is the appropriate credit union threshold given the higher bank threshold. We note that using the bank threshold would still capture half of all credit union assets of $10 billion or greater. Furthermore, that the combined assets of the fifth through eighth largest credit unions (all with assets less than the proposed $10 billion threshold) have combined assets greater than three times the size of the NCUSIF suggests that the proposed $10 billion threshold is arbitrary.[7]

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[5] Dodd-Frank Act §165(i)(2)(c).
[6] Ibid.
[7] http://www.creditunionsonline.com/top100creditunions.html

Results of the Credit Union Stress Tests Should Be Kept Confidential

In its proposal, NCUA specifically requests comments on whether the results of the stress tests should be made public. While NCUA takes no definitive position in the proposal on whether results of the stress tests should be made public, it states that it recognizes that "public disclosure helps to provide valuable information to market participants, enhances transparency, and facilitates market discipline." NCUA notes, however, that "the Board also understands that stress test results can be misinterpreted and lead to inaccurate conclusions about the health of an institution."[8]

NASCUS believes that results of NCUA's stress testing should be treated as confidential examination product.

Generally speaking, the rationale for making stress tests of a financial institution public are compelling. However, in this instance, the inexperience of the credit union system administering a formal stress testing regulation, the uniqueness of credit union structure, and the example set by the Dodd-Frank mandated large bank stress testing suggest the stress test results be treated as confidential examination product.

It is clear that implementing the stress testing as proposed by NCUA is going to be complicated. NCUA proposes to develop baseline, adverse and severely adverse scenarios to underlie the stress tests. NCUA's scenarios will be based upon those developed by the Federal Reserve, OCC, and FDIC for their regulated institutions. NCUA's stress testing scenarios will be tailored to account for credit union specific variations from the banking sector. However, *how* the scenarios will be modified to account for unique credit union characteristics, and which credit union characteristics will be considered, are not addressed in the proposal. It is not difficult to imagine that it will take several "cycles" through this process in order for NCUA to fine tune the development of the scenarios, the running of the stress tests themselves, and the interpretation of the results. Even if NCUA outsources the testing to a third party, and even allowing that this third party has some experience with credit unions, there remains a multitude of issues that would have to be worked out regarding the collection and transmission of information and how to equate structurally diverse credit unions for comparable testing.

In fact, it is the unique structure of credit unions that provides a persuasive case for treating the stress tests as confidential examination information. NCUA will have to develop scenarios and metrics that take into consideration credit unions that are geographically diverse, that are international in scope or in some cases virtually solely domestic, and that have community charters and closed association charters. How NCUA will account for these unique credit union features is not addressed in the proposed rule.

The unique structure of credit unions, compared to banks, also fundamentally alters the public policy rationale for disclosing the results of the test. For the bank sector, one of the goals of the Supervisory Capital Assessment Program (SCAP), and the subsequent ongoing Dodd-Frank Act stress tests (DFAST), was to provide investors with "credible information about prospective

[8] 78 FR 65583 (November 1, 2013).

losses at banks."[9] However, as credit unions do not have investors, facilitating an investor's informed decision making is inapplicable as a public policy goal. With respect to credit unions' individual members, we note that the goal of bank stress testing was a systemic reassurance as well as an individual assessment. Once again, it is unclear that public dissemination of the stress testing results for the covered credit unions serves any true "public" policy goal akin to the DFAST program for banks.

We also have concerns regarding what public disclosure of credit union stress testing would mean in an ongoing scenario where a covered credit union's stress test demonstrated a need to increase capital. Unlike its bank counterpart that can respond aggressively to shortcomings identified by the DFAST, a covered credit union has limited options available to it to build capital and restructure its balance sheet. Given the time it takes to enhance net worth through retained earnings, it is conceivable that a covered credit union would have to endure the stigma of a "failed" stress test for some time. In turn, the time it might take for an otherwise healthy credit union to increase capital to the stress test standards might lead to a run by its members unfamiliar with the distinction between "normal" capital levels and stress test levels. Such a run could endanger the NCUSIF, the very fund the stress test is intended to protect.

Furthermore, as the most prominent means of increasing retained earnings are through increasing fees, raising borrowing rates, reducing savings rates and reducing dividends, the credit union's members would be losing the value of service from their credit unions, in order for the credit union to remedy a deficiency resulting from a hypothetical, worst case-scenario test. Treating the stress tests confidentially might allow for an effective, but more moderate response on behalf of the credit union. The alternative to raising fees and reducing the "bargain" of membership is to drastically alter the balance sheet, resulting in a fire sale of performing portfolios. Again, this is neither an attractive option, nor one that is seemingly compatible to the long-term health and reputation of a credit union.

Finally, we note that the federal bank regulators themselves delayed publication of stress test results until they, and the covered banks, gained experience with the process. In finalizing its rule, the Federal Deposit Insurance Corporation (FDIC) made stress testing effective in 2013, but disclosure of results will not occur until the third testing cycle in 2015.[10] Furthermore, that the banking agency regulations require the banks to conduct their own stress testing and make *those* results public is an important distinction. Under NCUA's proposal, NCUA would conduct the stress testing as part of the agency's examination and supervision of the covered credit unions. Any move by NCUA down a path of making supervisory examination information public must be preceded by a discussion of which traditionally confidential examination information would be appropriate for public disclosure in the future.

For the reasons stated above, we strongly recommend that the results of the stress tests be treated as confidential examination product. If NCUA feels strongly about public disclosure, the

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[9] Ben S. Bernanke, "Stress Testing Banks: What have we Learned?" (Maintaining Financial Stability: Holding a Tiger by the Tail financial conference, Atlanta, Georgia, April 8, 2013). Transcript available: http://www.federalreserve.gov/newsevents/speech/bernanke20130408a.htm
[10] 77 FR 62417, 62419 (Oct. 15, 2012).

preamble to the final rule could establish a future date at which point another round of rulemaking and public comment could occur to thoroughly vet the public disclosure issue with the benefit of the experience of several rounds of testing to better inform the discussion.

Covered Credit Unions Conducting Their Own Stress Tests and the Paperwork Reduction Act

NCUA seeks comments on whether a final regulation should require covered credit unions to conduct their own stress tests. Whether the rule explicitly requires the covered credit unions to conduct their own stress tests in addition to the proposal's framework of NCUA conducting stress tests is, in many respects, immaterial. As a practical matter, covered credit unions will have to conduct their own stress tests. In fact, it is our understanding that the covered credit unions already conduct stress tests.

As proposed, NCUA would conduct stress testing and inform the covered credit unions by May 31 each year of the results of the test. If the covered credit union is informed by NCUA that it "failed" the stress tests, the credit union will be in no position to question the results or be prepared to take remedial action, unless it has conducted its own internal stress testing based on the scenarios released by NCUA in December of the previous year. Therefore, the question becomes not whether the covered credit unions should be required to do their own stress testing as a supervisory matter, but whether the rule, as proposed without the requirement, downplays the regulatory burden.

As NCUA notes, the Paperwork Reduction Act of 1995 (PRA) requires it to assess the information collection/record keeping burden of any new rule.[11] In its proposal, NCUA estimates the burden imposed by the rule at 500 hours initially and 250 hours annually after that, or 60 days of a single employee initially and 30 days thereafter. With respect to NCUA's estimates, the ongoing burden estimate of 200 hours is greater than the estimate provided by the Federal Reserve in 2011 for covered bank holding companies (those with assets in excess of $50 billion), but less than the Federal Reserve estimated for initially developing the plan in the first year (Federal Reserve estimate of 12,000 hours).[12] We also note that NCUA's estimates cover BOTH the development and submission of a capital plan as well as the submission of information for stress testing. The Federal Reserve estimates are ONLY for capital planning.

It is difficult to draw a direct parallel between NCUA's estimates of the amount of hours required for compliance of the stress testing part of the proposed rule with the FDIC's stress testing requirement for banks with assets of $10 billion or greater because under the FDIC's rule the banks themselves conduct the stress tests.[13] However, FDIC's estimates for stress testing were 2,000 hours per institution initially and 1,040 hours ongoing annually.[14] Setting aside the ability to directly compare the estimates, it does appear that NCUA has underestimated the amount of time that will be required for compliance. A discretionary rulemaking of this magnitude deserves a more thorough analysis of its real impact.

[11] 44 U.S.C. 3507(d); 5 CFR §1320.
[12] 76 FR 35351.
[13] 77 FR 62417.
[14] Ibid, 62423.

As noted above, NCUA's proposed rule, as a practical matter, will result in the covered credit unions conducting their own stress tests based upon NCUA's scenarios. The time to conduct those tests should be factored into NCUA's required analysis under the PRA. Furthermore, it raises questions about the underlying structure of NCUA's rule.

As proposed, NCUA, or likely a third party, will conduct the stress tests and inform the covered credit unions of the results. As previously noted, this approach differs from the regulatory framework in the bank sector where the covered banks conduct the stress tests under the scenarios published by the regulator. NCUA should discuss why a similar approach, with covered credit unions conducting the stress tests themselves and NCUA, or a third party validating that testing, is not a preferred approach. In many respects, restructuring the rule, to have the credit unions themselves conduct the stress test with NCUA validating the tests might be a more productive exercise for both NCUA and the credit unions.

The proposed capital plan submission and NCUA stress testing also raises a question of the timing of the two major provisions. As proposed, NCUA would be conducting the six-month long stress tests concurrently with the covered credit unions' preparation of the capital plans for submission. NCUA would then notify the covered credit unions of the results of the stress tests two months ***after*** those credit unions submit capital plans (that may be rendered insufficient as a result of the NCUA conducted stress tests). NCUA should consider whether it would make more sense, and be a more effective exercise to have the credit unions develop and submit capital plans after receiving the results of the stress tests.

<u>Any Final Rule Must Ensure State Regulator Remains Fully Informed Throughout the Process</u>

Part 702.506(f) of the proposed rule establishes NCUA's commitment to work with the state regulator of a covered credit union when implementing capital planning and stress testing. The proposed provision reads:

> (f) *Federally insured, state-chartered credit unions.* Before taking any action under this section against a federally insured state-chartered credit union, NCUA will consult with the applicable state supervisory authority.

- 78 FR 65583 (65588).

We commend NCUA for explicitly citing in the proposed regulation its intention to work with a covered credit union's state regulator. This is appropriate given that the state regulator is the covered state chartered credit union's primary regulator. However, we do not believe proposed §702.506(f) goes far enough. Although the proposed rule is not specifically part of the Prompt Corrective Action (PCA) framework per se, NCUA should commit to a similar level of cooperation as Congress mandated under PCA.[15] NCUA should adopt PCA's cooperative language as found in existing §702.205(c):

> (c) *Consultation on proposed discretionary action.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before taking any discretionary supervisory action under §§702.202(b), 702.203(b), 702.204(b), 702.304(b)

[15] Public Law 105-219, 112 Stat. 913 (1998).

> and 702.305(b) with respect to a federally-insured State-chartered credit union; shall provide prompt notice of its decision to the appropriate State official; and shall allow the appropriate State official to take the proposed action independently or jointly with NCUA.
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> \- 12 CFR 702.205(c)

Furthermore, in the preamble to the final rule, NCUA should make clear that it will work closely with the state regulator throughout all aspects of the application of the rule. As a whole, state regulators oversee more than $2.5 ***trillion*** in assets in various credit unions, banks, trusts and other financial service providers. This is more than twice the amount of assets of the entire credit union system. This experience with the large, diverse, and complex state financial services system, combined with the institution-specific knowledge of a covered state chartered credit union's state regulator, means state regulators are in a position to provide invaluable insight into the implementation of this complex regulation. In addition, some state regulators have experience with the Federal Reserve and FDIC stress testing due to the involvement of their state banks. State regulators are an invaluable resource to NCUA as this proposal is finalized and implemented and NCUA should make every effort to avail themselves, and the credit union system, of this state expertise to the fullest extent possible.

<u>Section by Section Analysis</u>

In addition to the comments provided above on several of the broad principles of the proposed rule, we submit the following comments on the specific proposed sections of the Stress Testing and Capital Planning rule.

- §702.502 Definitions - The proposed rule contains several definitions that might garner confusion as to what, precisely, is being required of covered credit unions. The provision contains overlapping definitions for both "capital plan" and for "capital policy." Both definitions appear to incorporate the overall elements of a covered credit union's need to have a written document that details the workings of the credit union and how capital adequacy will be maintained, monitored, and evaluated. NCUA should streamline the definitions and rule to provide for consistent terminology throughout.

- §702.503 Credit union capital planning - The proposed rule's requirements for the capital plan raise several questions. Proposed §702.503(b)(1) would require the capital plan to contain "a quarterly assessment of the expected sources and levels of capital over the planning horizon..." It is unclear what NCUA means by this. The covered credit unions may only build regulatory capital through retained earnings, so there are no "other" sources of capital with which to plan. Given that, it appears as though NCUA would require credit unions to forecast earnings by portfolio or product line. NCUA should clarify the meaning of this provision.

  Proposed §702.503(c)(2) also requires a covered credit union to perform an analysis of its net economic value using interest rate risk shocks of +/- 300 basis points. The Federal Reserve capital planning has no like provision. Furthermore, proposed (c)(2) would require all non-maturity shares to have a final maturity not exceeding two years. We will leave to other commenters to discuss whether a two-year maturity limit is realistic and appropriate for the modeling. We do question whether such specifics, be they the 300-basis point shock or the presumed maturity of non-maturity shares, should be included in the regulation. We do not suggest that the regulator should not establish parameters, rather, we believe that the regulation itself should establish the broad requirements, and specific modeling parameters could be issued through guidance. In this way, going forward, if a consensus develops that the basis points in a shock, or the maturity of shares, should be adjusted, the system may adjust these measures in a more seamless manner than having to revisit regulation. This provides the maximum flexibility as the rule is implemented to help ensure the most meaningful results of the exercise.

§702.504 Governance of capital planning and analysis - Proposed §702.504(a) requires senior management of the credit union to develop a comprehensive, integrated and effective process for the credit union's capital planning. The proposed provisions also require that "senior management responsible for capital planning and analysis must report directly to the credit union's board of directors or a designated committee of the board." This wording is too broad. NCUA should amend this provision to make clear that the direct reporting requirement applies only to updates on the capital planning process and not as a new requirement creating new lines of reporting by management position.

- §702.505 NCUA action on capital plans - This provision reads in subpart (a), "NCUA will notify the covered credit union of the acceptance or rejection of the capital plan by June 30..." NCUA should amend this subpart to read, "NCUA will notify ***in writing*** the covered credit union, ***and, in the case of a covered state chartered credit union, its state regulator,*** of the acceptance or rejection of the capital plan by June 30..."

  Proposed §702.505(d) allows a covered credit union 30 calendar days to resubmit an amended capital plan. NCUA should provide covered credit unions more time to respond to the rejection of the submitted capital plan. Thirty days may not be enough time to evaluate NCUA's written reasons for rejecting the plan, seek clarification and dialogue with NCUA to further understand the agency's concerns, and then redevelop the plan and obtain approval of the credit union's board. We recommend NCUA consider providing at least 45 days for resubmission. Furthermore, the provision should be amended to make clear the 45-day period begins running only after the covered credit union has received the written notice of the reasons for rejection of the submitted plan.

  Subpart (c) of this provision requires covered credit unions provide NCUA any relevant information upon request. NCUA provides no other detail as to what types of information will be requested, when it will be requested, in what format it will be delivered and how it will be delivered. All of these are crucial elements of the proposed rule and worthy of more detailed discussion. Concern over this provision is compounded by uncertainty over what entity, NCUA or a third party, will actually conduct the stress tests. Before finalizing a rule, we urge NCUA to provide more specifics regarding the nature of the information that might be requested as well as how it will be collected.

Pursuant to proposed subpart (d) of the provision, NCUA states that it will "provide each covered credit union with the results of the stress test by May 31..." Proposed subpart-(e) provides that a covered credit union will have 60 days to submit a capital enhancement plan if it fails the stress test or be subject to supervisory actions. NCUA should provide greater detail to such a critical element of this proposed rule. With respect to the notification to the covered credit union of the results of the stress test, the rule should provide that NCUA will furnish each covered credit union and its state regulator, when applicable, complete documentation of the stress test conducted. This information should be provided regardless of whether the credit union "passes" or "fails" the stress test.

In the case of a failed stress test in particular, a covered credit union would have little basis to evaluate and challenge the results of the test, absent access to the modeling and assumptions underlying the result. Given the complexity of this undertaking, it is essential, and basic equity compels, that a covered credit union be given the opportunity to challenge NCUA's conclusions.

The proposed rule also lacks a clear delineation of recourse for a covered credit union failing the stress test. NCUA should make clear whether the normal examination appeal process applies to stress testing and capital planning under the proposed rule. Furthermore, these issues regarding the recourse for a covered credit union give rise to concerns of whether the 60-day timeframe for remedial action is sufficient. NCUA itself is taking nearly six months to conduct and analyze the tests, yet expects a credit union to evaluate the tests, analyze the conclusions, and develop remedial actions in just 60 days.

NCUA's 2011 Regulatory Modernization Initiative

In 2001, NCUA announced a regulatory modernization initiative intended to, among other things, promote effective regulation.[16] NASCUS applauded NCUA's efforts at the time, and has since then worked with NCUA to help ensure effective regulation of the credit union system. NCUA's proposed Capital Planning and Stress Testing rule provides NCUA an opportunity to discuss the effective interplay of overlapping regulations. Should this proposal be finalized, covered credit unions would be subject to several distinct, but overlapping, regulations related to balance sheet management and capital adequacy. As noted above, NCUA's proposed rule contains specific interest rate risk shock requirements as part of a proposed mandatory capital adequacy plan. Covered credit unions are also subject to a 2012 final rule on Interest Rate Risk, which requires specific planning for the effects on net worth of sustained changes in interest rates.[17] NCUA is also developing a Risk Based Capital rule in an effort to ensure a credit union's regulatory net worth requirement is reflective of the risk presented. Of course, this entire proposed rule's stated goal is to establish additional net worth requirements to ensure a covered credit union's net worth is reflective of the composition of its balance sheet.

We understand that specific Interest Rate Risk, Stress Testing, and Risk Based Capital rules concentrate on related but distinct aspects of the covered credit union's balance sheet. However, given the overlap, in light of NCUA's announced Modernization initiative, it might be beneficial

[16] November 7, 2011, letter to the Office of Management and Budget by NCUA Chairman Debbie Matz.
[17] 77 FR 5155.

if NCUA discussed its vision for the interplay of these rules with respect to covered credit unions.

As stated at the beginning of our comments, we concur with NCUA that some more formal requirements related to ensuring capital adequacy at very large federally-insured credit unions might yield supervisory benefits. Taken as a whole, NCUA's proposal has identified aspects of a workable framework that could benefit the credit union system. However, that NCUA's proposal departs in substantial ways from the parameters established by Congress and the federal bank regulators remains a concern for NASCUS. In addition, the complexity of importing a bank stress testing framework into the unique parameters of credit union operations requires additional thought and consultation between NCUA and state regulators before any rule is finalized.

NASCUS and state regulators remain committed to working with NCUA to mitigate material risk throughout the credit union system. We appreciate the opportunity to submit comments on this proposed rule. NASCUS and state regulators would be pleased to discuss these comments at NCUA's convenience.

Sincerely,

- signature redacted for electronic publication -

Mary Martha Fortney
President and CEO