

BOARD ACTION MEMORANDUM

TO: NCUA Board

DATE: September 7, 2012

FROM: Office of Executive Director

SUBJ: Asset Thresholds affecting
Regulatory Relief for Small Credit
Unions; IRPS 12-2 & 12 C.F.R.
§§ 702.103; 741.3; 791.8.

ACTION REQUESTED: Board approval of a proposed Rule and Interpretive Ruling and Policy Statement (IRPS) that would update NCUA's definition of small entities for purposes of the Regulatory Flexibility Act (RFA)¹ to include credit unions with less than \$30 million in assets, subject to reevaluation every three years. For consistency, the proposed Rule and IRPS would amend two NCUA regulations that apply asset thresholds to risk-based net worth and interest rate risk provisions and amend another provision that would cross reference the proposed IRPS.

DATE ACTION REQUESTED: September 20, 2012.

OTHER OFFICES CONSULTED: Office of Examination and Insurance, Office of Chief Economist, Office of General Counsel, Office of Small Credit Union Initiatives, Regions.

VIEWS OF OTHER OFFICES CONSULTED: Concur.

BUDGET IMPACT, IF ANY: None.

SUBMITTED TO INSPECTOR GENERAL FOR REVIEW: Yes.

RESPONSIBLE STAFF MEMBERS: Executive Director David M. Marquis, Deputy Executive Director John Kutchey.

SUMMARY: To update NCUA's asset threshold used to define the term "small entity" in the RFA, staff recommends increasing the asset threshold from less than \$10 million to less than \$30 million. Based on asset growth, loss data, and inflation, this threshold provides an updated, reasonable, and historically consistent definition among credit unions. Updating and increasing regulatory asset thresholds, where the Federal Credit Union (FCU) Act does not otherwise mandate a specific threshold amount, will provide corresponding regulatory compliance relief to a new and larger subset of credit unions falling within the new threshold.

RECOMMENDED ACTION: Approve the proposed Rule and IRPS 12-2 updating the definition of small entities to include credit unions with less than \$30 million in assets for purposes of the RFA, subject to reevaluation every three years. Approve corresponding proposed changes, where the Board has such authority, to sections 702, 741, and 791 of the NCUA regulations, updating the asset thresholds in those provisions that affect

¹ The RFA generally requires federal agencies to determine whether a proposed rule will have a significant economic impact on a substantial number of small entities and, if so, prepare an analysis that describes the proposed rule's impact on small entities, including any significant alternatives that minimize the impact. 5 U.S.C. §§ 603, 604, & 605(b).

which credit unions are subject to risk-based net worth requirements and interest rate risk policy and program requirements.

ATTACHMENTS: Background Memorandum; Proposed Rule and IRPS 12-2.

TO: NCUA Board

FROM: David M. Marquis, Executive Director

SUBJ: Recommended Asset Threshold for Regulatory Flexibility Act (RFA)
Analysis and Regulatory Relief

DATE: August 20, 2012

To provide additional regulatory relief and reduce compliance burden for small credit unions, staff proposes increasing to \$30 million the asset threshold that defines which credit unions fall within the RFA's definition of small entity. Given expected credit union asset growth combined with inflation and consolidation, the RFA asset threshold for small credit unions should be reevaluated at least every three years. In addition, this threshold will be used as the basis for changes to asset thresholds that appear in existing NCUA regulations governing risk-based net worth and interest rate risk requirements. The threshold will also be considered for new rulemakings and updates to supervisory and examination programs.

Small Credit Union Asset Size History: In IRPS 81-4, NCUA determined credit unions with less than \$1 million in assets would be considered small entities for purposes of the RFA. The threshold set in IRPS 81-4 defined the group of credit unions to which NCUA was required to give special attention during rulemaking to ensure such credit unions had the ability to absorb incremental compliance burdens created by new rules. IRPS 87-2 continued the definition of small entities under the RFA as those credit unions with less than \$1 million in assets.

The Credit Union Membership Access Act (CUMAA), passed in 1998, established an asset threshold of \$10 million for certain statutory provisions, including those governing the use of generally accepted accounting principles and voluntary audits, defining and establishing a system of prompt corrective action for new credit unions, and mandating that NCUA provide assistance, on request, to small credit unions in filing net worth restoration plans. 12 U.S.C. §§ 1782(a)(6); 1790d. In 2000, NCUA used a \$10 million asset threshold as part of the definition of "complex" credit unions for purposes of risk-based net worth requirements. 12 C.F.R. § 702.103.

NCUA's RFA asset threshold increased from less than \$1 million to less than \$10 million in 2003, with IRPS 03-2. This change caused the percentage of federally insured credit unions (FICUs) covered by the RFA to return to a percentage much closer to that captured by the asset threshold first adopted in 1981 and made it consistent with the 1998 amendments to the FCU Act. NCUA's RFA asset threshold has not been increased since 2003.

Data Analysis: As of June 30, 2012, credit unions with less than \$10 million in assets represented 35 percent of all FICUs and accounted for one percent of all FICU assets. When Congress established a \$10 million threshold in the CUMAA in 1998, credit unions below that threshold represented 60.4 percent of FICUs and 5.5 percent of total system assets. In 2003, when NCUA increased its RFA asset threshold to \$10 million, these credit unions represented approximately 52 percent of FICUs.

The measures noted in the table below reflect a material proportionate decline in the number and relative assets of FICUs with less than \$10 million in assets since 1998:

Federally Insured Credit Unions <\$10 Million

	December 1998	June 2012
Number of FICUs	6,636	2,438
Percent of Total Units	60.4%	35.0%
Total Assets	\$21,376,801,396	\$9,735,413,650
Percent of Total Assets	5.5%	1.0%
Total Net Worth	\$2,911,019,491	\$1,396,317,929
Percent of System Net Worth	6.9%	1.4%
Percent of NCUSIF	561%	86.7%

From 1998 to 2012, the number of small credit unions declined by 63 percent and their respective assets declined by over 54 percent. Shifting industry characteristics resulted in fewer credit unions with significantly fewer collective assets receiving regulatory relief as credit unions grew in size and smaller credit unions merged at a faster pace than large credit unions.

As a principal reference point for determining a new asset threshold for small credit unions, the percentages from 1998 can be applied to 2012 to approximate the asset threshold that today would encompass around the same percentage of FICUs, similar asset and net worth percentages, and a similar NCUSIF percentage that existed when Congress passed the CUMAA. Unit, asset, net worth, and NCUSIF percentages that apply to a range of asset thresholds in 2012 are shown below, with the percentages shaded where they most closely correspond to the 1998 percentages of the less-than-\$10 million FICU demographic:

Threshold (\$mm)	% Units	% Assets	% System Net Worth	% NCUSIF	# Units
\$25	54.1%	3.1%	4.0%	282.1%	3,769
\$30	58.1%	3.9%	4.9%	348.3%	4,041
\$40	63.7%	5.2%	6.4%	470.0%	4,435
\$45	65.9%	5.9%	7.1%	528.0%	4,588

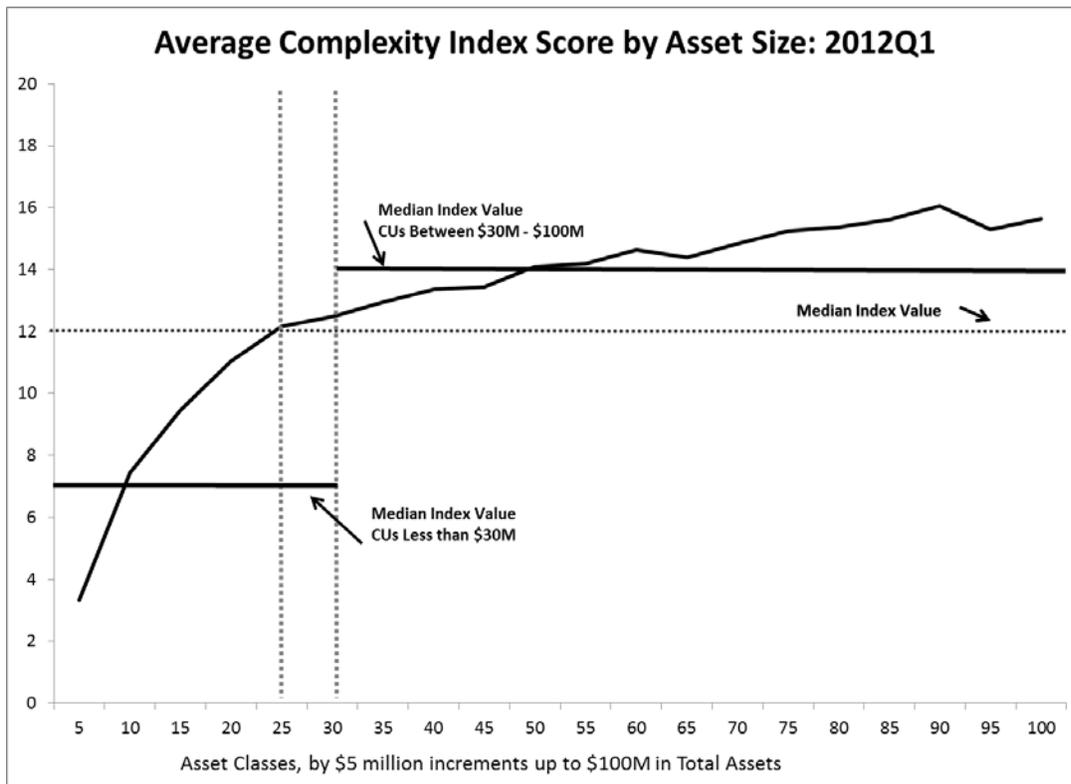
Considering these comparisons, the new asset threshold could range from \$30 million to \$45 million to approximate related 1998 percentages, depending on whether the percentage reference used is the percentage of units, the percentage of total system assets, or the percentage of the NCUSIF. Setting the threshold at \$40 million is the high end of the range, leaving ample room for industry growth and covering 4,435 credit unions or 63.7 percent of all FICUs. On the other hand, raising the threshold to \$30 million in assets will cause the percentage of FICUs under that threshold to be just over two percentage points less than the 1998 ratio. A \$30 million threshold will also cause the percentage of system assets and net worth at FICUs under the threshold to be within two percentage points of the comparable 1998 ratios.

Loss Consideration: The following table shows the history of failures causing NCUSIF losses from 1998 through 2012:

Assets (\$mm)	Number of Failures		NCUSIF Loss (\$mm)		Percentage of Total NCUSIF Losses	
	Failures for Asset Range	Cumulative	Loss for Asset Range	Cumulative	Percent for Asset Range	Cumulative
< \$10	202	202	\$116.1	\$116.1	12.3%	12.3%
\$10 to < \$20	12	214	\$31.2	\$147.3	3.3%	15.6%
\$20 to < \$30	8	222	\$22.8	\$170.1	2.4%	18.0%
\$30 to < \$40	9	231	\$36.2	\$206.3	3.8%	21.8%
\$40 to < \$50	4	235	\$11.3	\$217.6	1.2%	23.3%
\$50 to < \$60	1	236	\$3.6	\$221.2	0.4%	23.4%
\$60 to < \$70	0	236	\$0.0	\$221.2	0.0%	23.4%
\$70 to < \$80	2	238	\$11.3	\$232.5	1.2%	24.6%
\$80 to < \$90	4	242	\$22.5	\$255.0	2.4%	27.0%
\$90 to < \$100	3	243	\$64.9	\$319.9	6.9%	33.8%
\$100 to < \$200	9	254	\$76.2	\$396.1	8.1%	41.9%
\$200 to < \$500	7	261	\$513.2	\$909.3	54.3%	96.2%
≥ \$500	1	262	\$36.1	\$945.4	3.8%	100.0%

Since 1998, 202 FICUs with less than \$10 million in assets failed, costing the NCUSIF \$116 million, which represents only 12.3 percent of total period losses. Over the same period, FICUs with less than \$30 million in assets accounted for only 18 percent of losses, although accounting for 222, or over 84 percent, of period failures. In comparison, 40 FICUs with more than \$30 million in assets failed, costing the NCUSIF \$775.3 million or 82 percent of period losses. Thus, despite the higher number of failures among smaller FICUs, the NCUSIF experienced immensely greater losses from the far fewer FICUs with more than \$30 million in assets that have failed. While the same general conclusion could be drawn for some thresholds higher than \$30 million, the complexity index discussed below weighs against adjusting the threshold higher than \$30 million based on loss history alone.

Complexity Analysis: Staff also evaluated the asset threshold in terms of credit union complexity. This complexity index assigns points to credit unions incorporating many of the factors in a credit union’s portfolio requiring regulation (real estate loans, member business loans, credit union service organizations, and cash/liquidity positions). The higher the value of the index, the more the credit union will need to be part of the entire regulatory regime. Using the complexity index, the \$25 million to \$30 million asset size approximates the point below which, on average, credit union complexity decreases at the fastest rate. Credit unions above \$30 million in assets have a median complexity index value of 14, which is twice the median complexity index value of credit unions below \$30 million in assets.



Based on industry percentage data, NCUSIF loss history data, and FICU complexity data, a \$30 million threshold is reasonable and historically consistent. A \$30 million threshold provides roughly the same percentage today of FICUs defined as small in 1998, representing a slightly lower proportion of total system assets and net worth. A \$30 million threshold also provides a significant degree of assurance that the NCUSIF would not be subject to undue risk based on loss history and credit union complexity. Finally, the three-year review period this proposal requires will provide opportunity for more routine evaluation and supports increasing the threshold moderately at this time.

Regulatory Applicability: There are two regulations to which the Board can substantively apply a new asset threshold adopted for purposes of defining small entities under the RFA. A third regulation would require a corresponding change to cross reference the new RFA threshold. Additional relief in regulatory burden may be realized in future regulations that account for the new \$30 million threshold.

Publication	Citation	Content	Date Last Updated
NCUA Regulations	12 C.F.R. § 702.103	Complex credit union defined in part as being more than \$10 million in assets	July 20, 2000
NCUA Regulations	12 C.F.R. § 741.3(b)(5)(i)	Credit unions with less than \$10 million in assets excluded from interest rate risk requirements	February 2, 2012, effective September 30, 2012
NCUA Regulations	12 C.F.R. § 791.8(a)	Incorporates IRPS 87-02 and 03-02 by reference	May 29, 2003

All other asset thresholds incorporated into the NCUA regulations are determined by the FCU Act and, therefore, cannot be changed by the NCUA Board. Going forward, the recommended new asset threshold of \$30 million will be considered when developing new regulations. This will likely provide additional regulatory relief.

Section 702.103 of the NCUA regulations defines a complex credit union as one with more than \$10 million in assets and with a risk-based net worth requirement of more than six percent. If a complex credit union fails its risk-based net worth requirement despite having at least 6 percent net worth, the credit union is subject to mandatory prompt corrective action (PCA) requirements governing earnings retention, net worth restoration plans, asset increases, and member business loans. Under the proposed \$30 million threshold for defining complex credit unions, 1,603 more credit unions would be categorically excluded from the definition of complex based on asset size alone. Of these 1,603 credit unions, 230 FICUs with at least six percent net worth that currently must meet a risk-based net worth requirement to avoid PCA would no longer be subject to the risk-based net worth requirement. These FICUs will be removed one step further from the possibility of PCA requirements.

The Interest Rate Risk portion of NCUA regulations, 12 C.F.R. § 741.3(b)(5)(i), which goes into effect on September 30, 2012, would also be adjusted to correspond with the increased RFA threshold. The current version will require all credit unions greater than \$50 million in assets to adopt and implement an interest rate risk policy. In addition, the rule will require credit unions between \$10 million and \$50 million in assets holding combined first mortgages and investments with maturities greater than five years that equal or exceed net worth to adopt and implement an interest rate risk policy. Currently, 2,291 credit unions have between \$10 million and \$50 million in assets. By increasing the lower threshold to \$30 million, 1,603 more credit unions would be

categorically excluded from complying with this regulation when it goes into effect. Six hundred and twenty credit unions that otherwise would have had to adopt and implement an interest rate risk policy would no longer be required to do so. As part of the regulatory update, NCUA will reevaluate the \$50 million threshold to determine if further recalibration is appropriate for the interest rate risk regulation.

Finally, section 791.8(a) governs promulgation of NCUA regulations and incorporates NCUA's definition of small entity for purposes of the RFA. This regulation would therefore need to be changed to incorporate the updated IRPS.

The revolving three-year review period will ensure periodic reconsideration and updates to the asset threshold, if appropriate.

Small Credit Union Initiatives: The proposed \$30 million threshold would increase the number of small credit unions by 66 percent. NCUA's Office of Small Credit Union Initiatives (OSCUI) is preparing for the potential that many credit unions with assets between \$10 million and \$30 million may request assistance and consultation as a result of this proposed rule.

OSCUI also anticipates greater demand from credit unions under \$10 million due to NCUA's reduction of hours allocated to the small credit union examination program (discussed in the next section of this document).

Moreover, NCUA's approval of up to 1,003 additional low-income-designated credit unions will likely increase requests for OSCUI grants and loans.

OSCUI is preparing to handle the potential increase in workload by increasing its own efficiency. OSCUI is redesigning its service delivery to focus on impact and self-help:

- OSCUI's Economic Development Specialists are changing to a triage approach, providing services more efficiently by phone, web, group training, and referral, before going on-site.
- OSCUI has begun testing audience reception to video and webinar training in place of in-person workshops.
- OSCUI is building a resource center to enable a self-help option for credit unions.

The factors listed above will permit OSCUI to implement the proposed change to the small credit union asset threshold without additional staffing.

Examination Impact: In January 2012, the Office of Examination and Insurance implemented the small credit union examination program for federal credit unions with less than \$10 million in total assets and a CAMEL rating of 1, 2, or 3. Examination steps focus entirely on lending, recordkeeping, and internal audit functions with examination time reduced to 40 hours.

The effectiveness of this examination program will be evaluated in early 2013. During this evaluation, the office will determine whether a different examination program should be developed for credit unions with assets between \$10 million and \$30 million. At this time, no other changes to the examination program, including examination frequency, are recommended as a result of increasing the asset threshold used to define small entity under the RFA.

Summary: To update NCUA's definition of small entity under the RFA and to correspondingly increase other asset thresholds used in NCUA Regulations, staff is recommending that \$30 million be used as the proposed threshold, subject to review every three years. Based on historical asset growth, expected future asset growth, combined with NCUSIF loss data and credit union complexity, this threshold is reasonable, historically consistent, and supported across each of these applications.

The change to the RFA threshold, along with the Board's efforts to increase uniformity across regulations, will ensure that regulatory relief will be more consistently and robustly considered for all 4,041 credit unions with less than \$30 million in total assets. Future regulations, including the proposed liquidity regulation, will be fully evaluated to determine whether small credit unions falling under the new threshold should be excluded.

Current and prospective regulatory relief will be provided to 1,603 additional credit unions under the interest rate risk rule going into effect on September 30, 2012. Those credit unions will categorically fall out of the applicable asset range. Of the 1,603 credit unions, 620 that otherwise would have had to adopt and implement an interest rate risk policy by September 30, 2012, would no longer be required to do so. With respect to risk-based net worth, the same 1,603 credit unions between \$10 million and \$30 million will categorically be excluded from the definition of complex based on asset size alone. In all, the number of FICUs with relief from the risk-based net worth and interest rate risk rules, and that will receive more robust consideration for future regulatory relief, will be increased to 4,041.

No immediate examination program changes are planned, since the new small credit union examination program was just unveiled. In addition, no direct changes to OSCUI's mandate are recommended, although the office is preparing for any additional requests for assistance that could arise as a result of the changes. Future changes in the examination program for credit unions with assets between \$10 million and \$30 million may be considered in 2013 after evaluating the results of the new program.