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2015 Capital Planning - Observed and Leading Practices

Office of National Examinations and Supervision

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# 2015 Capital Planning: Observed and Leading Practices

## Introduction

The National Credit Union Administration (NCUA) adopted a capital planning rule and issued companion guidance<sup>1</sup> to ensure that credit unions with assets greater than \$10 billion (i.e., covered credit unions) were evaluating their capital sufficiency on a prospective basis. This effort would promote financial stability during adverse economic periods and promote the health of both credit unions and the National Credit Union Share Insurance Fund (NCUSIF). NCUA's rule and guidance set forth the minimum requirements for meeting capital planning expectations. NCUA also believes that encouraging leading practices in capital planning will further strengthen covered credit unions and the NCUSIF.

This document summarizes the capital planning practices observed in the 2015 capital plans provided to NCUA, including leading practices. Examples of weaker, or lagging, practices are presented to provide context and better illustrate the gap between the leading practices and those that minimally meet requirements. Observations in this document are intended to make covered credit unions aware of these practices with some evaluative comments to assist them in the iterative process of enhancing their capital plans where appropriate. As 2015 was the inaugural year for capital planning for covered credit unions, the evolution of practices is likely such that today's observed leading practices may not be those practiced and observed in the future.

## Background

NCUA places a high level of importance on capital planning at its largest credit unions. Accordingly, credit unions with \$10 billion or more in assets as of their March 31 Call Report (of a given calendar year) are covered by NCUA Rules and Regulations Part 702 Subpart E – Capital Planning and Stress Testing<sup>2</sup> in the following calendar year. NCUA's rule covers both capital policy and planning, and requires NCUA to accept or reject the plans after a period of review. The rule explained that the purpose of capital planning is for each covered credit union to consider its own risk exposures and establish capital goals to support these risks, and develop a capital contingency plan. Analysis beyond the rule's mandatory elements could also be necessary to capture a particular credit union's products, lines of business and fields of membership.

During the implementation phase of the rule, NCUA's Office of National Examinations and Supervision (ONES) provided its guidance for developing and implementing capital plans that emphasized the purpose of capital is to allow a covered credit union to absorb losses and continue to lend to creditworthy members. The guidance underscored NCUA's three main principles of capital policy and planning which are 1) sound risk management fundamentals, 2) effective capital policy and governance, and 3) comprehensive capital planning and analysis. This paper will focus on practices observed and noted primarily in principles 2 and 3, recognizing that these practices contribute to sound risk management fundamentals.

<sup>1</sup> NCUA ONES Supervisory Letter "Capital Planning Under NCUA Rules & Regulations §702 Subpart E", SL No. 14-05, September 12, 2014. Herein referred to as "guidance".

<sup>2</sup> Herein referred to as the "rule."

## Effective Capital Policy and Governance

ONES staff communicated to covered credit unions that NCUA's 2015 review would focus primarily on the governance element of the capital planning process. It is essential for covered credit unions to have strong board oversight and senior management participation in the capital planning process. The credit union's board of directors must be able to provide effective, credible challenge to the credit union's capital plan in order to establish a comprehensive capital planning process that is consistent with the credit union's business objectives and risk management processes. The board should therefore have sufficient information on the credit union's risk management practices, capital goals and target, appropriateness of stress scenarios and loss estimation methods, as well as any inherent uncertainties of analysis. The board should also approve any contingency capital actions.

### General Range of Practice

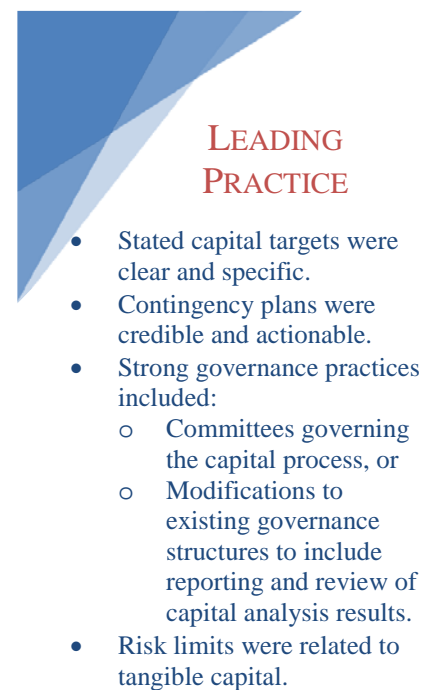
Credit unions with stronger capital policy practices formulated distinct policies that addressed the key elements of the credit union's capital planning process, and defined the roles and responsibilities for capital governance decisions. Stated capital targets were clear and specific. Contingency actions were credible and actionable. Credit unions with stronger governance practices had either established committees to govern the capital planning process or had clearly modified existing governance arrangements to incorporate new processes for the reporting and review of capital analysis results.

### Capital Policy Elements

#### *Goals and Limits*

Covered credit unions established various goals and limits in their capital plans. These limits were generally expressed in terms either of economic value or net worth under baseline and/or stressed conditions. Some credit unions expressed limits in terms of stress test capital as defined by the rule. Net worth minimum limits were at the Prompt Corrective Action (PCA) regulatory well-capitalized level of 7 percent or higher, while goals were set at higher levels. Net economic value (NEV) limits included baseline limits as well as under shocks, and limits on NEV volatility. NCUA considers relating risk limits to tangible capital to be a leading practice, though there is merit to further dimension capital limits in terms of net economic value, and PCA net worth.

In some cases risk limits were expressed in a graduated way to denote the corresponding level of concern and actions that would occur as risk elevated. Weaker practices in this area included establishing limits based primarily on regulatory capital minimums or without consideration of the credit union's capital needs as implied by its risk profile, business strategy, or sensitivity to changing market conditions.



**LEADING PRACTICE**

- Stated capital targets were clear and specific.
- Contingency plans were credible and actionable.
- Strong governance practices included:
  - Committees governing the capital process, or
  - Modifications to existing governance structures to include reporting and review of capital analysis results.
- Risk limits were related to tangible capital.

## Capital Analysis Roles

Credit unions generally addressed governance of capital analysis without differentiating this from the governance of capital planning in general. Roles of capital analysis were observed to fall under designated committees or other board directives governing the capital planning process. As a result, weakness was observed in identifying the roles and responsibilities for capital analysis. It would be a stronger practice to identify the governance and controls specific to capital analysis. In some cases this was mirrored by weaker separation of risk-taking and risk oversight functions. Capital analysis, and its corresponding governance, will be a matter of supervisory attention, and subject to increased attention in the 2016 capital plan reviews.

**2016 Focus Item – Capital Analysis Roles:** Capital analysis and governance will receive increased attention in 2016.

## Internal Audit and Capital Planning Controls

The development of internal audit reviews of the capital planning processes were a frequently identified gap at the covered credit unions. NCUA understands that this is an exercise which can take considerable time, and that it was appropriate to delay comprehensive audits until after the initial construction of the capital planning process. Credit unions are expected to complete audits prior to submission of the 2016 capital plans. Commentary in the 2015 plans indicated that the credit unions understood the importance of sound and rigorous internal controls which should cover independent model review, as well as review all of the elements of the capital

**2016 Focus Item – Internal Audit & Capital Planning Controls:** Adequacy of internal audit and capital planning controls.

planning process. However, some policies were not as specific as described by NCUA's rule in identifying internal controls governing capital planning, including audit review, controls of changes in capital planning procedures, and required documentation. NCUA will focus on the adequacy of internal audit and capital planning controls when reviewing 2016 capital plans.

## Governance of Capital Planning

### Effective Challenge of Risk Taking Functions

Effective challenge to risk taking and of the credit union's assessment of these risks are key aspects of capital planning. ONES will continue to emphasize this in 2016 and beyond. This challenge should occur both at the board level, as an oversight function, and at the management level in executing board directives, and the decisions made should be documented along with information used to make and support them. Strong practices occurred when boards were active in the process of making these decisions. Credit unions with weaker practices had board minutes that were brief or in some cases did not

**2016 Focus – Effective Challenge of Risk Taking:** Board and management challenge to risk taking and the credit union's assessments of these risks.

contain discussion of important decisions. In 2016, NCUA will further evaluate the level of board engagement in the capital

### LEADING PRACTICE

Boards actively exercising their oversight function and documenting decisions made along with the information used to make and support the decisions.

planning process as well as the development of management processes that promote the ability to question prevailing assumptions.

### *Board, Committee, Management, & Staff Responsibilities*

Each credit union established its own structure for governing its capital planning process. Credit unions with stronger practices facilitated their boards' understanding of institutional activities and resulting risk exposures. They sought to raise the board's level of expertise and engagement through presentations throughout the plan development process to orient board members and so facilitate the transfer of knowledge. This is essential to provide the means for effective challenge by the board. Some credit unions demonstrated clear commitment by forming specific management committees to support capital planning and testing for unfavorable circumstances which reported through to the board. Others with stronger practices reorganized existing roles and responsibilities to incorporate capital planning needs into the oversight structure.



### LEADING PRACTICE

Credit unions:

- Facilitated their board's understanding of institutional activities and risk exposures.
- Sought to raise board expertise and engagement in capital planning.

### *Risk Control*

Covered credit unions provided capital and risk analyses to NCUA to support their capital plans in accordance with the elements required by NCUA's final rule. These plans were accompanied by board resolutions approving the plans and, usually, the capital policies approved by the board. It was not, however, clear that all of the boards were well versed in the key assumptions and significance of the analytical results. While gaining this level of understanding may be an evolutionary process, it is important for boards to be able to assess the strength of its capital planning analyses and the credibility of results. ONES will continue to focus on the need to fully inform board members of the significance and implications of sound capital planning. Weaknesses in the planning process and inherent uncertainties in outcomes should be openly communicated in order to encourage awareness and timely remediation where appropriate.

**2016 Focus – Risk Control:**

Credit union board knowledge of the significance and implications of sound capital planning.

General risk management principles demand separation of duties. This separation is important at two levels. The risk taking function should be distinct from the risk oversight function of identifying, measuring, monitoring and controlling the risks to a credit union's capital. This may require elevating the role and resources of a Chief Risk Officer to effectively perform this function. Moreover, the risk oversight function is distinct from the production functions of the credit unions' lines of business. Covered credit unions indicated in their 2015 capital plans that the separation of risk oversight duties would be accomplished, in large part, by committees designated to oversee various risks. For example, some credit unions indicated they had formed Capital Planning and Stress Testing committees and identified Asset Liability Committees, Enterprise Risk Management Committees, and Credit Risk Committees as fulfilling this role. In some cases, credit unions indicated the role was fulfilled at management levels.

However, the separation of roles and responsibilities goes deeper than the establishing of committees and needs to be carried throughout the entire capital planning process to facilitate effective challenge across functional lines. In 2016, ONES will be considering the most useful ways that risk taking, risk assessment, and risk oversight can be separated and differentiated while still meeting the credit unions' business needs and enabling effective oversight of risk to capital by the credit union's board.

**2016 Focus – Risk Control:**  
Effective risk oversight;  
separating and differentiating  
between risk taking, risk  
assessment, and risk oversight  
functions.

## Comprehensive Capital Planning and Analysis

Covered credit unions should formulate a process for capital planning and analysis which reflects macro-economic and financial conditions relevant to their key vulnerabilities and risks. This should be based on factors such as the credit union's business model, asset and liability mix, funding sources, and member composition. Credit union management should be able to generate credible estimates under sufficiently unfavorable conditions while understanding the uncertainties of the analysis. The credit union should be aware of the sensitivity of the estimates to changes in inputs and assumptions and the estimation process should be transparent and repeatable. Conservative assumptions should be used to display the resilience of the credit union to unfavorable scenarios, while separating the impact of these scenarios from management actions taken to mitigate the outcomes. The credit union should seek credible sources of stress when performing reverse stress test and the interrelationship of interest rate and credit risk, since the purpose of these is to better inform the board and senior management of realistic sources of risk which the credit union confronts.

### General Ranges of Practice

Credit unions with strong planning and analysis practices used realistic loss methodologies that clearly distinguished the impact of unfavorable scenarios from management actions taken to mitigate the effects. Weaker practices failed in this. Credit unions should seek to enhance loss estimation techniques and avoid management overlays of scenario results. Strong analysis was characterized by scenarios tailored to the credit union's own idiosyncratic risk exposure, rather than relying on the stress test scenarios provided by NCUA. Strong application of sensitivity and reverse stress tests analysis depicted the key drivers of credit union risk exposure and the impact to capital of changes in these drivers, and avoided relying on formulaic or simple additive risk calculations. Credit unions with weaker practices relied on simplistic or limited sensitivity and reverse stress tests. The



### LEADING PRACTICE

Strong planning and analysis:

- Used realistic loss methodologies and distinguished the impact of unfavorable scenarios from management actions needed to mitigate the effects of the scenario.
- Used scenarios tailored to the credit unions own idiosyncratic risk exposure rather than relying on supplied stress test scenarios.
- Sensitivity and reverse stress test analysis depicted key drivers of credit union risk exposure and the impacting change to capital as a result of the drivers.



**2016 Focus – Comprehensive Capital Planning and Analysis:** Enhancement of credit union sensitivity analysis and reverse stress testing.

importance of sensitivity analysis and reverse stress testing should not be underestimated. NCUA will expect enhancement in 2016 of sensitivity and reverse stress testing methods used. These are tools by which credit unions can uncover key sources of risk and credit union vulnerability.

## Scenario Design

Credit unions utilized a number of different approaches in their scenario design, though all the covered credit unions incorporated scenarios constructed by the Federal Reserve to some extent. Most credit unions designed idiosyncratic threats relevant to their own business model and risk exposures to evaluate risk to capital, such as incorporating regional economic performance or localized statistics into scenarios. NCUA deems limiting analysis to scenarios presented by the Federal Reserve as a weaker practice. Capital planning is a real-time assessment of the potential impact of conditions that may be sufficiently unfavorable to threaten the credit union's capital reserve against unexpected losses.

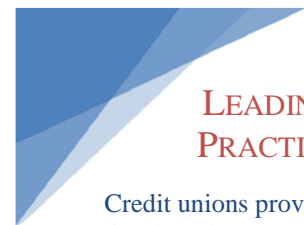
Rates of asset growth were generally incorporated in scenario analysis, with these levels declining in severely unfavorable projections. However, some credit unions failed to support growth rates and balance sheet compositions based on scenarios. Growth assumptions should be substantiated by narrative of business purposes and strategies. Any resulting changes in credit quality or asset/liability mix should be projected and supported by similar explanations.

## Risk Analysis

### *Credit Risk*

Each credit union employed a distinct approach to modeling credit risk, from the more simplistic approach of relying on historical losses on a time series basis to the more rigorous forward-looking approach of projecting probabilities of default and losses given default. Some tied loss forecasts to changes in other variables such as FICO scores, unemployment, and home price appreciation. As the Federal Reserve Board's own indicators described, the pressure on credit performance was greatest in the severely unfavorable scenarios.

The attribution of losses by line of business was described with various degrees of granularity. A key purpose of analyzing future credit performance is to anticipate potential changes and, in particular, deteriorations in credit quality. The dynamics can be complex and, as amply shown by recent history, can accelerate significantly under unfavorable conditions. Leading practice was to provide well-developed reasons for any credit performance attributions. NCUA will explore credit analysis performed by covered credit unions in greater detail in 2016.



### LEADING PRACTICE

Credit unions provided well-developed reasons for credit performance attributes.

**2016 Focus – Credit Risk Analysis:** Documentation and analysis of credit risk performed by credit unions.



## Interest Rate Risk

All the covered credit unions relied on scenarios based on the Federal Reserve's Treasury curves, or their own idiosyncratic Treasury curves to price asset and liabilities. Approaches to pricing spreads varied and was often not possible to discern. In some cases meaningful changes in

**2016 Focus – Interest Rate Risk:** Increased transparency through well documented support, beyond statistical correlation that also contains credible narrative.

spreads were not made explicit in either loan or deposit lines of business. This is an area in which credit unions are encouraged to provide well-documented support which goes beyond statistical correlation and has credible narrative. Changes in spreads directly affect pre-provision net revenue and should be made transparent to reviewers of scenario-based capital analysis.

## Interconnected Risk

Overall, credit unions used scenarios developed for credit and interest rate risks and combined these scenarios in additive ways to depict the interconnection of the risks. One credit union sought to use the Federal Reserve's severely adverse scenario to depict interest rate exposure to falling rates. In some cases manipulations of scenarios were used in conjunction with additional idiosyncratic projections of credit performance and interest rate behavior. In general, however, the reasons justifying these interconnections were not made explicit. Credit union capital analysis provided to NCUA did not contain documentation or dialogue on the relationship of interconnected risks under stress scenarios. NCUA will expect improvement in the narratives provided in 2016.

**2016 Focus – Interconnected Risk:** Capital analysis that explains and documents the relationship of interconnected risk under stress scenarios.

## Sensitivity Analysis

The techniques used by credit unions to assess sensitivity of variables in their analysis varied considerably. Some credit unions sought to focus on key variables, and increased these in structured ways focusing separately on credit risk variables and interest rate risk variables. In the case of credit risk, changes in gross charge-off losses and recoveries were adjusted directly, or were attributed based on macro-economic variables such as unemployment or the home price index. Interest rate risk variables were either attributed directly in terms of increased deposit rate sensitivity, or were attributed to shifts in deposit mix. Some credit unions analyzed the impact of sensitivity from changes in multiple variables. These included growth assumptions, changes in probabilities of default, yield curve changes, interest rate shocks, and changes in asset maturities or prepayments. NCUA recognizes that many different factors may affect each credit union's results, and encourages credit unions to assess, identify, and prioritize the set of variables to which credit union performance is most sensitive and capital may be most at risk. This leading practice is a natural step to performing reverse stress tests that usefully inform credit unions of their vulnerabilities and risks.

### LEADING PRACTICE

Assessing, identifying, and prioritizing the set of variables to which credit union performance is most sensitive and capital may be most at risk.

## Reverse Stress Testing

The purpose of reverse stress testing is to alert credit unions to the more unfavorable potential outcomes of their business models; it is not meant to be a mechanical practice. A majority of the credit unions appeared to approach reverse stress testing as mathematical exercise utilizing

increases in various adverse variables and then solving for a residual by means of manipulating a final variable. The first variables included high unemployment, low growth, and high repricing sensitivities. The variable most often solved for was an increase in net charge offs, which was typically found to be of an order that the credit unions stated was highly unlikely.



### LEADING PRACTICE

Credit unions posited an adverse unlikely event. The narrative described the event(s) and attributed consequences to construct the reverse stress test scenarios.

Credit unions with stronger practices, which were more in line with the intent of reverse stress testing, posited an adverse unlikely event with appropriate narrative and attributed consequences, such as significant deposit swings, to construct their reverse stress test scenarios. Credit unions should consider combinations of risks to which they are vulnerable, as well as assessing the impact of macro-variables on the tail risks of their exposures.

## Capital Contingency Plans

The range of contingency plans proposed by credit unions to deal with shortfalls in their capital was unexpectedly wide. It should be noted that contingency plans are integral to credit union capital plans which need to show not only that a credit union has considered stress events but has moreover considered actions it will take when capital comes under pressure. Unlike business plans, capital plans must consider that severely unfavorable events may occur and erode capital in such a way as to materially threaten credit union viability. As a leading practice, NCUA observed a contingency plan that provided an extensive series of actions to be considered, providing context of feasibility, timing and impact to capital of each action, and these actions were tied to triggers rendered in policy. Rigorous consideration of capital contingency plans is critical to sound capital planning.



### LEADING PRACTICE

Capital contingency plan provided a series of actions to be considered, provided context of feasibility, timing and impact to capital for each action, and actions were tied to triggers contained in policy.

## Conclusion

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NCUA sees capital planning as a prudent practice for covered credit unions. The evaluation of capital at risk is a rigorous and substantive expectation. Through the rule and the companion guidance, NCUA set increased expectations for covered credit unions to elevate the assessment of capital risk to an enterprise-wide level. As they gain more experience with the application of contemporary capital planning practices, NCUA will continue to communicate with credit unions to promote the evolution of the capital planning process.