NAVY FEDERAL Credit Union®

Office of the President

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

Submitted:
1100 Hours – 10 April 2015

Re: Notice of Proposed Rulemaking – Risk Based Capital – Second Proposal

Dear Mr. Poliquin,

Navy Federal Credit Union ("Navy Federal") is providing comments on the National Credit Union Administration's Notice of Proposed Rulemaking governing Risk Based Capital as it has been re-proposed on 27 January, 2015.

We believe the Risk Based Capital rule is unnecessary, burdensome, and that it will put credit unions at a competitive disadvantage to other financial institutions not regulated by NCUA. In addition, we believe a single-tier framework such as the one contained in the current PCA requirements mandated by Congress is sufficient to provide NCUA the necessary means to regulate credit unions.

NCUA has addressed some of the concerns credit unions raised related to the first proposal; however, we feel the following substantive changes must still be made to ensure the final rule is truly comparable to Other Banking Agency requirements and does not put credit unions at a competitive disadvantage:

1. **Eliminate the 10% Risk-Based Capital Ratio Requirement**
   Unless all credit unions have the ability to meet the 10% requirement with secondary (Tier 2) capital, as banks do, the proposed rule will create a more restrictive capital requirement that places credit unions at a competitive disadvantage to banks. NCUA should either delay the final release of the risk-based capital rule until it has developed a secondary capital rule or eliminate the 10% risk-based capital ratio requirement and establish a single-tier requirement of 8% that aligns with the banking industry's Tier 1 capital requirement.

2. **Eliminate the Concentration Risk Thresholds**
   The proposed rule also places credit unions at a competitive disadvantage to banks by requiring credit unions to hold incrementally more capital than banks given similar levels of asset concentration. The historical loss data provided by NCUA in the proposed rule does not support establishing a higher capital standard for credit unions than banks, and, NCUA has not provided any evidence the proposed concentration risk thresholds align with increased capital at risk. Additionally, none of the Other Banking Agencies have adopted concentration risk thresholds in

their risk weights. NCUA needs to eliminate the proposed concentration risk thresholds and manage concentration risk through the examination process as it has decided to do for Interest Rate Risk.

We discuss these concerns more fully in Attachment I. We have also identified an additional concern regarding the lack of guidance for overfunded pension plan assets; an issue we raised in our first comment letter that was not addressed in the revised proposal.

If you have any questions, please feel free to contact Vince Pennisi, Chief Financial 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 second Proposed Risk Based Capital (RBC) rule. It is organized in three sections: first, we provide our comments of the proposed risk-based capital ratio requirement; second, we provide comments on the risk weights in the proposed rule, and; third, we provide comments on the lack of guidance for an overfunded pension asset.

10% Risk-Based Capital Ratio Requirement

1. NCUA appears to have changed its basis for setting the capital ratio requirements

In the original proposal, NCUA proposed a 10.5% risk-based capital ratio requirement. According to NCUA:

> *"...the proposed 10.5 percent risk-based capital ratio target was comparable to the Other Banking Agencies' eight percent total risk-based capital ratio to be adequately capitalized plus the 2.5 percent capital conservation buffer that banks will be required to meet when the capital conservation buffer is fully implemented in 2019."*

NCUA's description of its rationale is important because it highlights the original intent was to establish a risk-based capital requirement tied to the adequately capitalized threshold for the banking industry; not the well capitalized threshold. In the second proposal, the Board stated the newly proposed risk-based capital requirement:

> *"simplifies the comparison with the Other Banking Agencies' rules by removing the effect of the capital conservation buffer."*

In our comment letter on the original RBC proposal, we urged NCUA to eliminate the capital conservation buffer because the fundamental design of the capital conservation buffer was not applicable to the credit union business model:

> 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... 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. *[Excerpt from NFCU's Comment Letter on the original RBC proposal dated xx/xx/xx]*

Clearly the NCUA Board agreed; however, removing the effect of the capital conservation buffer would lower the risk-based capital ratio requirement to 8%; not the 10% NCUA is currently proposing. NCUA has shifted the basis of its comparison in the second proposal without explanation. More specifically, NCUA was comfortable aligning the two capital frameworks at the adequately capitalized standard (e.g., 8% Total RBC), but now, the Board has inexplicably aligned the two frameworks at the well-capitalized standard of 10%. It appears NCUA has made an arbitrary shift in the basis, or rationale, it used to align the credit union RBC framework with that of the Other Banking Agencies.

2. **NCUA's 10% well-capitalized requirement is not comparable to the Other Banking Agencies and it puts credit unions at a competitive disadvantage**
In its justification for establishing a two-tier capital system, NCUA states it has the legal authority to establish this system.

> *"[NCUA has the authority] to design PCA regulations, including a risk-based net worth requirement, so long as the regulations are comparable to the Other Banking Agencies' PCA requirements..."*

NCUA states the 10% requirement is comparable to the Other Banking Agencies. **We do not believe the proposed 10% requirement is comparable to the Other Banking Agencies.**

Banks have the ability to meet their Total Risk-Based capital requirements with secondary capital (e.g., Tier 2 capital). Although NCUA allows credit unions to count the ALLL towards their risk-based capital requirement (a Tier 2 component under the banking framework), NCUA does not allow credit unions to use secondary capital to meet the rest of their capital requirements[1]. By not allowing credit unions to use secondary capital to meet their capital requirements, NCUA has, in effect, created a more stringent capital requirement for credit unions. **This more restrictive capital requirement places credit unions at a competitive disadvantage to banks.** Because credit unions will be disadvantaged to banks, we believe NCUA has failed to meet the requirement to establish a capital framework that is comparable to the Other Banking Agencies.

3. **NCUA should grant access to secondary capital to eliminate the competitive disadvantage**
NCUA does not need to put credit unions at a competitive disadvantage. It can level the playing field by granting complex credit unions the authority to raise secondary capital for RBC purposes only. NCUA has publically voiced its support for secondary capital for credit unions; not just low-income credit unions. Most recently, Chairman Matz stated at the 2015 Governmental Affairs Conference,

> *"I assure you, as part of modernizing risk-based capital, I am committed to allowing supplemental capital to be counted in full. I am open to proposing rules to accommodate these forms of supplemental capital through regulatory changes. These effective dates would coincide with the implementation of risk-based capital in 2019."*

To ensure a comparable framework between banks and credit unions, it is imperative NCUA eliminate this competitive disadvantage as part of the risk-based capital proposal. Since NCUA has stated it is committed to allowing supplemental capital to be counted in full, a position we support; **NCUA should delay the final release of the risk-based capital rule until it has developed a**

[1] NCUA does allow low-income credit unions to count secondary capital.

secondary capital rule. To be clear, we are *not* asking NCUA to delay the final implementation date of the risk-based capital rule (e.g., 2019), but rather, a delay in the publication of the final rule so that it can coincide with the publication of a final secondary capital rule. It does not benefit the industry to release a risk-based capital rule which effectively requires a higher capital for credit unions than banks with the promise to provide relief in a subsequent rule. We urge NCUA to address the secondary capital issue as part of the modernization of the risk-based capital framework. More specifically, we recommend NCUA allow credit unions to raise Tier 2 capital to satisfy their 10% Total RBC threshold in a manner that is consistent with the banking industry. Only then will NCUA's 10% requirement be truly comparable to that of the Other Banking Agencies.

Fortunately, NCUA has already cleared the path for establishing a secondary capital framework that can be applied to a credit union's RBC requirements. In her recent Governmental Affairs Conference speech, Chairman Matz stated:

> *"NCUA can allow certain forms of supplemental capital for both risk-based capital and low-income credit unions.... For credit unions without a low-income designation, legislation is required to allow supplemental capital to count towards the 7-percent net worth leverage ratio."*

NCUA acknowledges it has the legislative authority to count secondary capital for risk-based capital purposes. While NCUA stated it does not have the authority to count secondary capital towards the 7% leverage ratio; NCUA has been equally clear it does have the authority to establish a framework where secondary capital is applicable for risk-based capital purposes *only*. In other words, NCUA can allow credit unions to issue secondary capital that only counts towards the 10% risk-based capital requirement but not towards the 7% leverage ratio limit. While we encourage NCUA to continue to support legislative actions to make secondary capital applicable to the leverage ratio; we urge NCUA to publish a secondary capital rule that would be effective prior to the full implementation of the risk-based capital rule and the 10% risk-based capital ratio requirement. Granting credit unions access to secondary capital, even if just for risk-based capital purposes, would create a more comparable set of capital requirements to the Other Banking Agencies and remove the competitive disadvantage created by NCUA's current proposed rule.

We acknowledge developing a secondary capital framework will require substantial and careful thought to ensure the authorized instruments meet the definition of capital from both a regulatory and GAAP perspective, and, to ensure the instruments provide adequate protection to NCUSIF. We believe many of the alternatives presented by NCUA in its 2010 White Paper[2] provide a workable base from which to craft proposed regulation. For example; subordinated-debt meets all of the aforementioned criteria and has the added policy benefit of transferring risk from the credit union system to the broader capital markets. We understand there are challenges ahead for NCUA to draft this regulation; however, these challenges should not impede NCUA incorporating this important authority into a fully comprehensive risk-based capital framework.

[2] See NCUA report: Supplemental Capital White Paper prepared by the Supplemental Capital Working Group dated April 12, 2010

4. **Absent secondary capital, the framework must be adjusted to provide comparability to banks**
Should NCUA chose not to move forward with a capital framework that includes secondary capital, we strongly believe NCUA should only establish capital ratio requirements equivalent to the Tier 1 risk-based capital framework used by the Other Banking Agencies.

Examining the make-up of capital between credit unions and banks, Tier 1 capital is most similar in that both credit union and bank Tier 1 capital is comprised of either equity or retained earnings. Both bank and credit union Tier 1 capital represent the strongest form of capital on a financial institution's balance sheet. With the exception of low-income credit unions, this is the only point of comparability between a bank's capital and a credit union's. The differences occur when examining Tier 2 capital. Under NCUA's proposed rule credit unions would be able to count their ALLL towards their risk-based capital requirements which is similar to banks; however, banks have the added benefit of counting secondary capital as Tier 2 capital. Since NCUA has not yet authorized all credit unions to use secondary capital as part of their capital base for risk-based capital purposes, the most logical point of comparability between banks and credit unions is Tier 1 capital.

To ensure credit union and bank capital requirements are comparable, NCUA could set the risk-based capital ratio at 8% which aligns with the banking industry's Tier 1 requirement. To be clear, this would eliminate the capital benefit from the ALLL to ensure comparability to a bank's Tier 1 ratio. When NCUA is ready to issue a secondary capital rule; it can then implement a Tier 2 capital framework that includes both the uncapped ALLL and access to secondary capital. Only then would the point of comparability become the Total Risk Based capital ratio requirement of 10%.

Simply put, NCUA must give credit unions the same tools as the banks in order to establish a regulation that is truly comparable to the Other Banking Agencies' PCA requirements; otherwise, NCUA has disadvantaged credit unions. If NCUA is not ready to move forward with secondary capital, it should maintain comparability by setting the risk-based capital ratio requirement to 8% without the added capital benefit of the ALLL until such time NCUA is ready to establish a Tier 2 framework that includes authority for supplemental capital.

Concentration Risk

1. **Including concentration risk in the risk weights creates a framework that is not comparable to the Other Banking Agencies and it puts credit unions at a competitive disadvantage**
NCUA's risk weights for mortgages, equity loans, and commercial loans vary based on the concentration of these assets classes on the balance sheet. This structure requires credit unions to hold incrementally more capital than banks given similar levels of asset concentration. This requirement puts credit unions at a competitive disadvantage and it fails to meet the standard of comparability to the Other Banking Agencies' PCA requirements. Table 2 shows the different risk weights (e.g., capital requirements) for banks and credit unions for each of these asset classes at different levels of balance sheet concentration.

Proposed Tiered Risk Weights											
	Percent of Assets	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**	**100%**
Mortgages	**Credit Unions**	50%	50%	50%	75%	75%	75%	75%	75%	75%	75%
	Banks	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
	Difference	0%	0%	0%	25%	25%	25%	25%	25%	25%	25%
	Percent of Assets	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**	**100%**
Equity Loans	**Credit Unions**	100%	150%	150%	150%	150%	150%	150%	150%	150%	150%
	Banks	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Difference	0%	50%	50%	50%	50%	50%	50%	50%	50%	50%
	Percent of Assets	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**	**100%**
Commercial Loans	**Credit Unions**	100%	100%	100%	100%	100%	150%	150%	150%	150%	150%
	Banks	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Difference	0%	0%	0%	0%	0%	50%	50%	50%	50%	50%

Table 2

In short, NCUA's proposal requires credit unions to hold more capital than banks given similar levels of asset concentration (see highlighted section in Table 2). We do not believe this creates a comparable capital framework as it puts credit unions at a competitive disadvantage; particularly for mortgages and equity where the capital requirements materially increase even at relatively lower levels of concentration (e.g., 35% and 20% of assets).

Additionally, the historical loss data provided by NCUA does not support establishing a higher capital standard for credit unions than banks. Table 3 summarizes the loss data provided by NCUA in the second version of the proposed risk-based capital rule.

3yr Average Loss History		
	Credit Unions	**Banks**
Mortgage Loans	**0.34%**	**0.49%**
Equity Loans	**0.96%**	**0.73%**
Commercial Loans	**0.75%**	**0.78%**

Table 3

The loss history shows the performance of credit union loans is comparable to, and in the cases of mortgages and commercial loans better than, the banks. **The historical loss data shows there is no justification to establish higher capital requirements than those applied to the banks.** Adhering to the standard of comparability, we recommend NCUA eliminate the concentration risk thresholds for these asset classes and set the risk weights equal to those applied to the banking industry (e.g., 50% for mortgage and 100% for both equity and commercial loans). Not only will this remove the competitive disadvantage; it will better align with broader financial institution capital requirements and historical loss experience.

2. **There is no evidence the risk thresholds align with increased capital at risk**
   NCUA has made the case that high concentrations of these asset classes has been a significant factor in recent credit union failures; as such, capital requirements should increase as the level of concentration increases in order to protect NCUSIF. We disagree with NCUA's interpretation of the data. NCUA provided data (see Table 4) showing the differences in asset concentrations between those credit unions that failed and those that survived.

Five Year Survivial Beginning Q4'07			
	# of credit unions	Real Estate to Assets	Member Business Loans
Failures	27	58%	8.3%
Survivors	1138	49%	0.7%

Table 4

For real estate loans, the data is at best inconclusive. Credit unions that failed had 58% of their assets in real estate whereas those credit unions that survived had 49%. While there is a higher concentration of real estate assets for those that failed; the difference of 9% is hardly a firm basis from which to assert higher concentrations of real estate loans were a significant contributing factor to the credit union's failure such that it warrants higher capital levels for all complex credit unions. Similarly, the data for commercial loans (e.g., member business loans) does not support a concentration risk threshold of 50%.

Rather than determine how much capital could be at risk from higher concentrations of these asset classes and empirically setting the thresholds to match the point of increased risk to NCUSIF, it appears NCUA has set the concentration thresholds based on the current level of mortgage, equity and commercial loan exposures across the industry. This approach has no direct correlation to the risk of capital loss. For example; NCUA states it set the mortgage concentration threshold at roughly two standard deviations from the mean for credit union real estate holdings. In other words, NCUA examined the current level of real estate exposure across the industry and set the capital requirements such that roughly the top 10% of the industry will see their capital requirements increase. **We believe this methodology is unsupported by the evidence.** There is no empirical evidence to support that either a) two standard deviations is the right basis for determining this threshold, and more importantly, b) the resultant risk thresholds correlate directly to higher degrees of risk such that additional capital must be held by these institutions. Simply put, NCUA has failed to demonstrate that additional capital is necessary at a 35% level for mortgages, 20% for equity loans, or 50% for commercial loans. Our concern is further bolstered by the lack of comparability to Other Banking Agencies even though historical credit union losses have been comparable to, or lower than, those of banks. In other words, NCUA has failed to demonstrate why higher concentrations of these assets require more capital than banks require.

3. NCUA should not use risk weights to evaluate concentration risk

NCUA's approach is predicated on its position that it must consider all material risks when determining whether a credit union has sufficient capital. We must point out NCUA adopted the same rationale in its original proposal as the justification for including Interest Rate Risk in its risk weights, particularly for investment securities. We appreciate that NCUA listened to industry comments showing this approach was not an effective way to measure capital adequacy related to Interest Rate Risk. NCUA recognized there were several credit union specific aspects to understanding Interest Rate Risk that were ill-suited to a generalized risk-based capital framework. Instead, to fulfill its mandate to evaluate all material risks, NCUA correctly decided to address this risk either through enhanced examination and supervision, or, through additional regulations outside of the risk-based capital framework. Similar to Interest Rate Risk, the evaluation of concentration risk is better suited to the examination process and not amenable to a one-size-fits-all approach that relies on risk weights. This is why **<u>none</u> of the Other Banking Agencies have adopted concentration risk thresholds in their risk weights.**

Additionally, a good concentration risk framework **<u>must</u>** take into consideration the effects of diversification, even within a specific asset class. For example; geographic diversification can materially reduce the risk of holding certain asset classes like mortgages and equity loans[3]. Chart 1 shows the variability of real estate prices across the United States. Drastic changes in real estate prices were drivers of both the frequency and severity of losses during the Great Recession.

Home Price Change From July 2006 Through December 2014

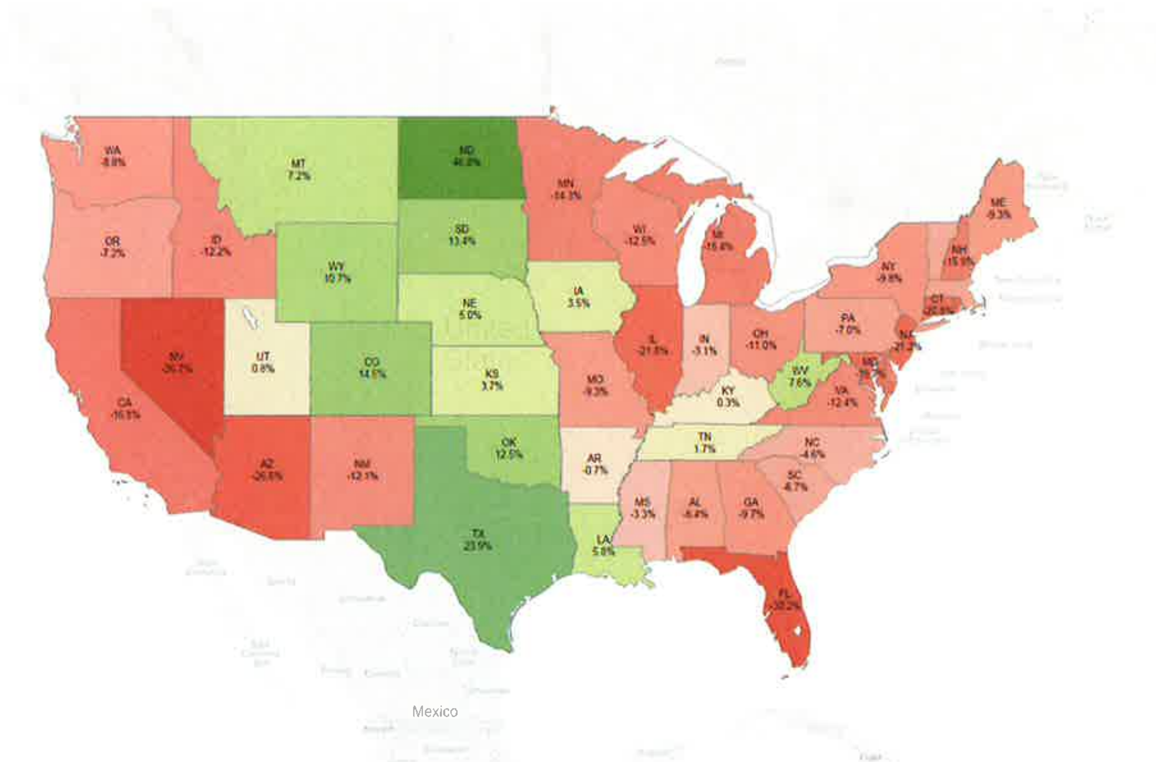

Chart 1

Cleary historical loss experience, and the resultant risk to capital, varied based on geographic concentration. More importantly, a diversified portfolio of loans would perform differently than a portfolio of loans concentrated in one state or region. NCUA's approach of including concentration risk thresholds in the risk weights is fundamentally flawed because it considers the relative size of the portfolio and not the benefit of diversification.

Consider a simple example where a credit union has 35% of its assets in mortgages in one geographic location. Through expansion efforts this credit union now originates mortgages in an area that has better loan performance. Although the percent of assets in mortgages on this credit union's balance

---

[3] We use geographic concentration as our example but other forms of concentration risk diversification include; product type, terms, credit risk profile, etc.

sheet will increase; this credit union is actually reducing its marginal risk, not increasing it as implied by the risk weights. NCUA's framework arbitrarily requires this credit union hold a higher level of capital simply because it has expanded its mortgage portfolio without regard to the true incremental risk of the additional assets. Admittedly, the credit union in our simple example could have easily expanded into a geographic area where losses were higher which would have increased its risk more than the corresponding increase in assets. This lack of correlation between asset size and capital at risk is precisely why comparable risk-based capital frameworks do not incorporate concentration risk into their risk weights and this is why the Other Banking Agencies rely on the exam process to assess risk associated with asset concentration. To be clear, we are not advocating that those credit unions who take on more concentration risk should not hold more capital; instead, we are saying the linkage between risk and capital requirements should be handled through the examination process similar to how NCUA has thoughtfully decided to address Interest Rate Risk.

Overfunded Pension Plan Assets

Following is an excerpt from our Original Comment Letter regarding the treatment of overfunded pension plan assets. It does not appear our comments were addressed by NCUA in the second proposal.

1. **Pension Plan Asset**

   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 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%

NCUA does not explicitly discuss how to treat the overfunded pension asset. NCUA's website *[data released as part of the original proposal]* 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 NCUA eliminate the inconsistent treatment by removing the overfunded pension asset from both the numerator and the denominator.