Chapter 16
NET WORTH AND OTHER EQUITY ACCOUNTS

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Chapter 16

NET WORTH AND OTHER EQUITY ACCOUNTS

Examination Objectives

- Determine whether the credit union complies with Regulation D, if applicable
- Ascertain compliance with the Credit Union Membership Access Act (CUMAA)
- Determine whether the credit union has sufficient net worth for its degree of risk
- Determine whether the credit union has adequate policies, practices, and procedures regarding net worth and capital accounts
- Determine if officials and employees adhere to established policies, practices, and procedures regarding net worth and capital accounts
- Determine whether reserve accounts are audited periodically
- Determine whether reserve accounts comply with the CUMAA, FCU Act, NCUA Rules and Regulations, and appropriate accounting guidance
- Determine if the credit union promptly corrects deficiencies or violations noted during examinations or audits

Associated Risks

- Credit risk can result from poor underwriting of loans or high-risk investments;
- Interest rate risk can result from insufficient net interest margin to cover operating expenses;
- Liquidity risk can result from inadequate pricing policies, and failure to properly structure share and loan products resulting in weak or negative profitability;
- Strategic risk can result from failure of management to plan for sufficient resources to fulfill business plans or continue offering competitive products and services;
- Transaction risk can result from failure to establish and implement policies and procedures that ensure the accuracy and integrity of data and information;
- Compliance can result when credit unions fail to comply with applicable laws and regulations; and
Overview

Reputation risk can result from loss of member confidence and withdrawal of member shares due to questions regarding the credit union’s on-going viability.

The adequacy of the credit union’s reserves should correlate to the amount of risk it has taken or plans to take.

Two types of reserves apply to credit unions: cash reserves and equity reserves. Cash reserves include transaction account reserves required by Regulation D. Credit unions hold cash reserves in the following forms:

- Vault cash;
- A balance maintained directly with the Federal Reserve Bank (FRB) in the District in which the credit union is located; or
- A pass-through account, which is considered a balance maintained with the FRB.

Cash reserves usually do not apply to smaller credit unions; however, equity reserves apply to all credit unions. Credit unions establish equity reserves (also called capital) by segregating part of their net income into reserve and undivided earnings accounts. Equity reserves may be either appropriated or unappropriated.

A credit union’s capital is defined as the total of its regular reserves, allowance for loan and lease losses, special reserves, undivided earnings, accumulated unrealized gains or losses on available-for-sale (AFS) securities, and that portion of year-to-date net income that has not yet been closed to the appropriate capital account. Capital accounts provide (1) a cushion for anticipated and unidentified losses, (2) a base for future growth, and (3) a means by which the credit union can meet competitive pressures as they arise. Capital provides the credit union a cost-free source of funds.

Net worth is defined as the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles (GAAP). See the FCU Act §216(d)(o)(2). Retained earnings consist of undivided earnings, regular reserves, and any other appropriations designated by management or
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regulatory authorities. Net worth does not include the Allowance for Loan and Lease Losses account. This means that net worth only includes undivided earnings and appropriations of undivided earnings. (Refer to the Prompt Corrective Action chapter of this Guide for additional information.)

A strong net worth position enables a credit union to take on more risk than can a credit union with a weak net worth position. A stronger overall net worth position better enables a credit union to deal with future uncertainties such as asset losses, sponsor layoffs, and adverse economic cycles.

The credit union board should have a plan for defining and maintaining an adequate net worth level. The examiner should review the net worth position and the officials’ philosophy toward building and maintaining net worth. If the net worth position does not meet the credit union’s short- or long-term needs, the examiner should determine if the shortfall poses a threat to safety and soundness.

Examiners may find the following ratios useful in reviewing capital and net worth:

- Net Worth to Assets;
- Net Worth Growth vs. Asset Growth (trend);
- Capital to Assets;
- Net Capital to Assets;
- Capital Growth to Asset Growth;
- Net Worth to Loans;
- Classified Assets to Net Worth;
- Total Delinquent Loans to Net Worth; and
- Solvency Evaluation.

When analyzing the adequacy of reserves and net worth, examiners should consider the following factors:

- Size of the credit union;
- Complexity of products and services;
- Degree of sponsor support;
- Level of management’s expertise;
• Quality of management’s due diligence for existing and new products, services and systems;
• Involvement of the officials;
• Interest rate risk;
• Internal control structure;
• Stability and diversity of the field of membership; and
• Concentrations of credit and savings.

Examiners should also consider the amount of coverage provided by the credit union’s surety bond. §713.5(a) of the NCUA Rules and Regulations defines the minimum coverage required. Some of the newer bond forms provide significantly less coverage than the standard bond. Examiners should ensure the credit union maintains adequate bond coverage. See the Bond Coverage chapter of this Guide for additional guidance.

Secondary Capital for Community Development Credit Unions

Federally insured credit unions designated as low-income may establish secondary capital accounts, which examiners should review for compliance with §701.34(b) of the NCUA Rules and Regulations. Before offering secondary capital accounts, the credit union must adopt, and forward to the appropriate regional director, a written plan for use of the secondary capital account funds and subsequent liquidity needs to meet repayment requirements upon maturity of the accounts.

The following restrictions apply to these secondary capital accounts:

• Establishment as an uninsured secondary capital account or other form of non-share account;

• Minimum five years maturity;

• Not redeemable before maturity;

• Not insured by the National Credit Union Share Insurance Fund (NCUSIF) or any governmental or private entity;
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- Holder’s claim against the credit union is subordinate to all other claims, including those of shareholders, creditors, and the NCUSIF;

- Required availability of funds deposited, including interest accrued and paid into the secondary capital account, to cover credit union’s operating losses that exceed net available reserves and undivided earnings (i.e., exclusive of allowance accounts for loan and lease losses.) Credit unions may not replenish the account for funds so used. Credit unions may pay interest accrued on the secondary capital account directly to the investor or into a separate account available to the investor for withdrawals. Pro-rata distribution of realized losses among all secondary capital accounts held by the credit union is required;

- May not pledge as security on a loan or other obligation with the credit union or any other party;

- Account funds not needed for covering losses at the time of merger (other than merger into another low-income designated credit union) or voluntary dissolution will be closed and paid out to the account holder;

- Contract containing terms and conditions required between representative of the account holder and the credit union; and

- Disclosure and acknowledgment signed by representative of account holder is required and the account holder will receive copies of contract and disclosure at the time of entering into the account agreement (see the Appendix to §701.34 of the NCUA Rules and Regulations.) Credit unions must retain original copies of the contract and the disclosure and acknowledgment for the term of the agreement.

The regulation establishes a declining scale for the capital value of accounts with less than five years remaining maturity. Even so, all funds will continue to be at risk to cover losses that exceed reserves and undivided earnings. The declining scale addresses accounts with remaining maturities of at least the following:
- Four years, but less than five years - counted as capital at 80 percent of face value;
- Three years, but less than four years - counted as capital at 60 percent of face value;
- Two years, but less than three years - counted as capital at 40 percent of face value;
- One year, but less than two years - counted as capital at 20 percent of face value; and
- Less than one year remaining maturity - counted as capital at 0 percent of face value.

Examiners should review the disclosure and acknowledgment that the account holder’s authorized representative must provide and execute. (See disclosure in the Appendix to §701.34 of the NCUA Rules and Regulations.)

**GAAP vs. RAP**

GAAP classifies secondary capital accounts as subordinated debt. As such, the account holder does not have voting or ownership rights. However, NCUA adopted a regulatory accounting position (RAP) that recognizes secondary capital accounts for low-income designated credit unions as capital accounts. This RAP position applies to all credit unions having a low-income designation, including those with assets equal to or greater than ten million. Examiners should understand that the credit union’s outside auditor may recognize these accounts as subordinated debt, and reflect the entire balance in these accounts in the liability section of the balance sheet consistent with GAAP for financial statement presentation.

Examiners should record secondary capital as “Other Revocable Reserves” in the equity section of the balance sheet to ensure their inclusion in capital when AIRES calculates CAMEL component and composite ratings. For secondary capital accounts having a remaining maturity of less than 5 years, AIRES requires examiners to split them into capital (Other Revocable Reserves) and non-capital (Other Liabilities) components based on the sliding scale (see the NCUA Rules and Regulations §701.34(c)).

The credit union records secondary capital accounts that have capital value (based on the sliding scale) as “Secondary Capital -
Uninsured”. Credit unions must transfer the portion of secondary capital accounts not considered capital to “Subordinated CDCU Debt” (The Accounting Manual for Federal Credit Unions contains more information on this subject.)

When reviewing call reports of low-income designated credit unions that have secondary capital accounts, examiners should ensure proper recording of these accounts. Credit unions should not use the Uninsured Secondary Capital line on the call report for reporting any other type of capital.

Other Considerations

A low-income credit union must include secondary capital accounts in its total borrowing amount. The FCU Act §107(9) limits credit union borrowing to 50 percent of paid-in and unimpaired capital and surplus.

Part 705 of the NCUA Rules and Regulations addresses the Community Development Revolving Loan Program for Credit Unions (the Program). A participating credit union may receive up to $300,000 in the form of a loan, which the credit union must match by increasing its shares by a like amount (see the Low-Income Credit Union chapter of this Guide for more information about the Program). The regulation’s matching requirement encourages credit unions to develop a permanent source of member shares as rapidly as possible.

Since secondary capital accounts are not member share accounts, low-income designated credit unions may not use secondary capital accounts as matching funds for purposes of the Program. Additionally, the limitations on public unit and nonmember accounts described in §701.32(b) do not apply to secondary capital accounts.

Capital and Solvency Evaluation

When reviewing reserve accounts, the examiner should consider capital adequacy, net worth, trends, materiality, unusual activity, and thoroughness of the audit work. In addition, the level of capital in relation to the perceived level of risk will determine the degree of review.
Undivided Earnings

The examiner should determine that the credit union appropriately accounts for its undivided earnings account. It should pay particular attention to the positive and negative growth trends of this account. A decreasing trend may trigger a detailed review to determine the cause.

When analyzing the adequacy of the undivided earnings account, the examiner should consider the following:

- Current and anticipated earnings capacity of the credit union;
- Quality of the loan and investment portfolios (overall assessment); and
- Unanticipated events, such as adverse economic conditions causing plant closings, layoffs, etc.

Credit unions cannot pay dividends, without the prior approval of the regional director if the payment results in a deficit in the undivided earnings account. Credit unions experiencing a deficit, or those in which paying a dividend would result in a deficit, must request and receive approval for 208 Assistance before paying dividends.

If a credit union has a deficit balance in the undivided earnings account at the time of the examination, the examiner should determine if it paid a dividend during the last accounting period. If it did pay a dividend, the dividend was material, and the examiner believes there was obvious intent on the part of the officials to pay an illegal dividend, then the examiner should consider initiating an administrative action against the responsible parties. The examiner should not recommend that the officials recall the dividend because neither the officials nor the NCUA Board has that authority. If the shareholders received the illegal dividend in good faith and without knowledge of the credit union’s financial condition, they have no legal obligation to refund the dividend.

However, the examiner should reach an agreement with the officials that a dividend declared at the end of the next accounting period will not exceed available earnings after elimination of the deficit. Examiners should treat an illegal dividend as an area of concern.
Regular Reserve

The regular reserve is a statutory reserve account. When analyzing the adequacy of this account’s balance, the examiner should consider the credit union’s compliance with statutory reserving requirements, including net worth restoration plans. Refer to §702.201 of the NCUA Rules and Regulations for guidance on transfers into this account.

Accumulated Unrealized Gains/Losses on Available for Sale Securities

This account records unrealized gains and losses on available for sale securities. When credit unions write available for sale securities to fair value, they make an entry directly to the investment account with the corresponding debit or credit to the accumulated unrealized gain and losses on the available for sale securities account. The credit union nets this account against undivided earnings when assessing a credit union’s ability to pay dividends.

Workpapers and References

- Workpapers
  - Regular Reserves
  - Undivided Earnings
  - Accumulated Unrealized Gain/Loss on Investments
  - Special Reserves
  - Other Reserves
  - Contingency
  - Appropriated Undivided Earnings
  - Critical Solvency
- References
  - Federal Credit Union Act
    107(9) – Borrowing Limitation
    216 – Prompt Corrective Action
  - NCUA Rules and Regulations
    701.32 – Payment on Shares by Public Units and Nonmembers
    701.34 (Appendix) – Disclosures and

Acknowledgment

702 – Prompt Corrective Action
702.2(f) – Definition of Net Worth
702.34(b) – Receipt of Secondary Capital Accounts by Low-Income Designated Credit Unions
702.401 – Reserves
705.7 – Loans to Participating Credit Unions
713 – Fidelity Bond and Insurance Coverage for Federal Credit Unions
- NCUA Letter to Credit Unions #182, dated November 1995
- NCUA Instruction No. 4020
- NCUA Accounting Bulletin 95-1