NAVY FEDERAL Credit Union

Office of the President

May 21, 2014

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

Re: Notice of Proposed Rulemaking – Risk Based Capital

Dear Mr. Poliquin,

Navy Federal Credit Union is pleased to provide comments on the National Credit Union Administration's Notice of Proposed Rulemaking (NPR) governing Risk Based Capital (RBC).

**We do not support the rule.** We have substantial concerns with the framework proposed by NCUA and the competitive disadvantage this rule will create for the credit union industry. NCUA states it is trying to modernize its RBC framework by establishing a regime that is more consistent with other Federal Banking Regulatory Agencies; however, NCUA's rule fails to meet this objective. Additionally, the rule has many fundamental flaws which, if implemented, will negatively impact credit unions' abilities to serve their members.

NCUA is trying to achieve parity with the banking industry while also adhering to 1998 Congressional guidance to consider other types of risk (e.g., interest rate, liquidity and concentration risk). This 16 year old guidance does not consider the advancements made in modern risk management and regulatory supervisory capabilities. As a result, **NCUA has created an RBC framework that has significant flaws resulting in materially increased capital requirements**. We have several structural concerns with the proposed rule, specifically:

- NCUA's risk weights are not consistent with banking regulators, and, while NCUA's proposed 10.5% minimum capital requirement gives the appearance of parity with banking regulations, it erroneously includes the impact of the bank's 2.5% capital conservation buffer. A bank's Tier 1 RBC ratio, the most comparable ratio to credit union's RBC requirements, is 8%. The additional 2.5% buffer was established by banking regulators primarily to protect against large returns of capital to shareholders during times of duress; credit unions do not payout capital to shareholders. Including the buffer increases credit union capital requirements for capital distribution activities that are not relevant to the credit union business model. As a result, **Navy Federal will be required to hold an astonishing $1.1 billion of additional capital because NCUA did not exclude the 2.5% capital conservation buffer. This capital would be better used to make**

**over $14 billion of loans to our members.** NCUA should adopt the bank's Tier 1 RBC ratio of 8% without the capital conservation buffer.

- NCUA believes it must account for interest rate risk in certain asset risk weights. Unfortunately, **NCUA's approach violates the single most basic requirement for interest rate risk management; determining the mismatch between assets *and* liabilities.** NCUA only considers interest rate risk from the asset side; the framework completely ignores the impact of liabilities or any actions a credit union has taken to mitigate risk. The framework is so flawed it can actually lead to incorrect results.
- **We do not support the concept of Individual Minimum Capital Requirements (IMCR).** IMCRs will create a lack of consistency across the industry and a lack of stability over time. Credit unions will become too exposed to the changing opinions of different exam teams; this creates a risk NCUA can arbitrarily impact the products and services we offer our members.
- In addition to requiring credit unions to hold more capital than banks, **NCUA's decision to immediately require 10.5% RBC puts credit unions at a competitive disadvantage for five years** because the FDIC has chosen to phase-in the additional capital requirements through 2019.
- NCUA has established a new capital framework without granting credit unions any additional means to manage their capital. NCUA should provide credit unions with the ability to raise secondary capital so they can better manage the new capital requirements. Additionally, the ability to raise secondary capital can enhance the safety and soundness of the industry.

In addition to these general concerns, we have significant concerns with the risk weights applied to various asset categories. In many cases these risk weights either increase the capital requirements for credit unions or do not fully consider the risks on the balance sheet. Most notably:

- **Investment risk weights are fundamentally flawed.** NCUA's approach is not consistent with best practices and represents a significant departure from other financial institution regulators, both domestic and international. The proposed framework is materially more punitive than the standard applied to banks even though credit unions have more restrictive investment authorities. Under the proposed rule Navy Federal would be required to hold almost $500 million more capital than a bank even though most of our investments are in US Treasuries and Agency securities. Any RBC framework that results in such a significant difference between credit unions and banks needs to be reworked.
- NCUA defines delinquent loans as 60 days past due but banking regulators use 90 days. NCUA has put credit unions at a competitive disadvantage with this inconsistent definition.
- **NCUA's escalating thresholds for real estate loans is inconsistent with regulatory best practices** and it creates a punitive capital regime that negatively impacts credit unions who wish to serve their members' real estate borrowing needs while effectively managing the financial risk on their balance sheets.
- The proposed rule establishes a lower capital requirement for loans guaranteed by the FHA/VA but it does not define if these loans are excluded from the capital risk thresholds. If FHA/VA

loans are not excluded from these thresholds, NCUA's framework would create a disadvantage for our active duty military and veterans.

- NCUA has patterned the capital requirements for derivatives after the FDIC rules; however, NCUA has elected not to adopt the FDIC's capital framework for derivative transactions that have been cleared on an exchange. NCUA's position is a disservice to Navy Federal and to the entire credit union industry.

We discuss all of these concerns more fully in Attachment I. We have also identified additional concerns regarding the treatment of other asset classes; these concerns are also discussed in Attachment I.

Lastly, given the concerns from the industry, and the broad impact this rule will have on the credit union industry for years to come, **we urge NCUA to issue a second NPR once they have evaluated all of the comment letters**. Given the major shortcomings of the present proposal, significant dialogue needs to occur between NCUA and credit unions. A flawed RBC rule is no better, and in fact considerably worse, than no rule at all. It is better to take the time to ensure it is done correctly. NCUA successfully used this approach when developing the 2013 derivatives rule; a rule with far less impact to the industry. Given the wide range of topics, issues, and concerns being raised by credit unions, we believe it is imperative for credit unions and NCUA to continue the dialogue before NCUA moves ahead with a final rule. Issuing a second NPR with an appropriate comment period will go a long way towards ensuring credit unions are prepared for any changes brought about by this new capital framework.

In summary, Navy Federal does not support the proposed rule. There are too many structural and philosophical inconsistencies to support the rule. The issues we have highlighted will have a measurable and significant impact on Navy Federal's ability to serve its members. Even more disturbing, many of these changes put credit unions at a **competitive disadvantage** to the banking industry. We cannot support a rule that has such broad sweeping negative implications for the industry and our membership; particularly when the increased capital requirements are not commensurate with the level of risk within the industry and the financial stability and performance of credit unions over time.

If you have any questions, please feel free to contact Vince Pennisi, Chief Investment & Risk Officer 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 Risk Based Capital (RBC) rule. It is organized in two sections: first, we provide our general comments on the rule, and second, we provide specific comments on individual sections in the proposed rule. These individual comments have been ordered to follow the sections of the proposed rule.

## General Comments

1. **The relationship between risk weights and minimum capital requirements**
   All RBC frameworks are comprised of two key elements; risk weights and limits. Combined, these elements work in unison to establish a capital regime that ensures financial institutions hold enough capital to weather their risks. NCUA's application of this framework is fundamentally flawed.

   NCUA states the structure of their proposed RBC framework is driven by Congressional guidance to establish a Risk Based Net Worth (RBNW) requirement that considers more than credit risk, specifically:

   > *The RBNW must "take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized [(6 percent net worth ratio)] may not provide adequate protection." Congress encouraged NCUA to, "for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks. The design of the [RBNW] requirement should reflect a reasoned judgment about the actual risks involved.*

   Additionally, NCUA states one of its goals is to revise the current PCA rules to:

   > *...include a new method for computing NCUA's risk-based capital measure that is more consistent with the risk-based capital measure for corporate credit unions and the risk-based capital measures used by the Other Federal Banking Regulatory Agencies.*

   Lastly, according to NCUA:

   > *"The proposed 10.5 percent risk-based capital ratio target is comparable to the Other Federal Banking Regulatory Agencies' 8 percent Total Risk-based Capital ratio plus the 2.5 percent capital conservation buffer which is expected to be fully implemented in 2019."*

   NCUA has failed to create a RBC framework that meets the standards outlined above. First, NCUA's risk weights are not consistent with banking regulators. Second, NCUA's 10.5% minimum capital requirement gives the appearance of parity with banking regulators but it includes a capital conservation buffer which needlessly increases credit union capital requirements. In its effort to create a framework that addresses interest rate, liquidity and concentration risk (hereafter referred to

as ancillary risks), NCUA has created a capital framework that not only increases the risk weights, but also increases capital requirements because the limits include the bank's capital conservation buffer. As a result, NCUA's framework is not balanced; the risk weights and limits are not working in tandem to effectively balance the total impact of the new capital requirements on credit unions. NCUA's framework increases capital requirements through the risk weights *and* increases capital requirements through higher minimum capital requirements.

Banks are subject to several RBC ratios and each of these ratios include different elements of bank capital (e.g., stock, retained earnings, subordinated debt, ALLL, etc.). None of these ratios provide a direct comparison between a bank's minimum capital requirements and a credit union's. In order to compare bank capital requirements to those proposed by NCUA, we need to determine which bank ratio is most similar to the proposed credit union RBC requirements. Using a bank's Total RBC is not an appropriate comparison because it encompasses the ability to raise Tier 2 capital via the capital markets; a restricted activity for credit unions and a source of capital NCUA does not measure. A banks' Tier 1 RBC ratio is most similar to a credit union's capital requirements because both ratios are largely comprised of high-quality capital and have limited reliance on hybrid forms of capital[1]. As such, we need to compare credit union capital requirements to a bank's Tier 1 RBC requirements.

As a response to the financial crisis, banking regulators developed the concept of a capital conservation buffer to ensure banking organizations retained capital when it was most needed. More directly, regulators noticed banks continued to distribute capital to shareholders and employees even though they were under duress. These regulators established the capital conservation buffer to address this issue. Once fully implemented in 2019, the FDIC will require banks to hold a base level of 8.0% Tier 1 RBC plus an additional 2.5% capital conservation buffer for a total Tier 1 RBC requirement of 10.5% to achieve well-capitalized status (see Table 1 below)[2].

**FDIC Minimum Capital Ratios**

| | |
|---|---|
| Minimum Tier 1 RBC | 8.0% |
| Capital Conservation Buffer | 2.5% |
| Minimum Tier 1 RBC plus CC Buffer | 10.5% |

**Table 1**

If banks do not hold this additional capital conservation buffer, their ability to pay stock dividends and buyback shares will be restricted. In other words, if banks do not hold the extra 2.5%, they cannot draw down capital for shareholders. This concept is not relevant to credit unions as we do not return capital to shareholders through equity dividends or stock buybacks. Including the 2.5% capital conservation buffer in credit union capital requirements is simply imposing additional capital

[1] Tier 1 RBC provides the best comparison because it aligns most directly with credit union capital. Banks can satisfy their Total RBC requirements using a combination of Tier 1 and Tier 2 capital. Credit unions do not have access to the full suite of Tier 2 capital products to satisfy their capital requirements. Credit unions must satisfy their capital requirement with elements most closely aligned with a bank's Tier 1 capital (e.g., retained earnings). While there are slight differences between a bank's Tier 1 RBC ratio when compared to credit union's RBC requirements; these differences can offset (e.g., treatment of ALLL versus the ability to use non-cumulative preferred stock). In principle, a bank's Tier 1 RBC is designed to reflect high-quality capital which is the same standard applied to credit union capital; accordingly a bank's Tier 1 RBC most closely aligns with the composition of credit union capital.

[2] Bank capital ratios are defined in Vol. 78, Federal Register, page 62041

requirements on credit unions. This 2.5% requirement means Navy Federal needs to hold an additional $1.1B of capital; capital that could otherwise support $14 billion of loans to our members.

Either NCUA has inexplicitly raised the capital standards for credit unions, or, NCUA adopted the 10.5% capital limit as a means of establishing a capital buffer for the ancillary risks not addressed by the traditional RBC framework. If NCUA has raised the capital standards for credit unions it has violated its stated goal of developing a capital regime that is consistent with other Federal Banking Regulators. Instead, it will have created a regime that imposes materially higher capital requirements that put credit unions at a disadvantage to the banks. Considering the difference between business models, and the historical performance of credit unions during the financial crisis, NCUA has identified no reasonable justification for requiring credit unions to hold more capital than banks.

Alternatively, if NCUA chose the 10.5% limit to ensure credit unions retain sufficient capital to cover ancillary risks, then the risk weights should focus on credit risk and mirror the banking risk weights. Increasing the capital requirements *and* increasing the risk weights creates a system of double-taxation because credit unions would be subject to higher risk weighted assets and higher minimum capital requirements.

A better approach would be to align with the FDIC risk weights, eliminate the capital conservation buffer, and manage the ancillary risks through the regulatory examination process[3]. We believe NCUA can use this approach to achieve regulatory parity, address the Congressional guidance, and establish a framework that does not disadvantage credit unions.

**2. Including Interest Rate Risk in Asset Risk Weights**

As noted above, we do not support NCUA's method of estimating capital requirements for ancillary risks. In particular, we are concerned about NCUA's approach for estimating capital requirements for interest rate risk.

The single most basic principle of determining interest rate risk is estimating the mismatch between assets ***and*** liabilities. NCUA's framework violates this most basic premise. NCUA only considers interest rate risk from the asset side; the framework completely ignores the impact of liabilities or any actions a credit union has taken to mitigate risk. In fact, the framework is so flawed it can actually lead to incorrect results. Consider the following stylized example: A credit union issues longer-term CDs but, because they have a view interest rates will rise, they hold the proceeds in cash. Even though the credit union has taken on substantial interest rate risk, under the proposed RBC framework, the credit union would have no capital requirements because cash carries a 0% risk weight[4]. If rates remain flat or fall, the credit union will lose money but it will not have any capital to offset the losses. Although this is clearly a simple, stylized example, it highlights the fundamental flaw of evaluating interest rate risk from only one side of the balance sheet.

[3] This approach towards overseeing ancillary risks is consistent with banking regulators and it is discussed more fully in section #2.
[4] A 0% risk weight for cash is appropriate because cash, in and of itself, poses no risk to capital.

This limitation of the RBC framework was addressed by the Basel Committee during its Basel 2.5 guidance. The Basel Committee recommended establishing a capital requirement exclusively to address market risk. While this capital recommendation is only applicable to the largest, internationally active banks, it highlights the inherent flaw in trying to ascribe a capital requirement for interest rate risk in a RBC framework that only considers the asset side of the balance sheet.

Banking regulators understand the limitations of the RBC framework for measuring interest rate risk. Rather than relying on the RBC framework to evaluate interest rate risk, banking regulators have a long history of using the annual examination process to ensure banks maintain sufficient capital for interest rate risk. In fact, the banking industry moved from a CAMEL approach to a CAMELS approach. The "S" component addresses the sensitivity of a bank to market risk. The "S" component focuses on an institution's ability to identify, monitor, manage and control market risk. NCUA has the same examination authority to ensure credit unions have enough capital to absorb the level of interest rate risk on their balance sheets. While NCUA believes it does not have the direct authority to require credit unions to hold more capital for a given type or level of risk, NCUA does have the authority to require credit unions to de-risk themselves through the CAMEL process. In effect, NCUA has the ability to ensure credit unions do not take disproportionate risk. There is no need to explicitly adjust the RBC risk weights to account for these ancillary risks considering the fundamental flaws in the approach and NCUA's existing ability to control risk at individual credit unions.

**3. Individual Minimum Capital Requirements**

We do not support the concept of Individual Minimum Capital Requirements (IMCR). The proposed rule grants NCUA the authority to require credit unions to hold additional capital based on numerous qualitative factors, and most disturbingly, individual examiner judgment. Establishing IMCRs will also create a lack of consistency across the credit union industry and a lack of stability over time. Credit unions will become too exposed to the changing opinions of different exam teams; this creates a risk NCUA can arbitrarily impact the products and services we offer our members.

We do not believe this aspect of the rule is necessary since NCUA already has discretionary authority to oversee, and if necessary direct, the risky activities of a credit union through the existing CAMEL process. We believe the CAMEL process provides NCUA sufficient authority to regulate credit unions should they believe the credit union does not have enough capital to operate in a safe and sound manner. For example, under today's environment, if NCUA believes a credit union is operating in a manner inconsistent with its capital level, NCUA can use the CAMEL process to issue a wide range of regulatory orders to ensure the credit union reduces its exposure.

We also believe this rule creates the potential for inconsistent regulatory examination standards across the industry. This creates the risk a credit union will be required to hold more capital because an individual examiner, or exam team, has a unique perspective or negative outlook towards a particular product or business line. Given the importance of capital, and the limited ways credit unions can build capital, we do not support a framework where the examination teams can apply different standards across the industry.

In the proposed rule NCUA outlines some considerations for establishing IMCRs, for example; "high degree of exposure to interest rate risk", "poor liquidity", high growth rates, etc. We recognize quantifying some of the items listed by NCUA may be challenging, but NCUA can easily define what it considers a high degree of interest rate risk or a poor level of liquidity. Quantifying as many factors as possible reduces the risk that different standards are applied by different examiners. Additionally, it is imperative for credit unions to understand where NCUA draws the line. If NCUA insists on pursuing IMCRs, we recommend NCUA quantify these factors to ensure a more consistent application of the IMCRs across the industry.

Lastly, the proposed rule implies the NCUA Board is involved in the IMCR process but it does not clearly define its role. Does NCUA's Board need to approve the IMCR? Does a credit union have an opportunity to address the IMCR recommendation while it is being considered by NCUA staff or the Board? How will IMCRs impact the publically disclosed capital status? If NCUA insists on pursuing IMCRs, we recommend NCUA more clearly outline the process for establishing an IMCR from recommendation by the examiner through any involvement by NCUA's Board.

**4. Phase-In of Minimum Capital Requirements**

As noted in section #1, we do not support a 10.5% RBC requirement because it includes the impact of a 2.5% capital conservation buffer which is only germane to the banking business model. Since credit union's cannot raise Tier 2 capital the way a bank can, any capital framework comparisons should be based on similar capital requirements; as noted in section #1, the comparable metrics are Tier 1 RBC for a bank and NCUA's proposed RBC requirements for a credit union. If NCUA insists on including the additional 2.5% buffer above the base 8% Tier 1 RBC capital requirements for banks, we recommend NCUA phase-in the capital requirements over time in a manner consistent with the FDIC.

NCUA has proposed immediately requiring credit unions to have a 10.5% RBC ratio to be *"comparable to the other Federal Banking Regulatory Agencies' 8% Total Risk Based Capital ratio plus the 2.5% capital conservation buffer."* NCUA also states it has adopted the 10.5% limit to *"avoid the complexity of implementing a capital conservation buffer"*. In addition to requiring credit unions to hold more capital than banks, NCUA's decision to immediately require this level of capital puts credit unions at a further disadvantage for at least five years (see Table 2 below).

**Comparison of FDIC vs NCUA Capital Limits**

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| NCUA RBC Limits | 10.5% | 10.5% | 10.5% | 10.5% | 10.5% | 10.5% |
| FDIC Minimum Tier 1 RBC | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| FDIC Capital Conservation Buffer | | | 0.625% | 1.250% | 1.875% | 2.500% |
| FDIC Minimum Tier 1 RBC plus CC Buffer | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| Additional Capital Req'd by NCUA | 2.5% | 2.5% | 1.9% | 1.3% | 0.6% | 0.0% |

**Table 2**

The FDIC Tier 1 RBC minimum capital requirement is 8%. The FDIC also requires institutions hold a capital conservation buffer of 2.5% but the requirement is phased-in over six years. This reflects a

balanced approach by the FDIC. In contrast, NCUA's RBC limit would immediately require credit unions to achieve a capital standard well in excess of the banking industry. Considering the financial performance of credit unions during the recent crisis, and the comparatively conservative nature of credit union balance sheets, NCUA is needlessly imposing a burden on credit unions by requiring them to hold substantially more capital than banks for the next five years. For example; in 2014 Navy Federal would be required to hold an astonishing $1.1B of additional capital relative to a bank because NCUA has chosen not to phase-in the capital requirements like the FDIC (see Table 3 below)[5]. This additional capital burden equates to over $14B of loans Navy Federal could otherwise make to its members.

| Impact of NCUA's Capital Limit on Navy Federal | | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
| Additional Capital Required ($mm) | $ 1,136 | $ 1,136 | $ 852 | $ 568 | $ 284 | $ - |

Table 3

Rather than imposing a competitive disadvantage on credit unions, if NCUA insists on capital levels above 8%, we recommend NCUA adopt a phased-in approach that mirrors the FDIC to give credit unions ample time to raise the additional capital, either organically, or through expanded authorities to raise secondary capital for RBC purposes.

## 5. Secondary Capital

NCUA has established a new capital framework without granting credit unions additional means of managing their capital. More specifically, NCUA is largely adopting the framework applied to banks without giving credit unions the same tools to manage capital that are commonplace in the banking industry. This puts credit unions in the precarious position of managing their balance sheets under a capital regime designed for a bank's active capital management program without the requisite tools to affect capital the way banks do. Simply put, credit unions are now fighting with one arm tied behind their backs.

NCUA has stated it is limited by the Federal Credit Union Act's (FCUA) definition of net worth under the current PCA framework; a position which could be easily rectified if the NCUA pursued a legislative remedy to align its PCA framework with the banking industry. On the other hand, NCUA does have complete discretion around the definition of capital for RBC purposes. For example; NCUA has chosen to exclude certain items from the definition of capital (e.g., NCUSIF deposit, goodwill, intangibles, etc.). Since NCUA has demonstrated an ability, and willingness, to alter the definition of capital for RBC purposes; it is clear NCUA has the authority to include secondary capital in the numerator for RBC purposes.

We recommend NCUA expand the definition of capital for RBC purposes by introducing the concept of Tier 2 capital. Examples of Tier 2 capital include; subordinated debt, voluntary member capital,

[5] Capital calculations reflect the risk weighted assets posted on NCUA's RBC website for Navy Federal's balance sheet as of 12/31/13. There are no assumptions for growth in the forecasts for 2014 – 2019. Any growth in Navy Federal's balance sheet would increase the disadvantage.

etc. The issue of secondary capital has been well researched, and was even supported by NCUA in its 2010 Supplemental Capital White Paper[6].

Providing credit unions the ability to raise secondary capital represents a significant opportunity to enhance the safety and soundness of the industry. Banks used this tool to respond to the financial crisis by issuing several billion dollars of stock and debt to improve their financial health. Credit unions lack this tool. Additionally, Tier 2 capital reduces risk across the industry because it transfers risk from credit unions to third parties; this reduces the risk to the industry by interjecting an additional layer of risk protection before losses are absorbed by NCUSIF.

We recognize the topic of secondary capital is complex, but now is the time to draw the connection between granting credit unions this authority and implementing a capital regime that was fundamentally designed with the concept of Tier 2 capital in mind.

[6] Supplemental Capital White Paper prepared by the Supplemental Capital Working Group, April 12th, 2010.

## Specific Comments on Risk Weight Categories

1. **Cash**

   a. **Deposits at the Federal Reserve**

   We believe cash on deposit with the Federal Reserve should have a 0% risk weight. The proposed rule does not specifically address cash held at the Federal Reserve. The rule addresses cash on hand, cash on deposit (e.g., at other financial institutions) and cash equivalents; it does not specify a risk weight for balances on deposit with the Federal Reserve.

   The rule describes cash on hand as *"cash held by a credit union for normal operations – such as vault cash, ATM cash, and teller cash"*. The rule assigns a 0% risk weight for cash on hand because it reflects no risk to the credit union. The rule also defines cash equivalents as *"short-term highly liquid investments that have original maturities of 3 months or less and are readily convertible to known amounts of cash"*. Unfortunately, the rule does not define cash on deposit; typically this category is interpreted as cash on deposit at other financial institutions (e.g., banks and other credit unions). The rule assigns a 20% risk weight to this category reflecting the incremental level of credit risk from deposits at other financial institutions.

   Unfortunately, the rule does not specifically identify a treatment for cash held at the Federal Reserve. Credit unions can have balances at the Federal Reserve either to cover their minimum reserve requirements or as a repository (e.g., short-term investment) for excess cash. Given the unique nature of the Federal Reserve, NCUA should assign a 0% risk weight for balances held at the Federal Reserve. This risk weight would be consistent with the treatment of other direct, unconditional U.S. Government obligations which are risk weighted at 0%. We recommend NCUA risk weight balances at the Federal Reserve at 0%.

   b. **Definition of Cash Equivalents**

   Part 702.104(c)(2)(ii) defines cash equivalents as *"short-term, highly liquid non-security investments that have an original maturity of 3 months or less at the time of purchase, are readily convertible to known amounts of cash, and are used as part of the credit union's cash management activities."* The proposed rule assigns a 20% risk weight. The proposed rule appears to be inconsistent with the definition of cash equivalents from other banking regulators. NCUA specifies "non-security" investments; it is unclear if this is intended to exclude cash equivalents like FHLB Discount Notes. Our belief is NCUA did not intend to exclude these from the definition of the cash equivalents subject to a 20% risk weight. We recommend NCUA either remove the "non-security" language, or, explicitly include the types of eligible cash equivalent investments that are subject to a 20% risk weight.

2. **Investments**

   The investment risk weights are fundamentally flawed. As noted above, the proposed rule attempts to combine three elements of risk (i.e., credit risk, liquidity, and, interest rate risk) into one capital standard. This approach is not consistent with best practices and represents a significant departure from other financial institution regulators, both domestic and international. As a result, the proposed

rule creates a RBC framework that is materially more punitive than the standard applied to banks; even though credit unions have materially more restrictive investment alternatives which make their investment portfolios inherently less risky than bank investment portfolios.

Consider the impact to Navy Federal based on our 12/31/13 balance sheet (see table 4 below).

**Investment Portfolio as of 12/31/13**

**NCUA Proposal**

| Asset Class | Balance | Risk Weight | RW Assets |
|---|---|---|---|
| Treasuries | $ 3.0 | 0% | $ - |
| Other Investments: | | | |
| 0-1 years | $ 0.9 | 20% | $ 0.19 |
| >1 to 3 years | $ 2.2 | 50% | $ 1.08 |
| 3 to 5 years | $ 3.7 | 75% | $ 2.74 |
| 5 to 10 years | $ 2.9 | 150% | $ 4.35 |
| >10 years | $ 0.2 | 200% | $ 0.40 |
| | $ 12.8 | | $ 8.76 |

**Capital Required @ 10.5% $920mm**

**FDIC Rules**

| Asset Class | Balance | Risk Weight | RW Assets |
|---|---|---|---|
| Treasuries | $ 3.0 | 0% | $ - |
| Agencies | $ 7.1 | 20% | $ 1.42 |
| Other Investments | $ 2.8 | 100% | $ 2.75 |
| | $ 12.8 | | $ 4.17 |

**Capital Required @ 10.5% $438mm**

**Additional Capital Required $481mm**

**Table 4**

Under the proposed rule Navy Federal would be required to hold almost $500 Million more capital than a bank even though the majority of our investments are concentrated in US Treasuries and Agency backed securities. ***Any RBC framework that results in such a significant difference between credit unions and banks must be reworked.***

As noted above, NCUA's decision to co-mingle credit risk, liquidity and interest rate risk represents a philosophical departure from every other financial institution regulator; as a result, NCUA's framework cannot be considered best practice. Even the Basel Committee's framework, considered by many to be the leading edge of capital theory, does not attempt to co-mingle interest rate risk and credit risk when determining capital requirements.

NCUA's risk weights range from 0% to 200% and are based on the weighted average principle life of the investment. NCUA established these risk weights to *"provide a fair measure of the interest rate and liquidity risks associated with longer term investments"*. Further, they were established by using the *"results of 300 basis point interest rate 'shock tests' to corroborate the assigned risk-weights"*. Essentially, NCUA assumes a 300 basis point increase in interest rates will translate into an immediate reduction in capital. NCUA's approach is flawed because it only focuses on the asset side of the balance sheet thereby ignoring the most basic premise of interest rate risk management – the matching of assets **and** liabilities.

In addition to the flaws associated with trying to incorporate interest rate risk into the investment risk weights, there are additional shortcomings in NCUA's approach:

a. **NCUA incorrectly attempts to include liquidity risk in investment risk weights.** NCUA's framework is designed to require credit unions to hold capital to offset the

impact of a decline in market value due to an increase in interest rates. It is clear NCUA is implying the compound effect of a shock in interest rates and a funding need. Essentially, NCUA's framework assumes a credit union will need to liquidate investments after experiencing a 300 basis point shock thus being forced to recognize the loss in value through earnings and subsequently into capital. This assumption does not fully capture the way investments are used by financial institutions.

The current investment authorities primarily limit the securities credit unions can hold to low risk, highly liquid investments, for example; US Treasuries and Agencies. NCUA's RBC framework assumes a credit union must liquidate these investments and recognize the loss through earnings because it has a liquidity need. The framework does not consider that a credit union is more likely to use the investment as collateral for borrowing. This strategy allows a credit union to meet its liquidity needs without selling the security and immediately recognizing the loss into earnings and capital. In effect, because credit unions carry highly liquid investments, they have the ability to use them to forestall the accounting recognition of a decline in market value. Requiring credit unions to hold capital for this risk does not reflect the way a financial institution manages its balance sheet. NCUA needs to strike a better balance between its desire to ensure credit unions have enough capital to withstand market fluctuations and the practical realities of how financial institutions manage investments and funding.

b. **NCUA's framework ignores credit risk.** The banking framework is primarily focused on the credit risk of the investment portfolio. The banking regulators recognize two important fundamentals of bank investment portfolio management; portfolio managers are primarily concerned about credit losses, and, the impact of changes in interest rates is managed holistically.

In contrast to the banking regulators, NCUA's framework ignores credit risk in favor of interest rate risk. For example; NCUA requires a much higher risk weight on a long-term Agency debenture which has materially less credit risk than a medium term unsecured bank note or CD. The banking framework would reverse these risk weights. Banks risk weight Agency investments at 20% reflecting the modest level of credit risk while the unsecured, albeit shorter-term, investment is risk weighted at 100% because it carries a higher level of credit risk.

Banking regulators understand portfolio managers are first concerned about principle repayment. At the end of the day, even if interest rates skyrocket, the "loss" is far less than if an issuer defaults. As such, credit risk is paramount and the banking framework reflects that dynamic. Additionally, banking regulators understand the interest rate risk in bank investment portfolios is typically combined with other assets and liabilities and managed holistically. As such, even though longer-term investments do carry more interest rate price sensitivity, bank regulators realize their capital framework needs to reflect a holistic approach rather than ascribing a capital charge to a risk which is typically offset elsewhere on the balance sheet. NCUA's approach does not reflect the

true risk on a financial institution's balance sheet and it levies a heavy burden on credit unions to hold more capital than necessary.

c. **NCUA's framework creates internal inconsistencies in capital treatment.** Under the proposed framework a 30 year fixed-rate mortgage loan originated by a credit union and held on its balance sheet as a whole loan would have a 50% risk weight, assuming it fell under the 25% concentration risk threshold. However, the same loan, bundled as part of a Fannie Mae or Freddie Mac mortgage backed security (MBS) would be risk weighted at 150% because its weighted average life (WAL) is greater than 5 years. NCUA's framework is inconsistent because it **triples** the capital requirement for this same asset simply because it is held in security form instead of whole loan form.

   An even greater flaw in NCUA's approach is that the risks to the credit union are lower by holding the loan in security form. First, the security has a 3rd party wrapper that stands in 1st loss position which reduces credit risk; second, the security is much more liquid than the whole loan thereby reducing liquidity risk; third, the security can be used more efficiently as collateral for borrowing which further reduces liquidity risk, and; fourth, securities have greater price transparency reducing the risk of incorrectly valuing the asset. Essentially, the credit union has lowered several risks by holding the loan in security form yet NCUA's framework has tripled the capital requirement. NCUA's approach is vastly misaligned with economic reality and it also creates an incentive for credit unions to hold riskier assets to minimize capital requirements.

d. **Using WAL as a measure of interest rate risk.** NCUA defines weighted average life (WAL) in part 703.1 as the *"weighted-average time to return a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal."* In part 702.105, NCUA further defines additional methods for calculating weighted average life of securities such as fixed rate obligations with call features, variable rate obligations, investments in registered investment companies and equity securities. These calculations are then used to designate investments into specific ranges for risk based capital weights. This method is contrary to market convention and we believe it to be an ineffective method for the purpose of assigning risk based capital weights to specific investments.

   Market convention for non-amortizing investments such as Treasury and Agency bullet securities is to use duration for analysis. Duration is a better measure of price sensitivity than the WAL approached proposed by NCUA. If NCUA insists on using the proposed RBC framework for investments, we recommend using duration instead of WAL.

In addition to the concerns highlighted above, we have specific comments based on the proposed risk weights for different investments:

**Treasuries**
The proposed rule applies a 0% risk weight to obligations of the US Government. The rationale is based on the de minimis credit risk associated with US Treasuries and their high level of liquidity in the market. This risk weight also reflects the ability of credit unions to leverage these securities in the repo market should a liquidity event arise after interest rates have risen. NCUA's proposed risk weight is consistent with banking regulators and it appropriately reflects the risk to capital of investing in Treasuries. We agree with NCUA's risk weights for US Treasuries.

**Agencies**
The proposed rule applies a range of risk weights based on the maturity of Agency Debentures and Agency MBS securities. We believe this framework results in a punitive capital regime that does not consider the ability to use these securities as borrowing collateral. Similar to Treasuries, Agency securities can be easily used as collateral for funding. To be consistent with the logic applied to US Treasuries, we recommend NCUA risk weight Agency Debentures and MBS at 20%. This risk weight is consistent with banking regulators and reflects the slightly higher credit risk associated with Agency securities vis-à-vis US Treasuries but still recognizes the inherent value of these securities to address post-interest rate shock liquidity shortfalls.

Lastly, we recommend NCUA identify which agencies are eligible for a lower capital treatment and ensure these definitions are consistent with Federal Banking regulations. For example, we expect NCUA to include agencies like Fannie Mae, Freddie Mac, Ginnie Mae, TVA and FHLB as well as any other agencies or GSEs that are included in the banking regulations.

**Municipal Bonds**
Similar to other non-Treasury investments, NCUA has proposed risk weights ranging from 20% to 200%. Typically municipal bonds have longer maturities, thus the likely risk weight will be 200%. This risk weight is punitive compared to the risk weights applied by banking regulators. The FDIC applies a 20% risk weight to general obligation bonds reflecting the low credit risk associated with investments issued by taxing authorities. Similarly, the FDIC applies a 50% risk weight to revenue obligation bonds reflecting the slightly higher credit risk associated with municipal revenue streams not directly tied to taxation authority. NCUA's risk weights are materially higher than the banking industry. We recommend NCUA adopt the FDIC's risk weights.

**Other Unsecured Investments**
Banking regulators have determined the standard capital requirements (e.g., 8%) are sufficient to address the risk associated with other unsecured investments. While we understand the lower utility of these types of investments (e.g., bank notes, P/L MBS, etc.) for liquidity purposes, NCUA's framework puts credit unions at a significant competitive disadvantage. We recommend NCUA adopt the banking framework and risk weight these investments at 100% irrespective of the maturity.

We cannot support NCUA proposed investment framework because of the punitive structure and the complete departure from regulatory best practices. The proposed framework completely misses the mark and creates a significant capital burden for credit unions. Regulatory best practices are to risk weight investments based primarily on the credit risk of the investment, not the interest rate risk. NCUA's framework does not consider various commonplace funding and risk management strategies and the framework needlessly penalizes credit unions for holding certain types of investments which have balance sheet utility for managing liquidity.

Lastly, banking regulators recognize that interest rate risk, while it can manifest itself in the valuations of investment securities, is not isolated to just the investment portfolio. NCUA's framework is inconsistent because it ignores the interest rate risk created, or offset, by other assets and liabilities on the balance sheet. NCUA, and the credit union industry, would be better served by aligning the framework with banking regulations and having NCUA assess interest rate risk at each credit union as part of the annual examination.

We recommend NCUA eliminate the punitive nature of its investment risk weights and adopt the best practices of other financial institution regulators.

3. **Loan Delinquency**

NCUA's proposed rule defines a delinquent loan *"as loans that are 60 days or more past due and loans placed on nonaccrual status"*. This definition is a departure from the definition used by the banking regulators. Under the banking framework, nonaccrual loans are defined as 90 days past due. NCUA's definition creates an additional capital requirement for credit unions over and above banks. This requirement puts credit unions at a competitive disadvantage. We recommend NCUA change the definition of a delinquent loan for RBC purposes to mirror the requirements of the banking industry.

4. **Real Estate Loans**

As highlighted under our general comments and again under the investment section, NCUA's escalating threshold for real estate loans is inconsistent with regulatory best practices and it creates a punitive capital regime that negatively impacts credit unions who wish to serve their members' real estate borrowing needs while effectively managing financial risk on the balance sheet. As a result, NCUA's framework puts credit unions at a significant competitive disadvantage because NCUA is tied to a capital regime that ignores the risk reducing impacts of effective balance sheet management.

It is clear NCUA's framework is designed to create a disincentive for credit unions to hold more than 25% of assets in 1st mortgages or more than 10% of assets in equity loans (see table 5 below).

| Real Estate Risk Weight Comparison | | | | | |
|---|---|---|---|---|---|
| 1st Mortgages | | | Equity Loans | | |
| NCUA | | Banks | NCUA | | Banks |
| < 25% | 50% | 50% | <10% | 100% | 100% |
| 25 - 35% | 75% | | 10-20% | 125% | |
| > 35% | 100% | | >20% | 150% | |

**Table 5**

As Table 5 highlights, NCUA's proposed rule creates a significant disadvantage for those credit unions committed to serving their member's real estate borrowing needs. The risk weights also highlight a recurring theme where NCUA consistently ignores the most basic tenant of risk management; the matching of assets and liabilities to determine the net risk to the institution. We understand NCUA's desire to ensure credit unions manage the risk associated with long-term assets to protect themselves from the specter of rising interest rates; however, materially increasing the capital requirements vis-à-vis the banks does not help credit unions manage risk. Instead, it forces credit unions to avoid risk and thereby fail in their core mission of serving members.

NCUA states the escalating thresholds are designed to reduce concentration risk, however NCUA does not discuss the empirical framework used for determining the threshold levels (e.g., <25%, 25% - 35% and >35%) nor how these thresholds correspond to the escalating risk weights (e.g., 50%, 75% and 100%, respectively). Simply put, NCUA does not present any analysis to justify why it has established these breakpoints and capital requirements. This is particularly concerning because banking regulators have chosen to apply a uniform risk weight for these assets.

In the sections below we provide specific comments of the various aspects of the proposed real estate capital requirements:

a. **VA/FHA 1st Mortgages.** The proposed rule establishes a lower capital requirement for loans guaranteed by the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA). The proposed risk weight of 20% is consistent with banking regulations; however, it is unclear whether these loans would be excluded from the numerator in determining total mortgage exposure for the purposes of the concentration risk thresholds (e.g., >25%). See table 6 for an example:

| Treatment of VA Loans | | | | |
|---|---|---|---|---|
| | | | Excluded | Included |
| VA Mortgages | $ | 25 | | |
| Non-VA Mortgages | $ | 25 | | |
| Total Mortgages | $ | 50 | 17% | 33% |
| | | | | |
| Total Assets | $ | 150 | | |

**Table 6**

Table 6 highlights the uncertainty. If VA loans are excluded from the concentration risk threshold, this credit union would only count non-VA/FHA loans when determining its concentration risk threshold. Based on the example, this credit union would only have

17% of assets in real estate and they would be subject to a 50% risk weight. Conversely, if VA/FHA loans must be included in the concentration risk threshold, this credit union would have 33% of its assets in mortgages and be subject to higher risk weights.

We recommend NCUA explicitly define how VA/FHA loans would be treated when determining concentration risk thresholds. This also applies to any other loan programs which may be excluded from the risk thresholds. Our expectation is NCUA intends to **exclude** VA/FHA loans from the concentration risk threshold. Including these loans in the threshold would create a significant disadvantage for our active duty military and veterans. We do not believe NCUA intends to disadvantage our military members; as such, we recommend NCUA clarify this language to exclude VA/FHA loans from the concentration risk thresholds.

b. **Non-VA/FHA 1st Mortgages.** As noted above, it appears the risk thresholds were not developed using any quantitative evidence that suggests credit unions must hold more capital due to concentration risk; instead, the thresholds appear to be driven by NCUA's desire to limit further growth in mortgages.

NCUA states that *"25% is based on the average percent of first mortgage real estate loans to total assets, which, as of June 30, 2103, is 24.9 percent for all complex credit unions"*. It appears NCUA has determined that growth beyond the current percent of mortgages requires credit unions to hold additional capital. Based on the performance of credit union originated 1st mortgages during the financial crisis, we are hard pressed to rationalize why credit unions would be required to hold materially more capital than banks; particularly given the lack of justification showing the need to hold more capital simply because the percent of mortgages has increased beyond NCUA's arbitrary line in the sand.

We recommend NCUA eliminate the escalating scale and adopt the banking framework of a uniform 50% risk weight. However, should NCUA insist on establishing an escalating scale, we recommend adjusting the scale to ensure credit unions are not required to hold more capital, on average, than a bank. While there are multiple ways to achieve this, NCUA could consider a) lowering the initial threshold and risk weights thereby reflecting the dynamic that credit union originated loans are less risky than bank loans, b) eliminating the middle threshold, and c) establishing a wider top threshold and setting the risk weights such that the average is equivalent to the 50% risk weight applied to banks. This approach would a) recognize the conservatism of credit union mortgages and, b) require credit unions to increase capital as the percent of loans increases but not be required to hold more capital, on average, than a bank.

c. **Definition of a 1st Mortgage Loan.** Under the definitions section, it appears NCUA has attempted to align the definition of a 1st mortgage real estate loan with recent industry

advances that address issues like ability to repay (ATR) and qualified mortgages (QM). For example, the ATR suggests creditors consider eight underwriting factors:

i. current or reasonably expected income or assets;
ii. current employment status;
iii. the monthly payment on the covered transaction;
iv. the monthly payment on any simultaneous loan;
v. the monthly payment for mortgage-related obligations;
vi. current debt obligations, alimony, and child support;
vii. the monthly debt-to-income ratio or residual income; and
viii. credit history.

Unfortunately, the definition used by NCUA does not fully mirror the definition used in industry. We strongly recommend NCUA adopt the language used in the ATR rule to define a 1st mortgage for RBC purposes. Since the mortgage rules are still in a state of flux, we suggest NCUA simply reference the ATR language so NCUA's rule will always be in sync with other regulatory requirements.

d. **Equity Loans.** Our concerns on the risk weights of equity loans mirror those of the non-VA/FHA 1st mortgage loans. In particular; we are concerned about the threshold points and the associated risk weights relative to bank capital requirements. Similar to 1st mortgages, we do not see any empirical evidence which suggests credit unions should be held to a higher capital standard than banks. Our recommendations for 1st mortgages also apply to equity loans, specifically; either adopt the bank framework verbatim, or, establish a sliding scale which, on average, does not require credit unions to hold more capital than banks.

In general, we believe the risk weights for real estate loans are unwarranted given the loss history experienced by credit unions during the financial crisis. The proposed risk weights materially increase the capital requirements thereby placing credit unions at a competitive disadvantage without any evidence that suggests credit unions should hold more capital than banks. Absent a justification for higher capital requirements, we recommend NCUA materially reduce the punitive nature of these risk weights by either adopting the banking framework, or, by adjusting the risk thresholds and risk weights so credit unions, on average, are not required to hold more capital than banks.

**5. Off Balance Sheet Activities: Recourse Loans**

The proposed rule establishes capital requirements for off balance sheet risks including unfunded lines of credit and loans sold with recourse. Under the proposed rule, NCUA would establish a process by which loans sold with recourse are converted to a risk weighted asset equivalent and then assigned a risk weight. Under the proposed rule, the risk weighted asset equivalent is determined by applying a credit conversion factor (CCF) to the total notional amount of loans subject to a recourse agreement. This amount is then assigned a risk weight depending on whether the sold loans were 1st mortgages (50%) or other real estate loans (100%). This process is generally consistent with banking regulations.

However, under the banking regulations, there is a provision for "low-level recourse transactions". This provision limits the amount of capital that needs to be set aside to the lesser of the amount required by the regulatory capital framework, or, the maximum remaining amount of the recourse obligation. In other words, banking regulators recognize that banks should not have to hold more capital than their maximum liability under the recourse obligation. For example; assume a bank has sold $100mm of other real estate loans with a recourse obligation but, because of the structure of the contract, the recourse obligation is capped at $5mm. Under the standard capital framework, the bank would be required to hold $7.8mm of capital against this obligation. Under the low-level recourse provisions, the bank only needs to hold enough capital to meet is maximum exposure (e.g., $5mm).

Additionally, under GAAP a financial institution should establish a liability for loans sold with recourse. The banking regulators allow banks to net an established on-balance sheet recourse liability against capital requirements because the risk has been reserved for on the balance sheet. For example; if the capital framework requires a bank to hold $250mm of capital against potential recourse obligations but the bank has an on-balance sheet liability established for $200mm, the bank's capital requirement would be limited to $50mm.

We recommend NCUA adopt the FFIEC's low-level recourse transaction provision thereby ensuring credit unions are not required to hold capital beyond the actual amount of risk created by any off-balance sheet recourse obligations.

**6. Cleared Derivatives**

NCUA needs to include a risk weighting regime for derivatives that are cleared on an exchange.

NCUA has patterned its derivatives RBC rules after the FDIC. NCUA also recognizes *"Under the FDIC's interim rule, derivatives transactions covered under clearing arrangements are treated differently than non-cleared transactions"*. Unfortunately, NCUA has decided to ignore the FDIC capital treatment for cleared derivatives. NCUA offers the following rationale for that approach: *"This approach was selected because most credit unions have less than $10 billion in total assets and are exempt from the Commodity Futures Trading Commission's (CFTC) clearing requirements. Credit unions with more than $10 billion in total assets would fall under the CFTC's recently issued final rule regarding clearing exemption for certain swaps entered into by cooperatives."*

NCUA's position on this topic is a disservice to Navy Federal and to the entire credit union industry. The overwhelming direction of the derivatives industry is to clear derivatives through an exchange. Not only is it mandated for larger market participants, clearing derivatives provides numerous risk reducing and operational benefits for those credit unions that elect to clear their transactions on an exchange. Navy Federal recognizes these benefits and has voluntarily chosen to clear its derivatives on an exchange. Currently we have over $850mm in plain-vanilla interest rates swaps which have been cleared through an exchange. While each credit union that uses derivatives must make its own determination, we expect credit unions that actively use derivatives as part of their risk management

program will likely conclude clearing derivatives is the right choice. We believe cleared derivatives will become more common given the passage of NCUA's new derivatives rule.

More fundamentally, NCUA is fully aware of the risk reducing benefits of clearing derivatives and the process the FDIC uses to recognize those benefits in its RBC framework. There is no justification for NCUA not to adopt a similar approach. NCUA could easily have adopted the FDIC approach which adjusts the RBC requirements based on whether the derivatives are cleared or not. Under the proposed framework, credit unions that have elected to reduce their risk by clearing derivatives on an exchange will not be able to realize the regulatory capital benefits of reducing risk through the clearing process. These credit unions are already required to post initial and daily variation margin to fully collateralize their transactions. As such, the risk to capital is de minimus. Requiring these credit unions to hold capital against derivatives that have been fully collateralized is punitive. For example; assume a credit union enters into a 10 year plain-vanilla interest rate swap and clears the transaction through the Chicago Mercantile Exchange (CME). This transaction will require ~$2.5mm in collateral posted immediately upon execution. This collateral serves as the first line of defense against subsequent changes in the value of the swap. Going forward, on a daily basis, as the market value of the swap changes, the credit union is required to post additional collateral in the form of variation margin to ensure the market value of the swap remains fully collateralized. In this fashion, there is very limited risk to capital given the collateral posted. This risk is further minimized considering the equity investment made by the exchange members (i.e., the FCMs and the exchange itself) also serves as another backstop against losses beyond the margined collateral. The FDIC recognizes this dynamic in its rule and adjusts the RBC requirements accordingly. We believe NCUA should follow suit.

Lastly, NCUA has taken the stance that *"This selection of regulatory capital treatment is not intended to express a position on credit union clearing."* We disagree. Regulatory best practices and industry best practices have evolved to embrace clearing transactions as a means of reducing risk, particularly for end-user credit unions that may not have sufficient capabilities to perform thorough counterparty risk analysis. By excluding a RBC framework for cleared transactions, NCUA has, in fact, taken a view on cleared transactions. Simply put, it has chosen not to afford regulatory capital relief to those credit unions who have chosen to reduce risk. As a prudential regulator, NCUA should, at a minimum, provide a level playing field to those credit unions that are willing to make the investment in resources to reduce risk. We recommend NCUA include a framework for derivative transactions that are cleared on an exchange.

**7. Pension Plan Assets**

The proposed rule does not address how to reflect an overfunded pension plan asset, the rule only discusses the treatment of an underfunded pension plan liability. The proposed rule requires a credit union to reduce its capital (i.e., numerator) by the amount of the underfunded portion of the pension plan. The rule is silent how to reflect an overfunded pension asset.

Consider the following example: a credit union has a $15.1B balance sheet comprised of $15.0B in assets and $100mm in an overfunded pension which is reflected on the balance sheet as an asset. The

credit union also has $1.6B in capital, of which, $100mm reflects the overfunded pension asset (see table 6 below).

| Methods of Treating Overfunded Pension Assets | | | | |
|---|---|---|---|---|
| | Website | | Proposed | |
| Capital | $ | 1,500 | $ | 1,500 |
| Pension Asset | $ | - | $ | - |
| Net Capital | $ | 1,500 | $ | 1,500 |
| | | | | |
| Other Assets | $ | 15,000 | $ | 15,000 |
| Pension Asset | $ | 100 | $ | - |
| Total Assets | $ | 15,100 | $ | 15,000 |
| | | | | |
| Capital Ratio | | 9.9% | | 10.0% |

**Table 6**

NCUA does not explicitly discuss how to treat the overfunded pension asset. NCUA's website excludes the overfunded portion from capital (i.e., the numerator) by excluding Other Comprehensive Income (OCI) but this asset is included in the denominator with a 100% risk weight. This results in a lower capital ratio and represents an inconsistent treatment between numerator and denominator. A more appropriate treatment would be to remove the overfunded portion from the both the numerator and the denominator.

We recommend NCUA provide specific guidance on the treatment of an overfunded pension asset. More specifically, we recommend eliminating the inconsistent treatment by removing the overfunded pension asset from both the numerator and the denominator.

In summary, Navy Federal does not support the proposed rule. There are too many structural and philosophical inconsistencies to support the rule. The issues we have highlighted above will have a measurable and significant impact on Navy Federal's ability to serve its members. Simply put, these changes put credit unions at a **competitive disadvantage** to the banking industry. We cannot support a rule that has such broad sweeping negative implications for the industry and our membership; particularly when the increased capital requirements are not commensurate with the level of risk within the industry and the financial stability and performance of credit unions over time.