Goals of NCUA's Final Risk-Based Capital Rule

On October 15, 2015, the NCUA Board approved a final risk-based capital rule. The rationale for and goals of the final rule mirror those of the original proposal. These goals include:

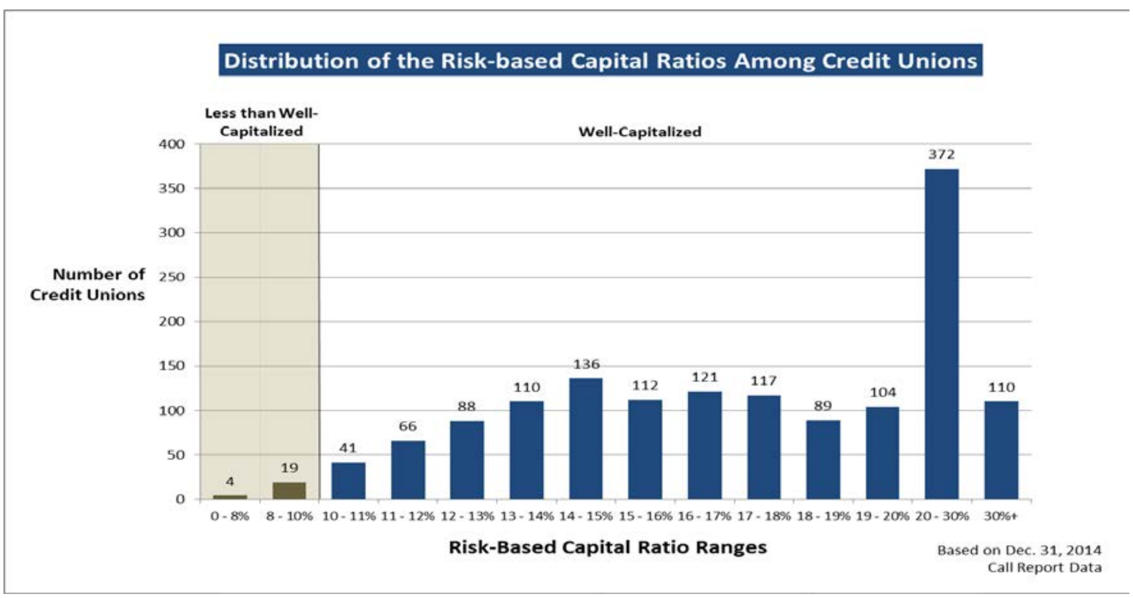
- Adhere to the requirements of the Federal Credit Union Act.
- Achieve NCUA's mission of protecting the credit union system.
- Correlate capital to risk.
- Implement a more meaningful and responsive metric.
- Address outliers holding insufficient capital compared to balance sheet risks.

The final rule systematizes a better calibrated and more refined structure of risk weights that are more reflective of the potential risks within credit unions. The rule is intended to help credit unions better absorb losses through sufficient capital. It will also establish a safer, more resilient, more stable credit union system, thereby reducing risk to the National Credit Union Share Insurance Fund.

The final rule is available at www.ncua.gov. This paper summarizes the impact of the final rule.

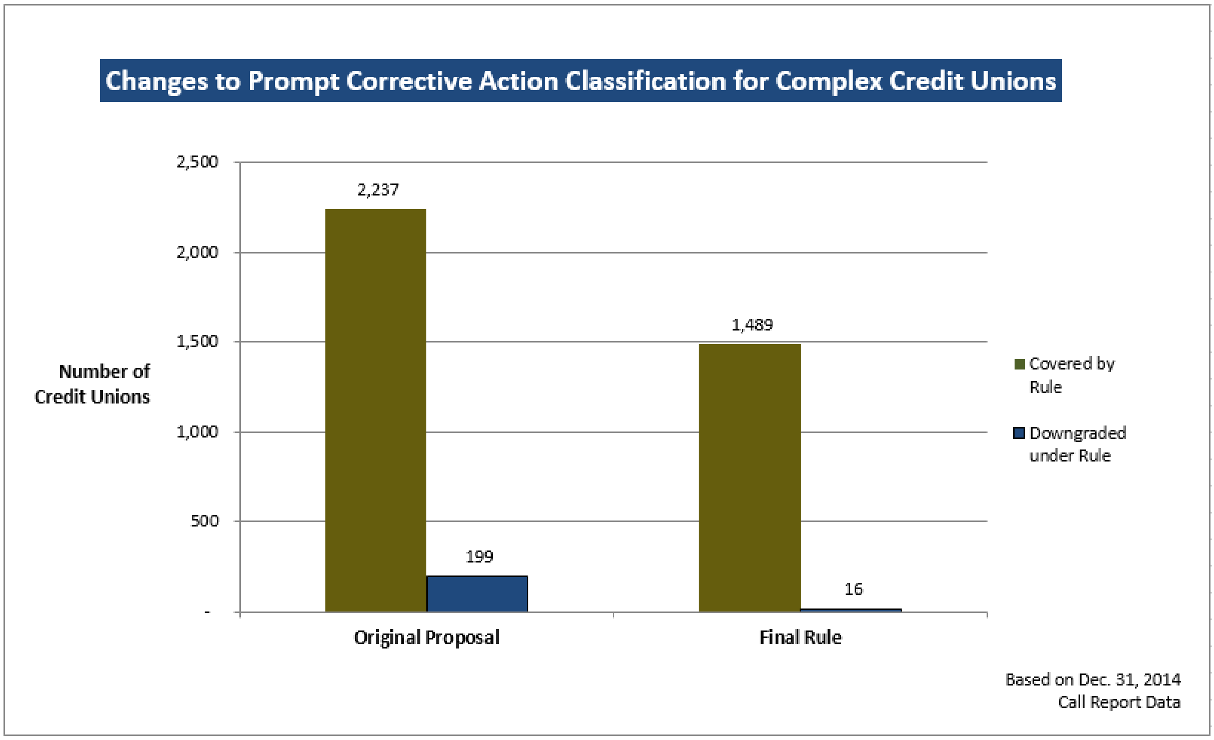
Impact of NCUA's Final Risk-Based Capital Rule

The final rule does not, on a systematic basis, require increased capital levels across the credit union system. In fact, the vast majority of covered credit unions have very healthy capital over the 10 percent well-capitalized level. The average covered credit union—those with more than $100 million in assets—currently has a 19 percent risk-based capital ratio, equivalent to 900 basis points above the 10 percent required threshold in the final rule.

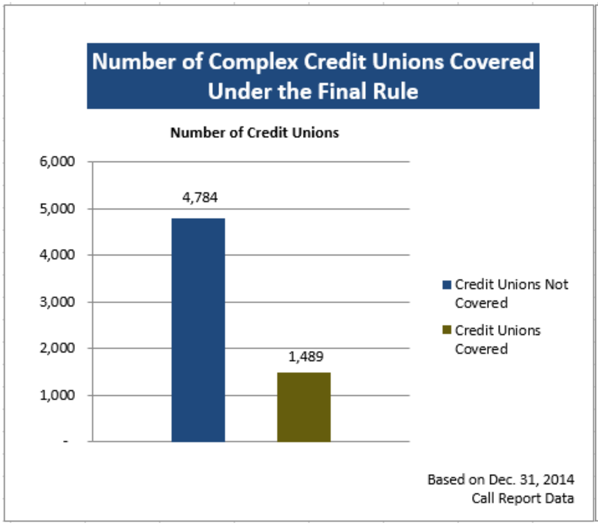


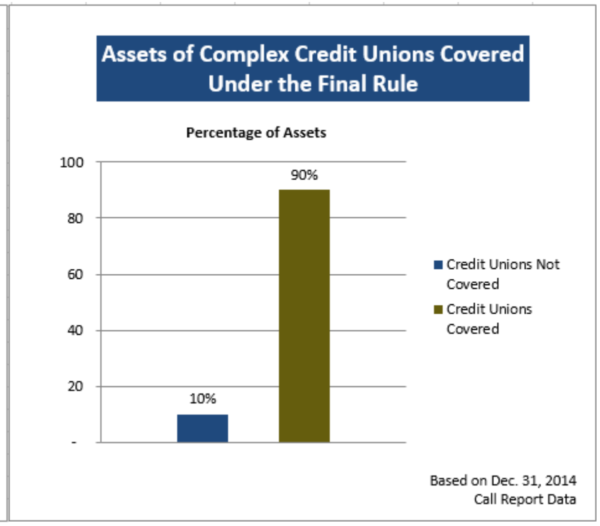
The chart above shows 23 credit unions falling below the risk-based capital threshold of 10 percent for being well-capitalized. Currently, seven of these 23 credit unions have a net worth leverage ratio of less than 7 percent and are already classified as less than well-capitalized under prompt corrective action. In contrast, 85 percent of covered credit unions have a risk based-capital ratio of 13 percent or greater—300 basis points or higher than the required level to be well-capitalized.

The chart below shows that NCUA's final risk-based capital rule affects fewer credit unions than the original proposal, both in the number of covered credit unions and in the number that would experience a change in prompt corrective action classification. In all, the final rule covers just 1,489 credit unions compared to the 2,237 credit unions covered by the original proposal. Moreover, far fewer credit unions—only 16 credit unions based on current balance sheets—would experience a downgrade in prompt corrective action category as a result of the final rule.



Additionally, the charts below show the number and percentage of assets of complex credit unions covered under the final rule. Approximately 24 percent of all federally insured credit unions are covered by the final rule. These credit unions account for approximately 90 percent of the total assets of the system.





In addition to providing a guide for credit unions to align with in considering their tolerance for risk, the final rule will achieve significant improvements, including:

- Ensuring larger, more complex credit unions remain well-capitalized as they grow and expand into activities with more risk.
- Identifying credit union outliers taking on higher risks, both today and tomorrow.
- Improving the relevancy of the risk-based capital system.
- Incorporating a modern approach to calculating the risk-based capital ratio and making it comparable to other financial institutions.
- Improving the definition of capital.
- Improving the required capital levels and risk-weight approach for many types of assets.
- Incorporating an explicit standard that complex credit unions must effectively manage their capital and put their plans in writing.
- Incorporating new areas of risk for credit unions, such as derivatives.
- Increasing the data collected from credit unions, ultimately improving off-site supervision capabilities.

Implementation Timeframe

The effective date of the final rule is January 1, 2019. This timeframe generally matches the risk-based capital implementation date for banks. The implementation period of more than three years also provides ample time for affected credit unions to choose to generate more capital while continuing to maintain their current portfolios, reduce risk, or execute some strategic combination of the two.

Capital Buffers under the Final Rule

As demonstrated in the table below, the number of covered credit unions operating with a 500-basis-point margin above the 10 percent risk-based ratio is two-and-a-half times greater than the number of covered credit unions operating 500 basis points above the 7 percent net worth (leverage) ratio.

Capital Buffers for Credit Unions with More than $100 Million in Assets

Well-Capitalized Level	Less than 0 basis points above	0 to 200 basis points above	200 to 350 basis points above	350 to 500 basis points above	More than 500 basis points above
Net Worth Ratio (7 percent)	14	297	449	334	395
Final Risk-Based Capital Ratio (10 percent)	23	107	140	194	1,025

Only those credit unions with higher percentages of total risk assets to total assets would tend to experience a moderate decline in the margin they currently have over the 7 percent net worth (leverage) ratio.

Costs and Benefits of Final Rule

With more than 101 million credit union members, the credit union system now exceeds $1.1 trillion in assets. It is protected by the $12.1 billion Share Insurance Fund, which is funded directly by credit unions and managed by NCUA. The ultimate purpose of this rule is to prevent or mitigate losses to the Share Insurance Fund by having a better calibrated, more forward-looking capital requirement and measurement based on actual risk.

As documented in the final rule, NCUA estimates the following implementation costs:

- NCUA anticipates additional NCUA budget costs of $2 million spread over three years. These costs primarily relate to updating NCUA's Call Report system to account for more granular and precise risk weights as requested by stakeholders, and for training NCUA field examiners on the rule.

- NCUA estimates the 16 (net) credit unions downgraded under the final rule on risk-based capital would need to raise $67 million to become well-capitalized. This conservative estimate assumes none of the credit unions would elect to comply with the final rule by reducing their risk profiles instead of raising capital.

- Additional one-time costs estimated by NCUA are $152,562 collectively, spread among 4,784 non-complex, non-covered credit unions, at an average of 1 hour for policy review and revision, for an average of $31.89 per credit union; and $1.9 million collectively, spread among 1,489 complex covered credit unions, at an average of 40 hours for policy review and revision, for an average of $1,275 per credit union.

The financial benefits to the credit union system through better protection of the Share Insurance Fund will far outweigh the final rule's costs. Consistent with the 2012 GAO Report's findings, NCUA's modernized final rule will better identify higher-risk credit union outliers, based on actual risks.[1]

For example, the average complex credit union has $675 million in assets. The average complex credit union that fails generally incurs total resolution costs of roughly 20 percent of its assets. ***Preventing just a single average complex credit union's failure could save the Share Insurance Fund $135 million alone***—a cost all federally insured credit unions would otherwise have to pay through the Share Insurance Fund.

Using back testing, NCUA estimates that if this rule had been in place before the financial crisis, actual losses to the Share Insurance Fund from eight of the nine complex credit unions that failed during this period would have been significantly curtailed, if those credit unions had held capital commensurate with their true risks.

[1] See U.S. Government Accountability Office's *Earlier Action Needed to Better Address Troubled Credit Unions* available at http://www.gao.gov/products/GAO-12-247.