Chapter 204

CAPITAL

Introduction

Capital analysis is the primary method of determining the strength, not only of an individual corporate credit union (corporate), but also of the corporate credit union system (System). Capital levels must meet minimum regulatory requirements, but more importantly take into account the risk assumed by a corporate both on and off its balance sheet. Examiners and corporate management must realize that the capital regulatory requirements represent just a floor; the real goal is to accumulate adequate capital to protect the corporate from market and operational risks.

Section 704.3 requires that corporates maintain minimum capital levels. It also requires NCUA to evaluate, and possibly take action against any corporate which does not have adequate capital.

Capital is the quantitative culmination of management's efforts to develop and implement policies, procedures, and practices which result in a balance sheet that provides a reasonable return to members and protection against risk.

This chapter offers guidance for ascertaining whether a corporate has adequate policies, procedures, and practices to maintain a sufficient capital level.

Purpose of Capital

Capital performs a variety of functions.

<u>Promotes Credit Union Member and Public Confidence</u>

Capital provides a measure of assurance to natural person credit unions that a corporate will continue to honor its obligations and provide financial services. Confidence in the corporate then will be transferred to confidence in the entire credit union industry, by credit union members, the public and legislative leaders.

<u>Supports the Type, Volume, and Character of the Business Conducted</u>

The amount of capital necessary to protect a corporate depends, not only on the type of transactions in which it engages, but also the volume and character (the way business is conducted) of the transactions. The key is to evaluate the total risk to capital.

Provide for the Possibility of Inherent Losses

Capital will allow a corporate to continue as a "going concern" during periods when it experiences operating losses, declines in asset values, or other adverse financial results.

Control Excessive Growth

A corporate must continuously evaluate the size of its balance sheet to determine it operates within its capital limitations. Thus, it promotes prudent growth and restrains uncontrolled expansion of assets.

Provides Protection for Depositors, Investors, Creditors, and the NCUSIF

Corporate management has a fiduciary obligation to protect its depositors, investors, and creditors from losses. The building of capital not only acts as a cushion for those parties, but also the National Credit Union Share Insurance Fund (NCUSIF).

Increasing retained earnings has been a primary goal of regulatory initiatives for a decade. There is a very important distinction between internally generated capital, retained earnings, and other types of capital accounts. An adequate level of internally generated capital is essential to avoid erosion of member confidence in the event losses occur. NCUA believes an earnings retention requirement is the appropriate means of ensuring a minimal level of retained earnings on an ongoing basis.

The inclusion in 1998 of paid-in capital (PIC) as an alternative form of capital expanded corporates' options for raising additional capital. This concept was brought to fruition when well capitalized natural person credit unions indicated a willingness to commit a portion of their equity to support the System.

It was intended PIC, because of its implicit high cost, would be used by corporates as a bridge during short periods when they needed to increase capital adequacy. When that need diminishes, it is expected corporates would call in these high cost funds. The corporate rule facilitates this process.

Due to PIC's inherent risks to investors and attendant cost to the issuer, it is anticipated most corporates would use these instruments as a last resort to achieve specific goals, or during periods of unanticipated rapid growth. Corporates which plan to use PIC for long periods should adequately address this in their capital and strategic plans.

Definitions

Section 704.2 defines capital and other terms necessary to determine the make-up of capital.

Capital

Capital is the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital.

Retained Earnings

Retained earnings includes the total of the corporate's undivided earnings, reserves, and any other appropriations designated by management or regulatory authorities. Retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses (UGL) on available for sale securities or other comprehensive income items. Valuation allowances established to meet full and fair disclosure requirements of Section 702.3 as well as UGLs are not included in retained earnings since they may distort capital levels and ratios during periods of steeply rising or falling interest rates.

Paid-In Capital

There are two types of paid-in capital authorized by Part 704: member paid-in capital and non member paid-in capital. Member paid-in capital is held by the corporate credit union's members. The following conditions apply to this obligation:

1. perpetual, non-cumulative dividend accounts;
2. a prohibition against a corporate from requiring membership, services, or prices of services as a condition for purchasing the instrument;
3. callable on a pro-rata basis across an issuance class only at the option of the corporate and only if the corporate meets its minimum level of required capital and Net Economic Value (NEV) ratios after the funds are called; and
4. the disclosure of the terms and conditions of the instrument when it is purchased.

Non member paid-in capital is sold on the market in accordance with conditions set by NCUA on a case-by-case basis.

Paid-in capital, regardless of the type, is

1. available to cover losses that exceed reserves and undivided earnings;
2. not insured by the NCUSIF or any other share or deposit insurers; and
3. callable only at the option of the corporate and only if the corporate meets its minimum level of required capital and NEV ratios after the funds are called.

Membership Capital

Membership capital is funds contributed by corporate members which:

1. May be issued as term certificates or as an adjusted balance account. Adjusted balance accounts may be adjusted based upon a measure that is established and disclosed by the corporate at the time the account is open. For instance, the required membership capital as of December 31 each year may be a percentage of a credit union's assets as of the preceding September 30. The percentage may change from year to year based upon a corporate's needs. Any reduction in the amount of the membership capital will not be considered a withdrawal if it occurs in conjunction with the periodic adjustment to all membership capital.

2. Have a three-year minimum withdrawal notification. Upon written notice of intent to withdraw membership capital, the balance of the account is frozen until the conclusion of the notice period, whether the account is a term certificate or an adjusted balance account. If the membership capital is in the form of an adjusted balance account, the frozen account may not be adjusted either up or down on the adjustment date. It remains the same until the end of the notice period. When notice is given, the amount of the account that can be considered membership capital (and thus a part of capital) must be reduced by a constant monthly amortization of the account until it is fully amortized at the end of the notice period.

3. Require disclosure of the terms and conditions to the recorded owner at the time the membership capital is issued and, at least, annually thereafter.

4. Are available to cover losses that exceed reserves and undivided earnings and paid-in capital. The full balance of membership capital, including the amortized portion, is available to absorb losses until the funds are released by the corporate at the end of the notice period.

5. Are not insured by NCUA or any other share or deposit insurers.

6. Cannot be pledged against borrowings.

7. May be sold to other members within the corporate's field of membership, subject to the corporate's approval.

<u>Order of Payout</u>

In the event of a corporate's liquidation, losses will be absorbed in the following order: current earnings, valuation allowances, undivided earnings, reserves, paid-in capital, membership capital, uninsured share obligations, NCUSIF, and liabilities.

<u>Capital Ratio</u>

The capital ratio is computed by dividing the corporate's capital by its moving daily average net assets (DANA). This is the ratio used in determining if base and base plus corporates are meeting the capital requirements of Section 704.3 (d); Part I corporates, Appendix B, Part I (c)(1),(2) and (3); and Part II corporates, Appendix B, Part II (c) (1), (2) and (3). It is also utilized for establishing concentration limits contained in Section 704.6(c), Credit Risk Management, Appendix B, Part I(b) and (d); Appendix B, Part II (a)(1), (b) and (d); Appendix B, Part III (b) (4) and (5); and Appendix B, Part V (a) as well as limiting changes in the NEV contained in Appendix B, Part I(c) (2) and (3) and Appendix B, Part II(c) (2) and (3).

<u>Core Capital Ratio</u>

The core capital ratio differs from the capital ratio in that it is computed by dividing the corporate's retained earnings (consistent with the definition of retained earnings on page 204-3, which does not include valuation allowances or UGL) and paid-in capital, if any, by its moving DANA. The core capital ratio does not include membership capital. This distinction was made to encourage corporates to build retained earnings and to limit risk to these accounts. The core capital ratio is considered when determining the earnings retention factor in conjunction with the calculation of earnings retention amounts.

Retained Earnings Ratio and Earnings Retention Requirement

The retained earnings ratio is computed by dividing the corporate's retained earnings by its moving DANA. A corporate must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent. Earnings retention requirements are contained in Section 704.3(i) and Section 704.19(b) for corporates and wholesale corporates, respectively.

Capital Requirements

All corporates operating as base or base plus must have 4 percent capital. Those operating under Part I or Part II authorities must have between 4 and 6 percent capital depending on the NEV volatility threshold established by the corporate.

Evaluating Capital Adequacy

Capital planning by corporates and regulatory analysis should include careful consideration of qualitative, as well as quantitative factors that may affect capital adequacy. Capital adequacy cannot be determined solely on the basis of a numeric formula or standard. Regulatory minimum requirements are not a proxy for analysis of the adequacy of an institution's capital position.

Risk Management - Qualitative Factors

The following factors should be viewed in conjunction with an overall analysis and understanding of a corporate, as well as the financial institution in general. The list is by no means all-inclusive.

<u>Quality of Management</u>

The quality, experience, depth, and sophistication of corporate management and officials are key in evaluating capital adequacy. Sound management entails developing procedures and practices, including reporting and auditing systems, which implement safe and sound policies. The corporate's board of directors must ensure it has competent managers. The board of directors and management should work together as a team, but they also must understand their distinct roles and responsibilities. The board ultimately remains responsible for the conduct of the corporate's affairs and provides independent checks and balances over management. Section 704.4 provides guidance to the board of directors on a wide range of areas for which the board of directors is responsible.

Inefficient or lax operations are costly. Shortcomings in systems, procedures, and controls expose corporates to losses through fraud, employee error, or miscalculation.

Capital Planning

Section 704.3(a) requires a corporate's board of directors to develop and ensure that written short- and long-term capital goals, objectives, and strategies are implemented. The combination of these should provide for building capital consistent with Part 704 and maintaining sufficient capital to support current and future risk exposures arising from the corporate's activities. The regulation also requires the periodic review and reassessment of the corporate's capital position.

Capital planning is a key aspect of managing a successful corporate. The board of directors, in conjunction with management and staff, should attempt to anticipate capital needs as well as maintain an adequate capital position. Although Part 704 stipulates minimum capital levels, management should not manage capital to the regulation. Rather, the board should target a minimum capital level consistent with its risk profile and future plans. Corporates undertaking significant expansion or exposed to high or unusual levels of risk are expected to maintain capital well above the minimum ratios.

Good capital planning is dynamic. The board of directors as well as management should be involved in formulating plans for the growth, mix, concentration, and effective management of assets and liabilities. A good plan sets forth specific strategies by which management intends to achieve established goals. Long- and short-term strategies should be developed. Long-term strategies should address the corporate's overall business plans including services intended for members. Strategies that may need to be used to increase capital and/or capital ratios (including NEV) are:

1. changing the mix of assets and liabilities to reduce the risk to asset portfolios;
2. reducing or slowing asset growth;
3. increasing earnings retention by changing the liability or deposit mix to reduce dividend payments;
4. streamlining operations or otherwise reducing the cost of operations; and
5. issuing paid-in or membership capital.

Funds Management

Section 704.8 provides the corporate with guidance in establishing effective asset-liability management policies. It is considered the core of sound planning and financial management and includes the supervision of the corporate's liquidity and interest rate sensitivity. Each corporate should have procedures minimizing the possibility of liquidity risk resulting in forced asset sales or interest rate risk resulting from asset maturities mismatched with source fund maturities. Policies and practices must include guidelines addressing off-balance sheet accounts if they exist.

Earnings Performance

The degree of profitability is a fundamental component of capital analysis, as it is a key indicator of the extent to which earnings can be relied upon as a source of new capital. Good earnings performance enables a corporate to remain competitive and even expand its operations. Included in that analysis is the payment of dividends. Dividends which are excessive can cause unnecessary growth which may reduce a corporate's capital position.

Credit Risk

Section 704.6 provides the corporate guidance in establishing policies that monitor and control credit risk in the corporate's various asset portfolios. Credit risk exists in a corporate's loan portfolio to members (although generally representing a small portion of overall assets) and its investment portfolio. Corporates that have Parts I, II, or III authorities generally can expand their capabilities to invest in instruments which have varying levels of credit risk.

The overall diversification in asset composition must be considered in determining capital adequacy. Likewise, the level of non-performing loans, securities ratings, and market value of securities are indicators of asset quality. Specific consideration should be given to the future effect on capital of continuing asset quality problems and the effectiveness of portfolio management.

Balance Sheet Diversification

The amount of capital required is a function of the risks associated with the composition and mix of assets and liabilities. Generally, a greater degree of asset and liability concentrations increases the need for capital. On- and off-balance sheet assets should be reviewed for concentrations in industries, product lines, customer types, and funding sources, as they apply to the corporate's strategic plan and its components.

Asset Growth

Growth in assets should be supported by growth in capital. Asset growth that outpaces the ability to maintain a sufficient level of capital is unsafe and unsound; however, determining the point and degree when growth negatively impacts capital is a more difficult task.

Traditionally, corporates have grown and contracted in response to the credit union industry's growth patterns. In the past, corporates were not concerned with the ratio of capital to assets, but relied on improving trends in the dollar amount of capital. Corporates are now looking for alternatives which enable them to meet their member needs without negatively impacting on their capital ratios. Examiners can expect corporates to utilize off-balance sheet transactions and CUSO operations as tools to control asset growth and thus the capital ratio.

Another method corporates may use to increase capital during periods of rapid growth will be membership capital and paid-in capital. While both are acceptable means to increase capital, an overall strategy for using each is a necessary element in capital adequacy.

Off-Balance Sheet Activities

Off-balance sheet activities should be examined to determine risk exposure and risk concentrations. Each source of risk must be viewed in light of its contribution to portfolio risk and the ability of management to administer it. It is important for management to be aware of these sources of risk, including the corporate's credit risk exposure under recourse obligations. Management must implement controls and procedures to identify, monitor, and manage the corresponding risks. Major off-balance sheet risks include credit, interest rate, and market risks, as well as pending litigation.

Field of Membership and Provided Services

The size and composition of a corporate's field of membership, combined with the philosophy of management are major contributors to the services provided to members. Some corporates which are limited in size are unable to provide some services to their members. Others, which have size have decided not to provide certain services. And others, without the size, still try to provide those services. The decision on what services to provide members rests with the board of directors.

In some institutions, services represent a significant portion of the corporate's income. The risks associated with services or the loss of income associated with the services must be clearly identified and addressed by the board of directors.

If services are provided through a CUSO, it should be capitalized commensurate with the industry standards for the activity in which it is engaged.

Financial Risk - Quantitative Factors

Financial ratio analysis should be used to supplement qualitative analysis of capital adequacy. In many financial institutions, the review of capital is often supplemented by comparing the ratio to peer groups or expanding the analysis to include a risk base capital standard. The unique nature of corporates may make these analyses difficult.

There are fewer than 30 corporates ranging in size from several million dollars to multi-billion dollars in assets; thus rendering a meaningful corporate-wide peer comparison impractical. Additionally, corporates vary significantly in the services they provide. The risk associated with these services adds another barrier in developing meaningful peer groups.

Corporates are primarily liquidity facilities. Their balance sheets are structured to respond to the liquidity needs of their members. As such, the balance sheets are generally comprised of short-term high quality investments which traditionally have little credit risk. Reliance on a risk based capital ratio as a forecaster of risk to corporates has proven to be unreliable in the past and does not appear to be an effective tool in the future.

Increasing leverage capital, while controlling the risk to a corporate's balance sheet by limiting changes to NEV and mitigating operational risks, is the most reasonable method of addressing capital adequacy in the System.

In lieu of comparing a corporate's capital ratio to a peer group, examiners, at the very minimum, should measure the empirical capital level against the minimum levels required in the regulation. However, it is more important to measure capital levels relative to the risk inherent in a corporate's balance sheet. This risk should be consistent with the corporate's own evaluation and be reflected in the goals the board sets. Thus, the examiner must ensure capital goals which corporates establish are adequate to meet these risks. This entails the quantitative review discussed previously.

More discussion of capital and the means to evaluate it are contained in the Empirical Capital Level and Capital Accumulation discussion in Chapter 401.

Additional Capital Requirement

Section 704.3(e) sets forth procedures by which the OCCU Director may determine the minimum capital requirements for an individual corporate are not appropriate. Examiners should be cognizant of any “significant circumstances or events” which might warrant either an increase or decrease in the capital levels established in the regulation. Since any action to adjust a corporate’s minimum capital ratio must be taken to the OCCU Director, examiners will have to clearly document the case. Prior to taking any action to initiate a recommendation, the examiner should thoroughly discuss the issues with the corporate field supervisor and the OCCU Director.

Section 704.3(f) outlines the process by which a corporate must notify the OCCU Director it has failed to meet its capital requirement.

Section 704.3(g) describes the conditions that must be contained in a capital restoration plan submitted by a corporate.

Section 704.3(h) describes the process by which NCUA may direct a corporate to increase a capital ratio which does not meet the requirement of the regulation or take other actions to achieve adequate capitalization.

Examination Objectives

The objectives for reviewing capital adequacy are as follows:

1. Determine that the risk inherent in the corporate's balance sheet and operations, as well as off-balance sheet operations, are adequately supported by its capital position.

2. Determine that the corporate complies with the FCU Act, NCUA Rules and Regulations, NCUA issued Capital Directives and Generally Accepted Accounting Principles.

3. Determine if the corporate's capital policies, procedures, and practices, as well as internal controls are adequate to address the risk.

4. Determine corporate management and officials are adhering to established guidelines.

5. Evaluate the propriety and consistency of the corporate's present and planned level of capitalization policy, in the context of existing conditions and future plans.

6. Initiate corrective action when necessary.

Examination Procedures

See Corporate Examination Procedures - Capital (OCCU 204P).

Examination Questionnaire

See Corporate Examination Questionnaire - Capital (OCCU 204Q).

References

NCUA Rules and Regulations, Part 704, Corporate Credit Unions