

PAUL HASTINGS

December 30, 2014

Board of Directors
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Dear Board Members:

We have acted as counsel to the Board of the National Credit Union Administration (hereinafter, "NCUA Board"), in connection with delivering this opinion letter regarding the legal authority of the National Credit Union Administration (hereinafter, the "NCUA") to implement the proposed rule (79 Fed. Reg. 11184 (Feb. 27, 2014), hereinafter, "Proposed Rule") which would amend Part 702 of the NCUA's regulations regarding prompt corrective action (hereinafter, "PCA") to, among other things, establish a two-tier risk-based net worth (hereinafter, "RBNW")¹ requirement for complex² credit unions, a copy of which is provided as Exhibit A.

You have requested our opinion as to the legal authority of the NCUA to establish a separate RBNW requirement for each of "adequately capitalized" and "well capitalized"³ credit unions that are deemed "complex."

In connection with this opinion letter, we have examined the Proposed Rule. In addition, we have reviewed the NCUA's statutory authority to implement the Proposed Rule as provided in Section 216 of the Federal Credit Union Act (hereinafter, "FCUA") as added by Section 301 of the Credit Union Membership Access Act (hereinafter, "CUMAA"), as well as the legislative history of the CUMAA, the NCUA's prior implementations and interpretations of Section 216, and other background information provided to us by the NCUA.

This opinion letter is based upon our analysis of the foregoing, pursuant to well established precedent under *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984), which establishes the standard of review for a court reviewing a challenge to a governmental agency's construction of a statute, including in connection with an implementing regulation. Under the so-called *Chevron* standard, in reviewing a federal agency's authority to take certain actions to implement a statute or in connection with a challenge to an agency's efforts to implement a statute, a court must apply a two-prong test. First, the court must determine whether Congress has "directly spoken to the precise question at issue." *Id.* at 842. If Congress's intent is clear in addressing the question at issue, the court must "give effect to the unambiguously expressed intent of Congress." *Id.* at 842-843. If, however, there is ambiguity regarding congressional intent based on the precise meaning of the statutory language, then the court must

¹ We understand that the NCUA has proposed to revise the term "risk-based net worth" to "risk-based capital" to "better describe the equity and assets the requirement would measure" and because "risk-based capital" is the term "more commonly used in the financial services industry." See 79 Fed. Reg. at 11185, 11191. However, this opinion letter uses the term "risk-based net worth" and the abbreviation "RBNW" consistent with the NCUA's current rule and the applicable statutes so as to avoid confusion.

² Section 216(d) of the Federal Credit Union Act requires the NCUA to develop a RBNW requirement for "complex" credit unions, "as defined by the Board based on the portfolios of assets and liabilities of credit unions." Thus, the "risk-based net worth requirement" at issue can only apply to "complex" credit unions. The NCUA currently defines "complex" credit unions as a credit union that meets both of the following requirements: (1) Minimum assets size. Its quarter-end total assets exceed fifty million dollars (\$50,000,000); and (2) Minimum RBNW calculation. Its risk-based net worth requirement as calculated under the standard calculation [12 C.F.R. § 702.106] exceeds six percent (6%). See 12 C.F.R. § 702.103.

³ "Adequately capitalized" and "well capitalized" are defined terms pursuant to Section 216(c) of the FCUA, as defined *infra* page 2-3.

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determine whether the agency's position is based on a permissible construction of the statute. *See id.* at 843. In this regard, an agency's interpretation will generally be deemed permissible and "given controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

With respect to this opinion letter, we note that the question raised herein ordinarily would be determined only through a litigated proceeding, and that the outcome of any proceeding before a United States court having jurisdiction over the NCUA, including, but not limited to, any federal district court or appellate court, cannot be predicted with certainty and depends upon the legal arguments, facts and circumstances as they would be presented, admitted and developed in such proceeding.⁴

1. RELEVANT FACTS, ASSUMPTIONS AND LIMITATIONS

a. General Assumptions

As to matters of fact, we have examined and relied exclusively, without independent investigation, upon the statements, and representations of the NCUA Board, its officials and representatives. We have assumed that the Proposed Rule's two-tier RBNW requirement is in substantially the form attached hereto as Exhibit A, that its issuance complied with the NCUA's rulemaking and public comment procedure requirements and that the NCUA will timely perform and satisfy in all respects all of its obligations with respect to implementing a new federal regulation. This opinion letter is based on the assumption that the facts set forth herein and which we have assumed, without investigation, to be true and correct, are, and except as set forth herein, will continue to be, accurate.

We express no opinion as to the law of any jurisdiction other than that of the federal courts. Furthermore, this opinion letter is being furnished to you solely for your benefit in connection with the implementation of the Proposed Rule and is not to be used, circulated, quoted, relied upon or otherwise referred to for any other purpose or by any other person without our prior express written consent, except as otherwise provided herein.

b. Summary of the Proposed Two-Tier RBNW Requirement

Currently, "well capitalized" and "adequately capitalized" credit unions that are deemed "complex" are required to meet a RBNW requirement.⁵ Under the current PCA system implemented by the NCUA, a credit union's RBNW requirement is calculated based on each credit union's aggregate risk-weighted amounts of certain types of assets. *See* 12 C.F.R. § 702.106. Thus, an individual credit union's RBNW requirement is unique to the institution and remains constant for the institution regardless of whether the institution seeks to qualify as an "adequately capitalized" or "well capitalized" credit union. *See* 12 C.F.R. Part 702.

Under the Proposed Rule, the NCUA proposes a separate RBNW requirement for each of the "well capitalized" and "adequately capitalized" categories. As explained by the NCUA, "Section 216(c) of the FCUA requires that a credit union that meets the definition of "complex,"⁶ and whose net worth ratio initially places it in either of the "adequately capitalized" or "well capitalized" net worth categories, also must satisfy a separate RBNW requirement. Under this separate RBNW requirement, the complex credit union must meet or exceed the minimum RBNW ratio corresponding to its net worth category

⁴ 12 U.S.C. § 1789(a)(2) grants U.S. district courts original jurisdiction over suits brought against the NCUA.

⁵ *See* 12 U.S.C. § 1790d(c) & (d); 12 C.F.R. § 702.102.

⁶ *See supra* n. 2.

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("adequately capitalized" or "well capitalized") in order to remain classified in that category." Proposed Rule, 79 Fed. Reg. at 11186.

With respect to the "well capitalized" and "adequately capitalized" categories, Section 216(c) provides:

(A) WELL CAPITALIZED – An insured credit union is "well capitalized" if – (i) it has a net worth ratio of not less than 7 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).

(B) ADEQUATELY CAPITALIZED – An insured credit union is "adequately capitalized" if – (i) it has a net worth ratio of not less than 6 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).

Section 216(d) sets forth the RBNW requirement for complex credit unions as follows:

(1) IN GENERAL – The regulations required under subsection (b)(1) shall include a risk-based net worth requirement for insured credit unions that are complex as defined by the Board based on the portfolios of assets and liabilities of credit unions.

(2) STANDARD – The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.

Notably, Section 216(b) of the FCUA requires the NCUA Board to "by regulation, prescribe a system of prompt corrective action for insured credit unions that is – (i) consistent with this section [216 – Prompt Corrective Action]; and (ii) comparable to" section 38 of the Federal Deposit Insurance Act. In this regard, the legislative history provides that "comparable" means "parallel in substance (though not necessarily identical in detail) and equivalent in rigor." See S. Rep. No. 193, 105th Cong. 2d Sess. 13, p. 12.

Finally, as noted by NCUA in its July 2000 implementation of 12 C.F.R. Part 702 with respect to the purpose and rationale for the RBNW requirement specific to complex credit unions:

CUMAA requires NCUA to develop a definition of a "complex" credit union based on the risk level of a credit union's portfolio of assets and liabilities, [12 U.S.C.] § 1790d(d)(1), and to formulate a [RBNW] requirement to apply to credit unions meeting that definition. The RBNW requirement must "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized [6 percent] may not provide adequate protection." [12 U.S.C.] § 1790d(d)(2). NCUA was encouraged 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." S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).

These specifications reflect the Department of the Treasury's recommendation to Congress to require NCUA to develop a supplemental RBNW requirement "for larger, more complex credit unions * * * to take account of risks * * * that may exist only for a small subset of credit unions." U.S. Dept. of Treasury, Credit Unions (1997) at 71.

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2. APPLICABLE LAW – *Chevron* Standard

Courts generally review challenges to a federal agency's construction of a statute that the agency administers under the two-pronged *Chevron* standard.⁷ As the U.S. Supreme Court noted in *Chevron*, "[w]hen a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue." *Chevron*, 467 U.S. at 842. According to the Court, under this threshold question, "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-843 (emphasis added). If, however, "Congress has not directly addressed the precise question at issue, . . . the question . . . is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843. In this regard, as noted in *Chevron*, when a statute is ambiguous with respect to a specific issue, courts must defer to a federal agency's construction of a statute, provided the federal agency's construction is permissible and not "arbitrary, capricious, or manifestly contrary to the statute." *See id.* at 842-843.

Question one of *Chevron* acknowledges the inherent challenge in assigning and determining congressional intent in connection with a statute, particularly in applying the specific laws an agency oversees and administers. In addressing this issue, the Court noted, "[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress." *Id.* The Court further noted it "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations has been consistently followed by [the] Court whenever [a] decision as to the meaning or reach of a statute has involved reconciling conflicting policies, and a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations." *Id.*, referencing *National Broadcasting Co. v. United States*, 319 U.S. 190; *Labor Board v. Hearst Publications, Inc.*, 322 U.S. 111; *Republic Aviation Corp. v. Labor Board*, 324 U.S. 793; *Securities & Exchange Comm'n v. Chenery Corp.*, 332 U.S. 194; *Labor Board v. Seven-Up Bottling Co.*, 344 U.S. 344. In the Court's view, if an agency's determination "represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, [a court] should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned." *Id.* at 844, citing *United States v. Shimer*, 367 U.S. 374, 383 (1961).

Thus, upon reaching question two of *Chevron*, a court must determine whether the NCUA's construction of Section 216 is a permissible construction. *See id.* at 843. *Chevron* provides that where Congress has explicitly or implicitly delegated authority to an agency to make rules, the agency's regulations will be permissible and given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Courts generally treat the "arbitrary" and "capricious" analysis as a single test when reviewing agency interpretations. *See, e.g., Nat'l Ass'n of Home Builders v. Defenders of Wildlife*,

⁷ *See City of Arlington v. FCC*, 133 S. Ct. 1863, 1871 (U.S. 2013); *American Bankers Ass'n v. NCUA*, 93 F. Supp. 2d 35, 2000 U.S. Dist. LEXIS 5209 (D.D.C. 2000) (finding that the NCUA's implementation of rules regarding the formation of multiple common-bond credit unions was a permissible interpretation of the CUMAA under the *Chevron* standard). *See, e.g., United States v. Eurodif S. A.*, 555 U.S. 305 (2009) (applying the *Chevron* test to the Commerce Department's interpretation of its authority to seek antidumping duties and holding that the agency's interpretation was valid); *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 974 (2005) (reviewing an FCC ruling under the Telecommunications Act of 1996 pursuant to a *Chevron* analysis); *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985) (applying *Chevron* to the Army Corps of Engineers' construction of its authority under the Clean Water Act).

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551 U.S. 644 (2007); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Citizens to Pres. Overton Park, Inc., v. Volpe*, 401 U.S. 402 (1971). A court applying the arbitrary and capricious test must determine "whether there has been a clear error of judgment" by the agency. See *Citizens to Pres. Overton Park*, 401 U.S. at 416; *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 416. Under the arbitrary and capricious test, a court will consider whether the agency based its statutory interpretation on a "consideration of all of the relevant factors" and demonstrated a "rational connection between facts and judgment." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 31. A court would likely deem an agency's interpretation "arbitrary and capricious" if the agency "relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that could not be ascribed to a difference in view or the product of agency expertise." *Id.* at 43; *Nat'l Ass'n of Home Builders*, 551 U.S. at 645.

Notably, even if other potential interpretations exist, *Chevron* provides that "[t]he court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding." *Chevron*, 467 U.S. at 843.

3. LEGAL DISCUSSION – NCUA's Legal Authority

In applying the *Chevron* standard to a determination of whether the NCUA has the legal authority under Section 216 of the FCUA to implement the two-tier RBNW requirement set forth in the Proposed Rule, a court would first need to determine whether Congress has "directly spoken to the precise question at issue." *Id.* at 842. If the court finds in the affirmative, then the court would need to determine whether the NCUA's Proposed Rule had given effect to the "unambiguously expressed intent of Congress." *Id.* at 842-843.

If, however, the court finds that Section 216 of the FCUA is silent or ambiguous with respect to the permissibility of a two-tier RBNW requirement, the court must then determine whether the NCUA's construction of Section 216 is a permissible construction. *Id.* at 843. *Chevron* specifies that where Congress has explicitly or implicitly delegated authority to an agency to make rules, the agency's regulations will be given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

This opinion letter sets forth our view as to what a court applying the *Chevron* standard would conclude upon review of the NCUA's legal authority to establish a two-tier RBNW requirement, as set forth in the Proposed Rule, pursuant to the FCUA. We note that this standard requires a court to give considerable deference to the NCUA where ambiguity exists within Section 216 of the FCUA.

a. *Chevron* Question One – Has Congress Directly Spoken to the Precise Question at Issue?

As discussed above, Section 216(d) mandates the NCUA Board to establish "a risk-based net worth requirement for insured credit unions that are complex" and that the NCUA Board "shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." Under the basic principles of statutory construction, one must review the plain language of the statute; however, "the meaning of statutory language, plain or not, depends on context . . . It is a longstanding principle of statutory construction that 'each part or section' of a statute 'should be construed in connection with every other part or section so as to produce a harmonious whole.'" See 2A Norman J. Singer, *Sutherland Statutory Construction* §§ 45:2, 46.05 (5th ed. 1992) (hereinafter, "*Sutherland*"). If the statute's language is ambiguous, the interpretation should be guided by the statute's legislative history.

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See *Sutherland* § 45.01. After careful review and deliberation, we find that the language of Section 216(d) is, at best, ambiguous with respect to the statutory authority of the NCUA to implement a two-tier RBNW requirement for complex credit unions, as the language can be interpreted in multiple ways, as discussed below.⁸

(i) **Section 216(d)(2)'s Reference to "Adequately Capitalized" and "Adequate Protection"**

Section 216(d)(2) highlights Congress's intent for the NCUA to consider certain types of risks when designing the RBNW requirement applicable to complex credit unions. Section 216(d)(2) requires the RBNW requirement to "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." We view Section 216(d)(2)'s reference to the "adequately capitalized" PCA category as a baseline reference that is intended to guide the NCUA in determining what types of material risks it must consider. That is, the NCUA must consider the specific types of material risks that would cause a complex credit union that is at least adequately capitalized to have inadequate protection. In other words, the NCUA must identify the "material risks" that would cause a credit union to fall from an adequately capitalized position into an undercapitalized position.

The plain language of Section 216(d)(2) does not expressly restrict the NCUA from imposing a higher RBNW requirement for "well capitalized" versus "adequately capitalized" credit unions for the supervisory purpose of building in additional risk management controls before a credit union becomes undercapitalized. Moreover, nor does the statutory language unambiguously mandate a single, uniform RBNW requirement applicable to "well capitalized" and "adequately capitalized" credit unions. In our view, the only clear restriction imposed on the NCUA as a result of the language in Section 216(d)(2) is that the RBNW requirement that is to be "designed"⁹ by the NCUA must take account of certain kinds of "material risks" contemplated by Congress. In this regard, and in our opinion, the language of Section 216(d)(2) does not prevent NCUA from imposing higher requirements on "well capitalized" credit unions to provide greater protection against these risks.

Thus, a reasonable interpretation of Section 216(d)(2) is that the NCUA is being asked to identify material risks that could cause a credit union to become undercapitalized, and to design a RBNW requirement that protects against those material risks. Such a requirement could reasonably impose different degrees of protection for "well capitalized" and "adequately capitalized" credit unions so that well capitalized credit unions are further insulated, and appropriately, *more* protected than adequately capitalized credit unions against the material risks that could cause each of such credit unions to become undercapitalized.

(ii) **Section 216(d)'s Use of "Requirement" in the Singular Form**

Section 216(d)'s reference to a RBNW "requirement" in its singular form is, at most, ambiguous and cannot be viewed as a precise statement of specific congressional intent for several reasons.

⁸ Further, given that the NCUA has exercised its general rulemaking authority to implement a two-tier risk-based capital structure in another context, i.e., for corporate credit unions, it appears there is a basis for the NCUA to proceed in this manner for complex credit unions. See *generally* 75 Fed. Reg. 64786 (October 20, 2010). In this regard, we view the more explicit language of Section 216(d) setting forth the standard for a RBNW requirement for complex credit unions as a logical extension of the general authority the NCUA has already previously exercised.

⁹ We note that Section 216(d)(2) requires the NCUA to "design" the RBNW requirement. This language suggests that Congress intended to provide the NCUA significant discretion and flexibility, in contrast to other words that Congress could have used, such as "implement."

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First, Section 216(d)'s reference to "requirement" in its singular form logically makes sense when read in conjunction with the language in Section 216(c), which sets forth the five PCA categories, including well capitalized and adequately capitalized. As specified, for each of these latter two categories:

(A) WELL CAPITALIZED – An insured credit union is "well capitalized" if – (i) it has a net worth ratio of not less than 7 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).

(B) ADEQUATELY CAPITALIZED – An insured credit union is "adequately capitalized" if – (i) it has a net worth ratio of not less than 6 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d). (emphasis added).

Specifically, it is appropriate that there would be only one RBNW requirement that is applicable at any one time to each PCA category. Section 216(c), the section defining the "well capitalized" and "adequately capitalized" categories, does not unequivocally provide that the same RBNW requirement must apply uniformly to both well capitalized and adequately capitalized credit unions. That is, the definitions for both "well capitalized" and "adequately capitalized" require the credit union to meet "any applicable risk-based net worth requirement under subsection (d)." The legislative history of the CUMAA with respect to Section 216 supports this view and provides that "in order to be well capitalized or adequately capitalized, a complex credit union must meet any applicable risk-based net worth requirement prescribed in this section." S. Rep. No. 193, 105th Cong. 2d Sess. 13, p. 13 (emphasis added).

A reasonable interpretation of the "any applicable risk-based net worth requirement" language includes the interpretation that Congress intended to allow the NCUA to determine what RBNW requirement would be "applicable" in each case for well capitalized and adequately capitalized credit unions. We do not view the language as evidencing congressional intent to preclude the NCUA from implementing different RBNW requirements for different capital categories. Section 216(c)'s reference to "any applicable" requirement supports the view that Congress did not intend to limit the NCUA's authority to implement more than one RBNW requirement for different capital categories. The fact that the legislative history makes reference to both the well capitalized and adequately capitalized categories at the same time and indicates that credit unions in these categories must comply with "any applicable [RBNW] requirement" provides support for why the reference to "requirement" in its singular form is ambiguous in terms of whether more than one requirement was intended. Had Congress intended for only one RBNW requirement to apply in all cases for all complex credit unions in different capital categories, rather than referring to "any applicable" requirement in Section 216(c), Congress could have specifically indicated its intent for "the" or "the same" rather than "any applicable" risk-based net worth requirement for both the adequately capitalized and well capitalized categories. Accordingly, as written, Section 216(d) does not clearly and unambiguously prohibit the NCUA from establishing a two-tier rather than single-tier RBNW requirement.

Secondly, Congress's use of the term "requirement" in its singular form in Section 216(d) should not be viewed as determinative in terms of whether Congress clearly intended for the NCUA to have the authority only to implement a single RBNW requirement. The reference to "requirement" does not directly address the question of whether there may be multiple sub-requirements or different sub-requirements for well capitalized and adequately capitalized credit unions. Notably, the PCA statute for banks also uses the term risk-based capital ("RBC")¹⁰ "requirement" in the singular form; however, banks are subject to

¹⁰ As noted in footnote 1, the NCUA views the term "risk-based capital" as congruous with "risk-based net worth," and has proposed to adopt the term "risk-based capital" in place of "risk-based net worth." See 79 Fed. Reg. at 11185, 11191.

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multiple sub-requirements under the RBC requirement, i.e., a common equity Tier 1 RBC requirement, a Tier 1 RBC requirement, and a total RBC requirement, that are different for well capitalized banks versus adequately capitalized banks. See, e.g., 78 Fed. Reg. 62018 (Oct. 11, 2013); 12 U.S.C. 1831o(c)(1)(A). In reviewing Congress's and the federal banking agencies' use of the term "requirement" in its singular form under the current PCA system for banks, Section 216(d)'s similar use of the term "requirement" in its singular form should also not preclude such a requirement from having multiple subparts that are applicable to different PCA categories. Thus, in our opinion, the use of the term "requirement" in its singular form should not be dispositive as to congressional intent.

We also note that even when the NCUA sought congressional authority in April 2007 to change the statutory language in the FCUA to expressly mandate the NCUA to implement a two-tiered RBNW requirement, the NCUA did not seek to change the word "requirement" to "requirements." See NCUA White Paper for "Prompt Corrective Action Reform Proposal," p. 10 (April 2007). This further supports our interpretation that the use of "requirement" in the singular form is reasonable and does not expressly and unambiguously demonstrate Congress's intent that only a single-tier RBNW requirement may be established for adequately capitalized and well capitalized credit unions. As such, the reference to "requirement" is at most ambiguous.

(iii) **Section 216(c)(1)(C)'s Reference to "Any Applicable Risk-Based Net Worth Requirement under Subsection(d)" for Undercapitalized Credit Unions**

Unlike the definitions of "well capitalized" and "adequately capitalized" set forth in Section 216(c)(1)(A) and (B), respectively, which require a credit union to meet both a net worth ratio requirement and a RBNW requirement, the definition for the "undercapitalized" PCA category imposes a disjunctive test – i.e., a credit union is deemed to be "undercapitalized" if "(i) it has a net worth ratio of less than 6 percent; or (ii) it fails to meet any applicable risk-based net worth requirement under subsection (d)." See Section 216(c)(1)(C) (emphasis added).

Some may interpret this distinction as supporting the view that Congress intended for NCUA to establish only a single RBNW requirement that is the "applicable" requirement for all complex credit unions, including for purposes of determining whether a credit union is undercapitalized. In our opinion, however, there is a more reasonable interpretation and application of the disjunctive test used in Section 216(c)(1)(C) for undercapitalized credit unions (as opposed to the conjunctive test used for well capitalized and adequately capitalized credit unions) with respect to the "any applicable [RBNW] requirement" language. This interpretation is that Congress specifically granted the NCUA the authority and flexibility to determine what RBNW requirement would be "applicable" in each case for: (i) well capitalized credit unions, pursuant to Section 216(c)(1)(A); (ii) adequately capitalized credit unions, pursuant to Section 216(c)(1)(B); and (iii) undercapitalized credit unions, pursuant to Section 216(c)(1)(C). This regulatory flexibility provided by the statutory language on its face does not restrict the NCUA from designating the RBNW requirement "applicable" to adequately capitalized complex credit unions as also being the requirement "applicable" to undercapitalized complex credit unions. Rather, it allows the agency to designate a separate higher RBNW requirement specifically "applicable" only to well capitalized complex credit unions, in each case due to the "any applicable . . . requirement" language in each provision. As such, the broad reference to "any applicable . . . requirement" in each of Section 216(c)(1)(A), (B), and (C) supports the view that the NCUA possesses the requisite legal authority and regulatory discretion to impose more than one RBNW requirement for credit unions falling within different PCA categories.

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(iv) **Section 216(b)'s Mandate for a PCA System "Consistent" with the Statute but "Comparable" to Section 38 of the Federal Deposit Insurance Act**

An equally compelling consideration is that Section 216(b) mandates that the NCUA develop a PCA system for credit unions that is "consistent" with Section 216 and "comparable" to the PCA system for banks. The legislative history of the CUMAA explains that "consistency" refers to the "specific restrictions and requirements of new section 216" and "'comparable' here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor." S. Rep. No. 105-193, p. 12 (1998) (emphasis added). As discussed herein, it is our view that the express language of Section 216 taken as a whole provides the NCUA with the necessary interpretive flexibility to implement a two-tier RBNW system that does not violate any specific restrictions and/or requirements of Section 216, as we have not identified any express statutory restriction or requirement imposed on the NCUA to implement a single-tier RBNW system. Thus, we believe the NCUA's interpretation and implementation of a two-tier RBNW system is consistent with the requirements of Section 216.

Moreover, in our opinion, the mandate for the NCUA to develop a PCA system that is "equivalent in rigor" with the PCA system for banks further supports an interpretation of Section 216(d) that allows the NCUA the flexibility to impose a two-tier RBNW system. It is not only logical but, arguably, imperative that the credit union PCA system reflect different gradations in protection for well capitalized and adequately capitalized credit unions, especially given Congress's clear intent for the credit union PCA system to be "equivalent in rigor" with the PCA system for banks. See S. Rep. No. 105-193, p. 12 (1998). Bolstering this view is that credit unions, unlike banks, do not have the ability to resort to capital raising activities in the market to increase and/or maintain capital. Instead, credit unions are largely restricted to preserving and protecting their capital through their own retained earnings. From a safety and soundness standpoint, a prudent and reasonable expectation from both a supervisory and regulatory perspective is for the NCUA to have in place a PCA system that takes account of differences between banks and credit unions – including weaknesses that credit unions have relative to banks – in a manner that allows the NCUA to act to maintain comparable levels of capital protection for well capitalized credit unions compared to well capitalized banks.

With respect to the particular vulnerabilities of credit unions relative to capital, imposing a two-tiered RBNW system appears to be the type of equivalence in rigor required to address the "lessons learned" by the NCUA in dealing with "several hundred millions of dollars in losses . . . of [failed] credit unions holding inadequate levels of capital relative to [their] levels of [portfolio] risk" that previously ignored warnings from NCUA officials "to hold higher levels of capital to offset the risks in their portfolios." 79 Fed. Reg. 11186. It is also reasonable that more stringent credit union capital rules should follow on the heels of more stringent bank capital and PCA rules finalized in July 2013, which are due to become effective in January 2015. Accordingly, an interpretation of Section 216(d) that is consistent with the policy objectives set forth by Congress in Section 216(b) for the credit union PCA system to be consistent with the statute but "equivalent in rigor" to that of banks supports a two-tiered RBNW requirement comparable to that imposed on banks.

(v) **Conclusion for Question One under Chevron**

While other potential interpretations and viewpoints of Section 216(d) are supportable, the existence of alternative interpretations does not preclude a court finding in favor of the NCUA's two-tier RBNW requirement under the Proposed Rule pursuant to the *Chevron* standard. Under *Chevron*, when statutory language is ambiguous, courts must defer to an agency's interpretation of the statute, provided the interpretation is permissible, i.e., not arbitrary, capricious, or manifestly contrary to the statute. As discussed above, the reference to "adequately capitalized" and use of the term "requirement" in the singular form in Section 216(d) does not demonstrate a "clear and unambiguous" congressional intent

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that a single-tier RBNW requirement must be applied uniformly to well capitalized and adequately capitalized credit unions. Moreover, the simple fact that the language in Section 216(d) may yield multiple interpretations clearly demonstrates the ambiguity of the statutory language. As such, it is our view that, in a case properly presented and argued, a court would likely conclude that Section 216 of the FCUA is ambiguous with respect to the permissibility of the NCUA's implementation of a two-tier RBNW requirement, as described in the Proposed Rule. The court would then be required to turn to the second question under *Chevron*, which is whether the NCUA's interpretation of Section 216 of the FCUA, as set forth in the Proposed Rule, is a permissible construction of the statutory language.

b. Chevron Question Two – Given the Determination in Question One that Section 216(d) Is at Most Ambiguous, Is the NCUA's Interpretation Based on a "Permissible Construction" of the Statute?

In applying *Chevron*, a court must determine whether the NCUA's construction of Section 216 of the FCUA is a permissible construction. See *Chevron*, 467 U.S. at 843. *Chevron* provides that where Congress has explicitly or implicitly delegated authority to an administrative agency to make rules, the agency's regulations will be permissible and given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Through the FCUA, Congress has explicitly delegated authority to the NCUA under Section 216(b) of the FCUA to promulgate rules to "prescribe a system of prompt corrective action for insured credit unions" that is (i) consistent with Section 216 of the FCUA and (ii) "comparable" to the PCA provisions of the Federal Deposit Insurance Act for banks. 12 U.S.C. § 1790d(b)(1)(A). Thus, the NCUA's interpretation of Section 216(d) authorizing the NCUA to establish a two-tier RBNW requirement, as set forth in the Proposed Rule, would generally be viewed by a court as permissible and be given controlling weight unless it is "arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Courts generally treat the "arbitrary" and "capricious" analysis as a single test when reviewing agency interpretations. See, e.g., *Natl Ass'n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644 (2007); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Citizens to Pres. Overton Park, Inc., v. Volpe*, 401 U.S. 402 (1971). As discussed below, it is our view that the NCUA's implementation of a two-tier RBNW requirement should withstand both a court challenge that asserts the NCUA's interpretation is "arbitrary and capricious," as well as a challenge asserting that the NCUA's position is "manifestly contrary to the statute."

(i) Arbitrary and Capricious Standard

Although the NCUA's interpretation set forth in the Proposed Rule constitutes a reasonable construction of Section 216(d) as discussed above, we note that questions could arise with respect to the potential arbitrariness and capriciousness of the NCUA's current interpretation under the Proposed Rule, in light of potentially inconsistent positions previously taken by the NCUA.

In regard to whether the NCUA's interpretation may withstand *Chevron* scrutiny and, in particular, whether the interpretation is arbitrary and capricious, the NCUA could encounter challenges with respect to its prior interpretation and actions in implementing Section 216. For example, the NCUA's prior regulations implemented the RBNW requirement in Section 216(d) by establishing a system with a single-tier structure, or alternatively, as a system that imposes multiple RBNW requirements where each complex credit union is subject to its own unique RBNW requirement. See 12 C.F.R. Part 702. The NCUA has held this position in the agency's regulations since 2000. See 65 Fed. Reg. 44950 (July 20, 2000). In its original proposed rule in 2000, the NCUA stated the "NCUA Board has determined that a 6 percent net worth ratio is sufficient to protect against an average level of risk, but that a measure of additional net worth is needed to compensate for risks which are above average. For this reason, the final rule limits the scope of its RBNW requirement to credit unions that have an above average level of risk exposure." *Id.* at 44955. Additionally, the U.S. Treasury Department assessed the NCUA's

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implementation of Section 216 in 2001 and found that "[i]n general, the NCUA implemented the RBNW requirements as Congress intended." See Treasury Report Required Under Sections 401 and 403 of the CUMAA, *Comparing Credit Unions With Other Depository Institutions*, p. 14 (Jan. 2001). Thus, the NCUA's current two-tier interpretation in the Proposed Rule, viewed in light of its prior interpretation and implementation of a single-tier RBNW requirement, could be viewed as an arbitrary change in position and, as such, may be susceptible to challenge under *Chevron's* arbitrary and capricious standard.

In our view, however, the NCUA's position is defensible, and there are reasonable arguments that such a challenge can be overcome under *Chevron* if the NCUA bolsters its rationale for and empirical data supporting the change in position to implement an enhanced system of PCA for credit unions. This view is supportable under case law, which provides that a reversal of position by an agency or interpretation "inconsistent with its past practice" is not arbitrary or capricious "if the agency adequately explains the reasons for a reversal of policy." See *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005). In *Nat'l Cable & Telecomms. Ass'n*, the Supreme Court held that under *Chevron* review a change in agency interpretation "is not invalidating, since the whole point of *Chevron* is to leave the discretion provided by the ambiguities of a statute with the implementing agency." 545 U.S. at 981. The Court specified that "[a]n initial agency interpretation is not instantly carved in stone. On the contrary, the agency . . . must consider varying interpretations and the wisdom of its policy on a continuing basis . . . for example, in response to changed factual circumstances, or a change in administrations." See *id.* In *Nat'l Cable & Telecomms Ass'n*, the Supreme Court found the National Cable and Telecommunication Association's reason for changing its position on the applicability of common-carrier treatment to facilities-based carriers as a result of changed market conditions to be adequate justification. See *id.* at 1001. Thus, even if the NCUA's establishment of a two-tier RBNW requirement is deemed to be a change in position, the NCUA's new interpretation would generally not be expected to be deemed arbitrary or capricious, provided the NCUA adequately justifies its new position. Given the change in market conditions over the past 14 years, the recent financial crisis, and changes in the PCA system for banks, it is our view that the NCUA can reasonably justify a transition to a more conservative two-tier RBNW requirement that is intended to better protect against potential risks to credit unions.

(ii) Manifestly Contrary to the Statute Standard

As discussed above in Section 3.a.iv., the NCUA's implementation of a two-tier RBNW requirement appears consistent with the specific restrictions and requirements of Section 216, as we believe that the express language of Section 216, taken as a whole, provides the NCUA with the necessary interpretive flexibility to implement a two-tier RBNW system that does not violate any specific restrictions or requirements of Section 216. Thus, the NCUA's interpretation and proposed implementation of a two-tier RBNW requirement, as set forth in the Proposed Rule, should not be viewed as being manifestly contrary to Section 216, specifically given that Section 216 does not expressly prohibit the establishment of a two-tier RBNW requirement and the NCUA's position is consistent with the policy objectives of Congress set forth in Section 216(b).

(iii) Conclusion for Question Two under *Chevron*

As Congress expressly delegated authority to the NCUA to design a RBNW requirement, the NCUA's proposed two-tier RBNW requirement under the Proposed Rule constitutes a permissible construction of the statute and, as such, should be upheld by a court under the *Chevron* doctrine. By providing sufficient explanation of its reasons for imposing a higher and more conservative RBNW requirement for complex credit unions to be deemed well capitalized, it is our view that the NCUA's implementation of a two-tiered RBNW requirement would withstand a court challenge alleging the agency's approach is arbitrary, capricious, or manifestly contrary to the statutory language of Section 216 of the FCUA.

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4. CONCLUSION

Based on the foregoing facts and a reasoned analysis of *Chevron* and Section 216 of the FCUA, we are of the opinion that, under current principles of applicable law and existing case law, a court of appropriate jurisdiction, in a litigated matter or proceeding, could conclude that the NCUA's statutory authority pursuant to Section 216 of the FCUA permits the NCUA to establish the proposed two-tier RBNW requirement set forth in the Proposed Rule.

In providing this reasoned legal opinion, we express no opinion as to the availability or effect of a preliminary injunction, temporary restraining order or other such temporary relief affording delay pending a determination of the issue on the merits. Furthermore, we express no opinion as to any legal or equitable principles with respect to the NCUA's rulemaking procedural requirements that would have the effect of negating implementation of the Proposed Rule.

The foregoing opinion is expressly subject to there being no material change in the law and there being no additional facts that would materially affect the validity of the assumptions and conclusions set forth herein or upon which this opinion letter is based. The opinion expressed in this opinion letter may be relied upon solely by you, the Board of NCUA, and no one else. In addition, reliance upon this opinion letter in connection with the matters set forth herein is subject to the understanding that this opinion letter is given on the date hereof and our opinion is rendered only with respect to facts described herein and laws, rules and regulations currently in effect. Without our prior express written consent, this opinion letter may not be furnished to, or used or relied upon by any other person or entity, or in any other context, and may not be quoted, in whole or in part, or otherwise referred to, nor filed with or furnished to any governmental agency or other person. This opinion letter is provided solely for the benefit of the NCUA and its Board of Directors in connection with the agency's deliberations on the Proposed Rule. This opinion letter may not be relied upon by the NCUA or its Board for any other purpose, relied upon by any other person or quoted without our prior express written consent.

We note that a court's decision would be based upon its own analysis and interpretation of the facts before it and applicable legal principles. Therefore, our opinion is based on the assumption that in any case in which this question is considered, the question will be competently briefed and argued by the NCUA. Our opinion is reasoned and also presumes that any decision rendered will be based on existing legal precedents on the date hereof, including those discussed above. The foregoing opinion is expressly subject to there being no material change in the FCUA or the precedential status of *Chevron*. Nothing in this opinion letter shall be construed as the rendering of advice with respect to the rulemaking process, strategies employed by counsel, or other factors or circumstances that might affect the outcome of those proceedings.

This opinion letter is not a guaranty as to outcome or results, or as to what any particular court would actually hold or what actions a particular court may take, but a reasoned opinion as to the decision we believe a court could well reach if the issues are properly presented to it and the court followed existing precedent on the date hereof as to legal and equitable principles applicable in challenges to agency statutory construction.

This opinion letter deals only with the specified legal issues expressly addressed herein, and you should not infer any opinion that is not explicitly addressed herein from any matter stated in this opinion letter. The opinions expressed herein are to be governed by the federal law of the United States and shall be construed in accordance with the customary practice of lawyers who regularly give, and lawyers who regularly advise opinion recipients regarding, opinions of the kinds contained herein.

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This opinion letter speaks only as of the date hereof and is not to be deemed to have been reissued by any subsequent delivery of a copy hereof. We expressly disclaim any responsibility to advise you or any other person of any development or circumstance of any kind, including any change in law or fact that may occur after the date of this opinion letter that might affect the opinions expressed in this opinion letter.

Very truly yours,

A handwritten signature in cursive script that reads "Paul Hastings LLP". The signature is written in dark ink and is positioned above the typed name of the firm.

PAUL HASTINGS LLP

EXHIBIT A

NCUA Proposed Rule, 79 Fed. Reg. 11184 (Feb. 27, 2014)



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Part II

National Credit Union Administration

12 CFR Parts 700, 701, 702 et al.

Prompt Corrective Action—Risk-Based Capital; Proposed Rule

**NATIONAL CREDIT UNION
ADMINISTRATION**

12 CFR Parts 700, 701, 702, 703, 713,
723, and 747

RIN 3133-AD77

**Prompt Corrective Action—Risk-Based
Capital**

AGENCY: National Credit Union
Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The NCUA Board (Board) is proposing to amend NCUA's regulations regarding prompt corrective action (PCA) to restructure the part, and make various revisions, including replacing the agency's current risk-based net worth requirements with new risk-based capital requirements for federally insured "natural person" credit unions. The proposed risk-based capital requirements would be more consistent with NCUA's risk-based capital measure for corporate credit unions and the regulatory risk-based capital measures used by the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, and Office of the Comptroller of Currency (Other Federal Banking Regulatory Agencies). In addition, the proposed revisions would revise the risk-weights for many of NCUA's current asset classifications; require higher minimum levels of capital for federally insured natural person credit unions with concentrations of assets in real estate loans, member business loans (MBLs) or higher levels of delinquent loans; and set forth the process for NCUA to require an individual federally insured natural person credit union to hold higher levels of risk-based capital to address unique supervisory concerns raised by NCUA. The proposed revisions would also eliminate several of NCUA's provisions, including provisions relating to regular reserve accounts, risk-mitigation credits, and alternative risk-weights.

DATES: Comments must be received on or before May 28, 2014.

ADDRESSES: You may submit comments, identified by RIN 3133-AD77, by any of the following methods (Please send comments by one method only):

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *NCUA Web site:* <http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx>. Follow the instructions for submitting comments.

- *Email:* Address to regcomments@ncua.gov. Include "[Your name]"

Comments on Proposed Rule: PCA—Risk-Based Capital" in the email subject line.

- *Fax:* (703) 518-6319. Use the subject line described above for email.

- *Mail:* Address to Gerard Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

- *Hand Delivery/Courier:* Same as mail address.

You can view all public comments on NCUA's Web site at <http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx> as submitted, except for those we cannot post for technical reasons. NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518-6546 or send an email to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT:

Technical: Steven Farrar, Loss/Risk Analyst, Office of Examination and Insurance, at 1775 Duke Street, Alexandria, VA 22314 or telephone: (703) 518-6393, or *Legal:* John H. Brolin, Staff Attorney, Office of General Counsel, at 1775 Duke Street, Alexandria, VA 22314 or telephone: (703) 518-6438.

SUPPLEMENTARY INFORMATION:

- I. Summary of the Proposed Rule
- II. Section-by-Section Analysis
- III. Effective Date
- IV. Regulatory Procedures

I. Summary of the Proposed Rule

The Board is proposing to revise and replace NCUA's current PCA rules for federally insured natural person credit unions.¹ The proposed revisions would 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 unions² and the risk-based capital measures used by the Other Federal Banking Regulatory Agencies.³ In general, the revisions would adjust the risk-weights for many asset classifications to lower the minimum risk-based capital requirement for credit unions with low risk operations. Conversely, the revisions would require higher minimum levels of risk-based capital for credit unions with

concentrations of assets in real estate loans, MBLs, or high levels of delinquent loans. In addition, due to the known limitations of any widely applied risk-based measurement system, the proposed rule includes procedures for NCUA to require an individual credit union to hold a higher level of risk-based capital where specific supervisory concerns arise regarding the credit union's condition. Finally, the revisions would eliminate the provisions of current § 702.401(b) relating to transfers to the regular reserve account, current § 702.106 regarding the standard calculation of risk-based net worth requirement, current § 702.107 regarding alternative components for standard calculation, and current § 702.108 regarding risk-mitigation credit.

A. Background

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. NCUA performs this public function by examining and supervising all federal credit unions, participating in the examination and supervision of federally insured state chartered credit unions in coordination with state regulators, and insuring federally insured credit union members' accounts.⁴ In its role as administrator of the National Credit Union Share Insurance fund (NCUSIF), NCUA insures and regulates approximately 6,753 federally insured credit unions, holding total assets exceeding \$1 trillion and representing approximately 94.6 million members.

In 1998, Congress enacted the Credit Union Membership Access Act (CUMAA),⁵ Section 301 of CUMAA added new section 216 of the Federal Credit Union Act (FCUA),⁶ which requires the Board to adopt by regulation a system of PCA to restore the net worth of federally insured "natural person" credit unions (credit unions) that become inadequately capitalized. In developing the system, the Board is required to take into account that credit unions do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers. In 2000, the Board implemented the required system of PCA primarily under part 702 of NCUA's regulations.⁷

¹ Within the nine states that allow privately insured credit unions, approximately 133 state-chartered credit unions are privately insured and are not subject to NCUA regulation or oversight.

² Public Law 105-219, 112 Stat. 913 (1998).

³ 12 U.S.C. 1790d.

⁴ 12 CFR Part 702; see also 65 FR 8584 (Feb. 18, 2000) and 65 FR 44950 (July 20, 2000).

¹ 12 CFR Part 702.

² See 12 CFR Part 704.

³ See 76 FR 55339 (Sept. 10, 2013).

The purpose of section 216 of the FCUA is to "resolve the problems of [federally] insured credit unions at the least possible long-term loss to the [NCUSIF]." To carry out that purpose, Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) A framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions defined as "new"; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as "complex." This proposed rule is primarily focused on principal components (1) and (3), although amendments to part 702 of NCUA's regulations relating to principal component (2) are also being proposed.

Section 216(c) of the FCUA requires NCUA to, among other things, use a credit union's net worth ratio to determine its classification among five

"net worth categories" set forth in the statute.⁹ In general, "net worth" is defined as the retained earnings balance of the credit union,¹⁰ and a credit union's "net worth ratio" is the ratio of its net worth to its total assets.¹¹ As a credit union's net worth ratio declines, so does its classification among the five net worth categories, thus subjecting it to an expanding range of mandatory and discretionary supervisory actions.¹²

In addition to the net worth ratio component described above, section 216(d) of the FCUA requires NCUA to define the term "complex" credit union "based on the portfolios of assets and liabilities of credit unions."¹³ It also requires NCUA to formulate a risk-based net worth (RBNW) requirement to apply to credit unions meeting that definition.¹⁴ The RBNW requirement must "take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized [(8 percent net worth ratio)] may not

provide adequate protection."¹⁵ 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."¹⁶

Under current § 702.103 of NCUA's regulations, a credit union is defined as "complex" if "[i]ts quarter-end total assets exceed fifty million dollars (\$50,000,000); and . . . [i]ts [RBNW] requirement, as calculated under § 702.106, exceeds six percent (6%)."¹⁷ Current § 702.104 of NCUA's regulations defines eight risk portfolios of complex credit union assets, liabilities, or contingent liabilities (Table 1); and current § 702.106 sets forth the specific risk-weightings that are applied to the assets (Table 2).

TABLE 1—CURRENT § 702.104 RISK PORTFOLIOS DEFINED

Risk portfolio	Assets, liabilities, or contingent liabilities
(a) Long-term real estate loans.	Total real estate loans and real estate lines of credit (excluding MBLs) with a maturity (and next rate adjustment period if variable rate) greater than 5 years.
(b) MBLs outstanding	MBLs outstanding.
(c) Investments	As defined by federal regulation or applicable state law.
(d) Low-risk assets	Cash on hand and NCUSIF deposit.
(e) Average-risk assets	100% of total assets minus sum of risk portfolios above.
(f) Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less.
(g) Unused MBL commitments.	Unused commitments for MBLs.
(h) Allowance	Allowance for Loan and Lease Losses limited to equivalent of 1.50% of total loans.

TABLE 2—§ 702.106 STANDARD CALCULATION OF RBNW REQUIREMENT

Risk portfolio	Amount of risk portfolio (as percent of quarter-end total assets) to be multiplied by risk-weighting	Risk-weighting
(a) Long-term real estate loans	0 to 25.00% over 25.00%06 .14
(b) MBLs outstanding	0 to 15.00% >15.00% to 25.00% over 25.00%06 .06 .14
(c) Investments	<i>By weighted-average life:</i> 0 to 1 year >1 year to 3 years >3 years to 10 years >10 years03 .06 .12 .20
(d) Low-risk assets	All %00
(e) Average-risk assets	All %06
(f) Loans sold with recourse	All %06
(g) Unused MBL commitments	All %06
(h) Allowance	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets).	.06 (1.00)

A credit union's RBNW requirement is the sum of eight standard components. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk-weighting. A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.

⁹ 12 U.S.C. 1790d(a)(1).
¹⁰ Section 1790d(c).
¹¹ Section 1790d(o)(2).
¹² Section 1790d(o)(3).

¹³ Section 1790d(c)-(g); 12 CFR 702.204(a)-(b).
¹⁴ Section 1790d(d).
¹⁵ *Id.*
¹⁶ Section 1790d(d)(2).

¹⁷ S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).
¹⁸ See 12 CFR 702.103 & .104 and 12 U.S.C. 1790d(c).

Section 216(c) of the FCUA requires that a credit union that meets the definition of "complex," and whose net worth ratio initially places it in either of the "adequately capitalized" or "well capitalized" net worth categories, also satisfy a separate RBNW requirement. Under this separate RBNW requirement, the credit union must meet or exceed the minimum RBNW ratio corresponding to its net worth category (adequately capitalized or well capitalized) in order to remain classified in that category.¹⁸ A complex credit union that meets the net worth ratio requirement for being adequately capitalized or well capitalized, but that fails to meet the corresponding RBNW requirement for either net worth category, is classified by section 216(c)(1) as "undercapitalized", and is subject to the mandatory and discretionary supervisory actions applicable to that category.¹⁹

The RBNW requirement for credit unions meeting the definition of "complex" was first applied on the basis of data in the Call Report reflecting activity in the first quarter of 2001.²⁰ NCUA's RBNW requirement has been largely unchanged since its implementation, with the following limited exceptions:

- Revisions were made in 2003 to amend the RBNW requirements for MBLs.²¹
- Revisions were made in 2008 to incorporate a change in the statutory definition of "net worth."²²

In addition, the Board amended part 702 in 2011 to expand the definition of "low-risk assets" to include debt instruments on which the payment of principal and interest is unconditionally guaranteed by NCUA,²³ and again in 2013 to exclude credit unions with total assets of \$50 million or less from the definition of "complex" credit union.²⁴

¹⁸ The RBNW requirement also indirectly impacts credit unions in the "undercapitalized" and lower net worth categories, which are required to operate under an approved net worth restoration plan. The plan must provide the means and a timetable to reach the "adequately capitalized" category. Section 1790d(f)(5); 12 CFR 702.206(c). However, for "complex" credit unions in the "undercapitalized" or lower net worth categories, the minimum net worth ratio "gate" to that category will be 6 percent or the credit union's RBNW requirement, if higher than 6 percent. In that event, a complex credit union's net worth restoration plan will have to prescribe the steps a credit union will take to reach a higher net worth ratio "gate" to that category. See 12 CFR 702.206(c)(1)(i)(A). Section 1790d(c)(1)(A)(i) and (c)(1)(B)(ii).

¹⁹ 12 U.S.C. 1790d(c)(1)(c)(ii).

²⁰ 65 FR 44950 (July 20, 2000).

²¹ 68 FR 56537 (Oct. 1, 2003).

²² 73 FR 72686 (Dec. 1, 2006).

²³ 76 FR 18234 (Mar. 23, 2011).

²⁴ 78 FR 4033 (Jan. 16, 2013).

B. Why is the NCUA Board issuing this rule?

The Board is proposing to change NCUA's general risk-based capital rules for determining the minimum level of required capital to enhance risk sensitivity and address weaknesses in the existing regulatory capital framework for credit unions. Capital and risk go hand-in-hand, and credit union senior management, boards, and regulators are all accountable for ensuring that appropriate capital levels are in place based on the credit union's risk exposure. The proposed rule reflects an effort to establish a risk-weighting system that is more indicative of the potential risks existing within credit unions. The proposed rule is intended to help credit unions better absorb losses and establish a safer, more resilient, and more stable credit union system. The improved resilience will enhance credit unions' ability to function during periods of financial stress and reduce risks to the NCUSIF.

In general, credit unions have high quality capital, with retained earnings being the predominant form of capital. However, in recent years, the NCUSIF did experience several hundred millions of dollars in losses due to failures of individual credit unions holding inadequate levels of capital relative to the levels of risk associated with their assets and operations. Examiners did warn officials at these credit unions that they needed to hold higher levels of capital to offset the risks in their portfolios, but the credit union officials ignored the examiners' recommendations, which were unenforceable. This proposal seeks to incorporate the lessons learned from those failures and better account for risks not addressed by the current rule.

The new risk-based capital requirements being proposed in this rule would apply to all credit unions with over \$50 million in total assets. The capital requirements and PCA supervisory actions for "new" credit unions and credit unions with \$50 million or less in assets would remain largely unchanged, with a few exceptions discussed in more detail below.

In developing the new risk-based capital requirement for "complex" credit unions, NCUA set forth the following goals for the proposed rule. First, the requirement should address weaknesses in the net worth ratio measure. Second, the requirement should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. Third, the requirement should enhance the

stability of the credit union system. Fourth, the rule should rely primarily on data already collected on the Call Report to minimize additional recordkeeping burdens. Fifth, the requirement should be, given the preceding four goals, as easy as possible to understand and implement.

The proposed rule would replace the RBNW method currently used by credit unions to apply risk-weightings to their assets with a new risk-based capital ratio method that is more commonly applied to depository institutions worldwide. The proposed risk-based capital ratio is the percentage of a credit union's net worth available to cover losses, divided by the credit union's defined risk-weighted asset base. The Board believes the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions. Use of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions.

This proposed rule would provide a common measure of asset risk and ensure that credit unions retain levels of capital that are commensurate with their level of risk. The proposal would also help NCUA identify, and credit unions to avoid, inadequately capitalized concentrations of asset classes that can lead to a credit union's failure. Further, under the proposed rule, credit unions would be better able to implement strategic plans based on their unique member service objectives and the corresponding risk by holding the appropriate level of capital.

The measure for a credit union's "net worth ratio," which is defined in section 216(c)(3) of the FCUA, is a generalized measure of a credit union's net worth.²⁵ The net worth ratio of a credit union includes balance sheet accounts in the numerator that may have little or no value in the event of liquidation and excludes off-balance sheet exposures from the numerator. Recognizing these limitations of the net worth measure, Congress directed the Board in section 216(d)(2) of the FCUA to develop a RBNW requirement that "take[s] account of any material risks against which the net worth ratio . . . may not provide adequate protection."²⁶ The proposed risk-based capital measure includes only capital available to cover losses and takes into

²⁵ 12 U.S.C. 1790d(0)(3) ("The term 'net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union.")

²⁶ 12 U.S.C. 1790d(d)(2).

consideration the credit union's off-balance sheet items and other risk factors.

Operating a credit union involves taking and managing a variety of risks,

with the major types of risks identified and defined in Table 3 below.

TABLE 3—MAJOR TYPES OF RISKS IDENTIFIED IN CREDIT UNION BUSINESS²⁷

Risk	Definition
Credit risk	The potential for loss resulting from the failure of a borrower or counterparty to perform on an obligation.
Compliance risk	The potential for loss arising from violations of laws or regulations or nonconformance with internal policies or ethical standards.
Concentration risk	The risk arising from excessive exposure to certain markets, industries, or groups.
Interest rate risk	A type of market risk that involves the potential for loss due to adverse movements in interest rates.
Liquidity risk	The risk that a credit union will be unable to meet its obligations when they become due, because of an inability to liquidate assets or obtain adequate funding.
Market risk	The potential for loss resulting from movements in market prices, including interest rates, commodity prices, stock prices, and foreign exchange rates.
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.
Reputation risk	The potential for loss arising from negative publicity regarding an institution's business practices.
Strategic risk	The potential for loss arising from adverse business decisions or improper implementation of decisions.

The current RBNW measure focuses primarily on interest rate risk. However, the proposed risk-based capital ratio measure would focus more broadly on the various types of risks to credit unions by addressing additional risk factors and assigning specific risk-weights to:

- Delinquent loans,
- Concentrations of MBLs and real estate-secured loans,
- Equity investments, and
- Additional off-balance sheet exposures.

Rigorous and disciplined risk-based (risk-based capital ratio measure) and non-risk-based (net worth ratio measure) capital requirements working well together can enhance the ability of a credit union to cope with capital impairment during economic downturns. Moreover, an adequate capital buffer can cushion performance deterioration during times of stress, thereby promoting safety and soundness of the credit union system.

The proposed risk-based capital ratio measure primarily uses existing information contained in the Call Report. As compared to the current RBNW measure, the proposed risk-based capital ratio measure would include a greater number of exposure categories for purposes of calculating total risk-weighted assets. Thus, some additional data would need to be collected on the Call Report. This additional data would not, however, represent a material increase to the burden of completing the Call Report. The proposed extended effective date of

the final rule would provide ample time for credit unions to adjust their systems to account for the additional data items that would be required in the Call Report.

Through this notice, NCUA invites public comment on all aspects of the proposed rule. Commenters are urged to recognize, however, that NCUA lacks discretion to deviate from the statutory requirements of section 216 of the FCUA.²⁸ To facilitate consideration of public comments on the proposed rule, the Board urges commenters to organize their comment letters on a section-by-section basis that corresponds with the proposed sections of the rule, and to include any general comments in its own section of the letter.

C. Impact of the Proposed Regulation

The proposed rule would make changes to the minimum regulatory capital requirement for credit unions that would be more reflective of risk, including additional subcategories of assets for risk measurement and additional concentration levels. This shift in emphasis would encourage credit unions to more actively manage risk in relation to the minimum required capital levels. As proposed, the rule would modify the current calculation method for computing RBNW to be more consistent with the risk-based capital measures used by the Other Federal Banking Regulatory Agencies. The proposed change in the calculation would allow setting specific risk-based capital ratio requirements for the top three capital classifications.

NCUA's analysis of 2013 Call Report data indicates that the overwhelming majority of credit unions with over \$50 million in assets already have sufficient

capital to comply with the proposed risk-based capital rules. In particular, NCUA estimates that over 90 percent of these credit unions, if subject to the requirements of the proposed rule today, would be in compliance with the minimum risk-based capital requirement under the rule. The Board recognizes, however, that some credit unions would likely need a transition period to accumulate additional capital or change their asset structure to achieve their desired capital classification. The Board also recognizes that credit unions would need a reasonable period of time to update their internal systems, policies, and procedures to account for these changes. As a result, the Board is proposing to delay the effective date of the new requirements after the final rule is published in the *Federal Register*, which is discussed in more detail below.

Using Call Report data as of June 2013, NCUA estimates that approximately 2,237 credit unions reported over \$50 million in total assets, all of which would be subject to the proposed risk-based capital measures.

Existing data available to NCUA, including Call Report data, does not contain all of the information required to analyze the impact of every aspect of the proposal. However, NCUA believes the current Call Report data available provides sufficient information for NCUA to reasonably estimate the impact of the proposed regulation. Accordingly, NCUA analyzed the impact of the proposed rule on credit unions using Call Report data as of June 30, 2013.

Over 90 percent of credit unions subject to the proposed capital measures currently hold capital in excess of the minimum net worth ratio and the risk-based capital ratio required to be

²⁷ See U.S. Govt. Accountability Office, GAO-07-253, *Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing The Proposed Basel II Framework 9-10* (2007), available at <http://www.gao.gov/new.items/d07253.pdf>.

²⁸ 12 U.S.C. 1790d.

classified as well capitalized. As of June 2013, the proposed changes to the risk-based capital measure, if applied immediately, would cause 189 credit unions to experience a decline in their PCA classification from well capitalized to adequately capitalized and 10 well capitalized credit unions to experience a decline to undercapitalized. NCUA estimates that, collectively, the 10 credit unions that would experience a decline to undercapitalized would need to retain an additional \$63 million in risk-based capital to become adequately capitalized, assuming no other adjustments. Affected credit unions may be required to change internal policies and practices to meet the new risk-based capital requirements of the proposed rule.

Based on June 2013 Call Report data, NCUA estimates that if the proposed risk-based capital requirements were applied today, the aggregate risk-based capital ratio for credit unions subject to the proposed risk-based capital measure would be 14.6 percent and the average risk-based capital ratio would be 15.7 percent. These numbers are well above the proposed 10.5 percent requirement for classification as well-capitalized.

II. Section-by-Section Analysis

Part 702—Capital Adequacy

Revised Structure of Part 702

The proposed rule would retitle current part 702, replacing the current title "Prompt Corrective Action" with the new title "Capital Adequacy."²⁰ The more general term Capital Adequacy better characterizes the components of proposed part 702, which include the prompt corrective action, minimum regulatory capital measures, and supervisory actions required under section 216 of the FCUA.²⁰

The proposed rule would also reorganize part 702 by consolidating NCUA's PCA requirements, which were previously included under subsections A, B, C, and D, under new subparts A and B. Proposed subpart A would be titled "Prompt Corrective Action" and proposed subpart B would be titled "Alternative Prompt Corrective Action for New Credit Unions."²¹ The

²⁰ The Board recently approved a proposed rule regarding capital planning and stress testing that also proposes to change the title of part 702 to "Capital Adequacy," 78 FR 65583 (Nov. 1, 2013).

²⁰ 12 U.S.C. 1700d.

²¹ Under both current § 702.301(b) and proposed § 702.201(b), a credit union is "new" if it is "a federally-insured credit union that both has been in operation for less than ten (10) years and has total assets of not more than \$10 million. A credit union which exceeds \$10 million in total assets may become 'new' if its total assets subsequently decline

below \$10 million while it is still in operation for less than 10 years."

reorganization of the proposed rule is designed so that credit unions need only reference the subpart applying to their institution to identify the applicable minimum capital standards and PCA regulations. The Board believes this consolidation will reduce confusion and avoid credit unions having to frequently flip back and forth through the four subparts of the current PCA rule.

In general, the proposed rule would restructure part 702 by consolidating most of the rules relating to capital and PCA that are applicable to credit unions that are not "new" credit unions under new subpart A. This change is intended to simplify the structure of part 702 by grouping the sections of the rule that are applicable only to credit unions not classified as new into a single subpart. The specific sections that would be included in new subpart A and the proposed changes to those sections are discussed in more detail below.

Similarly, the proposed rule would consolidate most of NCUA's rules relating to alternative capital and PCA requirements for "new" credit unions under new subpart B. This change is intended to simplify the structure of part 702 by grouping the sections of the rule that are applicable only to credit unions that are classified as new into one subpart. The sections under new subpart B would remain largely unchanged from the requirements of current part 702 relating to alternative capital and PCA, except for revisions to the sections relating to reserves and the payment of dividends. The specific sections included in new subpart B and the specific changes to the sections under new subpart B are discussed in more detail below.

Section 702.1 Authority, Purpose, Scope, and Other Supervisory Authority

Proposed § 702.1 would remain substantially similar to current § 702.1, but would be amended to update terminology and internal cross references within the section, consistent with the changes being proposed in other sections of part 702. No substantive changes to the section are intended.

Section 702.2 Definitions

Proposed § 702.2 would retain many of the definitions in current § 702.2 with no substantive changes. The proposed rule would, however, remove the paragraph number assigned to each definition under current § 702.2 and reorganize the section so the new and existing definitions are listed in

below \$10 million while it is still in operation for less than 10 years."

alphabetic order. This reformatting would make § 702.2 more consistent with current §§ 700.2, 703.2 and 704.2 of NCUA's regulations.²²

In addition, proposed § 702.2 would add a number of new definitions, and amend some existing definitions in § 702.2. These changes are intended to help clarify the meaning of terms used in new part 702. The definitions that would be added, amended, or removed are as follows:

Allowance for loan and lease loss (ALLL). The term "allowance for loan and lease loss (ALLL)" would be defined as reserves that have been established through charges against earnings to absorb future losses on loans, leases financing receivables or other extensions of credit. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Call Report. The proposed rule would define the term "Call Report" as the Call Report required to be filed by credit unions under § 741.6(a)(2). The term Call Report is a common expression within the credit union industry and is defined for clarification.

Capital. The proposed rule would define the term "capital" as the equity, as measured by GAAP, available to a credit union to cover losses. The term capital is a common expression within the financial services industry and is defined for clarification.

Cash equivalents. The proposed rule would define the term "cash equivalents" to mean short-term highly liquid investments that have original maturities 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 definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Commitment. The proposed rule would define the term "commitment" as any legally binding arrangement that obligated the credit union to extend credit or to purchase assets. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

CUSO. The proposed rule would define the term "CUSO" as a credit union service organization as defined in parts 712 and 741.

Delinquent loans. The proposed rule would define the term "delinquent loans" as loans that are 60 days or more

²² 12 CFR 700.2; 12 CFR 703.2; 12 CFR 704.2.

past due and loans placed on nonaccrual status. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Derivatives contract.³⁵ The proposed rule would define the term "derivatives contract" as, in general, a financial instrument, traded on or off an exchange, the value of which is directly depended upon the value on or more underlying securities, equity indices, debt instruments, commodities, interest rates other derivative instruments, or any agreed upon pricing index or arrangement. Derivatives contracts include interest rate derivatives contracts and any other instrument that poses similar counterparty credit risks. Derivatives contracts also include unsettled securities with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days.

First mortgage real estate loan. The proposed rule would define the term "first mortgage real estate loan" as loans and lines of credit fully secured by first liens on real estate (excluding MBLs), where the original amortization of the mortgage exposure does not exceed 30 years; the loan underwriting took into account all the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments; and the loan underwriting concluded the borrower is able to repay the exposure using the maximum interest rate that may apply in the first five years, the maximum contract exposure over the life of the mortgage, and verified income.

GAAP. The proposed rule would define the term "GAAP" as generally accepted accounting principles as used in the United States. The term "GAAP" is a common expression within the industry and is defined for clarification.

Goodwill. The proposed rule would define the term "goodwill" as an intangible asset representing the future economic benefits arising from other assets acquired in a business combination (i.e. merger) that are not individually identified and separately recognized. The definition would be

consistent with the related Call Report field and the definition contained in the Call Report instructions.

Intangible assets: The proposed rule would define the term "intangible assets" as those assets that are required to be reported as intangible assets in a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Investment in CUSO. The proposed rule would define the term "investment in CUSO" as the unimpaired value of the credit union's aggregate CUSO investments as measured under generally accepted accounting principles on an unconsolidated basis. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Identified losses. The proposed rule would define the term "identified losses" to mean those items that have been determined by an evaluation made by a state or federal examiner, as measured on the date of examination, to be chargeable against income, capital and/or valuation allowances such as the allowance for loan and lease losses. The proposed definition would also provide the following examples of identified losses: assets classified as losses, off-balance sheet items classified as losses, any provision expenses that are necessary to replenish valuation allowances to an adequate level, liabilities not shown on the books, estimated losses in contingent liabilities, and differences in accounts that represent shortages.

Loans to CUSO. The proposed rule would define the term "loans to CUSO" as the aggregate outstanding loan balance, available line(s) of credit from the credit union, and guarantees the credit union has made to or on behalf of a CUSO. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Loans transferred with limited recourse. The proposed rule would define the term "loans transferred with limited recourse" as the total principal balance outstanding of loans transferred, including participations, for which the transfer qualified for true sale accounting treatment under GAAP, and for which the transferor credit union retained some limited recourse (i.e. insufficient recourse to preclude true sale accounting treatment). The proposed definition would also clarify

that the term does not include transfers that qualify for true sale accounting treatment but contain only routine representation and warranty paragraphs that are standard for sale on the secondary market provided the credit union is in compliance with all other related requirements such as capital requirements. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Mortgage servicing asset. The proposed rule would define the term "mortgage servicing asset (MSA)" as those assets (net of any related valuation allowances) resulting from contracts to service loans secured by real estate (that have been securitized or owned by others) for which the benefits of servicing are expected to more than adequately compensate the services for performing the servicing. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Off-balance sheet items. The proposed rule would define the term "off-balance sheet items" as items such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements that are not included on the balance sheet but are normally included in the financial statement footnotes. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Qualifying master netting agreement. The proposed rule would define the term "qualifying master netting agreement" as a written, legally enforceable agreement, provided that: (1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty; (2) the agreement provides the credit union the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II

³⁵ In May 2013, the Board issued a proposed rule that would permit credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. 78 FR 32191 (May 29, 2013). NCUA is still developing its derivatives rule and had not issued a final rule as of the date this proposal was presented to the Board. However, NCUA anticipates amending this rule to be consistent with any final rule issued by the Board related to the May 2013 derivatives proposal.

of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs; (3) the agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate is a net creditor under the agreement); and (4) in order to recognize an agreement as a qualifying master netting agreement for purposes of part 702, a credit union must conduct sufficient legal review, at origination and in response to any changes in applicable law, to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement meets the requirements of paragraph (2) of the definition of qualifying master netting agreement; and in the event of a legal challenge (including one resulting from default or from conservatorship, receivership, insolvency, liquidation, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of relevant jurisdictions.

Risk-based capital ratio. The proposed rule would define the term "risk-based capital ratio" as the percentage, rounded to two decimal places, of the risk-based capital numerator to total risk-weighted assets, as calculated in accordance with § 702.104(a).

Risk-weighted assets. The proposed rule would define the term "risk-weighted assets" as the total risk-weighted assets as calculated in accordance with § 702.104(c).

Senior executive officer. The proposed rule would define the term "senior executive officer" as a senior executive officer as defined by § 701.14(b)(2).

Total assets. The proposed rule would retain the definition of "total assets" in current § 702.2, but would restructure the definition and provide additional clarifying language. Under proposed paragraph (1) under the definition of "total assets," for each quarter, a credit union must elect one of the four measures of total assets listed in paragraph (2) of the definition to apply for all purposes under part 702 except §§ 702.103 through 702.105 (risk-based capital ratio requirements). Proposed paragraph (2) under the definition of total assets would provide that "total assets" means a credit union's total assets as measured by either: (i) The credit union's total assets measured by the average of quarter-end balances of the current and three preceding calendar quarters; (ii) the credit union's

total assets measured by the average of month-end balances over the three calendar months of the applicable calendar quarter; (iii) the credit union's total assets measured by the average daily balance over the applicable calendar quarter; or (iv) the credit union's total assets measured by the quarter-end balance of the applicable calendar quarter as reported on the credit union's Call Report.

U.S. Government agency. The proposed rule would define the term "U.S. Government agency" as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

Verified income. The proposed rule would define the term "verified income" as receipt and retention of corroborative information to establish the reality of the income supporting the repayment of the loan. The term "verified income" is a common expression within the industry and is defined for clarification.

Weighted-average life. The proposed rule would remove the term "weighted-average life" from current § 702.2 and replace it with the newly defined term "weighted-average life of investments."

Weighted-average life of investments. The proposed rule would move the definition of "weighted-average life of investments" contained within current § 702.105 to proposed § 702.2 and would add additional clarifying language. The weighted-average life of investments for registered investment companies, collective investment funds, money market funds, callable fixed rate debt obligations and deposits, variable rate debt obligations and deposits, capital in mixed-ownership government corporations, and other equity securities would remain unchanged. The proposal would assign specific risk-weights to investments in CUSOs and capital in corporate credit unions, as addressed below, thus removing them from the weighted-average life measure.

The proposed rule would define the term "weighted-average life of investments" as follows: For investments in registered investment companies (e.g., mutual funds) and collective investment funds (e.g., common trusts), the term "weighted-average life of investments" would mean the maximum weighted-average life or duration target of the investment disclosed, directly or indirectly, in the most recent prospectus or trust instrument (if the maximum weighted-average life or duration target is not disclosed, the weighted-average life of

investments means greater than 5 years, but less than 10 years). For investments in money market funds, as defined in 12 CFR 270.2a-7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 CFR 9.18(b)(4)(ii)(B)(1) through (3), the term "weighted-average life of investments" would mean 1 year or less. For fixed rate debt obligations and deposits that are callable in whole, the term "weighted-average life of investments" would mean the period remaining to the maturity date. For fixed rate debt obligations and deposits that are non-callable and non-amortizing (e.g., bullet maturity instruments), the term "weighted-average life of investments" would mean the period remaining to the maturity date. For fixed rate debt obligations or deposits with periodic principal pay downs (e.g., mortgage-backed securities), the term "weighted-average life of investments" would be defined according to industry standard calculations, which include the impact of unscheduled payments. For variable rate debt obligations and deposits (regardless of whether the investment amortizes), the term "weighted-average life of investments" would mean the period remaining to the next rate adjustment date. For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), the term "weighted-average life of investments" would mean greater than 1 year but less than or equal to 3 years. For other equity securities, the term "weighted-average life of investments" would mean greater than 10 years. For any other investments not addressed above, the term "weighted-average life of investments" would mean the average time to the return of 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 taking the total of these time-weighted payments and dividing by the total amount of principal. The proposed definition of weighted-average life of investments reflects the current method used by credit unions to report investments on the Statement of Financial Condition on the Call Report. The definition has remained largely unchanged from when the risk-based net worth requirements of part 702 were first implemented.⁸⁴

⁸⁴ See 65 FR 8597 (Feb. 18, 2000) (providing that "The definition [of weighted-average life] is adopted in modified form from Fabozzi, Frank and T. Dossa, eds., *The Handbook of Fixed Income Securities* (4th ed. 1995) at 518, and reflects the

A. Subpart A—Prompt Corrective Action

The proposed rule would establish new subpart A titled "Prompt Corrective Action." New subpart A would contain the sections of part 702 relating to capital measures, supervisory PCA actions, requirements for net worth restoration plans, and reserve requirements for all credit unions not defined as "new" pursuant to section 216(b)(2) of the FCUA.³⁵

Section 702.101 Capital Measures, Effective Date of Classification, and Notice to NCUA

The requirements of proposed § 702.101 would remain largely unchanged from current § 702.101. The title of proposed § 702.101, however, would be changed to "Capital measures, effective date of classification, and notice to NCUA" to better reflect the three major topics that would be covered in the section. In addition, the proposed rule would replace the terms "net worth measures" with "capital measure," "net worth classification" with "capital classification," and "net worth category" with "capital category" to reflect the terminology changes being made throughout the proposed rule, which were discussed above and are discussed in further detail below.

Section 702.102 Capital Classifications

The proposal would change the title of § 702.102 from "Statutory net worth categories" to "Capital classifications." Although section 216(c) of the FCUA

uses the general term "net worth categories," NCUA believes that replacing the term "net worth" with the general term "capital categories" better describes the combined "net worth ratio" and "risk-based net worth" measurements that make up the five categories listed in the statute. Moreover, the term "capital" is generally more inclusive of all accounts available to pay losses than the term "net worth" and is more commonly used in the financial services industry. No substantive changes to the requirements of section 216(c) are intended by these changes in terminology. This section would continue to list the five statutory capital categories that are provided in section 216(c) of the FCUA.³⁶

102(a) Capital Categories

Proposed § 702.102(a) would replace current § 702.102(a) and would set forth new minimum capital measures for complex credit unions. Although sections 216(c)(1)(A)(ii), (B)(ii), (C)(ii) and 216(d) of the FCUA use the term "risk-based net worth" requirement, NCUA believes that replacing the term "risk-based net worth" with the functionally equivalent term "risk-based capital" in the proposed rule would better describe the equity and assets the requirement would measure. Moreover, the term "risk-based capital" is more commonly used in the financial services industry, and is defined in a manner consistent with the requirements set forth in section 216. No changes to the requirements of the statute are intended

by the use of the alternative term risk-based capital in the proposed rule.

Consistent with subsections 216(c)(1)(A) through (E) of the FCUA, the net worth ratio measures listed in proposed §§ 702.102(a)(1) through (5) would continue to match those listed in the statute for each capital category, and would use both the net worth ratio and the new risk-based capital ratio as elements of the capital categories for "well capitalized," "adequately capitalized" and "undercapitalized" credit unions. The risk-based capital ratio measure complements the net worth ratio, and section 216(d) of the FCUA requires the risk-based capital requirement be designed "to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." Accordingly, the risk-based capital ratio includes components that require higher capital levels to reflect increased risk due to interest rate risk, concentration risk, credit risk, market risk, and liquidity risk.

In essence, the current RBNW requirement is evaluated on a pass/fail basis. The proposed rule, in contrast, would introduce a new scaled risk-based capital measurement approach for assigning capital classifications for well capitalized, adequately capitalized, and undercapitalized credit unions. This scaled approach would recognize the relationship between higher risk-based capital ratios and the creditworthiness of credit unions.

TABLE 4—PROPOSED CAPITAL CATEGORIES

A credit union's net worth classification is . . .	Net worth ratio	Risk-based capital ratio*	And subject to following condition(s) . . .
Well Capitalized	7% or above	10.5% or above	Must pass both net worth ratio and risk-based capital ratio.
Adequately Capitalized	6% to 6.99%	8% to 10.49%	Must pass both net worth ratio and risk-based capital ratio.
Undercapitalized	4% to 5.99%	Less than 8%	Must pass both net worth ratio and risk-based capital ratio.
Significantly Undercapitalized.	2% to 3.99%	N/A	Or if undercapitalized at <5% net worth and fails to timely submit or materially implement an approved net worth restoration plan.
Critically Undercapitalized	Less than 2%	N/A	None.

* Applies only to credit unions with quarter-end total assets exceeding \$50 million.

method by which credit unions report investments in Schedule C of the Call Report.".

³⁵ 12 U.S.C. 1790d(b)(2).

³⁶ 12 U.S.C. 1790d(c).

102(a)(1) Well Capitalized

Under proposed § 702.102(a)(1), to be classified as well capitalized, a credit union must maintain a net worth ratio of 7 percent or greater and, if a complex credit union, must also have a risk-based capital ratio of 10.5 percent or greater. The higher proposed risk-based capital requirement for the well capitalized classification is designed to bolster the resiliency of complex credit unions throughout financial cycles. 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 2019.³⁷ NCUA is proposing the 10.5 percent risk-based capital ratio requirement, rather than the Other Federal Banking Regulatory Agencies' 8 percent, to avoid the complexity of implementing a capital conservation buffer.

102(a)(2) Adequately Capitalized

Under proposed § 702.102(a)(2), to be classified as adequately capitalized, a credit union must maintain a net worth ratio of 6 percent or greater and, if a complex credit union, must also have a risk-based capital ratio of 8 percent or greater. For example, a complex credit union with an 8 percent net worth ratio and an 8.5 percent risk-based capital ratio would be adequately capitalized under the proposed rule. The 8 percent risk-based capital ratio requirement for the credit union industry is a measure comparable to the 8 percent total risk-based capital ratio required by the Other Federal Banking Regulatory Agencies' for a bank to be adequately capitalized.

102(a)(3) Undercapitalized

Under proposed § 702.102(a)(3), to be classified as undercapitalized, a credit union must maintain a net worth ratio of 4 percent or greater and, if a complex credit union, fail to meet the minimum 8 percent total risk-based capital ratio requirement. For example, a complex credit union with an 8 percent net worth ratio and a 7.5 percent risk-based capital ratio would be undercapitalized under the proposed rule.

102(a)(4) Significantly Undercapitalized

Under proposed § 702.102(a)(4), a credit union is classified as significantly undercapitalized if: (1) It has a net worth ratio of less than 5 percent, and has received notice that its net worth

restoration plan has not been approved;³⁸ (2) the credit union has a net worth ratio of 2 percent or more but less than 4 percent; or (3) the credit union has a net worth ratio of 4 percent or more but less than 5 percent, and the credit union either fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111, or materially fails to implement a net worth restoration plan approved by NCUA. Although proposed § 702.102(a)(4) has been worded differently to help clarify the requirements of the paragraph, the proposed rule would not change the criteria for being classified as significantly undercapitalized under part 702.

102(a)(5) Critically Undercapitalized

Under proposed § 702.102(a)(5), a credit union is classified as critically undercapitalized if it has a net worth ratio of less than 2 percent. The proposal would not change the criteria for being classified as critically undercapitalized.

102(b) Reclassification Based on Supervisory Criteria Other Than Net Worth

Proposed § 702.102(b) would remain mostly unchanged from current § 702.102(b), with only a few amendments to update terminology and make minor edits for clarity. No substantive changes are intended.

102(c) Non-Delegation

Proposed § 702.102(c) would be unchanged from current § 702.102(c).

102(d) Consultation With State Officials

Proposed § 702.102(d) would remain mostly unchanged from current § 702.102(d), with only a few small amendments for consistency with other sections of NCUA's regulations. No substantive changes are intended.

Section 702.103 Applicability of Risk-Based Capital Ratio Measure

Proposed § 702.103 would change the title of current § 702.103 from "Applicability of risk-based net worth requirement" to "Applicability of risk-based capital ratio measure." Proposed § 702.103 would provide that, for purposes of § 702.102, a credit union is defined as "complex," and a risk-based capital ratio requirement is applicable, only if the credit union's quarter-end total assets exceed \$50 million, as reflected in its most recent Call Report.

³⁸ To qualify for a higher net worth classification, a significantly undercapitalized credit union must have a net worth restoration plan approved by NCUA.

The proposal would eliminate current § 702.103(b) and define all credit unions with over \$50 million in assets as "complex." Under the current rule, credit unions are "complex" and subject to the RBNW requirement only if they have quarter-end total assets over \$50 million and they have an RBNW over 6 percent. In the proposed rule all credit unions with total quarter end assets over \$50 million would be considered "complex" and subject to the risk-based capital ratio.

In January 2013, NCUA revised part 702 by increasing the asset size of credit unions subject to the risk-based net worth requirement from \$10 million to \$50 million.³⁹ In setting the \$50 million asset threshold, the Board considered the following factors for a variety of asset size ranges:

- The percentage of industry assets and units;
- Credit union complexity as measured by products and services;
- The history of failures; and
- The risk to the NCUSIF.

NCUA estimates that, as of June 30, 2013, approximately 2,237 of 6,681 credit unions reported total assets over \$50 million. These credit unions hold approximately 94 percent of total credit union system assets.

Section 702.104 Risk-Based Capital Ratio Measures

Proposed § 702.104 would change the title of current § 702.104 from "Risk portfolio defined" to "Risk-based capital ratio measures." Proposed § 702.104 would entirely replace the requirements for calculating the RBNW requirement for "complex" credit unions under current § 702.104 with a new risk-based capital ratio requirement.⁴⁰ The proposed section would require all "complex" credit unions to calculate the risk-based capital ratio as directed in this section. The proposed risk-based capital ratio is designed to enhance sound capital management and help ensure that credit unions maintain adequate levels of loss-absorbing capital going forward, strengthening the stability of the credit union system and ensuring credit unions serve as a source of credit in times of stress.

³⁹ On January 18, 2013, NCUA published a final rule and IRPS 13-1 redefining "small entity" as a credit union with less than \$50 million in assets and amending 12 CFR 702.103 increasing to \$50 million the asset threshold used to define "complex" credit union for determined whether RBNW requirements apply. 78 FR 4032 (Jan. 18, 2013).

⁴⁰ 12 U.S.C. 1790d(d).

³⁷ On September 10, 2013, FDIC published an interim final rule that revised its risk-based and leverage capital requirements for FDIC-supervised institutions. 78 FR 55339 (Sept. 10, 2013).

104(a) Calculation of Capital for the Risk-Based Capital Ratio

Proposed § 702.104(a) would provide that to determine its risk-based capital ratio, a complex credit union must calculate the percentage, rounded to two decimal places, of its risk-based capital numerator as described in § 702.104(b) to its total risk-weighted assets denominator as described in § 702.104(c). In simplest terms, the proposed risk-based capital ratio would be the percentage of a defined measure of the equity and other accounts held by a credit union that are available to cover losses, divided by a defined risk-weighted asset base. The proposed method of calculating risk-based capital would be generally consistent with the methods used in other sectors of the

financial services industry. Conversely, the method of computing the RBNW measure in current § 702.104 is unique within the financial services industry, and frequently results in confusion and incorrect analyses when industry analysts attempt to compare credit union risk-weights for assets to bank risk-weights for assets. As with the current RBNW ratio, the proposed risk-based capital ratio calculation would be calculated primarily using information credit unions already report on the Call Report form required under § 741.6(a)(2) of NCUA's regulations.

104(b) Risk-based Capital Ratio Numerator

Proposed § 702.104(b) would provide that the risk-based capital numerator is

the sum of the specific certain capital elements listed in § 702.104(b)(1), minus certain regulatory adjustments listed in § 702.104(b)(2). The proposed numerator for the risk-based capital ratio would continue to consist primarily of the components of a credit union's net worth. In order to capture all of the material risks while keeping the calculation from becoming overly complex, the proposed rule would add some additional equity items and other specified balance sheet items would be subtracted. The goal of the proposed risk-based capital ratio numerator is to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses.

TABLE 5—PROPOSED RISK-BASED CAPITAL NUMERATOR

Additions	Deductions
Undivided earnings (includes any regular reserve)	NCUSIF deposit. Goodwill. Other intangible assets. Identified losses not reflected as adjustments to components of the risk-based numerator.
Appropriations for non-conforming investments	
Other reserves	
Equity acquired in merger	
Net income. ALLL (limited to 1.25% of risk assets). Secondary capital accounts included in net worth. Section 208 assistance included in net worth (as defined in § 702.2).	

104(b)(1) Capital Elements of the Risk-Based Capital Ratio Numerator

Proposed § 702.104(b)(1) would list the capital elements of the risk-based capital numerator as follows:

- Undivided earnings (includes any regular reserve);
- Appropriation for non-conforming investments;
- Other reserves;
- Equity acquired in merger;
- Net income;
- ALLL, limited to 1.25% of risk assets;
- Secondary capital accounts included in net worth (as defined in § 702.2); and
- Section 208 assistance included in net worth (as defined in § 702.2).

The proposed risk-based numerator would include the equity acquired in merger component of the balance sheet. This equity item would be used in place of the total adjusted retained earnings acquired through business combinations amount credit unions report on the PCA Net Worth Calculation Worksheet in the Call Report. The equity acquired in merger is the GAAP equity recorded in a business combination and can vary from the amount of total adjusted retained earning acquired through business combinations, which is not a

GAAP accounting item. The use of equity acquired in a merger, as measured using GAAP, more accurately reflects the overall value of the business combination transaction.

Because the ALLL is available to cover expected levels of loan losses, the proposed numerator also would include the ALLL, but it would be limited to 1.25 percent of total risk-weighted assets.⁴¹ The RBNW calculation for ALLL in current § 702.104(h) is limited to 1.50 percent of loans and is included as a reduction in the level of risk assets. By establishing a limit in the amount of ALLL included in the numerator, the proposed rule would provide an incentive for granting quality loans and recording loan losses in a timely manner. The proposed 1.25 percent limit should not result in a disincentive to fully fund the ALLL above the 1.25 percent ceiling, because complex credit unions are bound by GAAP in maintaining the ALLL. NCUA estimates that, as of June 30, 2013, approximately 468 of the 2,237 "complex" credit unions have an ALLL greater than 1.25 percent of total risk assets.

⁴¹ The 1.25 percent of risk-weighted assets limitation is consistent with the Basel III framework and the regulatory capital rules for U.S. banks.

The proposed risk-based capital numerator would not include the following Call Report equity items:

- Accumulated unrealized gains (losses) on available for sale securities;
- Accumulated unrealized losses for OTTI on debt securities;
- Accumulated unrealized net gains (losses) on cash flow hedges; and
- Other comprehensive income.

NCUA recognizes the items listed above reflect a credit union's actual loss absorption capacity at a specific point in time, but includes gains or losses that may or may not be realized. NCUA also recognizes that including these items in the risk-based numerator could lead to volatility in the risk-based capital measure, difficulty in capital planning and asset-management and other unintended consequences.⁴² Accordingly, NCUA chose to exclude these items from the proposed risk-based capital numerator.

104(b)(2) Risk-Based Capital Ratio Numerator Deductions

Proposed § 702.104(b)(2) would provide that the elements deducted

⁴² The Other Federal Banking Agencies' regulatory capital rules (12 CFR 324.22) allow institutions to make an opt-out election for similar accounts. See, e.g., 78 FR 55339 (Sept. 10, 2013).

from the sum of the risk-based capital elements are:

- NCUSIF Capitalization Deposit;
- Goodwill;
- Other intangible assets; and
- Identified losses not reflected in the risk-based capital ratio numerator.

In order to achieve a risk-based capital numerator reflecting equity available to cover losses in the event of liquidation, goodwill and other intangible assets would be deducted from both the risk-based capital numerator and denominator. Goodwill and other intangible assets contain a high level of uncertainty regarding a credit union's ability to realize value from these assets, especially under adverse financial conditions.

The proposed rule would address concerns about the NCUSIF deposit reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. In the proposed rule, the NCUSIF deposit is subtracted from both the numerator and denominator of the risk-based capital ratio.⁴⁵ This treatment for the risk-based regulatory capital standard would not alter the NCUSIF deposit accounting treatment for credit unions.

The proposed rule would include a provision to allow for identified losses, not otherwise reflected as adjustments in the risk-based capital numerator, to be deducted to reflect an accurate risk-based capital ratio. The inclusion of identified losses would allow for the calculation of an accurate risk-based capital ratio. Examples of items that

would be subject to this provision include shortages in the ALLL, underfunded pension accounts, and unsupported valuations of bond claim receivables.

104(c) Total Risk-Weighted Assets

In developing the proposed risk-weights, NCUA reviewed the Basel accords and both the U.S. and international banking system's existing risk-weight measures.⁴⁴ NCUA considered the comments contained in material loss reviews prepared by the NCUA Inspector General and GAO comments in their reviews of the financial services industry's implementation of PCA.⁴⁵ As previously mentioned, because the FCUA requires the risk-based measure to include all material risks, consideration was given to credit risk, concentration risk, market risk, interest rate risk, operational risk, and liquidity risk.

Proposed § 702.104(c) would address concentration risk by assigning higher risk-weights to larger percentages of assets in MBLs and real estate loans. The concentration threshold amounts are generally based on the average percentage of assets held in the asset types.

104(c)(1) General

Proposed § 702.104(c)(1) would provide that total risk-weighted assets include risk-weighted on-balance sheet assets as described in § 702.104(c)(2), plus the risk-weighted off-balance sheet assets in § 702.104(c)(3), plus the risk-

weighted derivatives in § 702.104(c)(4), minus the risk-based capital numerator deductions in § 702.104(b)(2). The proposal would require a complex credit union to calculate its risk-weighted asset amount for its on- and off-balance sheet exposures. (NCUA's Call Report system would be upgraded to conduct the calculations automatically.) In the proposal, risk-weighted asset amounts would generally be determined by assigning an on-balance sheet asset to broad risk-weight categories according to the asset type, collateral, and level of concentration. Similarly, risk-weighted assets amounts for off-balance sheet items would be calculated using a two-step process: (1) Multiplying the amount of the off-balance sheet exposure by a credit conversion factor (CCF) to determine a credit equivalent amount, and (2) assigning the credit equivalent amount to a relevant risk-weighted category. A credit union would determine its total risk-weighted assets by calculating (1) its risk-weighted assets, minus (2) goodwill and other intangibles, and minus (3) the NCUSIF deposit.

104(c)(2) Risk-Weights for On-Balance Sheet Assets

Proposed § 702.104(c)(2) would define the risk categories and risk-weights to be assigned to each specifically defined on-balance sheet asset. All on-balance sheet assets would be assigned to one of the categories and risk-weights listed in Table 6.

TABLE 6—RISK-WEIGHT CATEGORIES AND ASSOCIATED RISK-WEIGHTS

Risk-weight category	Risk-weight	Items Included
Category 1	0 percent	<ul style="list-style-type: none"> • Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit, and currency supplied from automatic teller machines. • NCUSIF capitalization deposit. • Debt instruments unconditionally guaranteed by the NCUA or the FDIC. • U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government, including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS).
Category 2	20 percent	<ul style="list-style-type: none"> • Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency. • Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts. • Cash equivalents (investments with original maturities of three months or less). Cash equivalents are 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 total amount of investments with a weighted-average life of one year or less. • Residential mortgages guaranteed by the federal government through the FHA or the VA.

⁴⁵ See U.S. Govt. Accountability Office, GAO-04-849, Available Information Indicates No Compelling Need for Secondary Capital (2004), available at <http://www.gao.gov/assets/250/243642.pdf>.

⁴⁴ The Basel Committee on Banking Supervision (BCBS) published Basel III in December 2010 and revised it in June 2011, available at <http://www.bis.org/publ/bcbs189.htm>.

⁴⁶ Section 988 of the Dodd-Frank Wall Street Reform and Consumer Protection Act obligates the NCUA's Inspector General to conduct material loss reviews (MLRs) of credit unions that incurred a loss of \$25 million or more to the NCUSIF. In addition, section 988 requires the NCUA's Inspector General to review all losses under the \$25 million threshold to assess whether an in-depth review is warranted

due to unusual circumstances. The MLRs are available at <http://www.ncua.gov/about/Leadership/CO/OIG/Pages/MaterialLossReviews.aspx>; see also GAO/GGD-98-153 (July 1998); GAO-07-253 (Feb. 2007), GAO-11-612 (June 2011), GAO-12-247 (Jan. 2012), and GAO-13-71 (Jan. 2013).

TABLE 6—RISK-WEIGHT CATEGORIES AND ASSOCIATED RISK-WEIGHTS—Continued

Risk-weight category	Risk-weight	Items included
Category 3	50 percent	<ul style="list-style-type: none"> Loans guaranteed 75 percent or more by the SBA, U.S. Department of Agriculture, or other U.S. Government agency. The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years. The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.
Category 4	75 percent	<ul style="list-style-type: none"> The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years. Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans. (Excluding loans reported as MBLs). Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.
Category 5	100 percent	<ul style="list-style-type: none"> Corporate credit union nonperpetual capital. The total outstanding principal amount loaned to CUSOs. Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets. Delinquent first mortgage real estate loans. Other real estate-secured loans less than or equal to 10 percent of assets. MBLs less than or equal to 15 percent of assets. Loans held for sale. The total amount of any foreclosures and repossessed assets. Land and building, less depreciation on building. Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation. Current non-federally insured student loans. All other assets not specifically assigned a risk-weight but included in the balance sheet.
Category 6	125 percent	<ul style="list-style-type: none"> Total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.
Category 7	150 percent	<ul style="list-style-type: none"> The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years. Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as MBLs). The total amount of all other real estate-secured loans greater than 20 percent of assets.
Category 8	200 percent	<ul style="list-style-type: none"> Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets. Corporate credit union perpetual capital. The total amount of investments with a weighted-average life of greater than 10 years. The total amount of MBLs greater than 25 percent of assets, other than MBLs included in Category 3 above.
Category 9	250 percent	<ul style="list-style-type: none"> The total value of investments in CUSOs.
Category 10	1,250 percent	<ul style="list-style-type: none"> The total value of mortgage servicing assets. An asset-backed investment for which the credit union is unable to demonstrate, as required under §702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance.

A further explanation of risk-weights based on balance sheet asset type follows.

Cash and investment risk-weights. The proposal generally would maintain

the existing structure for measuring risk-weights for most cash items and investments. For specific investments, the risk-weights would continue to be based upon the "weighted-average life

of investments" (WAL), as defined within the regulation. The WAL is generally the average time until a dollar of principal is repaid.

TABLE 7—PROPOSED RISK-WEIGHTS FOR CASH AND INVESTMENTS

Item	Proposed risk-weight (percent)
Cash on hand	0
NCUA and FDIC Issued Guaranteed Notes	0
Direct, unconditional U.S. Government obligations	0
Cash on deposit	0
Cash equivalents	20
Total investments with WAL ≤ 1-year	20
Total investments with WAL >1-year and ≤ 3-years	20
Total investments with WAL >3-year and ≤ 5-years	50
Corporate credit union nonperpetual capital	75
Total investments with WAL >5-year and ≤ 10-years	100
Total investments with WAL > 10-years	150
	200

TABLE 7—PROPOSED RISK-WEIGHTS FOR CASH AND INVESTMENTS—Continued

Item	Proposed risk-weight (percent)
Corporate credit union perpetual capital	200

Cash held by a credit union for normal operations—such as vault cash, ATM cash, and teller cash—typically present no risk because it is protected from loss by a credit union’s fidelity bond and would be assigned a zero risk-weight.

To maintain continuity and provide a fair measure of the interest rate and liquidity risks associated with longer term investments, the proposed rule would continue to use the measure in current § 702.105 for investments. The current risk-weights for investments relied on the results of 300 basis point interest rate “shock tests” to corroborate the assigned risk-weights. The 300 basis point shock test is a widely accepted measure of interest rate risk. The proposed risk-weight for investments with a WAL of less than 5 years would be lower, relative to the existing rule, to reflect lower interest rate risk and liquidity risk. The proposed risk-weight for investments with a WAL from 5 to 10 years would be about the same and the risk-weight for investments with a WAL over 10 years would be decreased slightly.

The proposal would lower the risk-weight for direct and unconditional U.S.

Government obligations (FDIC issued Guaranteed Notes, and other U.S. Government obligations) from the WAL measure to zero risk-weighted assets, and maintain the current zero risk-weight for NCUA Guaranteed Notes.

In the current rule, the investment in nonperpetual and perpetual capital in a corporate credit union are reported in the “>1–3 Years” WAL bucket on the Call Report and assigned the associated risk-weight.

Member Business Loans (MBLs). Consistent with the existing rule, the risk portfolio for “member business loans outstanding” in the proposal will consist of loans outstanding that qualify as MBLs under NCUA’s definition,⁴⁶ or under a state’s NCUA-approved definition.⁴⁷ If a loan qualifies as a MBL when it is originated, it will remain so until it has been repaid in full, sold, or otherwise disposed of. Unused MBL commitments would be addressed in a separate off-balance sheet risk portfolio.

In the current rule, the risk-weights for MBLs apply across three thresholds based on the amount of MBLs as a percentage of total assets. The first threshold applies to concentrations between 0 and 15 percent, the second

applies to concentrations over 15 percent and up to 25 percent, and the third applies to concentrations in excess of 25 percent. The proposed rule would maintain the same threshold levels for assigning risk-weights. Since current MBL regulations generally limit MBLs to 12.25 percent of total assets,⁴⁸ typically only those credit unions with an MBL exemption are subject to the higher risk-weightings assigned to the higher concentrations of MBLs.

Supervisory experience has demonstrated that certain MBLs present multiple risks for which credit unions should hold additional capital. Many of the largest losses to the NCUSIF occurred in credit unions with high concentrations of MBLs.⁴⁹ Similarly, the failures of many small banks between 2008 and 2011 were also largely driven by high concentrations of MBLs. The GAO reported that in the 10 states with 10 or more bank failures between 2008 and 2011, the failure of the small and medium-size banks were largely associated with high concentrations of commercial real estate loans.⁵⁰

As illustrated in Table 8, the proposed rule would moderately increase all of the risk-weights for MBLs.

TABLE 8—COMPARISON OF CURRENT REGULATION AND PROPOSED MBL COMPONENT

Total MBLs	Current MBL risk-weightings ⁵¹ — (converted for 8% adequately capitalized level) (percent)	Proposed MBL risk-weightings (percent)
0 to 15% of Assets	75	⁵² 100
>15 to 25% of Assets	100	150
Amount over 25%	175	200

MBLs that are government guaranteed at least 75 percent, normally by the Small Business Administration (SBA) or

U.S. Department of Agriculture, would receive a lower risk-weight of 20 percent under the proposed rule.

As of June 2013, for the 1,579 complex credit unions with outstanding MBLs, MBLs comprise an aggregate of

⁴⁶ See 12 CFR 723.1.

⁴⁷ See 12 CFR 723.20.

⁴⁸ See 12 CFR 723.16(a).

⁴⁹ See NCUA Office of the Inspector General, OIG-10-20, OIG Capping Report on Material Loss Reviews (Nov. 23, 2010), Chart G, available at <http://www.ncua.gov/about/Leadership/CO/OIG/Documents/OIG201020CappRpt.pdf>.

⁵⁰ U.S. Government Accountability Office, GAO-13-704T, Causes and Consequences of Recent Community Bank Failures (June 12, 2013), page 4,

available at <http://www.gao.gov/assets/660/655193.pdf>.

⁵¹ The current MBL risk-weightings were converted to a comparable risk-weight by dividing the current risk-weighting by 8 percent, with 8 percent representing the level of risk-weighted capital needed to be adequately capitalized. In the current rule total MBLs less than the threshold 15 percent of assets receive a 8 percent risk-weighting, which is equivalent to a 75 percent risk-weight under this proposal (8% divided by 8%). The next threshold in the current regulation for total MBLs from 15 percent to 25 percent of assets received an

8 percent risk-weighting, which is equivalent to a 100 percent risk-weight under this proposal (8% divided by 8%) and the highest concentrations of MBLs received a 14 percent risk-weight, which is equivalent to a 175 percent risk-weight under this proposal (14% divided by 8%).

⁵² This is consistent with the Other Federal Banking Regulatory Agencies’ capital rules (e.g., 12 CFR 324.32), which maintain a 100 percent risk-weight for commercial real estate (CRE) and includes a 150 percent risk-weight for loans defined as high volatility commercial real estate (HVCRE). See, e.g., 78 FR 55339 (Sept. 10, 2013).

4.80 percent of assets and an average 5.14 percent of assets. Only 70 of the credit unions holding MBLs have MBL portfolios in excess of 15 percent of total assets. The threshold of 15 percent was selected to provide for the possibility of a decline in asset size once a credit union reaches the 12.25 percent statutory limit for MBLs.

NCUA considered developing an alternative version of the current method for computing the MBL's 15 percent concentration level that would have addressed the potential for reduced risk in a well-diversified MBL portfolio. However, before developing such a method, NCUA staff evaluated the diversity of MBL loan types using the data reported in the Call Report. The data was summarized into the following five subcategories: (1) Construction and development, (2) agriculture related loans, (3) non-farm, non-residential property, (4) commercial and industrial loans, and (5) unsecured business loans. NCUA noted as they evaluated the Call Report data that, of the 70 credit unions with MBLs over the 15 percent of assets threshold that would be subject to higher risk-weights on a portion of their MBLs, most tended to primarily originate one particular type of MBL. The Call Report data provides no information on the geographic distribution of the MBL portfolio and the additional information needed to properly identify the nature and extent of any diversification would place an additional data reporting burden on credit unions with an uncertain result. Due to the lack of diversity in the types of MBLs held by credit unions and the reporting requirements to potentially identify diversification, the Board decided to propose maintaining the current risk-weight concentration levels. The Board believes that maintaining the current methodology avoids adding the complexity required to define the adequate level of diversification and associated reporting necessary to implement such an alternative method in the proposed rule.

Real Estate Loans. The current rule excludes from the real estate risk-weights those real estate loans reported as MBLs. The proposed rule would continue this exclusion.

The current standard risk-weighting approach establishes higher capital requirements only for "long term" real estate loans, excluding loans that re-price, refinance, or mature within five years or less. By excluding loans that re-price, refinance, or mature within five years or less from higher capital requirements, the current formula does not address a large amount of real estate loans. As a result, credit unions build

real estate loan concentrations without appropriate capital. Additionally, the junior lien real estate loans, with a significantly higher loss history, are combined with first mortgage real estate loans. An unintended consequence of the current real estate loan risk-weight is the structuring of mortgage products to minimize capital requirements which could impact the marketability of such loans.

The proposed rule would recognize the lower loss history for current, prudently written first lien real estate-secured loans by assigning a lower risk-weight of 50 percent to the first 25 percent of assets.⁵³ To account for concentration risk, the risk-weight for first lien real estate loans would increase for loans between 25 and 35 percent of assets from 50 percent to 75 percent. First lien real estate loans over 35 percent of assets would be accorded a 100 percent risk-weight. The threshold of 25 percent is based on the average percent of first mortgage real estate loans to total assets, which, as of June 30, 2013, is 24.9 percent for all complex credit unions. Out of the 2,188 complex credit unions with first mortgage real estate loans, 510 have a concentration in excess of 25 percent of assets and 160 have a concentration in excess of 35 percent of assets.

In the proposed rule, if a credit union holds the first and junior lien(s) on a property, and no other party holds an intervening lien, the credit union could treat the combined exposure as a single loan secured by a first lien for purpose of assigning a risk-weight. A first lien real estate loan could be assigned to the 50 percent risk-weight category only if it is not restructured or modified. A first lien real estate loan modified or structured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordability Mortgage Program (HAMP) would not be considered to be restructured or modified. A first lien real estate loan guaranteed by the federal government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) generally would be risk-weighted at 20 percent. While a government guarantee against default mitigates credit risk, it does not affect interest rate risk.

During the recent market turmoil, the U.S. housing market experienced significant deterioration and

⁵³This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintained the 50 percent risk-weight for one to four family real estate loans that are prudently underwritten, not 90 days or more past due, and not restructured or modified, and a 100 percent risk-weight for such loans otherwise. See, e.g., 78 FR 55338 (Sept. 10, 2013).

unprecedented levels of mortgage loan defaults and home foreclosures. The cause for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards, high-risk mortgage products providing for negative amortization and significant payment shock to the borrowers, unverified or undocumented income, and a rise in unemployment.⁵⁴ Therefore, NCUA is proposing that real estate-secured loans not meeting the definition of first mortgage real estate loans would be referred to as "other real estate loans" and assigned a higher risk-weight. First lien real estate loans delinquent for 60 days or more or carried on non-accrual status would be included in the category of other real estate loans for the purpose of assigning the risk-weight.

In the proposed rule, other real estate loans would be assigned a risk-weight of 100 percent for the first 10 percent of assets. To account for concentration risk, the risk-weight for other real estate loans would increase to 125 percent for loans between 10 and 20 percent of assets. Other real estate loans over 20 percent of assets would be risk-weighted 150 percent. The threshold of 10 percent is roughly based on the average percent of other real estate loans to total assets, which, as of June 30, 2013, is 6.85 percent for all complex credit unions. Out of the 2,218 complex credit unions with other real estate loans, 533 have a concentration in excess of 10 percent of assets and 100 have a concentration in excess of 20 percent of assets.

Tables 9, 10, and 11 below provide a comparison of current and proposed risk-weights for real estate-secured loans:

TABLE 9—CURRENT RISK-WEIGHTS FOR LONG TERM REAL ESTATE LOANS

Current Risk-Weights for Long-Term Real Estate Loans (revised for an 8 percent adequately capitalized standard)

Definition: RE Loans—Loans Maturing, Refinancing, or Re-Pricing in 5 years—RE Loans also reported as MBLs = Long-Term RE Loans.

Threshold	Current risk-weight ⁵⁵ (percent)
0–25% of assets	75
Excess over 25% of assets	175

⁵⁴In drafting these proposed regulations, NCUA is mindful of the implications of other recently published regulations that have been issued to improve the quality of mortgage underwriting.

TABLE 10—PROPOSED RISK-WEIGHTS FOR FIRST LIEN REAL ESTATE LOANS

Proposed Risk-Weights for First Lien Real Estate Loans

Definition: 1st Lien RE Loans—1st Lien RE Loans also reported as MBLs—Delinquent 1st Lien RE Loans = First Lien RE Loans.

Threshold	Proposed risk-weight (percent)
0–25% of assets	50
>25–35% of assets	75
Excess over 35% of assets	100

TABLE 11—PROPOSED RISK-WEIGHTS FOR JUNIOR LIEN REAL ESTATE LOANS

Proposed Risk-Weights for Junior Lien Real Estate Loans

Definition: Junior Lien RE Loans + Delinquent 1st Lien RE Loans—Junior Lien RE Loans also reported as MBLs = Junior Lien Real Estate Loans.

Threshold	Proposed risk-weight (percent)
0–10% of assets	100
>10–20% of assets	125
Excess over 20% of assets	150

The aggregate minimum capital requirement, using the proposed risk-weights for first lien and junior lien real estate loans, is slightly less than the current minimum requirement.⁵⁵ The proposed risk-weights for real estate loans, however, would result in a higher variance in the minimum capital requirement for individual affected credit unions because the risk-weights better differentiate the risk associated with lien position and concentration.

Current consumer loans. Consumer loans (unsecured credit card loans, lines of credit, automobile loans, and leases) are generally highly desired credit union assets and a key element of providing basic financial services. For

⁵⁵ This risk-weightings were converted to a comparable risk-weight by dividing the current risk-weighting by 8 percent, representing the level of risk-weighted capital used to be adequately capitalized. In the current rule, long-term real estate loans less than the 25 percent threshold receive a 6 percent risk-weighting, which is equivalent to a 75 percent risk weight under this proposal (6% divided by 8%). Total long-term real estate loans over the 25 percent threshold receive a 14 percent risk-weighting, which is equivalent to a 175 percent risk weight under this proposal (14% divided by 8%).

⁵⁶ Analysis of call report data indicates that the proposed risk weights produce an aggregate minimum capital requirement, at the well capitalized level, of 97 percent of the current minimum RBNW requirement for real estate loans when applied to affected credit unions.

most current consumer loans, the proposed rule would assign a risk-weight of 75 percent, which maintains the existing risk-based capital requirement.⁵⁷ Non-federally guaranteed student loans, which contain higher risks (e.g., default risk and extension risk), would be risk-weighted at 100 percent in the proposal. Federally guaranteed student loans would receive a zero percent risk-weight.⁵⁸ Table 12 below lists the proposed risk-weights for each current consumer loan type reported on the Call Report.

TABLE 12—PROPOSED RISK-WEIGHTS FOR CONSUMER LOAN TYPES REPORTED ON CALL REPORT

Consumer loan type—Less than 60 days delinquent	Proposed risk-weight (percent)
Unsecured Credit Card Loan ...	75
All Other Unsecured Loans/ Lines of Credit	75
Short-Term, Small Amount Loans	75
Federally Guaranteed Student Loans	0
Non-Federally Guaranteed Student Loans	100
New Vehicle Loans	75
Used Vehicle Loans	75
Leased Receivable	75
All Other Loans/Lines of Credit	75

Delinquent consumer loans. The current risk-based capital measure does not contain a higher risk-weight for delinquent consumer loans. Rising levels of delinquent loans are an indicator of increased risk. To reflect the impaired credit quality of past due loans, the proposal would require credit unions to assign a 150 percent risk-weight to a non-real estate loan if it is 60 days or more past due or in nonaccrual status. NCUA realizes that the ALLL is already reflected in the risk-based capital numerator and increased provision expenses decrease retained earnings. However, the ALLL is intended to cover estimated, incurred losses as of the balance sheet date, rather than unexpected losses. The

⁵⁷ This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintained the 100 percent risk-weight for non-delinquent consumer loans. See, e.g., 78 FR 55390 (Sept. 10, 2013).

⁵⁸ Up until 2010, guaranteed student loans were available through private lending institutions under the Federal Family Education Loan Program (FFELP). These loans were funded by the Federal government, and administered by approved private lending organizations. In effect, these loans were underwritten and guaranteed by the Federal government, ensuring that the private lender would assume no risk should the borrower ultimately default. Loans issued under this program prior to June 30, 2012 will remain on the books of credit unions for many years.

higher risk-weight on past due exposures ensures sufficient regulatory capital for the increased probability of unexpected losses on these exposures. The higher risk-weights better capture the risk associated with the impaired credit quality of these exposures.

TABLE 13—PROPOSED RISK-WEIGHTS FOR DELINQUENT CONSUMER LOANS

Consumer loan type—Delinquent more than 60 days	Proposed risk-weight (percent)
Unsecured Credit Card Loan ...	150
All Other Unsecured Loans/ Lines of Credit	150
Short-Term, Small Amount Loans	150
Non-Federally Guaranteed Student Loans	150
New Vehicle Loans	150
Used Vehicle Loans	150
Leased Receivable	150
All Other Loans/Lines of Credit	150

Loans to CUSOs and CUSO investments. Since Call Reports are prepared on a consolidated basis, wholly owned or majority owned CUSO assets are consolidated with the credit union's books and records with applicable risk-weights assigned by the asset type. The current risk-based measure assigns the risk-weight for average-risk assets to the amount of the credit union's investments in CUSOs and loans to CUSOs, as reported in the Other Asset Call Report item. The proposal would increase the risk-weight to 250 percent for investments in CUSOs. This increase is due to the risk of this unsecured equity investment, which is almost always in a non-publicly traded entity. Loans to CUSOs are normally a higher payout priority in the event of liquidation of a CUSO, and thus would be assigned a risk-weight of 100 percent.

TABLE 14—PROPOSED RISK-WEIGHTS FOR LOANS TO CUSOS & INVESTMENTS IN CUSOS

	Proposed risk-weight (percent)
Loans to CUSO	100
Investment in CUSO	250

Mortgage servicing asset (MSA). The proposal would address the complexity and variability of the risks, including interest rate risk and market risk, associated with a MSA by assigning a 250 percent risk-weight. MSAs can become impaired when interest rates fall and borrowers refinance or prepay their mortgage loans. This impairment

can lead to earnings volatility and erosion of capital. Additional risks include those associated with valuation and modeling processes.

TABLE 15—PROPOSED RISK-WEIGHT FOR MORTGAGE SERVICING ASSETS

	Proposed risk-weight (percent)
MSA	250

Other on-balance sheet assets. The current risk-based measure for all other balance sheet assets not otherwise assigned a specific risk-weight is 100 percent of the risk-based target. Under the proposed rule, these same assets would receive a 100 percent risk-weight.⁵⁹ Credit unions with high levels of other assets, predominately non-earning assets, often have lower net income resulting in pressure on capital.

TABLE 16—PROPOSED RISK-WEIGHTS FOR OTHER ON-BALANCE SHEET ASSETS

Other asset type	Proposed risk-weight (percent)
Loans Held for Sale	100
Foreclosed and Repossessed Assets	100
Land and Building	100
Other Fixed Assets	100
Accrued Interest on Loans	100
Accrued Interest on Investments	100
All Other Assets not otherwise specifically assigned a risk-weight	100

104(c)(2)(i) Category 1—Zero Percent Risk-Weight

Proposed § 702.104(c)(2)(i) would require that credit unions assign a zero percent risk-weight to the following asset types:

- Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit, and currency supplied from automatic teller machines.
- NCUSIF capitalization deposit.
- Debt instruments unconditionally guaranteed by the NCUA or the FDIC.
- U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government, including U.S. Treasury bills, notes, bonds, zero coupon bonds,

⁵⁹ This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintained the 100 percent risk-weight for assets not assigned to a risk weight category. *See, e.g.,* 79 FR 55339 (Sept. 10, 2013).

and separate trading of registered interest and principal securities (STRIPS).

- Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency.

104(c)(2)(ii) Category 2—20 Percent Risk-Weight

Proposed § 702.104(c)(2)(ii) would provide that credit unions assign a 20 percent risk-weight to the following on-balance sheet assets:

- Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts.
- Cash equivalents (investments with original maturities of three months or less). Cash equivalents are 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 total amount of investments with a weighted-average life of one year or less.

- Residential mortgages guaranteed by the federal government through the FHA or the VA.
- Loans guaranteed 75 percent or more by the SBA, U.S. Department of Agriculture, or other U.S. Government agency.

104(c)(2)(iii) Category 3—50 Percent Risk-Weight

Proposed § 702.104(c)(2)(iii) would require that credit unions assign a 50 percent risk-weight to the following on-balance sheet assets:

- The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years.
- The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.

104(c)(2)(iv) Category 4—75 Percent Risk-Weight

Proposed § 702.104(c)(2)(iv) would require that credit unions assign a 75 percent risk-weight to the following on-balance sheet assets:

- The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years.

- Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans, new vehicle loans, used vehicle loans, leases receivable and all other loans. (Excluding loans reported as MBLs).

- Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.

104(c)(2)(v) Category 5—100 Percent Risk-Weight

Proposed § 702.104(c)(2)(v) would require that credit unions assign a 100 percent risk-weight to the following on-balance sheet assets:

- Corporate credit union nonperpetual capital.
- The total outstanding principal amount of loans to CUSOs.
- Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets.
- Delinquent first mortgage real estate loans.

- Other real estate-secured loans less than or equal to 10 percent of assets.
- MBLs less than or equal to 15 percent of assets.

- Loans held for sale.
- The total amount of any foreclosures and repossessed assets.
- Land and building, less depreciation on building.
- Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation.
- Current non-federally insured student loans.

- All other assets not specifically assigned a risk-weight but included in the balance sheet.

104(c)(2)(vi) Category 6—125 Percent Risk-Weight

Proposed § 702.104(c)(2)(vi) would require that credit unions assign a 125 percent risk-weight to the total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.

104(c)(2)(vii) Category 7—150 Percent Risk-Weight

Proposed § 702.104(c)(2)(vii) would require that credit unions assign a 150 percent risk-weight to the following on-balance sheet assets:

- The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years.

- Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle

loans; leases receivable; and all other loans (excluding loans reported as MBLs).

- The total amount of all other real estate-secured loans greater than 20 percent of assets.
- Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets.

104(c)(2)(viii) Category 8—200 Percent Risk-Weight

Proposed § 702.104(c)(2)(viii) would require that credit unions assign a 200 percent risk-weight to the following on-balance sheet assets:

- Corporate credit union perpetual capital.
- The total amount of investments with a weighted-average life of greater than 10 years.
- The total amount of MBLs greater than 25 percent of assets, other than MBLs included in Category 3 above.

104(c)(2)(ix) Category 9—250 Percent Risk-Weight

Proposed § 702.104(c)(2)(ix) would require that credit unions assign a 250 percent risk-weight to the following on-balance sheet assets:

- The total value of investments in CUSOs.
- The total value of MSAs.

104(c)(2)(x) Category 10—1,250 Percent Risk-Weight

Proposed § 702.104(c)(2)(x) would require that credit unions assign a 1,250 percent risk-weight (8% * 1,250% = 100%) to an asset-backed investment for which the credit union is unable to demonstrate, as required under § 702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance. A 1,250 percent risk-weight is equivalent to holding capital equal to 100 percent of the investment's balance sheet value.⁶⁰

During the recent financial crisis, it became apparent that many federally insured financial institutions relied

exclusively on ratings issued by Nationally Recognized Statistical Organizations (NRSOs) and did not perform internal credit analysis of asset-backed investments. Complex credit unions must be able to demonstrate a comprehensive understanding of any investment, particularly an understanding of the features of an asset-backed investment that would materially affect its performance. Upon purchase and on an ongoing basis, the credit union must evaluate, review, and update as appropriate the analysis performed on an asset-backed investment. In the event a credit union is unable to demonstrate a comprehensive understanding of an asset-backed investment, the proposed rule would provide for assigning a risk-weight of 1,250 percent to that investment.

104(c)(3) Risk-Weights for Off-Balance Sheet Activities

Proposed § 702.104(b)(3) would provide that the risk-weighted amounts for all off-balance sheet items are determined by multiplying the notional principal, or face value, by the appropriate conversion factor and the assigned risk-weight as follows:

- A 75 percent conversion factor with a 100 percent risk-weight for unfunded commitments for MBLs.
- A 75 percent conversion factor with a 100 percent risk-weight for MBLs transferred with limited recourse.
- A 75 percent conversion factor with a 50 percent risk-weight for first mortgage real estate loans transferred with limited recourse.
- A 75 percent conversion factor with a 100 percent risk-weight for other real estate loans transferred with limited recourse.
- A 75 percent conversion factor with a 100 percent risk-weight for non-federally guaranteed student loans transferred with limited recourse.
- A 75 percent conversion factor with a 75 percent risk-weight for all other loans transferred with limited recourse.

- A 10 percent conversion factor with a 75 percent risk-weight for total unfunded commitments for non-business loans.

The risk-based capital measure in current § 702.104 includes the amount of commitments outstanding for loans sold with recourse and unused member business loan commitments in the calculation of risk-assets. The current rule recognizes the potential for these commitments to quickly become on-balance sheet assets with their related risks.

Under this proposal, a credit union would calculate the exposure amount of an off-balance sheet component, which is usually the contractual amount multiplied by the applicable credit conversion factor (CCF). This treatment would apply to specific off-balance sheet items, including loans sold with recourse, unfunded commitments for business loans, and other unfunded commitments. The proposed rule would improve risk sensitivity and implement capital requirements for certain exposures through a simple methodology.

Large draws on unused MBL commitments may cause liquidity problems and heighten exposure to credit risk. MBL commitments typically do not feature a "material adverse conditions" clause as grounds for revocation. The proposed rule would assign a 75 percent CCF and a 100 percent risk-weight to unused member business loan commitments.

The proposal would retain the existing assumption that the risk exposure associated with recourse loans is analogous to that associated with similar on-balance sheet loans. The proposal would reduce the existing capital requirement for first mortgage real estate loans and consumer loans by assigning them a 75 percent CCF and a risk-weight consistent with the risk-weight assigned for the loan type for on-balance sheet loans.

TABLE 17—PROPOSED CREDIT CONVERSION FACTORS AND RISK-WEIGHTS FOR OFF-BALANCE SHEET ASSETS

	Proposed CCF (percent)	Proposed risk-weight (percent)
Unused MBL commitments	75	100
MBLs sold with recourse	75	100
First mortgage real estate loans sold with recourse	75	50
Other real estate loans sold with recourse	75	100
Non-federally guaranteed student loans sold with recourse	75	100
All other loans sold with recourse	75	75

⁶⁰ 8 percent adequately capitalized level * 1,250 percent = 100 percent.

This proposal would add a relatively small capital requirement for the total reported unfunded commitments for non-MBL. The proposal would apply a CCF of 10 percent with a 75 percent risk-weight. NCUA included this

commitment with a relatively small capital requirement in order to recognize the risk that a credit union with a substantial amount of unfunded loan commitments may unexpectedly be required to fund such obligations,

creating a drain on liquidity and a shifting of assets which could cause a significant increase in the minimum capital requirement.

TABLE 18—PROPOSED CREDIT CONVERSION FACTOR AND RISK-WEIGHT FOR TOTAL UNFUNDED COMMITMENTS FOR NON-BUSINESS LOANS

	CCF (percent)	Proposed risk-weight (percent)
Total unfunded commitments for non-business loans	10	75

The proposed rule would expressly exclude loans sold to the secondary mortgage market that feature representations and warranties customarily required by the U.S. Government (e.g., Ginnie Mae) and government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac). These include representations that the credit union has underwritten the loan and appraised the collateral in conformity with identified standards. These representations provide for the return of assets to the originating credit union in instances of incomplete documentation or fraud. Such representations would be exempt provided the history of payment on these representations is infrequent. Credit enhancing representations and warranties beyond the usual agency requirements would be considered recourse and thus would not be excluded from this risk portfolio.

104(c)(4) Derivatives

Proposed § 702.104(c)(4) would adopt an approach to assign risk-weights to derivatives that is generally consistent with the approach adopted by the FDIC in its recently issued interim final rule regarding regulatory capital.⁶¹

Under the FDIC's interim rule, derivatives transactions covered under clearing arrangements are treated differently than non-cleared transactions. The NCUA Board is proposing a single regulatory capital approach regardless of the credit union's derivatives transaction clearing status. This selection of regulatory capital treatment is not intended to express a position on credit union clearing. 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.⁶² 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.⁶³

Derivatives transaction risk-weighting. To determine the risk-weighted asset amount for a derivatives contract under the proposed rule, a credit union would first determine its exposure amount for the contract. It would then apply to that amount a risk-weight based on the counterparty or recognized collateral. For a single derivatives contract that is not subject to a qualifying master netting agreement (as defined further below in this section), the proposed rule would require the exposure amount to be the sum of (1) the credit union's current credit exposure (CCE), which is the greater of the fair value or zero, and (2) potential future exposure (PFE), which is calculated by multiplying the notional principal amount of the derivatives contract by the appropriate conversion factor, in accordance with Table 19 below.

TABLE 19—PROPOSED CONVERSION FACTOR MATRIX FOR DERIVATIVES CONTRACTS

Remaining maturity	Interest rate risk hedge derivatives	All other derivatives ⁶⁴
One year or less		
Greater than one year and less than or equal to five years	0.00	0.10
Greater than five years	0.005	0.12
	0.015	0.15

For multiple derivatives contracts subject to a qualifying master netting agreement, a credit union would calculate the exposure amount by adding the net CCE and the adjusted sum of the PFE amounts for all derivatives contracts subject to that qualifying master netting agreement.

The net CCE is the greater of zero and the net sum of all positive and negative fair values of the individual derivatives contracts subject to the qualifying

master netting agreement. The adjusted sum of the PFE amounts would be calculated as described in § 702.104(c)(4)(ii)(B) of the proposed rule.

To recognize the netting benefit of multiple derivatives contracts, the contracts would have to be subject to the same qualifying master netting agreement. For example, a credit union with multiple derivatives contracts with a single counterparty could add the

counterparty exposure if the transactions fall under an International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement and Schedule.

If a derivatives contract is collateralized by financial collateral, a credit union would first determine the exposure amount of the derivatives contract as described in § 702.14(c)(4)(i). Next, to recognize the credit risk mitigation benefits of the financial collateral, the credit union would use

⁶¹ See 78 FR 55339 (Sept. 10, 2013).

⁶² 17 CFR part 50.

⁶³ 78 FR 52285 (Aug. 22, 2013); see also 17 CFR 60.51.

⁶⁴ This would include all other derivatives contracts including foreign exchange, equity, credit, and commodity.

the approach for collateralized transactions as described in § 702.104(c)(4)(v)(B) of the proposed rule.

Collateralized transactions. Under the proposed rule, NCUA would permit a credit union to recognize risk-mitigating effects of financial collateral. The collateralized portion of the exposure receives the risk-weight applicable to the collateral. In all cases, (1) the collateral must be subject to a collateral agreement (for example, an ISDA Credit Support Annex) for at least the life of the exposure; (2) the credit union must revalue the collateral at least every three months; and (3) the collateral and the exposure must be denominated in U.S. dollars.

Generally, the risk-weight assigned to the collateralized portion of the exposure would be no less than 20 percent. However, the collateralized portion of an exposure may be assigned a risk-weight of less than 20 percent for the following exposures. Derivatives contracts that are marked to fair value on a daily basis and subject to a daily margin maintenance agreement could receive (1) a zero percent risk-weight to the extent that contracts are collateralized by cash on deposit, or (2) a 10 percent risk-weight to the extent that the contracts are collateralized by an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(i) of the proposed rule. In addition, a credit union could assign a zero percent risk-weight to the collateralized portion of an exposure where the financial collateral is cash on deposit. It also could do so if the financial collateral is an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(i) of the proposed rule, and the credit union has discounted the fair value of the collateral by 20 percent. The credit union would be required to use the same approach for similar exposures or transactions.

Risk management guidance for recognizing collateral. Before a credit union recognizes collateral for credit risk mitigation purposes, it should: (1) Conduct sufficient legal review to ensure, at the inception of the collateralized transaction and on an ongoing basis, that all documentation used in the transaction is binding on all parties and legally enforceable in all relevant jurisdictions; (2) consider the correlation between risk of the underlying direct exposure and collateral in the transaction; and (3) fully take into account the time and cost needed to realize the liquidation proceeds and the potential for a decline in collateral value over this time period.

A credit union should also ensure that the legal mechanism under which the collateral is pledged or transferred ensures that the credit union has the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the counterparty and, where applicable, the custodian holding the collateral.

In addition, a credit union should ensure that it (1) has taken all steps necessary to fulfill any legal requirements to secure its interest in the collateral so that it has, and maintains, an enforceable security interest; (2) has set up clear and robust procedures to ensure satisfaction of any legal conditions required for declaring the borrower's default and prompt liquidation of the collateral in the event of default; (3) has established procedures and practices for conservatively estimating, on a regular ongoing basis, the fair value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and deterioration of the collateral); and (4) has in place systems for promptly requesting and receiving additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds:

104(d) Due Diligence Requirements for Asset-Backed Investments

Proposed § 702.104(d) would contain due diligence requirements credit unions would have to implement in demonstrating a comprehensive understanding of the features of an asset-backed investment. The NCUSIF has experienced significant losses by credit unions that invested heavily in asset-backed investments without the board of directors or staff having sufficient expertise to understand and manage the risks. The proposed rule defines the general content of an adequate analysis and the timing of the analysis.

(d)(1)

Proposed § 702.104(d)(1) would provide that if a credit union is unable to demonstrate a comprehensive understanding, as required under proposed § 702.104(d)(2), of the features of an asset-backed investment exposure that would materially affect the performance of the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The proposed rule would also require that the credit union's analysis be commensurate with the complexity of the asset-backed investment and the

materiality of the position in relation to regulatory capital according to this part. (d)(2).

Proposed § 702.104(d)(2) would provide that a credit union must demonstrate its comprehensive understanding of each asset-backed investment exposure under § 702.104(d)(1) by:

- Conducting an analysis of the risk characteristics of an investment's exposure prior to acquiring the investment and documenting such analysis within three business days after acquiring the exposure, considering:

- Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

- Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

- Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and

- For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and

- On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure.

Current Section 702.105 Weighted-Average Life of Investments

As discussed above in the definitions part of the section-by-section analysis, proposed § 702.105 would replace current § 702.105 regarding weighted-average life of investments, and the definition in the current section would be moved to the definition of "weighted-average life of investments" in proposed § 702.2.

Section 702.105 Individual Minimum Capital Requirements

Capital helps ensure individual credit unions can continue to serve as credit intermediaries even during times of stress, thereby promoting the safety and soundness of the U.S. credit union system. As with the current Part 702, the proposed capital rules would be minimum standards generally based on broad credit risk and concentration considerations.

A complex credit union is generally expected to have internal processes for assessing capital adequacy that reflects a full understanding of its risk exposure and to ensure that it holds capital corresponding to those risks. The nature of such capital adequacy assessments should be commensurate with the credit union's size, complexity, and risk profile. Supervisory assessment of capital adequacy will take into account whether a credit union plans appropriately to maintain an adequate level of capital given its activities and risk profile, as well as risks and other factors that can affect a credit union's financial condition. The supervisory assessment will also consider the potential impact on earnings and the capital base from prospective economic conditions. For this reason, a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of a credit union's regulatory capital ratios.

In light of these considerations, as a prudent matter, a complex credit union is generally expected to operate with capital positions above the minimum risk-based capital measures and hold capital commensurate with the level and nature of the risk to which it is exposed. Credit unions contemplating significant expansion proposals are expected to maintain strong capital levels above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Complex credit unions with high levels of risk are also expected to operate with capital well above minimum risk-based standards.

This proposed rule includes a provision that NCUA may require a higher minimum risk-based capital ratio for an individual credit union in any case where the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. For example, higher capital may be

appropriate for a credit union that has significant exposure to declines in the economic value of its capital due to changes in interest rates. Part 747 would contain procedures for requiring a credit union to maintain a higher minimum capital.

105(a) General

Proposed § 702.105(a) would provide that the rules and procedures specified in this paragraph apply to the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirement(s) that would otherwise apply to the credit union under this part.

105(b) Appropriate Considerations for Establishing Individual Minimum Capital Requirements

Proposed § 702.105(b) would provide that minimum capital levels higher than the risk-based capital requirements under this part may be appropriate for individual credit unions. NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is or may become inadequate in view of the credit union's circumstances. In addition, the proposed rule provides the following situations in which NCUA may find that higher capital levels are appropriate:

- A credit union is receiving special supervisory attention.
- A credit union has or is expected to have losses resulting in capital inadequacy.
- A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk.
- A credit union has poor liquidity or cash flow.
- A credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance.
- A credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit.
- A credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms.

- A credit union has inadequate underwriting policies, standards, or procedures for its loans and investments.

- A credit union has failed to properly plan for, or execute, necessary retained earnings growth.

- A credit union has a record of operational losses that exceeds the average of other similarly situated credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

105(c) Standards for Determination of Appropriate Individual Minimum Capital Requirements

Proposed § 702.105(c) would provide that the appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria, and that the decision is necessarily based, in part, on a subjective judgment grounded in agency expertise. The proposed rule provides the following additional factors that may be considered by NCUA in making its determination:

- The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the credit union.
- The urgency of those circumstances or potential problems.
- The overall condition, management strength, and future prospects of the credit union and, if applicable, its subsidiaries, affiliates, and business partners.
- The credit union's liquidity, capital, and other indicators of financial stability, particularly as compared with those of similarly situated credit unions.
- The policies and practices of the credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

Current Section 702.106 Standard Calculation of Risk-Based Net Worth Requirement

The proposed rule would eliminate current § 702.106 regarding the standard RBNW requirement. The current rule is structured so that credit unions have a standard measure and optional alternatives for measuring a credit union's RBNW. The proposed rule, on the other hand, would contain only a single measurement for calculating a credit union's risk-based capital ratio.

Accordingly, current § 702.106 would no longer be necessary and has been eliminated from the proposed rule.

Current Section 702.107 Alternative Component for Standard Calculation

The proposed rule would eliminate current § 702.107 regarding the use of alternative risk-weight measures. NCUA believes the current alternative risk-weight measures add unnecessary complexity to the rule. The current alternative risk-weights focus almost exclusively on interest rate risk, which has resulted in some credit unions with higher risk operations reducing their regulatory minimum capital requirement to a level inconsistent with the risk of the credit union's business model. The proposed risk-weights would provide for lower risk-based capital requirements for those credit unions making good quality loans, investing prudently, and avoiding concentrations of assets.

Current Section 702.108 Risk Mitigation Credit

This proposed rule would eliminate § 702.108 regarding the risk mitigation credit. The risk mitigation credit provides a system for reducing a credit union's risk-based capital requirement if it can demonstrate significant mitigation of credit or interest rate risk. Credit unions have rarely taken advantage of risk mitigation credits, with only one credit union receiving a risk mitigation credit. The review of a credit union's application for a risk mitigation credit requires a substantial commitment of NCUA and credit union resources. In practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow.

Mandatory and Discretionary Supervisory Actions

Section 216(a)(2) of the FCUA directs NCUA to take prompt corrective actions to resolve the problems of insured credit unions.⁶⁵ To facilitate this purpose, the FCUA defined five regulatory capital categories that include capital thresholds for a defined net worth ratio and risk-based capital measure for "complex" credit unions. These five PCA categories are: Well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Credit unions that fail to meet these capital measures are

subject to increasingly strict limits on their activities.⁶⁶

The proposal would generally maintain the existing mandatory and discretionary supervisory actions (PCA actions) currently contained in §§ 702.201 through 702.204.⁶⁷ The PCA actions aid in accomplishing the PCA's purpose and provide a transparent guide of supervisory actions that a credit union can expect as capital measures decline.

Section 702.106 Prompt Corrective Action for Adequately Capitalized Credit Unions

The proposed rule would renumber current § 702.201 as proposed § 702.106, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.106(a) would be amended to remove the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.107 Prompt Corrective Action for Undercapitalized Credit Unions

The proposed rule would renumber current § 702.202 as proposed § 702.107, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.107(a)(1) would be amended to remove the requirement that undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.108 Prompt Corrective Action for Significantly Undercapitalized Credit Unions

The proposed rule would renumber current § 702.203 as proposed § 702.108, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.108(a)(1) would be amended to remove the requirement that significantly undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

⁶⁵ Credit union defined as "new credit unions" under section 1790(d)(2) of the FCUA are subject to an alternative PCA system.

⁶⁷ The requirements would be moved to proposed §§ 702.106 through 702.109.

Section 702.109 Prompt Corrective Action for Critically Undercapitalized Credit Unions

The proposed rule would renumber current § 702.204 as proposed § 702.109, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.109(a)(1) would be amended to remove the requirement that critically undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.110 Consultation With State Official on Proposed Prompt Corrective Action

The proposed rule would renumber current § 702.205 as proposed § 702.110, and would make only minor conforming amendments to the text of the section.

Section 702.111 Net Worth Restoration Plans (NWRPs)

The proposed rule would renumber current § 702.206 as proposed § 702.111, and would make only minor conforming amendments to the text of most of the subsections, with a few exceptions discussed in more detail below.

111(c) Contents of NWRP

Proposed § 702.111(c)(1)(i) would provide that the contents of an NWRP must specify a quarterly timetable of steps the credit union will take to increase its net worth ratio and *risk-based capital ratio, if applicable*, so that it becomes adequately capitalized by the end of the term of the NWRP, and will remain so for four (4) consecutive calendar quarters; and that if complex, the credit union is subject to a RBNW requirement that may require a net worth ratio higher than 6 percent to become adequately capitalized. The proposed rule would add the italicized words "and risk-based capital ratio, if applicable" above to clarify that an NWRP prepared by a complex credit union must specify the steps the credit union will take to increase its risk-based capital ratio.

In addition, consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.111(c)(1)(ii) would be amended to remove the requirement that credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

⁶⁵ 12 U.S.C. 1790d(a)(2).

111(g) NWRP Not Approved**111(g)(4) Submission of Multiple Unapproved NWRPs**

Proposed § 702.111(g)(4) would provide that the submission of more than two NWRPs that are not approved is considered an unsafe and unsound condition and may subject the credit union to administrative enforcement actions under section 206 of the FCUA.⁶⁸ NCUA regional directors have expressed concerns that some credit unions have in the past submitted multiple NWRPs that could not be approved due to non-compliance with the requirements of the current rule, resulting in delayed implementation of actions to improve the credit union's net worth. The proposed amendments are intended to clarify that submitting multiple NWRPs that are rejected by NCUA, or the applicable state official, because of the inability of the credit union to produce an acceptable NWRP is an unsafe and unsound practice and may subject the credit union to further actions as permitted under the FCUA.

111(j) Termination of NWRP

Proposed § 702.111(j) would provide that, for purposes of part 702, an NWRP terminates once the credit union has been classified as adequately capitalized or well capitalized and for four consecutive quarters. The proposed paragraph would also provide as an example that if a credit union with an active NWRP attains the classification as adequately capitalized on December 31, 2015, this would be quarter one and the fourth consecutive quarter would end September 30, 2016. The proposed paragraph is intended to provide clarification for credit unions on the timing of an NWRP's termination.

Section 702.112 Reserves

The proposed rule would renumber current § 702.401 as proposed § 702.112. Consistent with the text of current § 702.401(a), it also would require that each credit union establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or, in special cases, by the NCUA Board or appropriate state official.

Regular reserve account. As mentioned above, the proposed rule would eliminate current § 702.401(b) regarding the regular reserve account from the earnings retention process. Additionally, the process and substance of requesting permission for charges to the regular reserve would be eliminated upon the effective date of a final rule.

Upon the effective date of a final rule, federal credit unions would close out the regular reserve balance into undivided earnings. A state-chartered, federally insured credit union may still be required to maintain a regular reserve account by its respective state supervisory authority.

The Board initially included the regular reserve in part 702 for purposes of continuity from past regulatory expectations that involved this account to ease credit unions' transition to the then new PCA rules. The regular reserve account is not necessary to satisfying the statutory "earnings retention requirement" and is not required under GAAP. CUMAA requires credit unions that are not well capitalized to "annually set aside as net worth an amount equal to not less than 0.4 percent of its total assets."⁶⁹ The earnings retention requirement in current § 702.201(a) requires a credit union that is not well capitalized to increase the "dollar amount of its net worth either in the current quarter, or on average over the current and three preceding quarters by an amount equivalent to at least 1/10th percent of total assets." Under the current rule, the credit union must then "quarterly transfer that amount" from undivided earnings to the regular reserve account. Increasing net worth alone satisfies the statutory earnings retention requirement. The additional step of transferring earnings from the undivided earnings account to the regular reserve account is not necessary to meet the PCA statutory requirement.

The regular reserve was initially incorporated into the earnings retention process because of familiarity. Prior to PCA, credit unions used the regular reserve account under the former reserving process prescribed by the now repealed section 116 of the FCUA.⁷⁰ However, examiner experience indicates that since PCA was first implemented, the regular reserve account in part 702 has been a source of unnecessary confusion. Some credit unions have continued to make transfers as if the repealed section 116 were still in force. Other credit unions have confused the purpose of the regular reserve in the current PCA process. Thus, some credit unions have made earnings transfers that are not required and others have done so without first increasing net worth.

For these reasons, the Board now considers the regular reserve account to be obsolete and proposes its elimination upon the effective date of a final rule.

The proposed rule eliminates the cross references to the regular reserve requirement as discussed in more detail in each corresponding part of the section-by-section analysis.

Section 702.113 Full and Fair Disclosure of Financial Condition

The proposed rule would renumber current § 702.402 as proposed § 702.113, and would make only minor conforming amendments to the text of the section with one exception, which is discussed in more detail below.

113(d) Charges for Loan Losses

Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.113(d) would be amended to remove paragraph (d)(4) of the current rule, which provided that the maintenance of an ALLL shall not affect the requirement to transfer earnings to a credit union's regular reserve when required under subparts B or C of this part.

Section 702.114 Payment of Dividends

The proposed rule would renumber current § 702.402 as proposed § 702.114 and make a number of amendments to the text of subsections (a) and (b), and add new subsection (c).

114(a) Restriction on Dividends

Current § 702.402(a) permits credit unions with a depleted undivided earnings balance to pay dividends out of the regular reserve account without regulatory approval, as long as the credit union will remain at least adequately capitalized. Proposed § 702.114(a), however, would allow only credit unions that have substantial net worth, but no undivided earnings, to pay dividends without regulatory approval.

114(b) Payment of Dividends if Retained Earnings Depleted

Proposed § 702.114(b) would provide that well capitalized credit unions could pay dividends only if their net worth classification do not fall below adequately capitalized. As with the current § 702.402(b)(2), proposed § 702.114(b)(2) would require approval from the appropriate Regional Director, and if state-chartered, the appropriate state official, if after payment of the dividend the credit union's net worth classification would fall below adequately capitalized. In addition, the proposed rule would require that the credit union's request for written approval include the credit union's plan for eliminating any negative retained earnings balance. Secondary capital accounts would continue to be excluded

⁶⁸ 12 U.S.C. 1786 and 1790d.

⁶⁹ 12 U.S.C. 1790(a)(1).

⁷⁰ 12 U.S.C. 1762.

as a direct source of dividend payments. Dividends would not be considered operating losses and could not be paid out of secondary capital.

114(c) Restriction on Payments of Dividends if, After Payment of Dividends, the Credit Union's Net Worth Ratio Would Be Less Than 6 Percent

Proposed § 702.114(c) would prohibit a credit union from unreasonably dissipating its capital through excessive dividend payments or a refund of interest in a manner that would undermine the safety and soundness of the credit union. In particular, the proposed rule would prohibit a credit union currently classified as well capitalized from paying dividend rates that are higher than the prevailing market rates, declaring a non-repetitive dividend, or approving a refund of interest if, after the payment of the dividend, the credit union's net worth ratio would decline to less than 6 percent in the current quarter. This new provision would prevent the unsafe dissipation of capital through the payment of special or bonus dividends or interest refunds while still allowing for continuity of operations.

B. Subpart B—Alternative Prompt Corrective Action for New Credit Unions

The proposed rule would add new subpart B, which would contain most of the capital adequacy rules that would apply to "new" credit unions. Section 216(b)(2)(B)(iii) of the FCUA defines a "new" credit union as one that has been in operation for 10 years or less, or has \$10 million or less in total assets.⁷¹

The current net worth measures, net worth classification, and text of the PCA requirements applicable to new credit unions would be renumbered. They would remain mostly unchanged in the proposed rule, however, except for the following substantive amendments:

- (1) Elimination of the regular reserve account requirement in current § 702.401(b) and all cross references to the requirement;
- (2) Addition of new § 701.206(f)(3) clarifying that the submission of more than two revised business plans would be considered and unsafe and unsound condition; and
- (3) Amendment of the requirements of current § 702.403 regarding the payment of dividends.

Each of these substantive amendments is discussed in more detail below.

⁷¹ 12 U.S.C. 1790d(b)(2)(B)(iii).

Section 702.201 Scope and Definition

The proposed rule would renumber current § 702.301 as proposed § 702.201. The proposed rule would eliminate the ability of a credit union to regain a designation of new after reporting total assets in excess of \$10 million.

Section 216(b)(2) of the FCUA requires the NCUA to prepare regulations that apply to new credit unions. The FCUA further requires that rules for new credit unions prevent evasion of the purpose of section 216, which provides new credit unions a period of time to accumulate net worth. NCUA recently conducted a postmortem review of a credit union failure that caused a loss to the NCUSIF. The review revealed that the credit union intentionally reduced its total assets below \$10 million to regain the designation "new" credit union under current part 702 and the associated lower net worth requirement. Shifting back and forth between the minimum capital requirement for "new" and all other credit unions resulted in slowed capital accumulation, which contributed to the loss incurred by the NCUSIF. Accordingly, NCUA is now proposing to amend the definition of "new" credit union in current § 702.301 to eliminate such practices in the future.

In general, credit unions attaining an asset size of \$10 million begin to offer a greater range of services and loans, which increase the credit union's complexity and risk to the NCUSIF. In the event a new credit union reports total assets of over \$10 million and then subsequently declines to under \$10 million, the additional PCA regulatory requirements under the proposed rule would not be substantially increased. Both new credit unions and non-new credit unions with net worth ratios of less than 6 percent, but over 2 percent, are required under either § 702.206 or § 702.111 of the proposal to operate under substantially similar plans to restore their net worth. For example, a new credit union with a net worth ratio of 5 percent is required to operate under a revised business plan, and a non-new credit union with a net worth ratio of 5 percent is required to operate under a NWRP. Therefore, any burden associated with this change to the requirements of part 702 should be minimal.

Section 702.202 Net Worth Categories for New Credit Unions

The proposed rule would renumber current § 702.302 as proposed § 702.202, and would make only minor conforming amendments to the text of the section.

Section 702.203 Prompt Corrective Action for Adequately Capitalized New Credit Unions

The proposed rule would renumber current § 702.303 as proposed § 702.203, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.203 would be amended to remove the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.204 Prompt Corrective Action for Moderately Capitalized, Marginally Capitalized or Minimally Capitalized New Credit Unions

The proposed rule would renumber current § 702.304 as proposed § 702.204, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), which is discussed in more detail below, proposed § 702.204(a)(1) would be amended to remove the requirement that such credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.205 Prompt Corrective Action for Uncapitalized New Credit Unions

The proposed rule would renumber current § 702.305 as proposed § 702.205, and would make only minor conforming amendments to the text of the section.

Section 702.206 Revised Business Plans (RBP) for New Credit Unions

The proposed rule would renumber current § 702.306 as proposed § 702.206, would make mostly minor conforming amendments to the text of the section, and would add new § 702.206(g)(3). Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), which is discussed in more detail below, proposed § 702.206(b)(3) would be amended to remove the requirement that new credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

206(g)(3) Submission of Multiple Unapproved Revised Business Plans

Proposed § 702.206(g)(3) would provide that the submission of more than two RBPs that are not approved is considered an unsafe and unsound condition and may subject the credit

union to administrative enforcement actions under section 206 of the FCUA.⁷² NCUA regional directors have expressed concerns that some credit unions have in the past submitted multiple RBP's that could not be approved due to non-compliance with the requirements of the current rule, resulting in delayed implementation of actions to improve the credit union's net worth. The proposed amendments are intended clarify that submitting multiple RBP's that are rejected by NCUA, or the state official, because of the failure of the credit union to produce an acceptable RBP is an unsafe and unsound practice and may subject the credit union to further actions as permitted under the FCUA.

Section 702.207 Incentives for New Credit Unions

The proposed rule would renumber current § 702.307 as proposed § 702.207, and would make only minor conforming amendments to the text of the section.

Section 702.208 Reserves

The proposed rule would add new § 702.208 regarding reserves for new credit unions to the rule and, consistent with the text of current reserve requirement at § 702.401(a), would require that each new credit union establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

As explained under § 702.112, the proposed rule would eliminate the regular reserve account under current § 702.402(b) from the earnings retention requirement. Additionally the process and substance of requesting permission for charges to the regular reserve would be eliminated upon the effective date of a final rule. Upon the effective date of a final rule federal credit unions would close out the regular reserve balance into undivided earnings. A federally insured state chartered credit union may still be required to maintain a regular reserve account as dictated by state law or by its respective state supervisory authority.

Section 702.209 Full and Fair Disclosure of Financial Condition

The proposed rule would move the full and fair disclosure of financial condition requirements contained in the current § 702.402, and applicable to new credit unions, to new § 702.209 of the proposed rule. No substantive changes to the current full and fair disclosure of

financial condition requirements for new credit unions are intended.

Section 702.210 Payment of Dividends

The proposed rule would reorganize the rules regarding the payment of dividends contained in the current § 702.403, which also apply to new credit unions, to new § 702.210 of the proposed rule. The proposed rule would make a number of amendments to the text of paragraphs (a) and (b) of the current rule, and add a new paragraph (c). Each of these changes is discussed in more detail below.

210(a) Restriction on Dividends

Current § 702.402(a) permits credit unions with a depleted undivided earnings balance to pay dividends out of the regular reserve account without regulatory approval, as long as the credit union will remain at least adequately capitalized. Proposed § 702.210(a), however, would allow only new credit unions that have substantial net worth, but no undivided earnings, to pay dividends without regulatory approval.

210(b) Payment of Dividends if Retained Earnings Depleted

Proposed § 702.210(b) would provide that well capitalized new credit unions could pay dividends only if their net worth classification do not fall below adequately capitalized. As with the current § 702.402(b)(2), proposed § 702.210(b)(2) would require approval from the appropriate Regional Director, and if state-chartered, the appropriate state official, if after payment of the dividend the credit union's net worth classification would fall below adequately capitalized. In addition, the proposed rule would require that the credit union's request for written approval include the credit union's plan for eliminating any negative retained earnings balance. Secondary capital accounts would continue to be excluded as a direct source of dividend payments. Dividends would not be considered operating losses and could not be paid out of secondary capital.

210(c) Restriction on Payments of Dividends if, After Payment of Dividends, the Credit Union's Net Worth Ratio Would Be Less Than 6 Percent

Proposed § 702.210(c) would prohibit a new credit union from unreasonably dissipating its capital through excessive dividend payments or a refund of interest in a manner that would undermine the safety and soundness of the credit union. In particular, the proposed rule would prohibit a new credit union currently classified as well

capitalized from paying dividend rates that are higher than the prevailing market rates, declaring a non-repetitive dividend, or approving a refund of interest if, after the payment of the dividend or a refund of interest, the credit union's net worth ratio would decline to less than 6 percent in the current quarter. This new provision would prevent the unsafe dissipation of capital through the payment of special or bonus dividends or interest refunds while still allowing for continuity of operations.

C. Part 747—Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations

Subpart L—Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action

Section 747.2006 Review of Order Imposing Individual Minimum Capital Requirements

Section 216(k) of the FCUA provides that "material supervisory determinations, including decisions to require prompt corrective action, made . . . by [NCUA] officials other than the [NCUA] Board may be appealed to the [NCUA] Board" through an independent appellate process "pursuant to separate procedures prescribed by regulation."⁷³ Consistent with the requirements of section 216(k), decisions of NCUA staff to impose a discretionary supervisory action (including imposing individual minimum capital requirements on a credit union) would continue to be treated as "material supervisory determinations." Proposed § 747.2006 would require that NCUA provide reasonable prior notice and an independent process for appealing NCUA staff decisions to impose individual minimal capital requirements (IMCR) under proposed § 702.105.

2006(a) Notice of Proposed Individual Minimum Capital Requirements

Proposed § 747.2006(a) would require NCUA to provide a credit union with reasonable prior notice when NCUA proposes to impose IMCR for a particular credit union pursuant to proposed § 702.105. In addition, the proposed rule would require NCUA to forward a copy of the notifying letter to the appropriate state supervisory authority (SSA) if a state-chartered credit union would be subject to an IMCR.

⁷² 12 U.S.C. 1786 and 1790d.

⁷³ Section 1790d(k).

2006(b) Contents of the Notice

Proposed § 747.2006(b) would require that the notice of intention to impose IMCR for a credit union based on particular capital conditions at a credit union state all of the following: (1) The credit union's net worth ratio, risk-based capital ratio and net worth classification. (2) The specific minimum capital levels that the NCUA Board intends to impose on the credit union under the IMCR, and the specific causes for determining that the higher IMCR is necessary or appropriate for the credit union. (3) The proposed schedule for compliance with the new requirement. (4) That the credit union must file a written response to the notice, which shall be no less than 30 calendar days from the date of service of the notice.

In addition, proposed § 747.2006(b) would provide that the NCUA Board may extend the time period for good cause, and that the time period for response by the insured credit union may be shortened for good cause when, in the opinion of NCUA, the condition of the credit union so requires, and NCUA informs the credit union of the shortened response period in the notice; or with the consent of the credit union.

2006(c) Contents of Response to Notice

Proposed § 747.2006(c) would require that the credit union's response to a notice under § 747.2006(b) of this section include the following: (1) An explanation of why it contends the IMCR is not an appropriate exercise of discretion under this part; (2) a request that the NCUA Board modify or not issue the IMCR; (3) any information, mitigating circumstances, documentation, or other evidence in support of the credit union's position that the credit union wants NCUA to consider in deciding whether to establish or to amend an IMCR for the credit union; and (4) if desired, a request for a recommendation from the NCUA's Ombudsman pursuant to § 747.2006(g).

2006(d) Failure To File Response

Proposed § 747.2006(d) would provide that failure by the credit union to respond within 30 days, or such other time period as may be specified by NCUA, may constitute a waiver of any objections to the proposed IMCR or to the schedule for complying with it, unless NCUA has provided an extension of the response period for good cause.

2006(e) Final Decision by NCUA

Proposed § 747.2006(e) would provide that after the expiration of the response period, NCUA will decide whether or not the proposed IMCR should be

established for the credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the credit union's response and other relevant information. The proposed rule would require NCUA's decision to address comments received within the response period from the credit union and the appropriate state supervisory authority (if a state-chartered credit union is involved); and to state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the credit union could take to eliminate the need for continued applicability of the IMCR. In addition, the proposal would require NCUA to provide the credit union and the appropriate SSA (if a state-chartered credit union is involved) with a written decision on the IMCR, addressing the substantive comments made by the credit union and setting forth the decision and the basis for that decision. Finally, proposed § 747.2006(e) would provide that this decision represents final agency action; and that the IMCR becomes effective and binding upon the credit union upon receipt of the decision by the credit union.

2006(f) Request To Modify or Rescind IMCR

Proposed § 747.2006(f) would provide that the IMCR shall remain in effect while such request is pending unless otherwise ordered by the NCUA Board, but would permit a credit union that is subject to an existing IMCR to request in writing that the NCUA Board reconsider the terms of the IMCR due to changed circumstances. In addition the proposed rule would provide that a request under proposed § 747.2006(f) that remains pending 60 days following receipt by the NCUA Board is deemed granted.

2006(g) Ombudsman

Proposed § 747.2006(g) would permit credit unions to request in writing the recommendation of NCUA's ombudsman to modify or to not issue a proposed IMCR under § 747.2006(b), or to modify or rescind an existing directive due to changed circumstances under § 747.2006(f). However, the proposed rule would provide that a credit union that fails to request the ombudsman's recommendation in a response under § 747.2006(c), or in a request under § 747.2006(f), shall be deemed to have waived the opportunity to do so. Finally, the proposed rule would require the ombudsman to promptly notify the credit union and the NCUA Board of his or her recommendation.

D. Other Conforming Changes to the Regulations

In addition to the amendments discussed above, the proposed rule would make minor conforming amendments to §§ 700.2, 701.21, 701.23, 701.34, 703.14, 713.6, 723.7, 747.2001, 747.2002, and 747.2003. The conforming amendments would primarily involve updating terminology and cross citations to proposed part 702 and proposed § 747.2006. No substantive changes are intended by these amendments.

III. Effective Date

How much time would credit unions have to implement these new requirements?

The proposed amendments would go into effect approximately 18 months after the publication of a final rule in the *Federal Register*. This would give credit unions lead time to plan for the new risk-based capital ratio requirements and other proposed changes to part 702. During the 18 month implementation period, credit unions would be required to continue to comply with current part 702. The Board believes this implementation period is necessary to allow credit unions to make adjustments to internal systems, balance sheets and operations well in advance of the effective date.

IV. Regulatory Procedures**Regulatory Flexibility Act**

The Regulatory Flexibility Act (RFA)⁷⁴ requires NCUA to provide an initial regulatory flexibility analysis with a proposed rule to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include credit unions with assets less than or equal to \$50 million) and publish its certification and a short explanatory statement in the *Federal Register* also with the proposed rule.⁷⁵ The proposed amendments to part 702 will primarily impact only credit unions with more than \$50 million in total assets. NCUA recognizes that there may, however, be some burden associated with the amendments to the current rule relating to additional data that will need to be collected on the Call Report; the elimination of the regular reserve requirement; and changes to the payment of dividends. In particular, implementation of the proposed rule will likely impose some one-time costs associated with personnel training and updates to

⁷⁴ 5 U.S.C. 601 et seq.

⁷⁵ 78 FR 4032 (Jan. 18, 2013).

systems for calculating regulatory capital. NCUA believes these one-time implementation costs will not constitute a significant economic impact on small credit unions. Accordingly, the NCUA Board certifies the proposed rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or increases an existing burden.⁷⁶ For purposes of the PRA, a paperwork burden may take the form of a reporting or recordkeeping requirement, both referred to as information collections. The proposed changes to part 702 impose new information collection requirements. As required by the PRA, NCUA is submitting a copy of this proposal to OMB for its review and approval. Persons interested in submitting comments with respect to the information collection aspects of the proposed rule should submit them to OMB at the address noted below.

NCUA has determined that the proposed changes to part 702 will have some one-time costs associated with updating internal policies, and updating data collection and reporting systems for preparing Call Reports. NCUA estimates that all 6,681 credit unions will have to amend their procedures and systems for preparing Call Reports. However, a separate notice will be published for comment on the regulatory reporting requirements.

In addition, NCUA estimates that approximately 2,606 federally insured natural person credit unions hold asset-backed investments and would be subject to the proposed due diligence requirements. Credit unions are already required to perform due diligence under §§ 703.6, 703.10, and 703.12 of NCUA's regulations. Therefore, NCUA does not believe there will be any new burden associated with this requirement.

Finally, NCUA estimates that approximately 33.5 percent, or 2,237 credit unions, will be defined as "complex" under the proposed rule and will have new data collection requirements related to the new risk-based capital requirements.

Title of Information Collection: Risk-based Capital Ratio data.

Frequency of Response: On occasion and quarterly.

Affected Public: All credit unions.

Estimated Number of Respondents: 6,681.

Estimated Burden per Respondent: One-time recordkeeping, 122 hours; ongoing recordkeeping, 20 hours; one time policy review and revision, 20 hours.

Title of Information Collection: Risk-Based Capital Ratio policy implications for complex credit unions.

Affected Public: Complex Credit Unions.

Estimated Number of Respondents: 2,237.

Estimated Burden per Respondent: One-time policy review and revision, 40 hours.

Total Estimated Annual Burden: One-time recordkeeping and disclosures, (122 hours * non-complex credit unions, or 162 hours * complex credit unions); ongoing recordkeeping and disclosures (20 hours * all credit unions).

Submission of comments. NCUA considers comments by the public on this proposed collection of information in:

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of NCUA, including whether the information will have a practical use;
- Evaluating the accuracy of NCUA's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; e.g., permitting electronic submission of responses.

The PRA requires OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the *Federal Register*. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to NCUA on the substantive aspects of the proposed regulation.

Comments on the proposed information collection requirements should be sent to:

Office of Information and Regulatory Affairs, OMB, Attn: Shagufta Ahmed, Room 10226, New Executive Office Building, Washington, DC 20503, with a copy to the Secretary of the Board, National Credit Union Administration,

1775 Duke Street, Alexandria, Virginia 22314-3428.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This proposed rule will apply to all federally insured natural person credit unions, including federally insured, state-chartered natural person credit unions. Accordingly, it may have a direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. This impact is an unavoidable consequence of carrying out the statutory mandate to adopt a system of PCA to apply to all federally insured, natural person credit unions. Throughout the rulemaking process, NCUA has consulted with representatives of state regulators regarding the impact of PCA on state-chartered credit unions. The comments and suggestions of those state regulators are reflected in the proposed rule.

Assessment of Federal Regulations and Policies on Families

NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Public Law 105-277, 112 Stat. 2681 (1998).

List of Subjects

12 CFR Part 700

Credit unions.

12 CFR Part 701

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds.

12 CFR Part 702

Credit unions, Reporting and recordkeeping requirements.

12 CFR Part 703

Credit unions, Investments, Reporting and recordkeeping requirements.

12 CFR Part 713

Bonds, Credit unions, Insurance.

⁷⁶ 44 U.S.C. 3507(d); 5 CFR part 1320.

12 CFR Part 723

Credit unions, Loan programs—
business, Reporting and recordkeeping
requirements.

12 CFR Part 747

Administrative practice and
procedure, Bank deposit insurance,
Claims, Credit unions, Crime, Equal
access to justice, Investigations,
Lawyers, Penalties.

By the National Credit Union
Administration Board on January 23, 2014.
Gerard Poliquin,
Secretary of the Board.

For the reasons discussed above,
NCUA Board proposes to amend 12 CFR
parts 700, 701, 702, 703, 713, 723, and
747 as follows:

PART 700—DEFINITIONS

- 1. The authority citation for part 700
continues to read as follows:

Authority: 12 U.S.C. 1752, 1757(6), 1766.

§ 700.2 [Amended]

- 2. Amend the definition of “net
worth” in § 700.2 by removing
“§ 702.2(f)” and adding in its place
“§ 702.2”.

**PART 701—ORGANIZATION AND
OPERATION OF FEDERAL CREDIT
UNIONS**

- 3. The authority citation for part 701
continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756,
1757, 1758, 1759, 1761a, 1761b, 1766, 1767,
1782, 1784, 1786, 1787, 1789. Section 701.6
is also authorized by 15 U.S.C. 3717. Section
701.31 is also authorized by 15 U.S.C. 1801
et seq., 42 U.S.C. 1981 and 3601–3610.
Section 701.35 is also authorized by 42
U.S.C. 4311–4312.

§ 701.21 [Amended]

- 4. Amend § 701.21(h)(4)(iv) by
removing “§ 702.2(f)” and adding in its
place “§ 702.2”.

§ 701.23 [Amended]

- 5. Amend § 701.23(b)(2) by removing
the words “net worth” and adding in
their place the word “capital”, and
removing the words “or, if subject to a
risk-based net worth (RBNW)
requirement under Part 702 of this
chapter, has remained ‘well capitalized’
for the six (6) immediately preceding
quarters after applying the applicable
RBNW requirement”.

§ 701.34 [Amended]

- 6. Amend § 701.34 as follows:
■ a. In paragraph (b)(12) by remove the
words “§§ 702.204(b)(11), 702.304(b)
and 702.305(b)” and add in their place
the words “part 702”.

- b. In paragraph (d)(1)(i) remove the
words “net worth” and add in their
place the word “capital”.

Appendix to § 701.34 [Amended]

- 7. In the appendix to § 701.34, amend
the paragraph beginning “8. Prompt
Corrective Action” by removing the
words “net worth classifications (*see* 12
CFR 702.204(b)(11), 702.304(b) and
702.305(b), as the case may be)” and
adding in their place the words “capital
classifications (*see* 12 CFR part 702)”.
- 8. Revise part 702 to read as follows:

PART 702—CAPITAL ADEQUACY

Sec.

- 702.1 Authority, purpose, scope, and other
supervisory authority.
702.2 Definitions.

Subpart A—Prompt Corrective Action

- 702.101 Capital measures, effective date of
classification, and notice to NCUA.
702.102 Capital category classification.
702.103 Applicability of risk-based capital
ratio measure.
702.104 Risk-based capital ratio measure.
702.105 Individual minimum capital
requirements.
702.106 Prompt corrective action for
adequately capitalized credit unions.
702.107 Prompt corrective action for
undercapitalized credit unions.
702.108 Prompt corrective action for
significantly undercapitalized credit
unions.
702.109 Prompt corrective action for
critically undercapitalized credit unions.
702.110 Consultation with state officials on
proposed prompt corrective action.
702.111 Net worth restoration plans
(NWRP).
702.112 Reserves.
702.113 Full and fair disclosure of financial
condition.
702.114 Payment of dividends.

**Subpart B—Alternative Prompt Corrective
Action for New Credit Unions**

- 702.201 Scope and definition.
702.202 Net worth categories for new credit
unions.
702.203 Prompt corrective action for
adequately capitalized new credit
unions.
702.204 Prompt corrective action for
moderately capitalized, marginally
capitalized, or minimally capitalized
new credit unions.
702.205 Prompt corrective action for
uncapitalized new credit unions.
702.206 Revised business plans (RBP) for
new credit unions.
702.207 Incentives for new credit unions.
702.209 Reserves.
702.210 Full and fair disclosure of financial
condition.
702.211 Payment of dividends.

Authority: 12 U.S.C. 1766(a), 1790d.

**§ 702.1 Authority, purpose, scope, and
other supervisory authority.**

(a) *Authority.* Subparts A and B of this
part and subpart L of part 747 of this
chapter are issued by the National
Credit Union Administration (NCUA)
pursuant to sections 120 and 216 of the
Federal Credit Union Act (FCUA), 12
U.S.C. 1776 and 1790d (section 1790d),
as revised by section 301 of the Credit
Union Membership Access Act, Public
Law 105–219, 112 Stat. 913 (1998).

(b) *Purpose.* The express purpose of
prompt corrective action under section
1790d is to resolve the problems of
federally insured credit unions at the
least possible long-term loss to the
National Credit Union Share Insurance
Fund. Subparts A and B of this part
carry out the purpose of prompt
corrective action by establishing a
framework of minimum capital
requirements, mandatory, and
discretionary supervisory actions
applicable according to a credit union's
net worth classification, designed
primarily to restore and improve the
capital adequacy of federally insured
credit unions.

(c) *Scope.* This part implements the
provisions of section 1790d as they
apply to federally insured credit unions,
whether federally- or state-chartered; to
such credit unions defined as “new”
pursuant to section 1790d(b)(2); and to
such credit unions defined as
“complex” pursuant to section
1790d(d). Certain of these provisions
also apply to officers and directors of
federally insured credit unions. This
part does not apply to corporate credit
unions. Procedures for issuing,
reviewing and enforcing orders and
directives issued under this part are set
forth in subpart L of part 747 of this
chapter.

(d) *Other supervisory authority.*
Neither section 1790d nor this part in
any way limits the authority of the
NCUA Board or appropriate state
official under any other provision of law
to take additional supervisory actions to
address unsafe or unsound practices or
conditions, or violations of applicable
law or regulations. Action taken under
this part may be taken independently of,
in conjunction with, or in addition to
any other enforcement action available
to the NCUA Board or appropriate state
official, including issuance of cease and
desist orders, orders of prohibition,
suspension and removal, or assessment
of civil money penalties, or any other
actions authorized by law.

§ 702.2 Definitions.

Unless provided otherwise in this
part, the terms used in this part have the
same meanings as set forth in FCUA

sections 101 and 216, 12 U.S.C. 1752, 1790d. The following definitions apply to this part:

Allowance for loan and lease loss (ALLL) means reserves that have been established through charges against earnings to absorb future losses on loans, lease financing receivables, or other extensions of credit.

Appropriate regional director means the director of the NCUA regional office having jurisdiction over federally insured credit unions in the state where the affected credit union is principally located or, for credit unions with \$10 billion or more in assets, the Director of the Office of National Examinations and Supervision.

Appropriate state official means the commission, board or other supervisory authority having jurisdiction over credit unions chartered by the state which chartered the affected credit union.

Call Report means the Call Report required to be filed by all credit unions under § 741.6(a)(2) of this chapter.

Capital means the equity, as measured by GAAP, available to a credit union to cover losses.

Cash equivalents mean short-term highly liquid investments that:

- (1) Have original maturities of 3 months or less, at the time of purchase;
- (2) Are readily convertible to known amounts of cash; and
- (3) Are used as part of the credit union's cash-management activities.

Commitment means any legally binding arrangement that obligated the credit union to extend credit or to purchase assets.

Credit union means a federally insured, natural person credit union, whether federally- or state-chartered, as defined by 12 U.S.C. 1752(6).

CUSO means a credit union service organization as defined in part 712 and 741 of this chapter.

Delinquent loans means loans that are 60 days or more past due and loans placed on nonaccrual status.

Derivatives contract means, in general, a financial instrument, traded on or off an exchange, the value of which is directly depended upon the value on or more underlying securities, equity indices, debt instruments, commodities, interest rates other derivative instruments, or any agreed upon pricing index or arrangement. Derivatives contracts include interest rate derivatives contracts and any other instrument that poses similar counterparty credit risks. Derivatives contracts also include unsettled securities with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the

particular instrument or five business days.

First mortgage real estate loan means loans and lines of credit fully secured by first liens on real estate (excluding MBLs), where:

- (1) The original amortization of the mortgage exposure does not exceed 30 years,
- (2) The loan underwriting took into account all the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments, and
- (3) The loan underwriting concluded the borrower is able to repay the exposure using the maximum interest rate that may apply in the first five years, the maximum contract exposure over the life of the mortgage, and verified income.

GAAP means generally accepted accounting principles as used in the United States.

Goodwill means an intangible asset representing the future economic benefits arising from other assets acquired in a business combination (e.g., merger) that are not individually identified and separately recognized.

Intangible assets means those assets that are required to be reported as intangible assets in a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

Investment in CUSO means the unimpaired value of the credit union's aggregate CUSO investments as measured under GAAP on an unconsolidated basis.

Identified losses means those items that have been determined by an evaluation made by a state or federal examiner, as measured on the date of examination, to be chargeable against income, capital and/or valuation allowances such as the allowance for loan and lease losses. Examples of identified losses would be assets classified as losses, off-balance sheet items classified as losses, any provision expenses that are necessary to replenish valuation allowances to an adequate level, liabilities not shown on the books, estimated losses in contingent liabilities, and differences in accounts that represent shortages.

Loans to CUSOs means the aggregate outstanding loan balance, available line(s) of credit from the credit union, and guarantees the credit union has made to or on behalf of a CUSO.

Loans transferred with limited recourse means the total principal balance outstanding of loans transferred, including participations, for which the

transfer qualified for true sale accounting treatment under GAAP, and for which the transferor credit union retained some limited recourse (i.e. insufficient recourse to preclude true sale accounting treatment). The term does not include transfers that qualify for true sale accounting treatment but contain only routine representation and warranty paragraphs that are standard for sales on the secondary market provided the credit union is in compliance with all other related requirements such as capital requirements.

Mortgage servicing asset (MSA) means those assets (net of any related valuation allowances) resulting from contracts to service loans secured by real estate (that have been securitized or owned by others) for which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing.

NCUSIF means the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783.

Net worth means:

(1) The retained earnings balance of the credit union at quarter-end as determined under GAAP, subject to paragraph (3) of this definition. Retained earnings consists of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities.

(2) For a low income-designated credit union, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders, and the NCUSIF.

(3) For a credit union that acquires another credit union in a mutual combination, net worth also includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, less any bargain purchase gain recognized in either case to the extent the difference between the two is greater than zero. The acquired retained earnings must be determined at the point of acquisition under generally accepted accounting principles. A mutual combination is a transaction in which a credit union acquires another credit union or acquires an integrated set of activities and assets that is capable of being conducted and managed as a credit union.

(4) The term "net worth" also includes loans to and accounts in an insured credit union, established pursuant to section 208 of the Act [12 U.S.C. 1788], provided such loans and accounts:

- (i) Have a remaining maturity of more than 5 years;

(ii) Are subordinate to all other claims including those of shareholders, creditors, and the NCUSIF;

(iii) Are not pledged as security on a loan to, or other obligation of, any party;

(iv) Are not insured by the NCUSIF;

(v) Have non-cumulative dividends;

(vi) Are transferable; and

(vii) Are available to cover operating losses realized by the insured credit union that exceed its available retained earnings.

Net worth ratio means the ratio of the net worth of the credit union to the total assets of the credit union rounded to two decimal places.

New credit union means a federally insured credit union which both has been in operation for less than ten (10) years and has \$10,000,000 or less in total assets.

Off-balance sheet items means items such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements that are not included on the balance sheet but are normally reported in the financial statement footnotes.

Qualifying master netting agreement means a written, legally enforceable agreement, provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the credit union the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or under any similar insolvency law applicable to GSEs;

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate is a net creditor under the agreement); and

(4) In order to recognize an agreement as a qualifying master netting agreement for purposes of this part, a credit union must conduct sufficient legal review, at origination and in response to any changes in applicable law, to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of this definition of qualifying master netting agreement; and

(ii) In the event of a legal challenge (including one resulting from default or from conservatorship, receivership, insolvency, liquidation, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of relevant jurisdictions.

Risk-based capital ratio means the percentage, rounded to two decimal places, of the risk-based capital numerator to total risk-weighted assets, as calculated in accordance with § 702.104(a).

Risk-weighted assets means the total risk-weighted assets as calculated in accordance with § 702.104(c).

Senior executive officer means a senior executive officer as defined by § 701.14(b)(2) of this chapter.

Shares means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

Total assets. (1) For each quarter, a credit union must elect one of the measures of total assets listed in paragraph (2) of this definition to apply for all purposes under this part except §§ 702.103 through 702.105 (risk-based capital ratio requirements).

(2) Total assets means a credit union's total assets as measured by either—

(i) *Average quarterly balance.* The credit union's total assets measured by the average of quarter-end balances of the current and three preceding calendar quarters;

(ii) *Average monthly balance.* The credit union's total assets measured by the average of month-end balances over the three calendar months of the applicable calendar quarter;

(iii) *Average daily balance.* The credit union's total assets measured by the average daily balance over the applicable calendar quarter; or

(iv) *Quarter-end balance.* The credit union's total assets measured by the quarter-end balance of the applicable calendar quarter as reported on the credit union's Call Report.

U.S. Government agency means an instrumentality of the U.S. Government whose obligations are fully and

explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

Verified income means receipt and retention of corroborative information to establish the reality of the income supporting the repayment of the loan.

Weighted-average life of investments means:

(1) For investments in registered investment companies (e.g., mutual funds) and collective investment funds (e.g., common trusts), the maximum weighted-average life or duration target of the investment disclosed, directly or indirectly, in the most recent prospectus or trust instrument (if the maximum weighted-average life or duration target is not disclosed, the weighted-average life of investments means greater than 5 years, but less than 10 years);

(2) For investments in money market funds, as defined in 17 CFR 270.2a-7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 CFR 9.18(b)(4)(i)(B)(1) through (3), 1 year or less;

(3) For fixed rate debt obligations and deposits that are callable in whole, the period remaining to the maturity date;

(4) For fixed rate debt obligations and deposits that are non-callable and non-amortizing (e.g., bullet maturity instruments), the period remaining to the maturity date;

(5) For fixed rate debt obligations or deposits with periodic principal pay downs (e.g., mortgage-backed securities), the weighted-average life of investments as defined according to industry standard calculations, which include the impact of unscheduled payments;

(6) For variable rate debt obligations and deposits (regardless of whether the investment amortizes), the period remaining to the next rate adjustment date;

(7) For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), greater than 1 year but less than or equal to 3 years;

(8) For other equity securities, greater than 10 years.

(9) For any other investments not addressed above, the average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time it is expected to be received (based on a reasonable and supportable estimate of that time), and then taking the total of these time-weighted payments and dividing by the total amount of principal.

Subpart A—Prompt Corrective Action

§ 702.101 Capital measures, effective date of classification, and notice to NCUA.

(a) *Capital measure.* For purposes of this part, a credit union must determine its capital classification at the end of each calendar quarter using the following measures:

- (1) The net worth ratio; and
- (2) If determined to be applicable under § 702.103, the risk-based capital ratio.

(b) *Effective date of capital classification.* For purposes of this part, the effective date of a federally insured credit union's capital classification shall be the most recent to occur of:

(1) *Quarter-end effective date.* The last day of the calendar month following the end of the calendar quarter; or

(2) *Corrected capital classification.* The date the credit union received subsequent written notice from NCUA or, if state-chartered, from the appropriate state official, of a decline in capital classification due to correction of an error or misstatement in the credit union's most recent Call Report; or

(3) *Reclassification to lower category.* The date the credit union received written notice from NCUA or, if state-chartered, the appropriate state official, of reclassification on safety and soundness grounds as provided under §§ 702.102(b) or 702.202(d).

(c) *Notice to NCUA by filing Call Report.* (1) Other than by filing a Call Report, a federally insured credit union need not notify the NCUA Board of a change in its capital measures that places the credit union in a lower capital category;

(2) Failure to timely file a Call Report as required under this section in no way alters the effective date of a change in capital classification under paragraph (b) of this section, or the affected credit union's corresponding legal obligations under this part.

§ 702.102 Capital classifications.

(a) *Capital categories.* Except for credit unions defined as "new" under subpart B of this part, a credit union shall be deemed to be classified (Table 1 of this section)—

(1) *Well capitalized if:*

(i) *Net worth ratio.* The credit union has a net worth ratio of 7.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, has a total risk-based capital ratio of 10.5 percent or greater.

(2) *Adequately capitalized if:*

(i) *Net worth ratio.* The credit union has a net worth ratio of 6.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, has a total risk-based capital ratio of 8.0 percent or greater.

(3) *Undercapitalized if:*

(i) *Net worth ratio.* The credit union has a net worth ratio of 4.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, fails to meet the minimum 8.0 percent total risk-based capital requirement.

(4) *Significantly undercapitalized if:*

(i) The credit union meets the definition of undercapitalized, has a net worth ratio of less than 5.0 percent, and has received notice that its net worth restoration plan has not been approved (to qualify for a higher net worth classification, a significantly undercapitalized credit union must have a net worth restoration plan approved by NCUA);

(ii) The credit union has a net worth ratio of 2.0 percent or more but less than 4.0 percent; or

(iii) The credit union has a net worth ratio of 4.0 percent or more but less than 5.0 percent, and either—

(A) Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111; or

(B) Materially fails to implement a net worth restoration plan approved by the NCUA Board.

(5) *Critically undercapitalized* if it has a net worth ratio of less than 2.0 percent.

TABLE 1 TO § 702.102—CAPITAL CATEGORIES

A credit union's capital classification is . . .	Net worth ratio	Risk-based capital ratio	And subject to following condition(s) . . .
Well Capitalized	7% or above	10.5% or above	Must pass both net worth ratio and risk-based capital ratio.
Adequately Capitalized	6% to 6.99%	8% to 10.49%	Must pass both net worth ratio and risk-based capital ratio.
Undercapitalized	4% to 5.99%	Less than 8%	Must pass both net worth ratio and risk-based capital ratio.
Significantly Undercapitalized.	2% to 3.99%	N/A	Or if "undercapitalized at < 5% net worth and fails to timely submit or materially implement an approved net worth restoration plan.
Critically Undercapitalized . . .	Less than 2%	N/A	None.

(b) *Reclassification based on supervisory criteria other than net worth.* The NCUA Board may reclassify a well capitalized credit union as adequately capitalized and may require an adequately capitalized or undercapitalized credit union to comply with certain mandatory or discretionary supervisory actions as if it were classified in the next lower capital category (each of such actions hereinafter referred to generally as "reclassification") in the following circumstances:

(1) *Unsafe or unsound condition.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union is in an unsafe or unsound condition; or

(2) *Unsafe or unsound practice.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union has not corrected a material unsafe or unsound practice of which it was, or should have been, aware.

(c) *Non-delegation.* The NCUA Board may not delegate its authority to reclassify a credit union under paragraph (b) of this section.

(d) *Consultation with state officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before reclassifying a federally insured state-chartered credit union under paragraph (b) of this section, and shall promptly notify the appropriate state official of its decision to reclassify.

§ 702.103 Applicability of risk-based capital ratio measure.

For purposes of § 702.102, a credit union is defined as "complex" and a risk-based capital ratio requirement is applicable only if the credit union's quarter-end total assets exceed fifty million dollars (\$50,000,000), as reflected in its most recent Call Report.

§ 702.104 Risk-based capital ratio measures.

A complex credit union must calculate its risk-based capital ratio in accordance with this section.

(a) *Calculation of the risk-based capital ratio.* To determine its risk-based capital ratio a complex credit union must calculate the percentage, rounded to two decimal places, of its risk-based capital numerator as described in paragraph (b) of this section to its total risk-weighted assets as described in paragraph (c) of this section.

(b) *Risk-based capital ratio numerator.* The risk-based capital ratio numerator is the sum of the specific capital elements in paragraph (b)(1) of this section, minus the regulatory adjustments in paragraph (b)(2) of this section.

(1) *Capital elements of the risk-based capital ratio numerator.* The capital elements of the risk-based capital numerator are:

- (i) Undivided earnings (including any regular reserve);
- (ii) Appropriation for non-conforming investments;
- (iii) Other reserves;
- (iv) Equity acquired in merger;
- (v) Net income;
- (vi) ALLL, limited to 1.25% of risk assets;

(vii) Secondary capital accounts included in net worth (as defined in § 702.2); and

(viii) Section 208 assistance included in net worth (as defined in § 702.2).

(2) *Risk-based capital numerator deductions.* The elements deducted from the sum of the risk-based capital elements are:

- (i) NCUSIF Capitalization Deposit;
- (ii) Goodwill;
- (iii) Other intangible assets; and
- (iv) Identified losses not reflected in the risk-based capital ratio numerator.

(c) *Total risk-weighted assets.* (1) *General.* Total risk-weighted assets includes risk-weighted on-balance sheet assets as described in paragraph (c)(2) of this section, plus the risk-weighted off-balance sheet assets in paragraph (c)(3) of this section, plus the risk-weighted derivatives in paragraph (c)(4) of this section, less the risk-based capital numerator deductions in paragraph (b)(2) of this section.

(2) *Risk-weights for on-balance sheet assets.* The risk categories and weights for assets listed on a complex credit union's balance sheet are as follows:

(i) *Category 1—zero percent risk-weight.* A credit union must assign a zero percent risk-weight to:

(A) Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit and currency supplied from automatic teller machines.

(B) NCUSIF capital deposit.

(C) Debt instruments unconditionally guaranteed by the NCUA or the Federal Deposit Insurance Corporation.

(D) U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government, including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS).

(E) Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency.

(ii) *Category 2—20 percent risk-weight.* A credit union must assign a 20 percent risk-weight to:

(A) Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts.

(B) Cash equivalents (investments with original maturities of three months or less). Cash equivalents are 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.

(C) The total amount of investments with a weighted-average life of one year or less.

(D) Residential mortgages guaranteed by the U.S. Government through the Federal Housing Administration or the Department of Veterans Affairs.

(E) Loans guaranteed 75 percent or more by the Small Business Administration, U.S. Department of Agriculture, or other U.S. Government agency.

(iii) *Category 3—50 percent risk-weight.* A credit union must assign a 50 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years.

(B) The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.

(iv) *Category 4—75 percent risk-weight.* A credit union must assign a 75 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years.

(B) Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans. (Excluding loans reported as member business loans).

(C) Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.

(v) *Category 5—100 percent risk-weight.* A credit union must assign a 100 percent risk-weight to:

(A) Corporate credit union nonperpetual capital.

(B) The total outstanding principal amount of loans to CUSOs.

(C) Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets.

(D) Delinquent first mortgage real estate loans.

(E) Other real estate-secured loans less than or equal to 10 percent of assets.

(F) Member business loans less than or equal to 15 percent of assets.

(G) Loans held for sale.

(H) The total amount of any foreclosures and repossessed assets.

(I) Land and building, less depreciation on building.

(J) Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation.

(K) Current non-federally insured student loans.

(L) All other assets not specifically assigned a risk-weight but included in the balance sheet.

(vi) *Category 6—125 percent risk-weight.* A credit union must assign a 125 percent risk-weight to the total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.

(vii) *Category 7—150 percent risk-weight.* A credit union must assign a 150 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years.

(B) Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student

loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as member business loans).

(C) The total amount of all other real estate-secured loans greater than 20 percent of assets.

(D) Any member business loans greater than 15 percent of assets and less than or equal to 25 percent of assets.

(viii) *Category 8—200 percent risk-weight.* A credit union must assign a 200 percent risk-weight to:

(A) Corporate credit union perpetual capital.

(B) The total amount of investments with a weighted-average life of greater than 10 years.

(C) The total amount of member business loans greater than 25 percent of assets, other than member business loans included in Category 3 (paragraph (c)(2)(iii) of this section).

(ix) *Category 9—250 percent risk-weight.* A credit union must assign a 250 percent risk-weight to:

(A) The total value of investments in CUSOs.

(B) The total value of mortgage servicing assets.

(x) *Category 10—1,250 percent risk-weight.* A credit union must assign a 1,250 percent risk-weight (8% * 1,250% = 100%) to an asset-backed investment for which the credit union is unable to demonstrate, as required under paragraph (d) of this section, a comprehensive understanding of the

features of the asset-backed investment that would materially affect its performance.

(3) *Risk-weights for off-balance sheet activities.* The risk-weighted amounts for all off-balance sheet items are determined by multiplying the notional principal, or face value, by the appropriate conversion factor and the assigned risk-weight as follows:

(i) A 75 percent conversion factor with a 100 percent risk-weight for unfunded commitments for member business loans.

(ii) A 75 percent conversion factor with a 100 percent risk-weight for member business loans transferred with limited recourse.

(iii) A 75 percent conversion factor with a 50 percent risk-weight for first mortgage real estate loans transferred with limited recourse.

(iv) A 75 percent conversion factor with a 100 percent risk-weight for other real estate loans transferred with limited recourse.

(v) A 75 percent conversion factor with a 100 percent risk-weight for non-federally guaranteed student loans transferred with limited recourse.

(vi) A 75 percent conversion factor with a 75 percent risk-weight for all other loans transferred with limited recourse.

(vii) A 10 percent conversion factor with a 75 percent risk-weight for total unfunded commitments for non-business loans.

(4) *Derivatives.* (i) *Single derivatives contract exposure amount.* Except as modified by paragraph (c)(4)(iii) of this section, the exposure amount for a single derivatives contract that is not subject to a qualifying master netting agreement is equal to the sum of the credit union's current credit exposure and potential future credit exposure (PFE) on the derivatives contract.

(A) *Current credit exposure.* The current credit exposure for a single derivatives contract is the greater of the mark-to-fair value of the derivatives contract or zero.

(B) *Potential future credit exposure (PFE).* (1) The PFE for a single derivatives contract, including a derivatives contract with a negative mark-to-fair value, is calculated by multiplying the notional principal amount of the derivatives contract by the appropriate conversion factor in Table 1 of this section.

(2) For a derivatives contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity equals the time until the next reset date.

(3) For an interest rate derivatives contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

TABLE 1 to § 702.104—CONVERSION FACTOR MATRIX FOR DERIVATIVES CONTRACTS

Remaining maturity	Interest rate	Other
One year or less	0.00	0.10
Greater than one year and less than or equal to five years	0.005	0.12
Greater than five years	0.015	0.15

(ii) *Multiple derivatives contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (c)(4)(iii) of this section, the exposure amount for multiple derivatives contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE amounts for all derivatives contracts subject to the qualifying master netting agreement.

(A) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-fair values of the individual derivatives contracts subject to the qualifying master netting agreement or zero.

(B) *Adjusted sum of the PFE amounts.* The adjusted sum of the PFE amounts,

is calculated as $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$, where:

(1) *Agross* equals the gross PFE (that is, the sum of the PFE amounts as determined under paragraph (c)(4)(i)(B) of this section for each individual derivatives contract subject to the qualifying master netting agreement); and

(2) *Net-to-gross Ratio (NGR)* equals the ratio of the net current credit exposure to the gross current credit exposure. In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph (c)(4)(i)(A) of this section) of all individual derivatives contracts subject to the qualifying master netting agreement.

(iii) *Recognition of credit risk mitigation of collateralized derivatives contracts.* A credit union may recognize the credit risk mitigation benefits of financial collateral that secures a derivatives contract or multiple derivatives contracts subject to a qualifying master netting agreement (netting set) by using the simple approach in paragraph (c)(4)(v) of this section.

(iv) *Alternative approach.* As an alternative to the simple approach, a credit union may recognize the credit risk mitigation benefits of financial collateral that secures such a contract or netting set if the financial collateral is marked-to-fair value on a daily basis and subject to a daily margin maintenance requirement by applying a risk-weight to the exposure as if it were

uncollateralized and adjusting the exposure amount calculated under paragraph (c)(4)(i) of this section using the collateral approach in paragraph (c)(4)(v) of this section. The credit union must substitute the exposure amount calculated under paragraph (c)(4)(i)(A) or (B) of this section for exposure amount in the equation in paragraph (c)(4)(v).

(v) *Collateralized transactions.* (A) *General.* A credit union may use the approach in paragraph (c)(4)(v)(B) of this section to recognize the risk-mitigating effects of financial collateral.

(B) *Simple collateralized derivatives approach.* To qualify for the simple approach, the financial collateral must meet the following requirements:

(1) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(2) The collateral must be revalued at least every six months; and

(3) The collateral and the exposure must be denominated in the same currency.

(C) *Risk-weight substitution.* (1) A credit union may apply a risk-weight to the portion of an exposure that is secured by the fair value of financial collateral (that meets the requirements for the simple collateralized approach of this section) based on the risk-weight assigned to the collateral as established under § 702.104(c).

(2) A credit union must apply a risk-weight to the unsecured portion of the exposure based on the risk-weight applicable to the exposure under this subpart.

(D) *Exceptions to the 20 percent risk-weight floor and other requirements.* Notwithstanding the simple collateralized derivatives approach in paragraph (c)(4)(v)(B) of this section:

(1) A credit union may assign a zero percent risk-weight to an exposure to a derivatives contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

(2) A credit union may assign a 10 percent risk-weight to an exposure to an derivatives contract that is marked-to-market daily and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(ii).

(E) A credit union may assign a zero percent risk-weight to the collateralized portion of an exposure where:

(1) The financial collateral is cash on deposit; or

(2) The financial collateral is an exposure that qualifies for a zero

percent risk-weight under § 702.104(c)(2)(ii), and the credit union has discounted the fair value of the collateral by 20 percent.

(d) *Due diligence requirements for asset-backed investments.* (1) If a credit union is unable to demonstrate to the NCUA a comprehensive understanding of the features of an asset-backed investment exposure that would materially affect the performance of the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The credit union's analysis must be commensurate with the complexity of the asset-backed investment and the materiality of the position in relation to regulatory capital according to this part.

(2) A credit union must demonstrate its comprehensive understanding of an asset-backed investment exposure under paragraph (d)(1) of this section, for each asset-backed investment exposure by:

(i) Conducting an analysis of the risk characteristics of an investment exposure prior to acquiring the exposure and documenting such analysis within three business days after acquiring the exposure, considering:

(A) Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and

(D) For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and

(ii) On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate

the analysis required under this section for each investment exposure.

§ 702.105 Individual minimum capital requirements.

(a) *General.* The rules and procedures specified in this paragraph (a) apply to the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirement(s) that would otherwise apply to the credit union under this part.

(b) *Appropriate considerations for establishing individual minimum capital requirements.* Minimum capital levels higher than the risk-based capital requirements under this part may be appropriate for individual credit unions. NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is or may become inadequate in view of the credit union's circumstances. For example, higher capital levels may be appropriate when NCUA determines that:

(1) A credit union is receiving special supervisory attention;

(2) A credit union has or is expected to have losses resulting in capital inadequacy;

(3) A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk;

(4) A credit union has poor liquidity or cash flow;

(5) A credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance;

(6) A credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit;

(7) A credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms;

(8) A credit union has inadequate underwriting policies, standards, or procedures for its loans and investments;

(9) A credit union has failed to properly plan for, or execute, necessary retained earnings growth, or

(10) A credit union has a record of operational losses that exceeds the

average of other similarly situated credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

(c) *Standards for determination of appropriate individual minimum capital requirements.* The appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise. The factors to be considered in NCUA's determination will vary in each case and may include, for example:

(1) The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the credit union;

(2) The urgency of those circumstances or potential problems;

(3) The overall condition, management strength, and future prospects of the credit union and, if applicable, its subsidiaries, affiliates, and business partners;

(4) The credit union's liquidity, capital, and other indicators of financial stability, particularly as compared with those of similarly situated credit unions; and

(5) The policies and practices of the credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

§ 702.106 Prompt corrective action for adequately capitalized credit unions.

(a) *Earnings retention.* Beginning on the effective date of classification as adequately capitalized or lower, a federally insured credit union must increase the dollar amount of its net worth quarterly either in the current quarter, or on average over the current and three preceding quarters, by an amount equivalent to at least 1/10th percent (0.1%) of its total assets (or more by choice), until it is well capitalized.

(b) *Decrease in retention.* Upon written application received no later than 14 days before the quarter end, the NCUA Board, on a case-by-case basis, may permit a credit union to increase the dollar amount of its net worth by an amount that is less than the amount required under paragraph (a) of this section, to the extent the NCUA Board determines that such lesser amount—

(1) Is necessary to avoid a significant redemption of shares; and

(2) Would further the purpose of this part.

(c) *Decrease by FISCO.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before permitting a federally insured state-chartered credit union to decrease its earnings retention under paragraph (b) of this section.

(d) *Periodic review.* A decision under paragraph (b) of this section to permit a credit union to decrease its earnings retention is subject to quarterly review and revocation except when the credit union is operating under an approved net worth restoration plan that provides for decreasing its earnings retention as provided under paragraph (b) of this section.

§ 702.107 Prompt corrective action for undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111, *provided however*, that a credit union in this category having a net worth ratio of less than five percent (5%) which fails to timely submit such a plan, or which materially fails to implement an approved plan, is classified significantly undercapitalized pursuant to § 702.102(a)(4)(ii);

(3) *Restrict increase in assets.* Beginning the effective date of classification as undercapitalized or lower, not permit the credit union's assets to increase beyond its total assets for the preceding quarter unless—

(i) *Plan approved.* The NCUA Board has approved a net worth restoration plan which provides for an increase in total assets and—

(A) The assets of the credit union are increasing consistent with the approved plan; and

(B) The credit union is implementing steps to increase the net worth ratio consistent with the approved plan;

(ii) *Plan not approved.* The NCUA Board has not approved a net worth restoration plan and total assets of the credit union are increasing because of increases since quarter-end in balances of:

(A) Total accounts receivable and accrued income on loans and investments; or

(B) Total cash and cash equivalents; or

(C) Total loans outstanding, not to exceed the sum of total assets plus the

quarter-end balance of unused commitments to lend and unused lines of credit provided however that a credit union which increases a balance as permitted under paragraphs (a)(3)(i)(A), (B) or (C) of this section cannot offer rates on shares in excess of prevailing rates on shares in its relevant market area, and cannot open new branches;

(4) *Restrict member business loans.*

Beginning the effective date of classification as undercapitalized or lower, not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *Second tier discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to an undercapitalized credit union having a net worth ratio of less than five percent (5%), or a director, officer or employee of such a credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, unless the NCUA Board has approved the credit union's net worth restoration plan, the credit union is implementing its plan, and the NCUA Board determines that the proposed action is consistent with and will further the objectives of that plan;

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to reduce or divest its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates the credit union pays on shares to the prevailing rates paid on comparable accounts and maturities in the relevant market area, as determined by the NCUA Board, except that dividend rates already declared on shares acquired before imposing a restriction under this paragraph may not be retroactively restricted;

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce its assets or a category of assets;

(5) *Alter, reduce, or terminate activity.* Require the credit union or its CUSO to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however*, that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(8) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval); and

(9) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (8) of this section.

(c) *First tier application of discretionary supervisory actions.* An undercapitalized credit union having a net worth ratio of five percent (5%) or more, or which is classified undercapitalized by reason of failing to satisfy a risk-based net worth requirement under § 702.104, is subject to the discretionary supervisory actions in paragraph (b) of this section if it fails to comply with any mandatory supervisory action in paragraph (a) of this section or fails to timely implement an approved net worth restoration plan under § 702.111, including meeting its prescribed steps to increase its net worth ratio.

§ 702.108 Prompt corrective action for significantly undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is significantly undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.107(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.107(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any significantly undercapitalized credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided in § 702.107(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.107(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however*, that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Except with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the

four (4) calendar quarters preceding the effective date of classification of the credit union as significantly undercapitalized, and prohibit payment of a bonus or profit share to such officer;

(11) *Other actions to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (10) of this section; and

(12) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Discretionary conservatorship or liquidation if no prospect of becoming adequately capitalized.*

Notwithstanding any other actions required or permitted to be taken under this section, when a credit union becomes significantly undercapitalized (including by reclassification under § 702.102(b)), the NCUA Board may place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming adequately capitalized.

§ 702.109 Prompt corrective action for critically undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is critically undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.107(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.107(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any critically undercapitalized credit union, or a director, officer or employee of such credit union, if it determines that those

actions are necessary to carry out the purpose of this part:

- (1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided by § 702.107(b)(1);
- (2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;
- (3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.107(b)(3);
- (4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;
- (5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;
- (6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;
- (7) *New election of directors.* Order a new election of the credit union's board of directors;
- (8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however*, that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);
- (9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);
- (10) *Restricting senior executive officers' compensation.* Reduce or, with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as critically undercapitalized, and prohibit payment of a bonus or profit share to such officer;
- (11) *Restrictions on payments on uninsured secondary capital.* Beginning 60 days after the effective date of classification of a credit union as critically undercapitalized, prohibit payments of principal, dividends or

interest on the credit union's uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law;

(12) *Requiring prior approval.* Require a critically undercapitalized credit union to obtain the NCUA Board's prior written approval before doing any of the following:

- (i) Entering into any material transaction not within the scope of an approved net worth restoration plan (or approved revised business plan under subpart C of this part);
- (ii) Extending credit for transactions deemed highly leveraged by the NCUA Board or, if state-chartered, by the appropriate state official;
- (iii) Amending the credit union's charter or bylaws, except to the extent necessary to comply with any law, regulation, or order;
- (iv) Making any material change in accounting methods; and
- (v) Paying dividends or interest on new share accounts at a rate exceeding the prevailing rates of interest on insured deposits in its relevant market area;

(13) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (12) of this section; and

(14) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Mandatory conservatorship, liquidation or action in lieu thereof—(1) Action within 90 days.* Notwithstanding any other actions required or permitted to be taken under this section (and regardless of a credit union's prospect of becoming adequately capitalized), the NCUA Board must, within 90 calendar days after the effective date of classification of a credit union as critically undercapitalized—

- (i) *Conservatorship.* Place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(G); or
- (ii) *Liquidation.* Liquidate the credit union pursuant to 12 U.S.C. 1787(a)(3)(A)(ii); or
- (iii) *Other corrective action.* Take other corrective action, in lieu of conservatorship or liquidation, to better achieve the purpose of this part, provided that the NCUA Board

documents why such action in lieu of conservatorship or liquidation would do so, *provided however*, that other corrective action may consist, in whole or in part, of complying with the quarterly timetable of steps and meeting the quarterly net worth targets prescribed in an approved net worth restoration plan.

(2) *Renewal of other corrective action.* A determination by the NCUA Board to take other corrective action in lieu of conservatorship or liquidation under paragraph (c)(1)(iii) of this section shall expire after an effective period ending no later than 180 calendar days after the determination is made, and the credit union shall be immediately placed into conservatorship or liquidation under paragraphs (c)(1)(i) and (ii) of this section, unless the NCUA Board makes a new determination under paragraph (c)(1)(iii) of this section before the end of the effective period of the prior determination;

(3) *Mandatory liquidation after 18 months—(i) Generally.* Notwithstanding paragraphs (c)(1) and (2) of this section, the NCUA Board must place a credit union into liquidation if it remains critically undercapitalized for a full calendar quarter, on a monthly average basis, following a period of 18 months from the effective date the credit union was first classified critically undercapitalized.

(ii) *Exception.* Notwithstanding paragraph (c)(3)(i) of this section, the NCUA Board may continue to take other corrective action in lieu of liquidation if it certifies that the credit union—

(A) Has been in substantial compliance with an approved net worth restoration plan requiring consistent improvement in net worth since the date the net worth restoration plan was approved;

(B) Has positive net income or has an upward trend in earnings that the NCUA Board projects as sustainable; and

(C) Is viable and not expected to fail.

(iii) *Review of exception.* The NCUA Board shall, at least quarterly, review the certification of an exception to liquidation under paragraph (c)(3)(ii) of this section and shall either—

- (A) Recertify the credit union if it continues to satisfy the criteria of paragraph (c)(3)(ii) of this section; or
- (B) Promptly place the credit union into liquidation, pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), if it fails to satisfy the criteria of paragraph (c)(3)(ii) of this section.

(4) *Nondelegation.* The NCUA Board may not delegate its authority under paragraph (c) of this section, unless the

credit union has less than \$5,000,000 in total assets. A credit union shall have a right of direct appeal to the NCUA Board of any decision made by delegated authority under this section within ten (10) calendar days of the date of that decision.

(d) *Mandatory liquidation of insolvent federal credit union.* In lieu of paragraph (c) of this section, a critically undercapitalized federal credit union that has a net worth ratio of less than zero percent (0%) may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.110 Consultation with state officials on proposed prompt corrective action.

(a) *Consultation on proposed conservatorship or liquidation.* Before placing a federally insured state-chartered credit union into conservatorship (pursuant to 12 U.S.C. 1786(h)(1)(F) or (G)) or liquidation (pursuant to 12 U.S.C. 1787(a)(3)) as permitted or required under subparts A or B of this part to facilitate prompt corrective action—

(1) The NCUA Board shall seek the views of the appropriate state official (as defined in § 702.2), and give him or her an opportunity to take the proposed action;

(2) The NCUA Board shall, upon timely request of the appropriate state official, promptly provide him or her with a written statement of the reasons for the proposed conservatorship or liquidation, and reasonable time to respond to that statement; and

(3) If the appropriate state official makes a timely written response that disagrees with the proposed conservatorship or liquidation and gives reasons for that disagreement, the NCUA Board shall not place the credit union into conservatorship or liquidation unless it first considers the views of the appropriate state official and determines that—

(i) The NCUSIF faces a significant risk of loss if the credit union is not placed into conservatorship or liquidation; and

(ii) Conservatorship or liquidation is necessary either to reduce the risk of loss, or to reduce the expected loss, to the NCUSIF with respect to the credit union.

(b) *Nondelegation.* The NCUA Board may not delegate any determination under paragraph (a)(3) of this section.

(c) *Consultation on proposed discretionary action.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before taking any discretionary supervisory action under §§ 702.107(b), 702.108(b), 702.109(b), 702.204(b) and 702.205(b) with respect to a federally

insured state-chartered credit union; shall provide prompt notice of its decision to the appropriate state official; and shall allow the appropriate state official to take the proposed action independently or jointly with NCUA.

§ 702.111 Net worth restoration plans (NWRP).

(a) *Schedule for filing—(1) Generally.* A credit union shall file a written net worth restoration plan (NWRP) with the appropriate Regional Director and, if state-chartered, the appropriate state official, within 45 calendar days of the effective date of classification as either undercapitalized, significantly undercapitalized or critically undercapitalized; unless the NCUA Board notifies the credit union in writing that its NWRP is to be filed within a different period.

(2) *Exception.* An otherwise adequately capitalized credit union that is reclassified undercapitalized on safety and soundness grounds under § 702.102(b) is not required to submit a NWRP solely due to the reclassification, unless the NCUA Board notifies the credit union that it must submit an NWRP.

(3) *Filing of additional plan.* Notwithstanding paragraph (a)(1) of this section, a credit union that has already submitted and is operating under a NWRP approved under this section is not required to submit an additional NWRP due to a change in net worth category (including by reclassification under § 702.102(b)), unless the NCUA Board notifies the credit union that it must submit a new NWRP. A credit union that is notified to submit a new or revised NWRP shall file the NWRP in writing with the appropriate Regional Director within 30 calendar days of receiving such notice, unless the NCUA Board notifies the credit union in writing that the NWRP is to be filed within a different period.

(4) *Failure to timely file plan.* When a credit union fails to timely file an NWRP pursuant to this paragraph, the NCUA Board shall promptly notify the credit union that it has failed to file an NWRP and that it has 15 calendar days from receipt of that notice within which to file an NWRP.

(b) *Assistance to small credit unions.* Upon timely request by a credit union having total assets of less than \$10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing an NWRP required to be filed under paragraph (a) of this section.

(c) *Contents of NWRP.* An NWRP must—

(1) Specify—

(i) A quarterly timetable of steps the credit union will take to increase its net worth ratio, and risk-based capital ratio if applicable, so that it becomes adequately capitalized by the end of the term of the NWRP, and to remain so for four (4) consecutive calendar quarters. If "complex," the credit union is subject to a risk-based net worth requirement that may require a net worth ratio higher than six percent (6%) to become adequately capitalized;

(ii) The projected amount of net worth increases in each quarter of the term of the NWRP as required under § 702.106(a), or as permitted under § 702.106(b);

(iii) How the credit union will comply with the mandatory and any discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(iv) The types and levels of activities in which the credit union will engage; and

(v) If reclassified to a lower category under § 702.102(b), the steps the credit union will take to correct the unsafe or unsound practice(s) or condition(s);

(2) Include pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years; and

(3) Contain such other information as the NCUA Board has required.

(d) *Criteria for approval of NWRP.* The NCUA Board shall not accept a NWRP plan unless it—

(1) Complies with paragraph (c) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(e) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become adequately capitalized, the NCUA Board shall, in evaluating an NWRP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by state law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(f) *Review of NWRP—(1) Notice of decision.* Within 45 calendar days after receiving an NWRP under this part, the NCUA Board shall notify the credit union in writing whether the NWRP has been approved, and shall provide reasons for its decision in the event of disapproval.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (f)(1) of this section, the NWRP is deemed approved.

(3) *Consultation with state officials.* In the case of an NWRP submitted by a federally insured state-chartered credit union (whether an original, new, additional, revised or amended NWRP), the NCUA Board shall, when evaluating the NWRP, seek and consider the views of the appropriate state official, and provide prompt notice of its decision to the appropriate state official.

(g) *NWRP not approved*—(1) *Submission of revised NWRP.* If an NWRP is rejected by the NCUA Board, the credit union shall submit a revised NWRP within 30 calendar days of receiving notice of disapproval, unless it is notified in writing by the NCUA Board that the revised NWRP is to be filed within a different period.

(2) *Notice of decision on revised NWRP.* Within 30 calendar days after receiving a revised NWRP under paragraph (g)(1) of this section, the NCUA Board shall notify the credit union in writing whether the revised NWRP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Disapproval of reclassified credit union's NWRP.* A credit union which has been classified significantly undercapitalized shall remain so classified pending NCUA Board approval of a new or revised NWRP.

(4) *Submission of multiple unapproved NWRPs.* The submission of more than two NWRPs that are not approved is considered an unsafe and unsound condition and may subject the credit union to administrative enforcement actions under section 206 of the FCUA, 12 U.S.C. 1786 and 1790d.

(h) *Amendment of NWRP.* A credit union that is operating under an approved NWRP may, after prior written notice to, and approval by the NCUA Board, amend its NWRP to reflect a change in circumstance. Pending approval of an amended NWRP, the credit union shall implement the NWRP as originally approved.

(i) *Publication.* An NWRP need not be published to be enforceable because publication would be contrary to the public interest.

(j) *Termination of NWRP.* For purposes of this part, an NWRP terminates once the credit union is classified as adequately capitalized and remains so for four consecutive quarters. For example, if a credit union with an active NWRP attains the classification as adequately classified on December 31, 2015 this would be quarter one and the

fourth consecutive quarter would end September 30, 2016.

§ 702.112 Reserves.

Each credit union shall establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

§ 702.113 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* "Full and fair disclosure" is the level of disclosure which a prudent person would provide to a member of a credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when presented to members, to creditors or to NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with GAAP;

(2) The ALLL established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALLL will be recorded in the expense account "Provision for Loan and Lease Losses"; and

(4) At a minimum, adjustments to the ALLL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.114 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from net worth, if any.

(b) *Payment of dividends if retained earnings depleted.* The board of directors of a well capitalized credit union that has depleted the balance of its retained earnings may authorize dividend payments, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below adequately capitalized under subpart A of this part; or

(2) If the payment of dividends will cause the net worth classification to fall below adequately capitalized, the appropriate Regional Director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise) to pay a dividend. The request for written approval must include the plan for eliminating any negative retained earnings balance.

(c) *Restriction on payment of dividends if, after payment of dividends, the credit union's net worth ratio would be less than 6 percent.* If, after payment of a dividend or refund of interest, a well capitalized credit union's net worth ratio would fall below 6 percent in the current quarter, the board of directors of the credit union may not:

(1) Declare a dividend at a rate that is higher than the prevailing rates paid on comparable accounts and maturities in the relevant market area;

(2) Declare a non-repetitive dividend; or

(3) Authorize a refund of interest.

Subpart B—Alternative Prompt Corrective Action for New Credit Unions

§ 702.201 Scope and definition.

(a) *Scope.* This subpart B applies in lieu of subpart A of this part exclusively to credit unions defined in paragraph (b) of this section as "new" pursuant to section 216(b)(2) of the FCUA, 12 U.S.C. 1790d(b)(2).

(b) *New credit union defined.* A "new" credit union for purposes of this subpart is a credit union that both has been in operation for less than ten (10) years and has total assets of not more than \$10 million. Once a credit union reports total assets of more than \$10 million on a Call Report, the credit union is no longer new, even if its assets subsequently decline below \$10 million.

(c) *Effect of spin-offs.* A credit union formed as the result of a "spin-off" of a group from the field of membership of an existing credit union is deemed to be in operation since the effective date of the spin-off. A credit union whose total assets decline below \$10 million because a group within its field of membership has been spun-off is deemed "new" if it has been in operation less than 10 years.

(d) *Actions to evade prompt corrective action.* If the NCUA Board determines that a credit union was formed, or was reduced in asset size as a result of a spin-off, or was merged, primarily to qualify as "new" under this subpart, the credit union shall be deemed subject to prompt corrective action under subpart A of this part.

§ 702.202 Net worth categories for new credit unions.

(a) *Net worth measures.* For purposes of this part, a new credit union must determine its capital classification quarterly according to its net worth ratio.

(b) *Effective date of net worth classification of new credit union.* For purposes of subpart B of this part, the effective date of a new credit union's classification within a capital category in paragraph (c) of this section shall be determined as provided in § 702.101(b); and written notice to the NCUA Board of a decline in net worth classification in paragraph (c) of this section shall be given as required by § 702.101(c).

(c) *Net worth categories.* A credit union defined as "new" under this section shall be classified (Table 1 of this section)—

- (1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater;
- (2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%);
- (3) *Moderately capitalized* if it has a net worth ratio of three and one-half percent (3.5%) or more but less than six percent (6%);
- (4) *Marginally capitalized* if it has a net worth ratio of two percent (2%) or more but less than three and one-half percent (3.5%);
- (5) *Minimally capitalized* if it has a net worth ratio of zero percent (0%) or greater but less than two percent (2%); and
- (6) *Uncapitalized* if it has a net worth ratio of less than zero percent (0%) (e.g., a deficit in retained earnings).

TABLE 1 TO § 702.202—CAPITAL CATEGORIES FOR NEW CREDIT UNIONS

A new credit union's capital classification is . . .	If its net worth ratio is . . .
Well Capitalized	7% or above.
Adequately Capitalized	6 to 7%.
Moderately Capitalized	3.5% to 5.99%.
Marginally Capitalized	2% to 3.49%.
Minimally Capitalized	0% to 1.99%.
Uncapitalized	Less than 0%.

(d) *Reclassification based on supervisory criteria other than net worth.* Subject to § 702.102(b), the NCUA Board may reclassify a well capitalized, adequately capitalized or moderately capitalized new credit union to the next lower capital category (each of such actions is hereinafter referred to generally as "reclassification") in either of the circumstances prescribed in § 702.102(b).

(e) *Consultation with state officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before reclassifying a federally insured state-chartered credit union under paragraph (d) of this section, and shall promptly notify the appropriate state official of its decision to reclassify.

§ 702.203 Prompt corrective action for adequately capitalized new credit unions.

Beginning on the effective date of classification, an adequately capitalized new credit union must increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan in accordance with § 702.204(a)(2), or in the absence of such a plan, in accordance with § 702.106 until it is well capitalized.

§ 702.204 Prompt corrective action for moderately capitalized, marginally capitalized, or minimally capitalized new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the date of classification as moderately capitalized, marginally capitalized or minimally capitalized (including by reclassification under § 702.202(d)), a new credit union must—

- (1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan;
- (2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.206 if the credit union either:
 - (i) Has not increased its net worth ratio consistent with its then-present approved business plan;
 - (ii) Has no then-present approved business plan; or

(iii) Has failed to comply with paragraph (a)(3) of this section; and

(3) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.109(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Discretionary conservatorship or liquidation.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board may place a new credit union which is moderately capitalized, marginally capitalized or minimally capitalized (including by reclassification under § 702.202(d)) into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming adequately capitalized.

§ 702.205 Prompt corrective action for uncapitalized new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the effective date of classification as uncapitalized, a new credit union must—

- (1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in the credit union's approved initial or revised business plan;
- (2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.206, providing for alternative means of funding the credit union's earnings deficit, if the credit union either:
 - (i) Has not increased its net worth ratio consistent with its then-present approved business plan;
 - (ii) Has no then-present approved business plan; or
 - (iii) Has failed to comply with paragraph (a)(3) of this section; and
- (3) *Restrict member business loans.* Not increase the total dollar amount of member business loans as provided in § 702.204(a)(3).

(b) *Discretionary supervisory actions by NCUA.* Subject to the procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.109(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Mandatory liquidation or conservatorship.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board—

(1) *Plan not submitted.* May place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an uncapitalized new credit union which fails to submit a revised business plan within the time provided under paragraph (a)(2) of this section; or

(2) *Plan rejected, approved, implemented.* Except as provided in paragraph (c)(3) of this section, must place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an uncapitalized new credit union that remains uncapitalized one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as uncapitalized; or

(ii) The last day of the calendar month following expiration of the time period provided in the credit union's initial business plan (approved at the time its charter was granted) to remain uncapitalized, regardless whether a revised business plan was rejected, approved or implemented.

(3) *Exception.* The NCUA Board may decline to place a new credit union into liquidation or conservatorship as provided in paragraph (c)(2) of this section if the credit union documents to the NCUA Board why it is viable and has a reasonable prospect of becoming adequately capitalized.

(d) *Mandatory liquidation of uncapitalized federal credit union.* In lieu of paragraph (c) of this section, an uncapitalized federal credit union may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.206 Revised business plans (RBP) for new credit unions.

(a) *Schedule for filing—(1) Generally.* Except as provided in paragraph (a)(2) of this section, a new credit union classified moderately capitalized or

lower must file a written revised business plan (RBP) with the appropriate Regional Director and, if state-chartered, with the appropriate state official, within 30 calendar days of either:

(i) The last of the calendar month following the end of the calendar quarter that the credit union's net worth ratio has not increased consistent with its then-present approved business plan;

(ii) The effective date of classification as less than adequately capitalized if the credit union has no then-present approved business plan; or

(iii) The effective date of classification as less than adequately capitalized if the credit union has increased the total amount of member business loans in violation of § 702.204(a)(3).

(2) *Exception.* The NCUA Board may notify the credit union in writing that its RBP is to be filed within a different period or that it is not necessary to file an RBP.

(3) *Failure to timely file plan.* When a new credit union fails to file an RBP as provided under paragraphs (a)(1) or (a)(2) of this section, the NCUA Board shall promptly notify the credit union that it has failed to file an RBP and that it has 15 calendar days from receipt of that notice within which to do so.

(b) *Contents of revised business plan.* A new credit union's RBP must, at a minimum—

(1) Address changes, since the new credit union's current business plan was approved, in any of the business plan elements required for charter approval under chapter 1, section IV.D. of appendix B to part 701 of this chapter, or for state-chartered credit unions under applicable state law;

(2) Establish a timetable of quarterly targets for net worth during each year in which the RBP is in effect so that the credit union becomes adequately capitalized by the time it no longer qualifies as "new" per § 702.201(b);

(3) Specify the projected amount of earnings of net worth increases as provided under § 702.204(a)(1) or 702.205(a)(1);

(4) Explain how the new credit union will comply with the mandatory and discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(5) Specify the types and levels of activities in which the new credit union will engage;

(6) In the case of a new credit union reclassified to a lower category under § 702.202(d), specify the steps the credit union will take to correct the unsafe or unsound condition or practice; and

(7) Include such other information as the NCUA Board may require.

(c) *Criteria for approval.* The NCUA Board shall not approve a new credit union's RBP unless it—

(1) Addresses the items enumerated in paragraph (b) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in building the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(d) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become adequately capitalized, the NCUA Board shall, in evaluating an RBP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by state law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(e) *Review of revised business plan—*

(1) *Notice of decision.* Within 30 calendar days after receiving an RBP under this section, the NCUA Board shall notify the credit union in writing whether its RBP is approved, and shall provide reasons for its decision in the event of disapproval. The NCUA Board may extend the time within which notice of its decision shall be provided.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (e)(1) of this section, the RBP is deemed approved.

(3) *Consultation with state officials.* When evaluating an RBP submitted by a federally insured state-chartered new credit union (whether an original, new or additional RBP), the NCUA Board shall seek and consider the views of the appropriate state official, and provide prompt notice of its decision to the appropriate state official.

(f) *Plan not approved—(1) Submission of new revised plan.* If an RBP is rejected by the NCUA Board, the new credit union shall submit a new RBP within 30 calendar days of receiving notice of disapproval of its initial RBP, unless it is notified in writing by the NCUA Board that the new RBP is to be filed within a different period.

(2) *Notice of decision on revised plan.* Within 30 calendar days after receiving an RBP under paragraph (f)(1) of this section, the NCUA Board shall notify the credit union in writing whether the new RBP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Submission of multiple unapproved RBPs.* The submission of more than two RBPs that are not approved is considered an unsafe and

unsound condition and may subject the credit union to administrative enforcement action pursuant to section 206 of the FCUA, 12 U.S.C. 1786 and 1790d.

(g) *Amendment of plan.* A credit union that has filed an approved RBP may, after prior written notice to and approval by the NCUA Board, amend it to reflect a change in circumstance. Pending approval of an amended RBP, the new credit union shall implement its existing RBP as originally approved.

(h) *Publication.* An RBP need not be published to be enforceable because publication would be contrary to the public interest.

§ 702.207 Incentives for new credit unions.

(a) *Assistance in revising business plans.* Upon timely request by a credit union having total assets of less than \$10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing a revised business plan required to be filed under § 702.206.

(b) *Assistance.* Management training and other assistance to new credit unions will be provided in accordance with policies approved by the NCUA Board.

(c) *Small credit union program.* A new credit union is eligible to join and receive comprehensive benefits and assistance under NCUA's Small Credit Union Program.

§ 702.208 Reserves.

Each new credit union shall establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

§ 702.209 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* "Full and fair disclosure" is the level of disclosure which a prudent person would provide to a member of a new credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a new credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when

presented to members, to creditors or to NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a new credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with generally accepted accounting principles (GAAP);

(2) The allowance for loan and lease losses (ALL) established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALL will be recorded in the expense account "Provision for Loan and Lease Losses; and

(4) At a minimum, adjustments to the ALL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.210 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from net worth, if any.

(b) *Payment of dividends if retained earnings depleted.* The board of directors of a well capitalized new credit union that has depleted the balance of its retained earnings may authorize dividend payments, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below adequately capitalized under subpart B of this part; or

(2) If the payment of dividends will cause the net worth classification to fall below adequately capitalized, the appropriate Regional Director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise) to pay a dividend. The request for written approval must include the plan for eliminating any negative retained earnings balance.

(c) *Restriction on payment of dividends if, after payment of dividends, the new credit union's net worth ratio would be less than 6 percent.* If, after payment of a dividend or refund of interest, a well capitalized new credit union's net worth ratio would fall below 6 percent in the current quarter, the board of directors of the new credit union may not:

(1) Declare a dividend at a rate that is higher than the prevailing rates paid on comparable accounts and maturities in the relevant market area;

(2) Declare a non-repetitive dividend;

or

(3) Authorize a refund of interest.

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 9. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

§ 703.14 [Amended]

■ 10. Amend § 703.14 as follows:

■ a. In paragraph (i) remove the words "net worth classification" and add in their place the words "capital classification", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

■ b. In paragraph (j)(4) remove the words "net worth classification" and add in their place the words "capital classification", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

PART 713—FIDELITY BOND AND INSURANCE COVERAGE FOR FEDERAL CREDIT UNIONS

■ 11. The authority citation for part 713 continues to read as follows:

Authority: 12 U.S.C. 1761a, 1781b, 1786(a), 1786(h), 1789(a)(11).

■ 12. Amend § 713.6 as follows:

■ a. In paragraph (a)(1), revise the table; and

■ b. In paragraph (c) remove the words "net worth" each place they appear and add in their place the word "capital", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

§ 713.6 What is the permissible deductible?

(a)(1) * * *

Assets	Maximum deductible
\$0 to \$100,000	No deductible allowed.
\$100,001 to \$250,000	\$1,000.
\$250,000 to \$1,000,000	\$2,000.
Over \$1,000,000	\$2,000 plus 1/1000 of total assets up to a maximum of \$200,000; for credit unions that have received a composite CAMEL rating of "1" or "2" for the last two (2) full examinations and maintained a capital classification of "well capitalized" under part 702 of this chapter for the six (6) immediately preceding quarters the maximum deductible is \$1,000,000.

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PART 723—MEMBER BUSINESS LOANS

■ 13. The authority citation for part 723 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1757A, 1786, 1785, 1789.

§ 723.7 [Amended]

■ 14. Amend § 723.7(c)(1) by removing the words "as defined by § 702.102(a)(1)" and adding in their place the words "under part 702".

PART 747—ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS

■ 15. The authority citation for part 747 continues to read as follows:

Authority: 12 U.S.C. 1786, 1782, 1784, 1785, 1786, 1787, 1790a, 1790d; 42 U.S.C. 4012a; Pub. L. 101-410; Pub. L. 104-134; Pub. L. 109-351; 120 Stat. 1986.

§ 747.2001 [Amended]

■ 16. Amend § 747.2001(a) by removing the citation "702.302(d)" and adding in its place the citation "702.202(d)".

§ 747.2002 [Amended]

■ 17. Amend § 747.2002(a) by removing the words "§§ 702.202(b), 702.203(b) and 702.204(b)" and adding in their place the words "§§ 702.107(b), 702.108(b), or 702.109(b)", and by removing the words "§§ 702.304(b) or 702.305(b)" and adding in their place the words "§§ 702.204(b) or 702.205(b)".

§ 747.2003 [Amended]

■ 18. Amend § 747.2003(a) by removing the citation "702.302(d)" and adding in its place the citation "702.202(d)".

■ 19. Add § 747.2006 to subpart L to read as follows:

§ 747.2006. Review of order imposing individual minimum capital requirements (IMCR).

(a) *Notice of proposed individual minimum capital requirements.* When NCUA proposes to impose individualized minimal capital

requirements for a particular credit union pursuant to § 702.105 of this chapter (each such action hereinafter referred to as an "IMCR"), NCUA shall issue and serve on the credit union reasonable prior notice of the proposed IMCR. NCUA shall also forward a copy of the notifying letter to the appropriate state supervisory authority (SSA) if a state-chartered corporate credit union would be subject to an IMCR.

(b) *Contents of the Notice.* A notice of intention to impose an IMCR for a credit union based on particular capital conditions at a credit union shall state the following:

(1) The credit union's net worth ratio, risk-based capital ratio and net worth classification.

(2) The specific minimum capital levels that the NCUA Board intends to impose on the credit union under the IMCR, and the specific causes for determining that the higher IMCR is necessary or appropriate for the credit union.

(3) The proposed schedule for compliance with the new requirement.

(4) That the credit union must file a written response to the notice, which shall be due no less than 30 calendar days from the date of service of the notice. The NCUA Board may extend the time period for good cause, and the time period for response by the insured credit union may be shortened for good cause:

(i) When, in the opinion of NCUA, the condition of the credit union so requires, and NCUA informs the credit union of the shortened response period in the notice; or

(ii) With the consent of the credit union.

(c) *Contents of response to notice.* A credit union's response to a notice under paragraph (b) of this section must include:

(1) An explanation of why it contends the IMCR is not an appropriate exercise of discretion under this part;

(2) A request that the NCUA Board modify or not issue the IMCR;

(3) Any information, mitigating circumstances, documentation, or other

evidence in support of the credit union's position that the credit union wants NCUA to consider in deciding whether to establish or to amend an IMCR for the credit union; and

(4) If desired, a request for a recommendation from the NCUA's Ombudsman pursuant to paragraph (g) of this section.

(d) *Failure to file response.* Failure by the credit union to respond within 30 days, or such other time period as may be specified by NCUA, may constitute a waiver of any objections to the proposed IMCR or to the schedule for complying with it, unless NCUA has provided an extension of the response period for good cause.

(e) *Final decision by NCUA.* After expiration of the response period, NCUA will decide whether or not the proposed IMCR should be established for the credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the credit union's response and other relevant information. NCUA's decision will address comments received within the response period from the credit union and the appropriate state supervisory authority (SSA) (in the case of a state-chartered credit union) and will state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the credit union could take to eliminate the need for continued applicability of the IMCR. NCUA will provide the credit union and the appropriate SSA (if a state-chartered credit union is involved) with a written decision on the IMCR, addressing the substantive comments made by the credit union and setting forth the decision and the basis for that decision. Upon receipt of this decision by the credit union, the IMCR becomes effective and binding upon the credit union. This decision represents final agency action.

(f) *Request to modify or rescind IMCR.* A credit union that is subject to an existing IMCR may request in writing that the NCUA Board reconsider the

terms of the IMCR due to changed circumstances. Unless otherwise ordered by the NCUA Board, the IMCR shall remain in effect while such request is pending. A request under this paragraph (f) that remains pending 60 days following receipt by the NCUA Board is deemed granted.

(g) *Ombudsman*. A credit union may request in writing the recommendation

of NCUA's ombudsman to modify or to not issue a proposed IMCR under paragraph (b) of this section, or to modify or rescind an existing IMCR due to changed circumstances under paragraph (f) of this section. A credit union which fails to request the ombudsman's recommendation in a response under paragraph (c) of this

section, or in a request under paragraph (f) of this section, shall be deemed to have waived the opportunity to do so. The ombudsman shall promptly notify the credit union and the NCUA Board of his or her recommendation.

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