



Report to the House Financial Services Committee
on the Final Risk-Based Capital Rule

NCUA is the independent federal agency created by the U.S. Congress to regulate, charter and supervise federal credit unions. With the backing of the full faith and credit of the United States, NCUA operates and manages the National Credit Union Share Insurance Fund, insuring the deposits of more than 101 million account holders in all federal credit unions and the overwhelming majority of state-chartered credit unions.

At MyCreditUnion.gov and [Pocket Cents](#), NCUA also educates the public on consumer protection and financial literacy issues.

National Credit Union Administration Report to the House Financial Services Committee on the Final Risk-Based Capital Rule

November 2015

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Section I

Introduction

In 1998, Congress enacted the Credit Union Membership Access Act.¹ Section 301 of this law added a new section 216 to the Federal Credit Union Act, which requires the National Credit Union Administration Board to adopt by regulation a system of prompt corrective action to restore the net worth of federally insured credit unions that become inadequately capitalized.² 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 consisting primarily of volunteers. In 2000, the Board implemented the required system of prompt corrective action primarily under part 702 of NCUA's regulations.³

In 2011, several factors compelled the NCUA Board to begin work on modernizing its risk-based net worth rule, including the lessons learned during the 2007–2009 financial crisis, the international adoption of new Basel capital accords, and the recommendations of the Government Accountability Office and NCUA's Inspector General.

In 2013, the other federal banking agencies adopted new risk-based capital rules.^{4, 5} These final rules provided a new impetus for NCUA Board action on the risk-based capital rules for credit unions. In addition to taking into consideration the cooperative character of credit unions, the Credit Union Membership Access Act also requires the prompt corrective action system for credit unions developed by NCUA to be comparable to the system established by the other banking agencies for banks.⁶

On January 23, 2014, the NCUA Board issued its original proposed rule on risk-based

¹ See Public Law 105–219, 112 Stat. 913 (1998).

² See 12 U.S.C. 1790d.

³ See 12 CFR Part 702; see also 65 FR 8584 (Feb. 18, 2000) and 65 FR 44950 (July 20, 2000).

⁴ Within this report, the use of the term “other banking agencies” or “other federal banking agencies” refers to the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of Currency.

⁵ See 78 FR 62017 (Oct. 11, 2013) (for the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System); and 78 FR 55339 (Sept. 10, 2013) (for the Federal Deposit Insurance Corporation).

⁶ See 12 U.S.C. 1790d(b)(1)(A); see also 12 U.S.C. 1831o (section 38 of the Federal Deposit Insurance Act setting forth the prompt corrective action requirements for banks).

capital.⁷ During an extended comment period, NCUA received 2,056 letters from diverse set of stakeholders, including lawmakers, trade associations, state regulators, and credit unions. Responding to all the comments received in the initial comment period, the Board acted on January 15, 2015, to issue a revised proposed rule.⁸

NCUA's primary goals for the revised proposed risk-based capital rule remained the same as the original proposal:

- To prevent or mitigate losses to the National Credit Union Share Insurance Fund by having a better calibrated, meaningful, and more forward-looking capital requirement to ensure credit unions can continue to serve their members during economic downturns without relying on government intervention or assistance; and
- To modernize the risk-based capital calculations and framework, in accordance with the Federal Credit Union Act's directives.

The revised proposed rule reflected many significant changes sought by Members of Congress, including members of the House Financial Services Committee, and other stakeholders. Some of the more significant changes:

- Narrowed the definition of "complex" credit unions so that only credit unions with assets over \$100 million must comply with the rule;
- Lowered the risk weights for certain investments, real estate loans, member business loans, and consumer loans;
- Eliminated the provision addressing interest rate risk; and
- Extended the implementation date to January 1, 2019.

The comment period on the revised proposed risk-based capital rule closed on April 27, 2015. Seven weeks after the comment period closed, Representatives Stephen Fincher, Bill Posey, and

⁷ See 79 FR 11184 (Feb. 27, 2014).

⁸ See 80 FR 4340 (Jan. 27, 2015).

Denny Heck introduced H.R. 2769, the Risk-Based Capital Study Act of 2015. Five months later, the House Financial Services Committee subsequently considered and favorably reported H.R. 2769 on September 30, 2015.

As reported by the House Financial Services Committee, H.R. 2769 calls for NCUA to study four aspects of its risk-based capital rule. These include:

- An analysis of whether the agency has the legal authority to prescribe separate risk-based capital thresholds for both adequately capitalized and well-capitalized credit unions;
- A discussion of the differences between credit unions and other types of depository institutions and the reasons why they should have similar or different risk weights for their capital requirements;
- A review of the rationale behind the risk-weights assigned by the agency in the revised proposed rule; and
- An examination of the impact the revised proposed rule would have on excess capital above the minimum level for a credit union to be well capitalized (otherwise known as a capital cushion), including the impact the rulemaking could have on credit union lending and credit union examinations.

H.R. 2769 also would direct NCUA to report the findings of this study—along with any legislative recommendations to improve the capital system for credit unions or establish a risk-based capital system for credit unions—to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services within prescribed timeframes.

On October 6, 2015, Representatives Fincher, Posey, and Heck wrote to NCUA Board Chairman Debbie Matz and encouraged the agency to voluntarily undertake the study and report outlined in H.R. 2769 before finalizing the risk-based capital rule. Chairman Matz replied on October 8, 2015, that NCUA had already closely studied each of the matters outlined in the legislation. She also committed the agency to completing and transmitting a report following the parameters outlined in H.R. 2769 after the NCUA Board acted on a final rule. This report to the House Financial Services Committee fulfills that commitment.

On October 15, 2015, the NCUA Board approved the risk-based capital final rule marking the culmination of a multi-year process with two separate comment periods and careful analysis of all stakeholder comments. The overarching intent of the final rule is to reduce the likelihood of a relatively small number of high-risk outliers exhausting their capital and causing systemic losses—which, by law, all federally insured credit unions would be required to pay through the Share Insurance Fund. The final rule restructures NCUA's prompt corrective action regulations and makes significant revisions suggested by commenters.

The NCUA Board took action on a final rule for three reasons. First, as noted earlier, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued new risk-based capital rules in 2013. By law, NCUA is required to maintain risk-based capital rules for credit unions that are comparable to the risk-based capital rules for banks.

Second, both the GAO and NCUA's Inspector General found that the existing NCUA rule on risk-based net worth failed to prevent credit union losses as a result of the financial crisis. GAO concluded that NCUA should propose "additional triggers" for prompt corrective action that "would require early and forceful regulatory action."⁹ The Inspector General noted that NCUA needs a prompt corrective action framework that will identify increasing risks on a timely basis, before losses occur.¹⁰

Third, the final rule will protect the entire credit union system. Requiring those credit unions that are high-risk outliers to hold sufficient capital to offset their risks will minimize systemic losses. And putting safeguards in place before the next financial crisis occurs is good public policy. A modernized risk-based capital rule will help more credit unions avoid capital losses and reduce the losses to the Share Insurance Fund which all credit unions have to pay.

The analyses called for in H.R. 2769 were addressed largely through the preamble to the final rule.¹¹ This report builds on that preamble and incorporates other information gathered by the agency during the course of the rulemaking. While this report studies the issues specifically

⁹ See U.S. Gov't Accountability Office, *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO-12-247 (2012), available at <http://www.gao.gov/products/GAO-12-247>.

¹⁰ Material Loss Review of Telesis Community Credit Union (OIG-13-05), March 2013, available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

¹¹ See 80 FR 66626 (Oct. 29, 2015).

contained in the legislation, it only covers a subset of the many matters the NCUA Board analyzed before approving a final rule.

As the legislation requests, this report includes several legislative recommendations related to the capital requirements for federally insured credit unions. To strengthen the credit union system, NCUA has long supported legislation pending in Congress to allow all credit unions to access supplemental capital for purposes of net worth. Accordingly, this report requests that the House Financial Services Committee consider and pass H.R. 989, the Capital Access for Small Businesses and Jobs Act.

Introduced by Representatives Peter King and Brad Sherman, H.R. 989 would allow healthy and well-managed credit unions to issue supplemental capital that will count as net worth. This legislation would result in a new layer of capital, in addition to retained earnings, to absorb losses at failed credit unions, protect the Share Insurance Fund from losses, and safeguard taxpayers.

This report also contains several other legislative recommendations for technical amendments to the Federal Credit Union Act related to the prompt corrective action standards for federally insured credit unions.

Consistent with the parameters found in H.R. 2769, the remainder of this report is organized to cover the following topics:

- A general analysis of the differences and similarities between credit unions and other depository institutions;
- The rationale for risk weights assigned in the final risk-based capital rule;
- A discussion of the differences in NCUA's final risk-based capital rule for credit unions compared to the requirements for other depository institutions;
- An examination of the impact of the final risk-based capital rule on federally insured credit unions;

- A review of how the final rule will impact examinations once the final rule becomes effective at the start of 2019;
- A study of the legal authority for the NCUA Board to prescribe a two-tiered risk-based capital system; and
- Legislative recommendations related to capital standards for federally insured credit unions.

This report concludes with several appendices designed to supplement the material contained within the report.

Section II

Credit Unions and Other Depository Financial Institutions – Differences and Similarities

The Federal Credit Union Act requires the NCUA Board to prescribe, by regulation, a system of prompt corrective action that is:

- “*consistent with*” section 216 of the Federal Credit Union Act; and
- “*comparable*” to the system of prompt corrective action prescribed in the Federal Deposit Insurance Act.¹²

The Federal Credit Union Act also requires the NCUA Board to take into account the cooperative character of credit unions when designing the prompt corrective action system.

Congress specifically listed the traits of the cooperative character of credit unions. Namely, credit unions are not-for-profit cooperatives that do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors consisting primarily of volunteers.¹³ These traits accurately identify the important differences between credit unions and other U.S. depository institutions. Other than these traits, credit unions face the same financial and operational risks as other federally insured depository institutions.

In addition to the potential for mismanagement and the customary uncertainties regarding actual versus expected performance of investments and loans, banks and credit unions face a variety of broadly applicable external sources of risk. Examples of such risk include:

¹² Although the Federal Credit Union Act does not define the term “comparable,” the Senate report that accompanied the Credit Union Membership Access Act defines it as “parallel in substance (though not necessarily identical in detail) and equivalent in rigor.” See S. Rep. No. 193, 105th Cong., 2d Sess. §301 (1998).

¹³ See 12 U.S.C. 1790d(b)(1)(B). NCUA has simplified certain aspects of the final rule to take into account the cooperative character of credit unions while still imposing risk-based capital requirements that are substantially similar and equivalent in rigor to the standards imposed on banks. A few examples include using a \$100 million asset threshold as a proxy for “complex,” the treatment of any equity exposures that are significant, exclusion of the capital conservation buffer, and having only one risk-based capital requirement versus three for the other banking agencies.

- Interest rate risk that results from changes in the interest rate environment affecting the margin between the yield on an institution's assets and its cost of funds,
- Credit risk that arises from changes in the economy and job market affecting loan and investment performance, and
- Liquidity risk from any unexpected changes in incoming cash flows on assets and outflows on deposits and other funding sources.

Because of the statutory requirement for NCUA's prompt corrective action system to be comparable—and the fact that credit unions are exposed to credit risk like all depository financial institutions—NCUA's general approach was to defer to the capital treatment used by the other banking agencies and the Basel Committee on Banking Supervision.¹⁴

However, NCUA has tailored the risk weights in the final rule for certain assets that are unique to credit unions or where a demonstrable and compelling case exists, based on contemporary and sustained performance differences, to differentiate for certain asset classes—such as consumer loans—between banks and credit unions, or where a provision of the Federal Credit Union Act requires doing so. In the few instances where the risk weights are higher for credit unions, primarily concentrations of real estate and commercial loans, they apply to a very low percentage of total complex credit union assets and relate to sources of higher losses to the Share Insurance Fund.

Thus, the final rule fundamentally maintains equal treatment for equal risks in all federally insured depository institutions. This provides equivalent protection to the taxpayer across federally insured financial institutions and minimizes any competitive distortions that could result from significantly different capital requirements for particular asset classes.

The section entitled *Rationale for Risk-Based Capital Treatment* contains a discussion of each element of the risk-based capital ratio calculation in the final rule, including how NCUA's treatment of each element compares to the other banking agencies.

¹⁴ Like the other banking agencies' risk-based capital standards, NCUA's risk-based capital ratio addresses credit risk. Also, NCUA continues to incorporate an element of credit concentration risk.

Section III

Rationale for Risk-Based Capital Treatment

1. Summary of Comparability to Other Banking Agencies' Risk-Based Capital Treatment

NCUA's risk-based capital final rule is generally comparable to the other banking agencies' capital regulations. Figure 1 below shows the percentage of aggregate complex credit union assets by risk weight as they compare to the risk weights assigned by the other banking agencies. The risk weights overall are equivalent to those for banks, with some more favorable due to credit unions' conservative lending record.

As shown in Figure 1, nearly 76 percent of complex credit union assets are estimated to be comparable to those for banks. The 75 percent risk weight for secured consumer loans, primarily automobile loans, results in a lower risk weight on about 21 percent of complex credit union assets when compared to the 100 percent risk weight for banks for similar assets. Almost 97 percent of complex credit union assets have risk weights the same as or lower than those assigned by the other banking agencies. Less than 3 percent of complex credit union assets receive a more conservative risk weight—most of which accounts for credit concentration risk.

Figure 1: Comparison of NCUA and Other Banking Agency Risk Weights for Aggregate Complex Credit Union Assets (As a Percent of Complex Credit Union Assets)

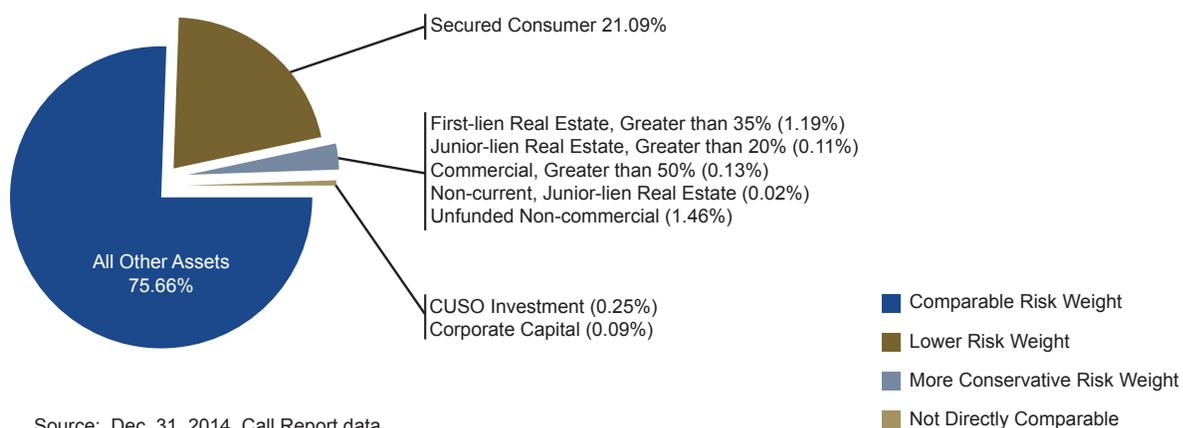


Table 1 below provides a more detailed list of the risk weights and comparisons between NCUA's and the other banking agencies' assigned risk weights.

Table 1: Comparison of Risk Weights between NCUA's Risk Based-Capital Final Rule and the Other Banking Agencies' Rules

	NCUA Risk Weight	Other Banking Agencies Risk Weight
Cash on Hand		
Cash, Currency, Coin	0%	0%
Investments		
Unconditional Claims - U.S. Government	0%	0%
Balances Due from Federal Reserve Banks	0%	0%
Federally Insured Deposits in Financial Institutions	0%	0%
Debt Instruments Issued by NCUA and FDIC	0%	0%
Central Liquidity Facility Stock	0%	Not Applicable
Uninsured Deposits at U.S. Federally Insured Institutions	20%	20%
Agency Obligations	20%	20%
Fannie Mae and Freddie Mac Pass-through Mortgage-Backed Securities	20%	20%
General Obligation Bonds Issued by State or Political Subdivisions	20%	20%
Federal Home Loan Bank Stock and Balances	20%	20%
Senior Agency Residential Mortgage-Backed or Asset-Backed Securities Structured	20%	20%
Revenue Bonds Issued by State or Political Subdivisions	50%	50%
Senior Non-Agency Residential Mortgage-Backed Securities Structured	50%	Gross-up or Simplified Supervisory Formula
Corporate Membership Capital	100%	Not Applicable
Industrial Development Bonds	100%	100%
Agency Stripped Mortgage-Backed (Interest Only)	100%	100%
Part 703 Compliant Investment Funds	100% ^a	Not Applicable
Value of General Account Insurance (Bank-Owned Life Insurance, and Credit Union-Owned Life Insurance) [*]	100%	100%
Corporate Perpetual Capital	100%/150% ^{***}	Not Applicable
Mortgage Servicing Assets	250%	250%
Separate Account Life Insurance	300% [*]	Look-through
Publicly Traded Equity Investment (non-CUSO)	100%/300% ^{***}	300%
Mutual Funds Part 703 Non-Compliant	300% ^a	Not Applicable
Non-Publicly Traded Equity Investments (non-CUSO)	100%/400% ^{***}	400%
Subordinated Tranche of Any Investment	1,250% ^{**}	Gross-up or Simplified Supervisory Formula
Consumer Loans		
Share-Secured (Shares Held at the Credit Union)	0%	0%
Share-Secured (Shares Held at Another Depository Institution)	20%	20%

	NCUA Risk Weight	Other Banking Agencies Risk Weight
Current Secured	75%	100%
Current Unsecured	100%	100%
Non-Current Consumer	150%	150%
Real Estate Loans		
Share-Secured (Shares Held at the Credit Union)	0%	0%
Share-Secured (Shares Held at Another Depository Institution)	20%	20%
Current First Lien Less than 35% of Assets	50%	50%
Current First Lien Greater than 35% of Assets	75%	50%
Not Current First Lien	100%	100%
Current Junior Lien Less than 20% of Assets	100%	100%
Current Junior Lien Greater than 20% of Assets	150%	100%
Noncurrent Junior Lien	150%	100%
Commercial Loans		
Share-Secured (Shares Held at the Credit Union)	0%	0%
Share-Secured (Shares Held at Another Depository Institution)	20%	20%
Portion of Commercial Loans with Compensating Balance	20%	Not Applicable
Commercial Loans Less than 50% of Assets	100%	100%/150% ****
Commercial Loans Greater than 50% of Assets	150%	100%/150% ****
Non-Current Commercial	150%	150%
Miscellaneous:		
Loans to CUSOs	100%	100%
Equity Investment in CUSO	100%/150% ***	100%–600%
Other Balance Sheet Items not Assigned	100%	100%

* With the option to use the look-through options.

** With the option to use the gross-up approach.

*** If a credit union's total equity exposures are "non-significant" under section 702.104(c)(3)(i), then the risk weight is 100 percent. This lowers the risk weight to 100 percent for CUSO equity exposures, corporate perpetual capital, and all other equity investments when they are part of a credit union's non-significant equity exposures.

**** FDIC identifies certain commercial loans as High Volatility Commercial Real Estate and assigns a 150 percent risk weight.

In addition to the risk weight differences noted in the table above, NCUA's rule differs from the other banking agencies' capital regulation in the following ways:

- Credit unions can include the entire balance of the Allowance for Loan and Lease Losses account in the risk-based capital numerator, whereas the other banking agencies cap the amount at 1.25 percent of risk-weighted assets.

- Only credit unions greater than \$100 million in assets are subject to the risk-based capital requirement while all banks are subject to the other banking agencies' risk-based capital requirements.
 - As of year-end 2014, there were 1,872 banks with assets less than \$100 million. In comparison, there were 4,784 federally insured credit unions with less than \$100 million in assets.
 - Thus, while NCUA's risk-based capital final rule exempts 76 percent of federally insured credit unions, the risk-based capital rule of the other banking agencies applies to all banks and thrifts regardless of size.
- Credit unions are not required to maintain a 2.5 percent capital conservation buffer, whereas the other banking agencies require banks to hold a 2.5 percent capital conservation buffer in order to avoid dividend and discretionary bonus payment restrictions.
- Banks must apply a higher risk weight (150 percent) for high volatility commercial real estate loans. NCUA's final rule does not include such requirement.
- Credit unions have a lower risk weight (75 percent) on current secured consumer loans than the risk weight for banks (100 percent).
- Credit unions have a lower risk weight on contractual compensating balances associated with commercial loans, while the other banking agencies' rules have no such provision.
- NCUA's rule simplifies the risk-weight treatment for significant equity exposures. As such, credit unions are not required to deduct any significant exposures from regulatory capital whereas banks are required to deduct certain significant exposures from regulatory capital.

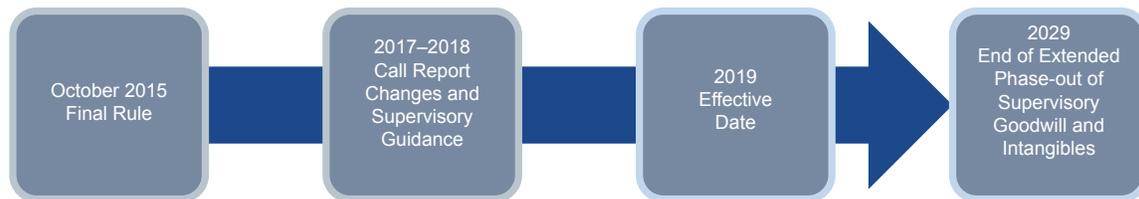
Most of the differences between NCUA's risk-based capital requirements and those of the other banking agencies are to the benefit of credit unions, in part to account for their cooperative character. Each risk-based capital ratio element and the similarities or variances from the other banking agencies' risk-based capital regulations are discussed in detail below.

2. Deferred Effective Date

The final rule includes an extended implementation period, with an effective date of January 1, 2019. Even though the overwhelming majority of credit unions have sufficient capital to be well capitalized under the final rule, the January 1, 2019, effective date provides credit unions—and NCUA—with more than three years to prepare. This time period should be more than sufficient for credit unions and NCUA to make the necessary adjustments to systems and operations.

This effective date generally aligns with the full implementation timeframe of the other banking agencies' capital regulation. Figure 2 below outlines the implementation timeline for NCUA's risk-based capital rule.

Figure 2: NCUA Risk-Based Capital Rule Implementation Timeline



Even after the final rule becomes effective in 2019, credit unions will have until 2029 before certain forms of goodwill and other intangible assets that were acquired as part of a supervisory combination must be deducted from the risk-based capital ratio numerator. For additional information on this provision of the rule, see the discussion on goodwill and other intangible assets below.

To prepare for implementation of the final rule, NCUA will revise the Call Report by early 2018, update examination and supervision systems to include the new data and risk-based capital ratio, issue examiner guidance, and provide examiner training on the rule.

NCUA examiners will not be requiring credit unions to meet the new minimum risk-based capital regulatory requirement until it becomes effective in 2019. However, NCUA will continue

to evaluate the capital adequacy of all credit unions for safety and soundness based on existing guidance.

3. Risk-Based Requirement Is Only Applicable to Complex Credit Unions

The Credit Union Membership Access Act of 1998 added to the Federal Credit Union Act a requirement for NCUA to implement a risk-based net worth requirement (risk-based capital) for “complex” credit unions.¹⁵ While the other banking agencies’ capital regulations apply to all banks regardless of size or complexity, the Federal Credit Union Act directs NCUA to apply the risk-based requirement only applicable to those credit unions the NCUA Board defines as complex.

Section 216(d)(1) of the Federal Credit Union Act directs NCUA, in determining which credit unions will be subject to the risk-based net worth requirement, to base its definition of complex “on the portfolios of assets and liabilities of credit unions.”¹⁶ The statute does not require NCUA to adopt a definition of “complex” that takes into account the portfolio of assets and liabilities of each credit union on an individualized basis. Rather, section 216(d)(1) authorizes NCUA to develop a single definition of “complex” that takes into account the portfolios of assets and liabilities of all credit unions. Consistent with section 216(d)(1), the definition of a “complex” credit union included an asset size threshold that, as explained in more detail below, was designed by taking into account the portfolios of assets and liabilities of all credit unions.¹⁷

For the purpose of defining a complex credit union in the final risk-based capital rule, assets include tangible and intangible items that are economic resources (products and services) that are expected to produce economic benefit (income), and liabilities that are obligations (expenses) the credit union has to outside parties. There are products and services—which under GAAP are reflected as the credit unions’ portfolio of assets and liabilities—in which credit unions are engaged that are inherently complex based on the nature of their risks and the expertise and

¹⁵ See 12 U.S.C. 1790d(d).

¹⁶ 12 U.S.C. 1790d(d).

¹⁷ Under the current rule, credit unions are “complex” and subject to the risk-based net worth requirement only if they have quarter-end total assets more than \$50 million and a risk-based net worth ratio over 6 percent. This approach requires all credit unions with more than \$50 million in assets to compute their risk-based net worth ratio to determine if they meet the complex definition.

operational demands necessary to manage and administer such activities effectively.¹⁸ Thus, credit unions offering such products and services are complex for purposes of NCUA's risk-based capital requirement.

The following inherently complex products and services were used to set the definition of a "complex" credit union:

- Member business loans,
- Participation loans,
- Interest-only loans,
- Indirect loans,
- Real estate loans,
- Non-federally guaranteed student loans,
- Investments with maturities of greater than five years (where the investments are greater than one percent of total assets),
- Non-agency mortgage-backed securities,
- Non-mortgage-related securities with embedded options,
- Collateralized mortgage obligations and real estate mortgage investment conduits,
- Commercial mortgage-related securities,
- Borrowings,
- Repurchase transactions,
- Derivatives, and
- Internet banking.

Based on Call Report data as of March 31, 2015, all credit unions with more than \$100 million in assets were engaged in offering at least one of the products and services listed above, 99 percent were engaged in two or more complex activities, and 80 percent were engaged in four or more. In contrast, less than two-thirds of credit unions below \$100 million in assets were involved in even a single complex activity, and only 15 percent had four or more. Moreover, credit unions with total assets of less than \$100 million are only a small share (approximately 10 percent) of the overall assets in the credit union system—which limits the exposure of the Share Insurance

¹⁸ Products and services comprise a portfolio of assets and liabilities through the accounts and fixed assets that must be maintained to operate, the resources of staff and funds necessary to operate the credit union, and the liabilities that may arise from contractual obligations, among other things. Altogether, these products and services are accounted for on the balance sheet through assets and liabilities according to GAAP.

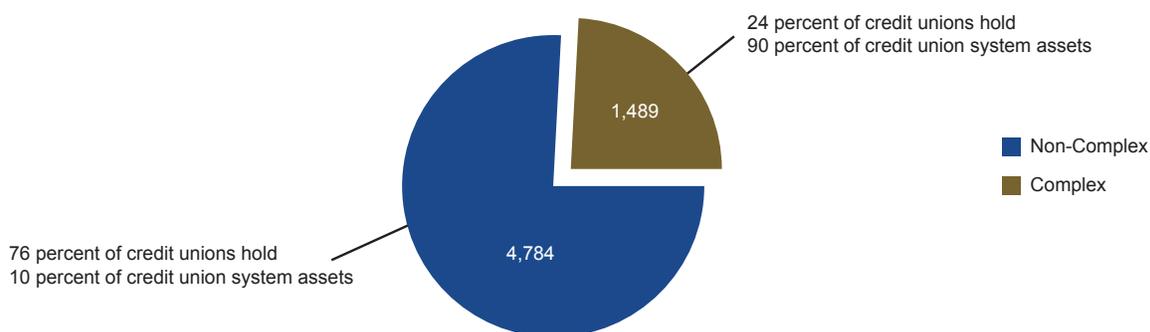
Fund to these institutions. Table 2 below summarizes the asset-liability complexity for credit unions with less than \$100 million in assets, credit unions between \$100 million and \$250 million in assets, and credit unions with more than \$250 million in assets.

Table 2: Asset-Liability Complexity Index, 2015 First Quarter

Asset Category	Number of Credit Unions	Average Index Value	Index Greater or Equal to 1	Index Greater or Equal to 2	Index Greater or Equal to 3	Index Greater or Equal to 4	Index Greater or Equal to 7	Index Greater or Equal to 10
Less than \$100 Million	4,690	1.6	66%	42%	26%	15%	2%	0%
\$100 Million to \$250 Million	704	5.2	100%	99%	92%	80%	26%	1%
Greater than \$250 Million	812	7.2	100%	100%	98%	95%	62%	15%

Thus, NCUA's final rule defines a complex credit union as one with total assets greater than \$100 million. Based on December 31, 2014, Call Report data, approximately 76 percent of credit unions are exempt from any of the regulatory burdens associated with complying with the risk-based requirement of the final rule. However, as shown in Figure 3 below, the risk-based requirement will still cover almost 90 percent of the assets in the credit union system that are held by the 24 percent credit unions defined as complex for purposes of the risk-based requirement. Comparatively, there were 1,872 FDIC-insured banks with assets less than \$100 million as of December 31, 2014, that must comply with all of the other banking agencies' risk-based capital requirements.

Figure 3: Distribution of Complex and Non-Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

Table 3 below summarizes NCUA losses by asset cohort since 2002. In all, 194 federally insured credit unions with less than \$50 million in inflation-adjusted assets failed at a cost to the Share Insurance Fund of \$327 million in current dollar terms. This represents 27.6 percent of total period losses. Over the same period, 8 federally insured credit unions with between \$50 million and \$100 million in inflation-adjusted assets failed, accounting for only 4.4 percent of Share Insurance Fund losses. Also during this period, 22 federally insured credit unions with at least \$100 million in assets failed at a cost to the Share Insurance Fund of \$806.3 million, accounting for 68 percent of total Share Insurance Fund losses. Thus, despite the higher propensity for smaller credit unions to fail during this period, the bulk of the losses to the Share Insurance Fund came from failed credit unions with more than \$100 million in assets. Therefore, using a \$100 million threshold as the definition of complex will not pose undue risk to the Share Insurance Fund based on recent trends.

Table 3: NCUA Losses by Asset Cohort

Asset Cohort	Number of Failures	Share Insurance Fund Dollar Losses (millions)	Share Insurance Fund Percent Losses
Less than \$50 Million	194	\$327.0	27.6%
\$50 Million to \$100 Million	8	\$51.7	4.4%
Greater than \$100 Million	22	\$806.3	68.0%

Defining the term “complex” credit union using an asset size threshold of \$100 million also reduces the complexity of the rule, provides regulatory relief for smaller institutions, and eliminates the potential unintended consequences of having a checklist of activities that would determine whether a credit union is subject to the risk-based capital requirement.¹⁹ Conversely, using a credit union’s percentage of risk assets to total assets as the factor for determining whether the credit union is complex would require all credit unions to understand, monitor, and apply a complex measure of their risk asset-to-asset ratio each quarter. This would be an additional and unnecessary burden for credit unions below the \$100 million asset size threshold.

Accordingly, a \$100 million asset size threshold is a clear demarcation above which complex activities are always present, and where credit unions are almost always engaged in multiple complex activities. It is logical, clear, and easy to administer. It is also consistent with the fact

¹⁹ Potential unintended consequences include a credit union limiting member services to avoid being subject to the risk-based capital rule.

that the majority of losses (68 percent as measured as a proportion of the total dollar cost) to the Share Insurance Fund spanning the last 12 years have come from credit unions with assets greater than \$100 million.^{20, 21}

4. Prompt Corrective Action Categories

The other banking agencies' capital regulations subject all banks to three minimum risk-based capital ratios to be well capitalized:²²

- Total risk-based capital ratio – 10 percent
- Tier 1 risk-based capital ratio – 8 percent
- Common equity Tier 1 risk-based capital ratio – 6.5 percent

The other banking agencies also incorporate a 2.5 percent capital conservation buffer that will be fully phased-in by 2019, which is applied to the three risk-based capital ratios at the adequately capitalized level.²³ Table 4 below shows the minimum capital ratio for banks once the full capital conservation buffer takes effect.

Table 4: Other Banking Agencies' Capital Requirements with Capital Conservation Buffer

Prompt Corrective Action Capital Category	Threshold Ratios		
	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Common Equity Tier 1 Risk-Based Capital Ratio
Adequately Capitalized	8%	6%	4.5%
Plus Conservation Buffer	2.5%	2.5%	2.5%
Equals Minimum Capital Ratio Including Conservation Buffer	10.5%	8.5%	7.0%

²⁰ The 68 percent is based on an analysis of loss and failure data collected by NCUA.

²¹ NCUA performed a back-testing analysis of Call Report and failure data to determine whether this final regulation would have resulted in earlier identification of emerging risks and possibly reduced losses to the Share Insurance Fund. The impact of the final rule on more recent failures of credit unions with total assets over \$100 million was also evaluated. The testing revealed that maintaining a risk-based capital ratio in excess of 10 percent would have triggered eight out of nine such failing credit unions to hold additional capital, which could have prevented failure or reduced losses to the Share Insurance Fund.

²² See 12 CFR 324.403.

²³ A bank with a capital conservation buffer of less than 2.5 percent of risk-weighted assets would be subject to increasingly stringent limitations on capital distributions and discretionary bonus payments to executive officers as the capital conservation buffer approaches zero.

Therefore, a bank could be well capitalized with a total risk-based capital ratio of 10 percent, but an inadequate capital conservation buffer would still limit its ability to make capital distributions and discretionary bonus payments.

In part to take into account of the cooperative character of credit unions, NCUA's final rule only employs one risk-based capital ratio measure and excludes the capital conservation buffer imposed on banks. Not including the capital conservation buffer simplifies NCUA's risk-based capital requirement relative to the other banking agencies' rules without appreciably lowering the protections provided by NCUA's risk-based capital regulations.

Table 5: Comparison of NCUA's and the Other Banking Agencies' Risk-Based Capital Thresholds

	NCUA's Final Rule	Other Banking Agencies' Rule
Well Capitalized		
Risk-Based Capital Measure	10% or higher	10% or higher
Adequately Capitalized		
Risk-Based Capital Measure	8% to 9.99%	8% to 9.99%*
Undercapitalized		
Risk-Based Capital Measure	Less than 8%	Less than 8%

* Federally insured banks also have to hold a 2.5 percent capital conservation buffer by January 2019.

NCUA's final risk-based capital rule incorporates 10 percent and 8 percent risk-based capital ratio thresholds for well capitalized and adequately capitalized, respectively. This achieves comparability with other banking agencies' capital regulations, ensuring NCUA's capital regulation is equivalent in rigor.^{24, 25} Table 5 above compares the risk-based capital thresholds for credit unions and banks.

The rigor of a regulatory capital standard is primarily a function of how much capital an institution is required to hold for a given type of asset. Capital ratio thresholds are largely a function of risk weights. For a given risk asset, the amount of capital required to be held for that risk asset is calculated by multiplying the dollar amount of the risk asset times the risk

²⁴ See 12 CFR 324.32 and 12 CFR 324.403.

²⁵ See S. Rep. No. 193, 105th Cong., 2d Sess. §301 (1998). "Comparable here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor."

weight times the desired capital level. To illustrate, where the threshold for well capitalized is 10 percent, a credit union that has one dollar in a risk asset assigned a 50 percent risk weight would need to hold capital of five cents—that is, \$1 multiplied by 50 percent multiplied by 10 percent. The point of this illustration is that the risk weights are interdependent with the thresholds set for the regulatory capital categories.

If NCUA chose any threshold below 10 percent for the minimum required level of regulatory capital, it would either result in systematically lower incentives for credit unions to accumulate capital or the risk weights would need to be adjusted commensurately to offset the effect of the lower threshold. For example, if a uniform threshold for both well capitalized and adequately capitalized were maintained and set at only 8 percent, there would be a decline in the overall rigor of the risk-based capital ratio. While NCUA's risk weights for various assets could be increased by 20 percent to offset this effect, adjusting the risk weights in this manner would create more difficulty in comparing asset types and risk weights across financial institutions, and lead to misunderstanding.

Conversely, the uniform threshold level for the well-capitalized and adequately capitalized categories could be maintained, but raised to maintain the rigor of the risk-based capital standard and avoid adjusting the risk weights. This approach would set a higher point at which credit unions would fall to undercapitalized (such as any risk-based capital ratio under 10 percent), and therefore be subject to mandatory and discretionary supervisory actions. This approach would not be optimal, as the supervisory consequences for credit unions with risk-based capital ratios between 8 percent and 10 percent would be worse than for institutions operating under the other banking agencies' rules.

Further, there are sound policy reasons for setting a higher risk-based capital ratio threshold for the well-capitalized category than the one for the adequately capitalized category. Under the current rule, which will be replaced by the new rule in 2019, a credit union's capital classification could rapidly decline directly from well capitalized to undercapitalized if it fails to meet the required risk-based net worth ratio level.²⁶ Moreover, credit unions classified as well capitalized are generally considered financially sound and afforded greater latitude under some other

²⁶ Per the Federal Credit Union Act, "undercapitalized" is the lowest prompt corrective action category in which a failure to meet the risk-based net worth requirement can result.

regulatory provisions.²⁷ With the exception of a small earnings retention requirement, well-capitalized credit unions also are not subject to mandatory or discretionary supervisory actions. In contrast, credit unions that fall to the undercapitalized category are financially weak and are subject to various mandatory and discretionary supervisory actions intended to resolve the capital deficiency and limit risk taking until capital levels are restored to prudent levels.

The lack of graduated thresholds in the current rule's construct for the risk-based net worth requirement does not effectively provide for early reflection of declining capital strength through a credit union's net worth category, as suggested by GAO and NCUA's Office of the Inspector General. Under the current rule, a change in the credit union's risk profile, capital levels, or both, that results in a decline in the credit union's risk-based net worth ratio, does not affect its net worth category until it results in the credit union falling to the point where the situation mandates that supervisory actions be taken.

The more effective approach and better policy option is a higher threshold for the well-capitalized category than for the adequately capitalized category to provide a more graduated framework where a credit union does not necessarily drop directly from well capitalized to undercapitalized. In fact, this policy objective is reflected in how Congress, in section 216(c) of the Federal Credit Union Act, and the other banking agencies in their risk-based capital regulations, designed the graduated prompt corrective action capital categories.

Maintaining the rigor of the risk-based net worth requirement is also important for another key policy objective: to ensure the risk-based net worth requirement is relevant and meaningful. A relevant and meaningful risk-based net worth requirement will result in capital levels better correlated to risk and better inform credit union decision-making.²⁸ To be relevant and meaningful, the risk-based net worth requirement must result in minimum regulatory capital levels on par with the net worth ratio for credit unions with elevated risk. It must also be the governing ratio (require more capital than the net worth ratio) for credit unions with extraordinarily high risk profiles. If the highest threshold for the risk-based capital ratio were set as low as 8 percent for well-capitalized credit unions, then the risk-based net worth requirement would govern very few, if any, credit unions. If the highest risk-based capital ratio threshold

²⁷ See 12 CFR 745.9-2 and 12 CFR 723.7.

²⁸ The benefits of a capital system better correlated to risk are discussed in the *Summary of the Final Rule* section of the final rule's preamble. See 80 FR 66626 (Oct. 29, 2015).

were set at 8 percent, NCUA estimates at most seven credit unions would have the risk-based capital ratio be the governing requirement, with only one credit union currently holding insufficient capital to meet the requirement.

Further, capital is a lagging indicator because it is founded primarily on accounting standards, which by their nature are largely based on past performance. The net worth ratio is even more so a lagging indicator because it applies capital—a lagging measure in itself—to total assets. Thus, the net worth ratio does not distinguish among risky assets or changes in a balance sheet's composition. A risk-based capital ratio is more prospective by accounting for asset allocation choices and driving capital requirements before losses occur and capital levels decline. The more relevant the risk-based net worth requirement is, then the more likely that credit unions will build capital sufficient to prevent precipitous declines in their prompt corrective action capital classifications that could result in greater regulatory oversight and even failure.

To be relevant and meaningful, the risk-based net worth requirement also needs to encourage credit unions to build and maintain capital as they increase risk to be able to absorb any corresponding unexpected losses. A graduated, or tiered, system of capital category thresholds that distinguishes between the well-capitalized and adequately capitalized categories will incentivize credit unions to hold sound levels of capital without invoking supervisory action before necessary. While there is no requirement for a credit union to be well capitalized, and there are no supervisory interventions required for a credit union with an adequately capitalized classification, there are some regulatory privileges and other benefits for a credit union that is well capitalized. Chief among those benefits is the accumulation of sufficient capital to weather financial and economic stress.

During the 2007–2009 financial crisis, some credit unions experienced large losses in a compressed timeframe, resulting in a rapid deterioration of net worth. A number of credit unions that historically had been classified as well capitalized were quickly downgraded to undercapitalized. Credit unions that failed at a loss to the Share Insurance Fund on average were very well capitalized, based on their net worth ratios, 24 months prior to failure (average net worth ratio of 12.1 percent). Over the last 10 years, more than 80 percent of all credit union failures involved institutions that were well capitalized in the 24 months immediately preceding failure. Unlike the net worth ratio, which is indifferent to the composition of assets, a well-designed risk-based net worth requirement should reflect material shifts in the risk profile of assets.

A risk-based capital framework that encourages and promotes capital accumulation benefits not only those credit unions that achieve the well-capitalized classification, but the entire credit union system. For additional discussion on the benefits of a meaningful risk-based capital requirement, see Appendix A.

5. Qualifying Risk-Based Capital

The final rule incorporates a broadened definition of capital for purposes of calculating the risk-based capital ratio that would serve as the risk-based net worth requirement. This treatment provides for a more comparable measure of capital across all financial institutions and better accounts for related elements of the financial statement that are available (or not) to cover losses and protect the Share Insurance Fund. The Federal Credit Union Act gives NCUA broad discretion in designing the risk-based net worth requirement. Accordingly, the final rule incorporates a broadened definition of capital, versus the narrower statutory definition of net worth, for purposes of calculating the new risk-based capital ratio.²⁹

Table 6: Comparison of NCUA's and the Other Banking Agencies' Risk-Based Capital Ratio Numerator Elements

Risk-Based Capital Ratio Numerator Item	NCUA's Final Rule Treatment	Other Banking Agencies' Treatment*
Equity	100% included in numerator Includes undivided earnings, appropriations for non-conforming investments, other reserves, equity acquired in merger, section 208 assistance included in net worth, and secondary capital included in net worth	100% include in numerator Includes common stock, retaining earnings, other Tier 1 capital, and Tier 2 capital A bank that is not an advanced approaches institution may make a one-time, permanent election to opt out of the requirement to include accumulated other comprehensive income in regulatory capital.
Allowance for Loan and Lease Losses	100% included in numerator	Included up to 1.25% of total risk-weighted assets
Share Insurance Fund Deposit	Deducted	Not applicable

²⁹ The final rule does not authorize supplemental capital for non-low-income designated credit unions. See Appendix B for a discussion of supplemental capital for all credit unions and NCUA's related rulemaking plans.

Risk-Based Capital Ratio Numerator Item	NCUA's Final Rule Treatment	Other Banking Agencies' Treatment*
Goodwill and Other Intangible Assets	Deducted Exception for goodwill and other intangible assets acquired in a supervisory merger prior to 2016	Deducted Net of associated deferred tax liabilities
Identified Losses not Reflected in the Risk-Based Capital Numerator	Deducted	Deducted

* As they relate to the total risk-based capital ratio.

a. Equity

NCUA's final rule includes all equity, as defined in Table 6 above, in the risk-based capital ratio numerator. This treatment is consistent with the other banking agencies for items that are relevant to credit unions. However, the other banking agencies' capital rules include a substantial number of additional deductions or adjustments to capital that are either not applicable to credit unions or were excluded from NCUA's final rule for simplicity.³⁰

The risk-based capital ratio numerator does not include the following Call Report equity items:

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

Including accumulated unrealized gains and losses in the risk-based ratio numerator could lead to volatility in the risk-based capital ratio measure, difficulty in capital planning and asset management, and other unintended consequences.³¹

³⁰ See 12 CFR 324.22(a)(3) through (8) for the additional regulatory capital deductions. See 12 CFR 324.22(b) through (e) for additional adjustments to regulatory capital required for banks.

³¹ The other banking agencies' regulatory capital rules allow institutions to make an opt-out election for similar accounts. See 12 CFR 324.22; and 78 FR 55339 (Sept. 10, 2013). NCUA chose not to incorporate the opt-out election because of the added volatility and limited utility of this provision.

The risk-based capital numerator includes any equity acquired in a merger instead of the non-GAAP compliant statutory net worth provision to include what was previously retained earnings of a merged credit union. Equity acquired in a merger qualifies as equity under GAAP, more accurately reflects the overall value of a business combination transaction, and is included in regulatory capital by the other banking agencies.

The risk-based capital numerator includes secondary capital amounts that are included in the statutory definition of net worth. The statutory definition of net worth only includes secondary capital held by low-income designated credit unions. Secondary capital issued under NCUA's rules provides protection to the Share Insurance Fund because it includes maturity requirements and is subordinate to all other claims of creditor, shareholders, and the Share Insurance Fund. Secondary capital is comparable to subordinated debt, which the other banking agencies include as Tier 2 regulatory capital when it meets certain requirements.

b. Allowance for Loan and Lease Losses³²

The allowance for loan and lease losses, or ALLL, provides an estimate of expected losses in the loan portfolio. Unlike capital, it is not a reserve for future unexpected losses. The definition of the ALLL in the final rule is consistent with the Interagency Policy Statement on the ALLL and includes specific reference to compliance with GAAP.³³ NCUA also has related guidance on loan charge-offs.³⁴

Under the final rule, the entirety of the ALLL balance maintained in accordance with GAAP is included in the risk-based capital ratio numerator. The entire ALLL balance is available to absorb losses. Allowing the entire ALLL balance to count in the risk-based capital numerator is appropriate as credit unions will have already expensed through the income statement the expected credit losses on the loan portfolio, yet the related loans are still on the books and assigned a risk weight in the risk-based capital denominator. Allowing the entire ALLL balance

³² The Allowance for Loan and Lease Loss Account is a contra-asset account established and maintained by periodic charges to operating expense to provide a credit union's best estimate of the probable amount of loans it will be unable to collect based on current information and events and where the amount of the loss can be reasonably estimated.

³³ See NCUA Accounting Bulletin No 06-01, Dec. 2006.

³⁴ See NCUA Letter to Credit Unions No. 03-CU-01, Loan Charge-off Guidance, Jan. 2003.

to be included in the numerator also insulates its capital treatment from any changes in GAAP.³⁵

However, this treatment is different from that taken by the other banking agencies.³⁶ Under the Federal Deposit Insurance Corporation's risk-based capital rules, when calculating its total capital ratio using the standardized approach, a banking organization would be permitted to include in Tier 2 capital the amount of ALLL that does not exceed 1.25 percent of its standardized total risk-weighted assets. Consistent with the ALLL treatment under the general risk-based capital rules, the other banking agencies have elected to permit only limited amounts of the ALLL in Tier 2 capital given its limited purpose of covering incurred rather than unexpected losses.

For banks and other financial institutions, the 1.25 percent limitation prevents the use of the ALLL as a means to control taxable revenue by maintaining excessive reserves. Because credit unions have no incentive to manipulate the reserve in such a manner, NCUA has elected to include the full ALLL balance in the risk-based capital ratio numerator. This results in most credit unions recognizing a higher risk-based capital ratio numerator, contributing to a higher risk-based capital ratio, all other things equal.

Including the entire ALLL balance in the risk-based capital ratio numerator is appropriate given the high quality of credit union capital. The quality of credit union capital should eliminate concerns that the ALLL could account for too much of the capital required to be held against total risk-weighted assets.

In times of financial stress, while risk may be increasing (such as rising non-current loans), an uncapped inclusion of the ALLL in the risk-based capital ratio numerator will allow a properly funded ALLL to somewhat offset the impact of the financial stressors on the risk-based capital ratio. An uncapped ALLL in the risk-based capital ratio numerator will reduce the impact of the risk-based capital ratio during economic downturns when credit unions are more likely to be funding higher levels of loan losses.

Allowing the entire balance of the ALLL to be included in the risk-based capital numerator could lead to slower recognition of loan losses. Hence, the final rule includes a provision to ensure the

³⁵ See FASB Financial Instruments-Credit Losses Subtopic 825-15 (exposure draft dated Dec. 20, 2012).

³⁶ See 12 CFR 324.20(d)(3).

ALLL can be fully included only to the extent the credit union is funding it in compliance with GAAP and charging off loans on a timely basis.

Table 7 below displays the number of credit unions that hold ALLL reserves in excess of 1.25 percent of assets. Additionally, the table shows the increase in credit unions which would be negatively impacted during times of stress (for example in 2009 and 2010) if a 1.25 percent cap on inclusion of the ALLL had been adopted. This could result in several more credit unions falling under prompt corrective action requirements despite having reserves available.

Table 7: Impact of Cap on Allowance for Loan and Lease Losses on Complex Credit Unions

	2008	2009	2010	2011	2012	2013	2014
Number of Complex Credit Unions with ALLL above 1.25% of Risk Assets	326	543	647	598	531	408	306
Amount of ALLL in Excess of 1.25% of Risk Assets	\$1.44 Billion	\$3.25 Billion	\$3.64 Billion	\$3.03 Billion	\$2.24 Billion	\$1.39 Billion	\$0.94 Billion
Aggregate Risk-Based Capital Ratio of Complex Credit Unions with a 1.25% Cap on the ALLL							
Aggregate Risk-Based Capital	16.04%	15.55%	16.43%	16.94%	17.64%	17.92%	17.80%
Average Risk-Based Capital	18.21%	17.30%	17.96%	18.50%	19.02%	19.13%	19.11%
Aggregate Risk-Based Capital Ratio of Complex Credit Unions with No Cap on the ALLL							
Aggregate Risk-Based Capital – No ALLL Cap	16.38%	16.27%	17.23%	17.57%	18.08%	18.18%	17.95%
Average Risk-Based Capital – No ALLL Cap	18.46%	17.80%	18.54%	18.97%	19.35%	19.34%	19.24%

Source: NCUA Call Report data.

c. Share Insurance Fund Deposit

In accordance with the Federal Credit Union Act, a credit union will place on deposit with the Share Insurance Fund an amount equal to one percent of its insured shares.³⁷ Section 1783 of the Federal Credit Union Act further outlines how the deposit shall be used:

³⁷ See 12 U.S.C. 1782(c)(1)(A)(i).

There is hereby created in the Treasury of the United States a National Credit Union Share Insurance Fund which shall be used by the Board as a revolving fund for carrying out the purposes of this subchapter. Money in the fund shall be available upon requisition by the Board, without fiscal year limitation, for making payments of insurance under section 1787 of this title, for providing assistance and making expenditures under section 1788 of this title in connection with the liquidation or threatened liquidation of insured credit unions, and for such administrative and other expenses incurred in carrying out the purposes of this subchapter as it may determine to be proper.³⁸

The deposit is maintained by the Share Insurance Fund and included in the fund's equity ratio. The purpose of the Share Insurance Fund deposit is to cover losses in the credit union system. This results in the deposit being double-counted in the credit union system as capital for the Share Insurance Fund and as an asset for the credit union.³⁹ The Share Insurance Fund deposit is not available for a credit union to cover losses from risk exposures on its own individual balance sheet while the credit union is an active going concern or in the event of insolvency.⁴⁰ The Share Insurance Fund deposit is refundable only in the event a solvent credit union voluntarily liquidates, or converts to a bank charter or private insurance.

The final rule deducts the Share Insurance Fund deposit from both the numerator and denominator in calculating the risk-based capital ratio. This treatment addresses the concerns with double counting of the Share Insurance Fund deposit and is more in-line with the capital treatment of other assets with no value in liquidation, such as goodwill and intangible assets.

Additionally, this treatment is consistent with long-standing views of the U.S. Department of the Treasury and Congress. It is also the most mathematically accurate way to account for the Share Insurance Fund deposit in the risk-based capital ratio calculation. The 1997 U.S. Treasury Report on Credit Unions supports NCUA's position of excluding the Share Insurance Fund deposit from the risk-based capital ratio calculation. The Treasury report concluded that the Share Insurance Fund deposit is double counted because it is an asset on credit union balance

³⁸ 12 U.S.C. 1783(a).

³⁹ The Gov't Accountability Office recommended in 1991 that if Congress does not require credit unions to expense the one-percent deposit, then NCUA should require credit unions to exclude the amount from both sides of their balance sheets when assessing capital adequacy. See U.S. Gov't Accountability Office, *Credit Unions: Reforms for Ensuring Future Soundness*, GAO/GGD 91-85 (July 1991), p. 174.

⁴⁰ See 12 U.S.C. 1782(c)(1)(B)(iii).

sheets and equity in the Share Insurance Fund.⁴¹ The Treasury report noted that, instead of expensing the Share Insurance Fund deposit, holding additional capital is necessary to offset risk of loss from required credit union replenishment. Congress established a higher statutory leverage ratio for credit unions, in part, to offset the risk of loss from required credit union replenishment of the Share Insurance Fund Deposit.⁴²

The Share Insurance Fund deposit needs to be deducted in the risk-based capital ratio, not just the leverage ratio, to correct for the double-counting concern in those credit unions where the risk-based capital ratio is the governing requirement.⁴³

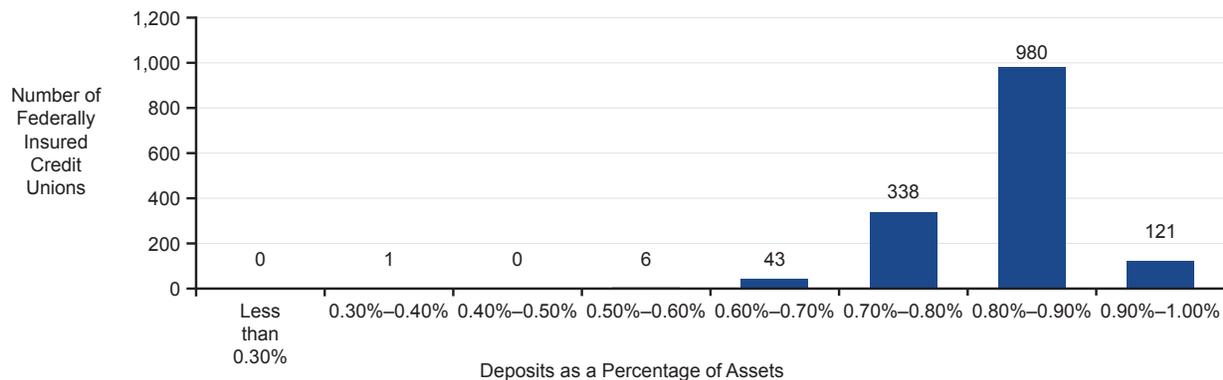
The other banking agencies' risk-based capital rules make no specific reference to federal deposit insurance capitalization deposits, as their system does not have a capitalization deposit similar to the Share Insurance Fund. All premiums paid into the Deposit Insurance Fund and included in its equity are expensed by banks and are not reported on the banks' balance sheets.

Figure 4 below includes a distribution of the Share Insurance Fund deposits as a percent of assets for complex credit unions as of December 31, 2014. On average, the Share Insurance Fund represents 0.83 percent of a complex credit union's assets.

⁴¹ See U.S. Dep't of Treasury Rep., *Credit Unions*, 1997, p. 58 ("The 1 percent deposit does present a double-counting problem. And it would be feasible for credit unions to expense the deposit now, when they are healthy and have strong earnings. However, expensing the deposit would add nothing to the Share Insurance Fund's reserves and...better ways of protecting the [Share Insurance] Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.")

⁴² The Senate report on the Credit Union Membership Access Act of 1998 references the 1997 Treasury Report by stating: "H.R. 1151 incorporates recommendations from the Treasury Department's 1997 study of credit unions and establishes capital standards and a system of prompt corrective action" See S. Rep. No. 193, 105th Cong., 2d Sess. §301 (1998).

⁴³ Based on Dec. 31, 2014, data, 313 out of 1,489 complex credit unions would have the risk-based capital ratio as the governing constraint.

Figure 4: Share Insurance Fund Deposits in Complex Credit Unions

Source: Dec. 31, 2014, Call Report data

d. Goodwill and Other Intangible Assets

Goodwill and other identifiable intangibles, excluding mortgage servicing assets, are most often on a credit union's balance sheet as a result of a business combination, such as a merger. Goodwill—or a bargain purchase gain—can result from application of generally accepted accounting principles in a business combination. The institution being acquired is assessed at fair value. Any gap in combining the fair value of the acquired credit union, such as equity acquired in merger, with the fair value of the continuing credit union's net assets will be measured as goodwill when the equity acquired and fair value of the liabilities exceed the fair value of the assets, or a bargain purchase gain when the fair value of the assets exceeds the equity acquired and fair value of the liabilities.

Goodwill and other intangible assets are recorded on the financial statements as an asset and must be evaluated at least annually for impairment, unless they have a definitive useful life in which case they will be amortized over the useful life. These assets typically have no real or tangible value that can be transferred or sold. Thus, in liquidation these assets are not available to fund liabilities. They contain a high level of uncertainty regarding a credit union's ability to realize value from these assets, especially under adverse financial conditions.⁴⁴

⁴⁴ The material loss review of Telesis Community Credit Union conducted by NCUA's Office of Inspector General indicates inadequate due diligence related to business combinations can adversely impact a credit union's financial condition. The review concluded the credit union did not perform appropriate due diligence before acquiring a credit union service organization and, once acquired, did not appropriately value intangibles or goodwill. The credit union's auditors recognized impairments related to goodwill and intangible assets exceeding \$2 million in both 2008 and 2009. See NCUA, *Material Loss Review of Telesis Community Credit Union*, OIG-13-05 (Mar. 15, 2013) available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

Therefore, the final rule requires credit unions to deduct goodwill and other intangible assets from the numerator of the risk-based capital ratio. This treatment is consistent with the longstanding view of the other banking agencies and international capital standards, which require all goodwill and intangible assets to be deducted from the numerator of the risk-based ratio.⁴⁵ However, NCUA's risk-based capital calculation differs slightly by allowing certain goodwill and other intangibles to be included for a specific time period.

Specifically, the final rule allows credit unions until January 1, 2029, to include in the risk-based capital numerator goodwill and other intangible assets originating from a supervisory merger or combination that was completed no more than 60 days after the publication of the final rule in the *Federal Register*. The final rule incorporates this treatment by defining goodwill, excluded goodwill, other intangible assets, and excluded other intangible assets as follows:

- **Goodwill** means an intangible asset, maintained in accordance with GAAP, representing the future economic benefits arising from other assets acquired in a business combination, such as a merger, that are not individually identified and separately recognized. Goodwill does not include excluded goodwill.
- **Excluded goodwill** means the outstanding balance, maintained in accordance with GAAP, of any goodwill originating from a supervisory merger or combination that was completed on or before December 28, 2015. This term and definition expire on January 1, 2029.
- **Other intangible assets** means intangible assets, other than servicing assets and goodwill, maintained in accordance with GAAP. Other intangible assets does not include excluded other intangible assets.
- **Excluded other intangible assets** means the outstanding balance, maintained in accordance with GAAP, of any other intangible assets such as core deposit intangible, member relationship intangible, or trade name intangible originating from a supervisory merger or combination that was completed on or before December 28, 2015. This term and definition expire on January 1, 2029.

The amount of goodwill and other intangible assets deducted from the risk-based capital ratio

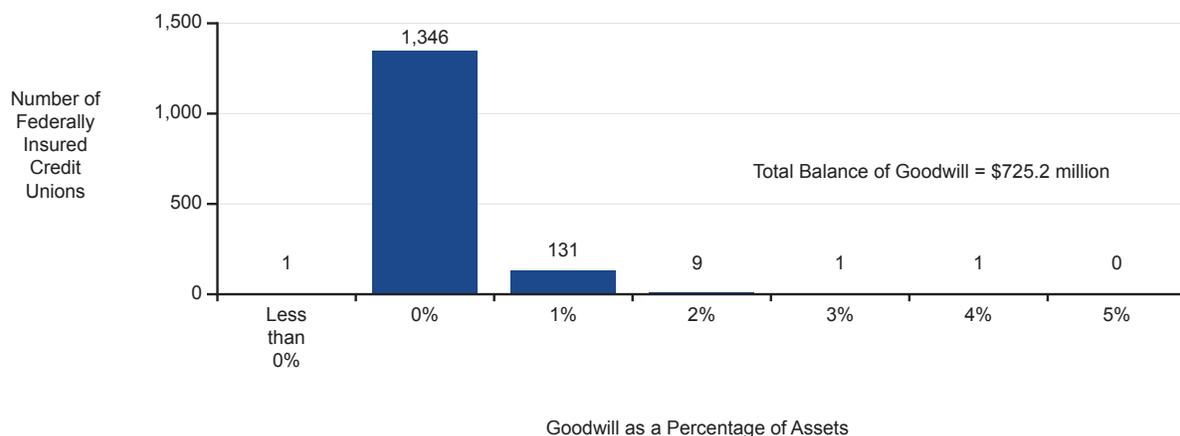
⁴⁵ See 12 CFR 324.22(a).

numerator is reduced by the balance of excluded goodwill or excluded other intangible assets recorded, in accordance with GAAP, as of the measurement date. Credit unions still need to conform to GAAP in the measurement and disclosure of goodwill and other intangible assets, regardless of whether it was obtained through a supervisory merger or combination.

The extended phase-out provision will allow affected credit unions time to revise business practices to ensure goodwill and other intangible assets directly related to supervisory mergers do not adversely impact the risk-based capital calculation. NCUA believes the extended phase-out period is appropriate because credit unions that were involved in supervisory mergers or combinations prior to publication of the final rule were not able to incorporate any potential risk-based capital requirement into their acquisition pricing and plans.

As shown in Figure 5 below, goodwill makes up less than one percent of assets as of December 31, 2014, for the vast majority of complex credit unions.⁴⁶

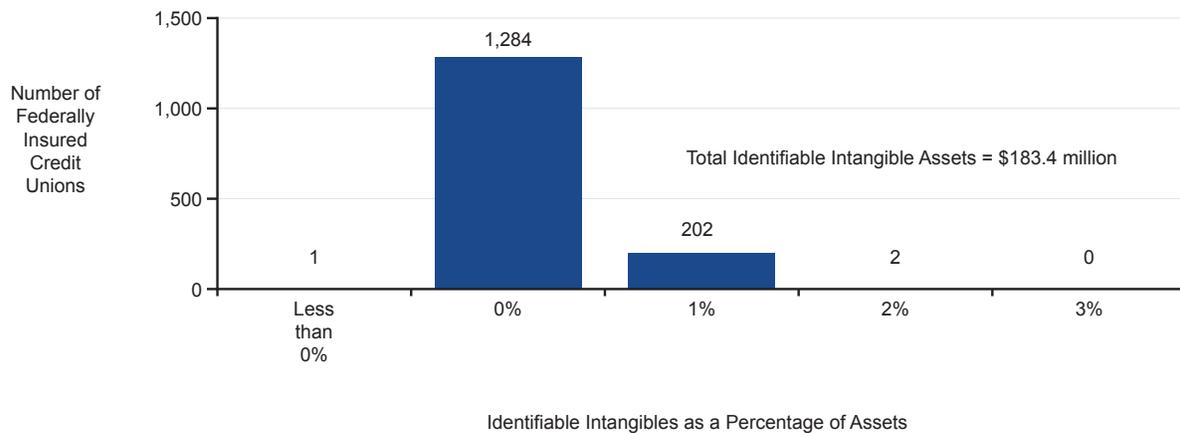
Figure 5: Goodwill in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

Similarly, Figure 6 below shows the distribution of complex credit unions based on the amount of intangible assets to total assets.

⁴⁶ The amount of goodwill reported that is less than zero is a reporting error by the credit union.

Figure 6: Identifiable Intangible Assets in Complex Credit Unions

Source: Dec. 31, 2014, Call Report data

As with goodwill, the vast majority of credit unions do not report any intangible assets.⁴⁷ Thus, the risk-based capital requirement for goodwill and other intangibles will have a minimal impact on the credit union system.

Only 12 complex credit unions reported total goodwill and intangible assets of more than 1 percent of assets as of December 31, 2014. The projected risk-based capital ratios for these 12 credit unions ranged from 6.73 percent to 20.21 percent, with an average projected risk-based capital ratio of 14.76 percent. Only one of the 12 would have a risk-based capital ratio less than 10 percent. Earnings and growth simulations show the impact of deducting goodwill and other intangible assets from the risk-based capital ratio numerator is manageable given the extended effective date of the rule and the extension for phasing-out goodwill and other intangible assets related to a supervisory merger or combination.

Going forward, credit unions will need to consider the impact on both the leverage and risk-based capital ratio of any future combinations. For mergers, this means a credit union with higher capital may be able to outbid a competing credit union. A credit union will need to consider the impact on its capital when determining the appropriate price, which may result in marginally higher costs to the Share Insurance Fund in some situations. However, stronger capital will reduce the number and cost of failures, resulting in a net positive benefit to the Share

⁴⁷ The amount reported as less than zero is a reporting error by the credit unions.

Insurance Fund and the credit union system.

e. Identified Losses Not Reflected in the Risk-Based Capital Ratio Numerator

The evaluation of a credit union's capital adequacy must include recognition of all loss contingencies. The final rule defines identified losses as those items that have been determined by an evaluation made by NCUA, or in the case of a state-chartered credit union the appropriate state official, as measured on the date of examination in accordance with GAAP, to be chargeable against income, equity or valuation allowances such as the allowances for loan and lease losses.⁴⁸ 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.

The final rule includes 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. This treatment is consistent with the approach in the other banking agencies' capital rules.⁴⁹

6. Cash and Deposits

Credit unions use cash to fund daily operations, including member withdrawals. Generally, credit unions retain just enough cash to sustain operations and cover liquidity needs, and invest excess funds into interest-earning assets such as loans and investments.

a. Cash on Hand: Cash, Currency, and Coin

Other than inflationary considerations, the value of cash is constant. Cash held by a financial institution for normal operations—such as vault, ATM, and teller cash—typically presents no risk because it is protected from loss by the institution's fidelity bond. Therefore, it is assigned a zero risk weight. The zero percent risk weight for cash as part of a risk-based capital framework is a

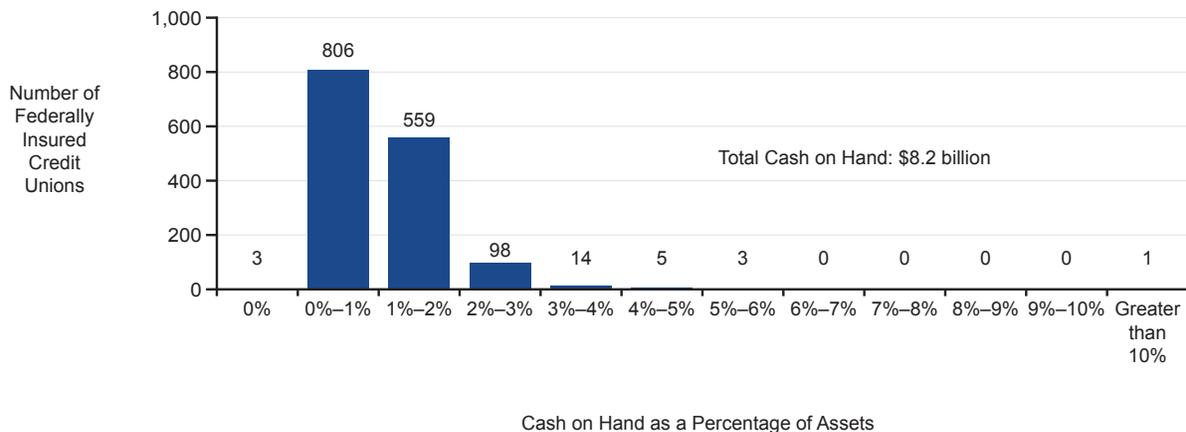
⁴⁸ Under U.S. GAAP, ASC 450 and ASC 460 are the primary sources of guidance on contingencies.

⁴⁹ See 12 CFR 324.22(a)(9).

longstanding treatment under U.S. and international capital standards.⁵⁰

As of December 31, 2014, 1,486 of the 1,489 (99.8 percent) complex credit unions reported cash balances. Total aggregate cash is 0.81 percent of assets, while the average reported cash to assets ratio is 1.06 percent. The distribution of total cash as a percentage of assets for complex credit unions is shown in Figure 7.

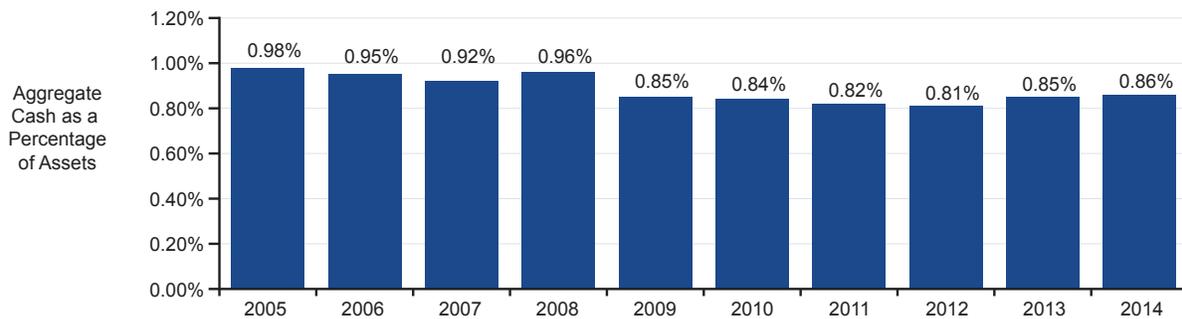
Figure 7: Cash on Hand in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

The total aggregate amount of cash held as a percent of system assets has fluctuated over the past ten years, but more recently the proportional cash levels have declined. Figure 8 shows the historical amount of cash as a percent of assets for all federally insured credit unions (complex and non-complex).

⁵⁰ See 12 CFR 324.32(l)(1).

Figure 8: Cash on Hand as a Percentage of Assets at Year-End

Source: NCUA Call Report data

Cash on hand has fluctuated slightly over time, but remains a relatively small portion of credit unions' balance sheets. Because cash, currency, and coin held by credit unions is subject to the same risks as that held by other depository institutions, NCUA's final rule uses the same risk weight assigned by the other banking agencies.

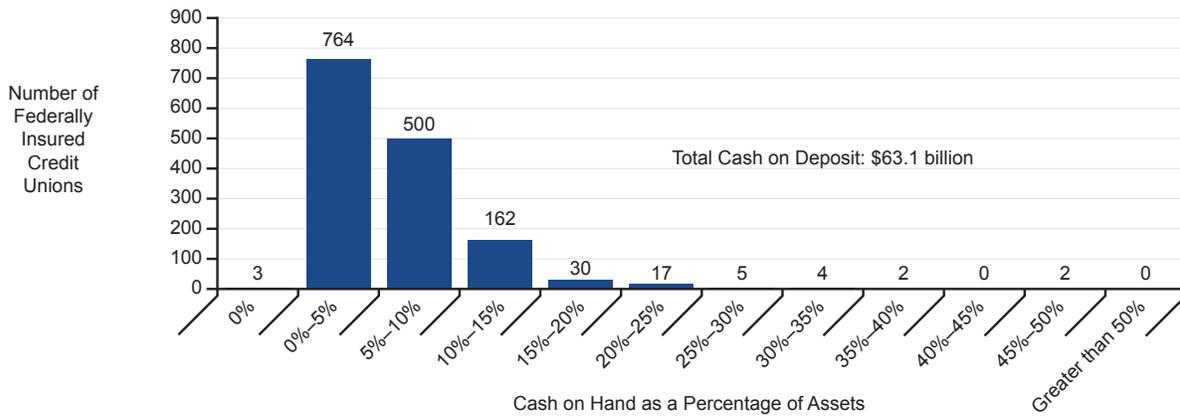
b. Cash on Deposit

Cash on deposit includes cash on deposit in transaction accounts and cash items in process of collection. Unlike cash on hand, cash on deposit exhibits additional credit and transaction risk. These inherent risks cannot be completely mitigated, although strong internal controls and insurance reduce the risk of operational losses and associated costs.

The risk-based capital requirement is determined based on the insured status of the cash of the cash on deposit. Insured deposits in U.S. federally insured depository institutions are assigned a risk weight of zero. Uninsured deposits in U.S. federally insured depository institutions are assigned a risk weight of 20 percent. Different risk weights for cash on deposit is appropriate because of the different risks between insured and uninsured deposits.

As of December 31, 2014, most of the 1,489 complex credit unions reported cash on deposit balances. Total aggregate cash on deposit was 6.24 percent of assets, while the average reported cash on deposit to assets ratio was 5.92 percent. Figure 9 shows the distribution of total cash on deposit as a percentage of assets for complex credit unions.

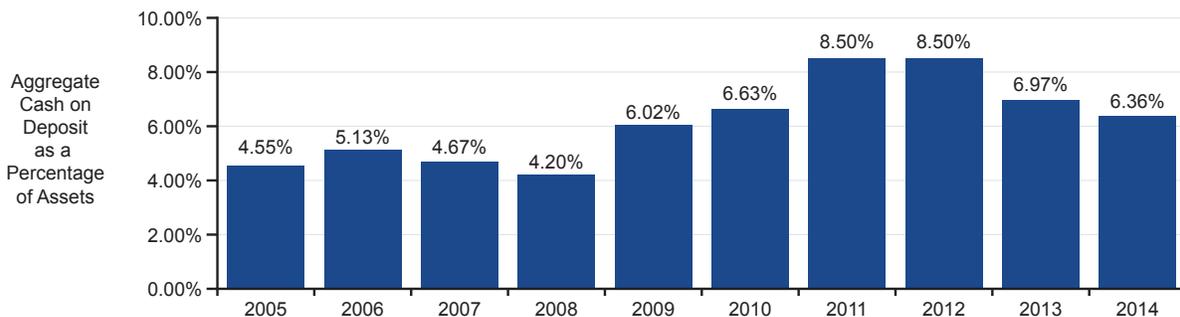
Figure 9: Cash on Deposit in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

While most complex credit unions do report cash on deposit, it remains a relatively small percentage of assets at less than 5 percent. The total aggregate amount of cash on deposit held as a percent of system assets has fluctuated over time, but increased overall throughout the recent recession. However, cash on deposit levels have fallen since 2012. Figure 10 below shows the historical amount of cash as a percent of assets for all federally insured credit unions, both complex and non-complex credit unions.

Figure 10: Cash on Deposit as a Percentage of Assets at Year-End



Source: NCUA Call Report data

The majority of credit unions maintain cash on deposit at levels close to six times that of cash on hand, which makes cash on deposit a more substantial balance sheet asset. The historical cash on

deposit trends reflect the value of cash on deposit as a lower-risk asset. Cash on deposit provides only marginal earnings, but benefits credit unions in terms of liquidity.

NCUA's risk-based capital treatment for cash on deposit is the same as the other banking agencies given the risk profile of these assets is the same for both credit unions and banks.⁵¹

7. Corporate Credit Union Capital Investments

Corporate credit union capital investments are comprised of investments consumer credit unions make in the perpetual and non-perpetual capital instruments of corporate credit unions.^{52, 53}

These corporate credit union capital instruments serve as at-risk capital in the corporate credit unions, but as assets on the financial statements of consumer credit unions.⁵⁴ These capital instruments are most analogous to bank stock and subordinated debt.

As a result of over-concentration in private-label residential mortgage-backed securities, five corporate credit unions failed during the 2007–2009 recession. Over 2,400 consumer credit unions lost almost \$5.1 billion invested in corporate capital instruments. To prevent such an occurrence from happening again, NCUA modified its corporate credit union rule to impose significant restrictions on investment activities and incorporate stronger capital and governance

⁵¹ See 12 CFR 324.32(1)(2).

⁵² Perpetual contributed capital investments are accounts or other interests of a corporate credit union that are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the Share Insurance Fund or other share or deposit insurers; and cannot be pledged against borrowings. A corporate credit union may issue perpetual contributed capital to both members and nonmembers. Terms and conditions of the perpetual contributed capital must be disclosed to the recorded owner at the time of creation and signed by all of the member credit union director, or if authorized by board resolution, the chair and secretary of the board. Perpetual contributed capital is included in the Tier 1 capital calculation for corporate credit unions.

⁵³ Non-perpetual capital investments are funds contributed by members or nonmembers that are term certificates with an original minimum term of five years or that have an indefinite term—that is no maturity—with a minimum withdrawal notice of five years; are available to cover losses that exceed retained earnings and perpetual contributed capital, are not insured by the Share Insurance Fund or other share or deposit insurers; and cannot be pledged against borrowings. The terms and conditions of the capital account must be disclosed to the owner of record at the time the account is opened and at least annually thereafter. Non-perpetual capital is included in the Tier 2 capital calculation for corporate credit unions.

⁵⁴ Non-perpetual and perpetual accounts are available to cover corporate credit union losses that exceed retained earnings. A corporate credit union may redeem perpetual, and non-perpetual accounts prior to the end of the notice period, only if it meets the minimum required capital and net economic value ratios. Likewise, a corporate credit union may call perpetual contributed capital if it meets the minimum required capital and net economic value ratios. Capital redemption and calls require prior NCUA approval.

standards.⁵⁵

Unless non-significant (see discussion in Non-significant Equity Exposure subsection), the risk weights for perpetual and non-perpetual corporate credit union capital investments are as discussed below.

a. Non-Perpetual Corporate Capital Investments

The final rule assigns a risk weight of 100 percent to the balance of non-perpetual corporate capital investments. Non-perpetual capital investments are subordinate to deposits in a corporate credit union and warrant a higher risk weight than deposits. The 100 percent risk weight is comparable to the other banking agencies' risk weight for subordinated debt acquired by a bank in another financial institution.

b. Perpetual Corporate Capital Investments

The final rule assigns a risk weight for perpetual contributed capital investments at corporate credit unions to 150 percent. Perpetual corporate capital investments receive a higher risk weight than non-perpetual corporate capital investments because perpetual contributed capital investments are available to absorb losses in the corporate credit union before non-perpetual capital investments, putting them at a higher risk of loss. While not directly comparable, the closest bank analog is a non-publically traded equity instrument, which receives a 400 percent risk weight under the other banking agencies' rule. However, as noted above, corporate credit unions are now subject to very strict regulatory limitations that significantly limit their risk profile. Corporate credit unions now primarily function as payment system providers. Thus, the lower risk weight of 150 percent reflects the lower risk profile corporate credit unions must now maintain.

NCUA did not adopt the other banking agencies' requirement that banks under certain circumstances deduct from their regulatory capital any capital instruments counting as regulatory capital in other financial institutions.⁵⁶ This approach to capital treatment adds a fair degree of complexity and was projected to have limited applicability to credit union investments in

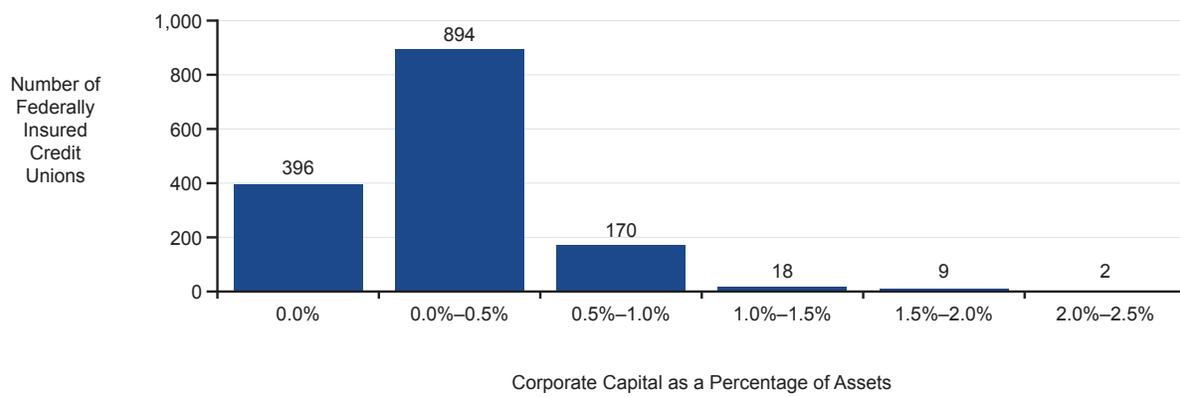
⁵⁵ See 12 CFR 704.

⁵⁶ See 12 CFR 324.22.

corporate capital instruments. As of December 31, 2014, total corporate capital investments (non-perpetual and perpetual) account for just 0.09 percent of complex credit union assets.

Figure 11 shows the distribution of corporate capital instruments in complex credit unions as of December 31, 2014. The vast majority of complex credit unions hold less than 1 percent of assets in corporate credit capital instruments.

Figure 11: Corporate Capital Instruments in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

8. Investments

The Federal Credit Union Act specifies the types of investments permitted for federal credit unions.⁵⁷ Part 703 of NCUA's rules establishes the types of investments federally chartered credit unions are permitted to make and other requirements for investment programs, in accordance with the law. Federally insured, state-chartered credit unions are subject to state regulations regarding permissible investments, which can involve a broader range of investments than for federal credit unions.

Under NCUA's current risk-based net worth requirement, investments are generally assigned risk weights based on weighted-average life. Applying risk weights based on weighted-average life was designed to address the interest rate risk for investments. These risk weights, however, did not take risk of principal loss into account. This means an investment backed by the full faith

⁵⁷ See 12 U.S.C. 1757(7) and (15).

and credit of the United States might receive the same risk weight as an investment issued by a corporation with investment-grade credit risk.

The final rule removed interest rate risk from the risk weights and focused on credit risk—that is the risk of principal loss. The final rule adopted a risk weight framework for investments based largely on the credit risk of the issuer or underlying collateral. This is the same framework used by the other banking agencies for investments.⁵⁸ Because the same types of investments perform identically on a credit risk basis for credit unions and banks, the variations in the final rule from the other banking agencies' investment risk weights primarily involve credit union-specific investments or incorporation of some expedients to simplify measurement or risk weighting of certain investments.⁵⁹

a. Zero Percent Risk Weight Investments

The final rule applies a risk weight of zero percent to the exposure amounts of an obligation of the U.S. Government, its central bank, or a U.S. Government agency that is directly and unconditionally guaranteed—excluding detached security coupons, ex-coupon securities, and interest-only mortgage-backed strips. This zero percent risk weight excludes indirect ownership and securities collateralized with zero percent risk weight assets.

This treatment is appropriate for these types of exposures because they have no or very limited credit risk. However, exposures that are through a trust, or similar vehicle, do not receive a zero percent risk weight, as discussed in the sections below. In addition, conditional guarantees that can be revoked if a condition is or conditions are not met do not receive a zero percent risk weight.

The following types of investment exposures are assigned a zero percent risk weight:⁶⁰

- U.S. Treasury Securities
- Ginnie Mae securities (not including interest-only strips)

⁵⁸ See 12 CFR 324.32.

⁵⁹ For example, investment funds and securitization tranches.

⁶⁰ The list provided is not meant to be comprehensive. Any exposure in an interest-only mortgage-backed strip would not be assigned a zero percent risk weight.

- SBA pools (not including interest-only strips)
- SBA loan participations
- FDIC-guaranteed securities
- NCUA-guaranteed securities

The final rule also applies a zero percent risk weight to Federal Reserve Bank stock and Central Liquidity Facility stock. Under the applicable statutes, these two types of stock do not carry a risk of loss of principal and, therefore, warrant a zero percent risk weight.⁶¹

The final rule materially increases the amount of zero risk-weighted investments compared to the current rule. The zero percent risk weight category is consistent with risk weights applicable to banks.⁶²

b. 20 Percent Risk Weight Investments

The final rule applies a risk weight of 20 percent to non-subordinated obligations of the U.S. Government, its central bank, or a U.S. Government agency that is conditionally guaranteed, excluding interest-only mortgage-backed strips. This 20 percent risk weight is also applied to indirect and unconditionally guaranteed exposures to the U.S. Government, its central bank, or a U.S. Government agency. Additionally, a risk weight of 20 percent is applied to non-subordinated exposures of a government-sponsored enterprise, other than an equity exposure or preferred stock, excluding interest-only government-sponsored enterprise obligation strips.

The following exposures are assigned a 20 percent risk weight:

- Farm Credit System,
- Federal Home Loan Bank System,
- Federal Home Loan Mortgage Corporation,
- Federal National Mortgage Association,
- Financing Corporation,
- Resolution Funding Corporation,
- Tennessee Valley Authority, and

⁶¹ See 12 U.S.C. 287 and 12 U.S.C. 1795f(a).

⁶² See 12 CFR 324.32(a).

- U.S. Postal Service.

The above list is not all-inclusive. Mortgage-backed securities issued and guaranteed by U.S. Government agencies and government-sponsored enterprises are assigned a 20 percent risk weight.⁶³ The types of investments assigned to the 20 percent risk weight category are consistent with the other banking agencies' capital rules.⁶⁴

The final rule also applies a 20 percent risk weight to securities issued by public sector entities in the United States that represent a general obligation. General obligation securities are backed by the full faith and credit of a public sector entity, which warrants the lower risk weight. This risk weight is consistent with risk weights applicable to banks.⁶⁵

Indirect unconditionally guaranteed exposures to the U.S. Government, its Central Bank, or a U.S. Government agency also receive a 20 percent risk weight. An example is U.S. Treasury securities in a trust that are sold to an investor. The U.S. Treasury security would be an indirect obligation because the obligation is to the trust and not the credit union. Being indirect adds a layer of risk, which would increase the level of risk from risk-free to low, which warrants the 20 percent risk weight. This risk weight is also consistent with other banking agencies' corresponding risk weight.⁶⁶

The final rule applies a 20 percent risk weight to investment funds with portfolios permitted to hold only part 703 permissible investments that qualify for the zero to 20 percent risk categories. This restriction must be stated in the fund documentation, such as the prospectus, and must be binding—that is intent alone is not sufficient.

c. 50 Percent Risk Weight Investments

The final rule applies a risk weight of 50 percent to the exposure amount of securities issued by public sector entities in the United States that represent non-subordinated revenue obligation securities (revenue bonds). These securities are backed by the revenue assigned when the

⁶³ However, interest-only mortgage-backed strips are assigned a 100 percent risk weight.

⁶⁴ See 12 CFR 324.32(a)(1)(ii) and (c).

⁶⁵ See 12 CFR 324.32(e).

⁶⁶ See 12 CFR 324.53.

security is issued. An example is a revenue security backed by tolls on the toll road for which the funding was used.

The 50 percent risk weight is comparable to the other banking agencies' capital regulations.⁶⁷ This risk weight also reflects the greater risk that non-subordinated revenue obligations have compared to securities issued by a public sector entity that represent general obligation securities.

The final rule also applies a risk weight of 50 percent to other non-subordinated, non-agency and non-government-sponsored enterprise guaranteed, residential mortgage-backed securities, excluding interest-only strips. The underlying loans in the security must be first-lien residential real estate loans, in order to qualify for the 50 percent risk weight. Furthermore, the security must be in the most senior position in the securitization if losses are applied to the securitization. The senior position is not based on allocation of principal, only losses.

This risk weight is consistent with the 50 percent risk weight assigned to first-lien residential real estate loans under the final rule and the other banking agencies' capital regulations.⁶⁸ However, NCUA's treatment includes a slight variation from the other banking agencies' rules, which apply the gross-up approach to non-agency residential mortgage-backed securities instead of assigning a default risk weight. If a credit union were to use the gross-up approach, it would result in a 50 percent risk weight, which is the default risk weight under NCUA's final rule.

d. 100 Percent Risk Weight Investments

The final rule applies a 100 percent risk weight to the following investments:

- The exposure amount of:
 - Industrial development bonds,
 - All interest-only mortgage-backed security strips,

⁶⁷ See 12 CFR 324.32(e)(1)(ii).

⁶⁸ See 12 CFR 32.32(g)(1).

- Part 703 compliant investment funds, with the option to use the look-through approaches,
 - Corporate debentures and commercial paper,
 - General account permanent insurance,
 - Government-sponsored enterprise equity exposure or preferred stock,
 - Charitable Donation Accounts, and
 - Non-significant equity exposure.
- All other investments listed on the statement of financial condition not specifically assigned a different risk weight, with the option of using the gross-up approach for non-subordinated tranches.⁶⁹

Unless otherwise noted below, these investment risk weights and risk-based capital treatment are consistent with the risk weights applicable to banks.⁷⁰

Industrial development bonds are issued under the auspices of a state or political subdivision, but are an obligation of a private party or enterprise and are therefore akin to a corporate exposure. An example of an industrial development bond is a security issued by an airport authority for a terminal of an airliner. The security would be issued by the airport authority and be an obligation of the airliner.

Interest-only mortgage-backed security strips represent the payment of interest from an underlying pool of mortgages. The cash flow from the interest on the underlying mortgages is highly sensitive to the speed at which the mortgages are repaid. In a declining rate environment, many mortgages are typically refinanced, resulting in faster prepayments in the pool and a decline in interest payments. This can result in failure to recoup the initial investment, even

⁶⁹ Subordinated tranches are assigned to the 1,250 percent risk weight category, also with the option of using the gross-up approach.

⁷⁰ See 12 CFR 324.32 and 324.42.

without an increase in defaults on the underlying mortgages, which would also result in a loss of interest cash flows. The increased risk associated with this type of investment warrants a higher risk weight compared to other types of mortgage-backed securities with similar collateral.

The final rule assigns a risk weight of 100 percent to part 703-compliant investment funds, with the option to use the look-through approaches. The risk weight for investment funds deviates slightly from the approach applicable to banks. NCUA has added a default risk weight of 100 percent for part 703-compliant funds, in addition to adopting the look-through approaches applicable to banks.⁷¹ The look-through approaches are described in detail in Appendix C. For an investment fund to be assigned a 100 percent risk weight, compliance with part 703 of NCUA's regulations must be stated in the investment fund's documentation (such as the prospectus) and must be binding (intent alone is insufficient).

The final rule applies a 100 percent risk weight to general account permanent insurance.⁷² The credit risk associated with general account permanent insurance is to the insurance company. Thus, the risk of this investment is similar to a corporate obligation and therefore assigned a 100 percent risk weight.

Non-significant equity exposures—see the subsection titled Non-significant Equity Exposures for additional discussion—are also assigned a 100 percent risk weight. Under the other banking agencies' capital regulations, banks are permitted to assign a 100 percent risk weight to equity exposures when the aggregate amount of the exposures does not exceed 10 percent of the bank's total capital. NCUA's treatment is generally consistent with the other banking agencies.

NCUA's treatment also applies to unique credit union investments such as perpetual contributed capital in corporate credit unions and equity in credit union service organizations. If the aggregate exposure of all equity investments is non-significant to the investing credit union, the risk weight on perpetual contributed capital in corporate credit unions and equity in CUSOs would be 100 percent. Non-significant equity exposure includes amounts up to 10 percent of the sum of the investing credit union's capital elements in the risk-based capital ratio numerator. Most credit unions currently have non-significant equity exposures and would thus benefit from this 100 percent risk weight, as opposed to the 150 percent risk weight discussed in the next

⁷¹ See 12 CFR 324.53.

⁷² This type of insurance is typically associated with the funding of employee benefits.

subsection.

Under the final rule, charitable donation accounts receive a risk weight based on the underlying collateral or a 100 percent risk weight, at the credit union's discretion. The other banking agencies provide a similar risk-based capital treatment for community development equity exposures at banks, with certain limits. Charitable donation accounts are limited to five percent of a credit union's net worth, which limits the risks of such accounts to the Share Insurance Fund.⁷³ In addition, charitable donation accounts are required to be transparent segregated accounts, which enables NCUA to ensure that such accounts comply with applicable laws.

The final rule assigns a 100 percent risk weight to investments not specifically assigned a different risk weight. Similar to banks, credit unions have the option of applying the gross-up approach on non-subordinated tranches of an investment. By applying the gross-up approach to a non-subordinated tranche of an investment, a credit union can risk weight a non-subordinated tranche of an investment with the same risk weight as if it had owned the loans directly. Allowing credit unions to apply a 100 percent risk weight or use the gross-up option is a simplified version of the other banking agencies' rules, which require banks to use the gross-up or simplified supervisory formula approach.

e. 150 Percent Risk Weight Investments

The rule applies a 150 percent risk weight to perpetual contributed capital investments in corporate credit unions and equity investments in credit union service organizations if the aggregate exposure of all equity investments is significant to the investing credit union. A significant investment exposure is defined as exceeding 10 percent of the sum of the credit union's capital elements in the risk-based capital ratio numerator. See subsection 7(b) above for more information about perpetual corporate capital investments and subsection 19(b) below for more details about CUSO equity investments.

f. 300 Percent Risk Weight Investments

The final rule applies a 300 percent risk weight to the following investments:

⁷³ See 12 CFR 721.3(b).

- Publicly traded equity investments, other than an investment in a credit union service organization.
- Investment funds that are not in compliance with part 703 of NCUA's on investments, with the option to use the look-through approaches.
- Separate account insurance, with the option to use the look-through approaches.

The 300 percent risk weight for these investments is due to the heightened level of uncertainty and potential risks within these assets as discussed below.

Publicly traded equities have no contractual returns, no maturity date, and are generally considered more volatile than fixed-income investments. Furthermore, publicly traded equities have a greater risk of loss because they are in a first-loss position versus the debt of a company. The final rule applies a 300 percent risk weight to publicly traded equity exposures. This would include direct exposure through purchasing an equity investment or having exposure to publicly traded equities through some other structure. Structured products can be designed to have returns based off the return of an index or one or more publicly traded equities. The 300 percent risk weight for publicly traded equities is consistent with the risk weight applicable to banks.⁷⁴ NCUA believes this risk weight is appropriate due to the elevated risk of loss with publicly traded equities.

The risk weights for investment funds and separate account insurance deviate slightly from the other banking agencies' capital regulations.⁷⁵ Allowing credit unions to apply a 300 percent default risk weight or use one of the look-through approaches for a non-part 703 compliant fund is a simplified version of the other banking agencies' rules, which require banks to use the look-through approach.^{76, 77} The final rule adds a standard risk weight of 300 percent for non-part 703 compliant funds, in addition to the look-through approaches a bank can apply, as an additional option for credit unions.

⁷⁴ See 12 CFR 324.52(b)(5).

⁷⁵ See 12 CFR 324.53.

⁷⁶ See *id.*

⁷⁷ Credit unions may get a lower risk weight if they opt to use a look-through approach for investment funds and separate account insurance.

Investment funds that are not compliant with part 703 and separate account insurance may contain equities, or other volatile and risky investments, which warrants the 300 percent risk weight. The risk exposure of both of these investments comes from the underlying assets supporting the investment fund or separate account insurance. Thus, credit unions will have the option of applying one of the look-through approaches, discussed in more detail below, to potentially lower the risk weights for investment funds and separate account insurance. To reduce the burden for credit unions, NCUA's final rule allows credit unions to apply a 300 percent risk weight for these investments instead of calculating a risk-based capital requirement only through the look-through approaches.

g. 400 Percent Risk Weight Investments

The final rule applies a 400 percent risk weight to non-publicly traded equity investments that are held on-balance sheet, other than equity investments in CUSOs. This 400 percent risk weight is due to the greater relative risk versus publicly traded equity investments, which have a 300 percent risk weight. The greater risk is due to non-publicly traded equity investments not having the reporting requirements and active market that a publicly traded equity has. The 400 percent risk weight for non-publicly traded equity investments is consistent with the risk weight applicable to banks.⁷⁸ The risk weight is appropriate due to the increased risk of non-publicly traded equities versus publicly traded equities.

h. 1,250 Percent Risk Weight Investments

The final rule applies a 1,250 percent risk weight to subordinated tranches of any investments with the option to use the gross-up alternative approach.

The 1,250 percent risk weight will apply to subordinated tranches of mortgage-backed securities, asset-backed securities, revenue bonds, and areas where there is subordinated credit risk in a structured product. Subordinated mortgage-backed and asset-backed securities are the most common form of subordinated tranches, and include any mortgage-backed or asset-backed securities that take credit losses before a more senior class. Senior mezzanine tranches would be considered subordinated unless the more senior tranches have paid off.⁷⁹ A subordinated tranche

⁷⁸ See 12 CFR 324.52(b)(6).

⁷⁹ Senior mezzanine tranches are subordinated to more senior tranches at issuance.

can become a non-subordinated tranche if the more senior tranches pay off.

Subordinated revenue bonds would typically involve a bond similar to an asset-backed security that is issued as a revenue bond. An example is a subordinated revenue bond issued by a state corporation that facilitates the granting of student loans. The performance of these types of subordinated bonds is based on the revenue provided by the underlying loans, as in the case of an asset-backed security.

Structured products that take credit losses based on a reference pool would be considered subordinated tranches. An example would be the loss sharing bonds that are issued by Fannie Mae and Freddie Mac. These structured securities are Fannie Mae or Freddie Mac debentures that pay less than par to investors if the reference pool takes a certain amount of losses. In this case the majority of the credit risk comes from the principal payout formula, not the issuer.

As discussed above, subordinated tranches are leveraged. This leverage allocates a disproportionate amount of losses to subordinated tranches in relation to the pool of collateral, or reference pool. By applying a 1,250 percent risk weight, NCUA is ensuring that the risk of highly leveraged subordinated tranches will be captured.

A 1,250 percent risk weight is appropriate for subordinated tranches based on the leveraged nature of the credit risk in these investments. NCUA also provides credit unions with the ability to use the gross-up approach to apply a lower risk weight to less leveraged subordinated tranches, which may result in a lower risk weight. The gross-up approach is discussed in more detail below. This approach is comparable with the approach applicable to banks, with a slight variation.⁸⁰ To reduce the burden on credit unions, NCUA provides a default risk weight for credit unions to use if they elect not to use the gross-up approach. Banks are required to use either the gross-up approach or simplified supervisory formula approach under the other banking agencies' rules.

Unlike the other banking agencies, NCUA elected not to include in the final rule the discretion to assign a 1,250 percent risk weight in the event a credit union is unable to demonstrate a

⁸⁰ See 12 CFR 324.43(e) and 324.44. We note that the NCUA Board is not offering the option for the Simplified Supervisory Formula Approach permitted under the other banking agencies' capital regulations due to its complexity and limited applicability.

comprehensive understanding of the subordinated tranche.⁸¹ NCUA will address any such concerns through the supervisory process.

Table 8: Investments of Complex Credit Unions by Risk Weight

Risk Weight	Complex Credit Union Investments	Percent of Complex Credit Union Investments	Cumulative Percent of Complex Credit Union Investments
0 Percent	\$10.5 Billion	4.92%	4.92%
20 Percent	\$201.2 Billion	93.88%	98.80%
50 Percent or Greater	\$2.6 Billion	1.20%	100.00%

Source: Dec. 31, 2014, Call Report data

9. Current Consumer Loans

Consumer loans—unsecured credit card loans, lines of credit, automobile loans, and leases—are generally a key element of credit unions' approach to providing basic financial services to members.⁸²

The other banking agencies' risk-based capital requirements do not include a consumer loan category. Therefore, consumer loans are included in the risk weight of 100 percent for all other assets under the other banking agencies' rules. NCUA's final rule varies from the approach taken by the other banking agencies because consumer loans represent a substantial portion of a credit union's loan portfolio and because secured consumer loans in credit unions have historically performed better compared to banks.

Under the final rule, NCUA differentiates between current secured consumer loans and current unsecured consumer loans and assigns each a separate risk weight. As discussed below, this treatment is appropriate given the different risk profile of secured and unsecured consumer loans. Separating these two distinct loan categories more accurately relates the risk weight to the underlying credit risk.

⁸¹ See 12 CFR 324.41(c).

⁸² Per Call Report data for years ending Dec. 31, 2012, and Dec. 31, 2013, total consumer loans were greater than 40 percent of loans in credit unions with total assets greater than \$100 million.

a. Current Unsecured Consumer Loans

Current unsecured consumer loans are assigned a risk weight of 100 percent under the final rule, which is comparable to the other banking agencies' risk weight for consumer loans, which fall under the all other assets category.⁸³ Unsecured consumer loans generally include credit card loans, signature loans, and co-maker and cosigner loans. Comparisons of historical losses on all consumer loans between credit unions and banks is limited due to differences in Call Report data, but generally the difference in historical performance of all consumer loans, as measured by loss history, is not significant. Accordingly, NCUA has elected to retain comparability in the risk weight for current unsecured consumer loans.

As shown in the Table 9, credit card loan losses are generally more than three times the rate of total loan losses, for both credit unions and banks. This trend supports the 100 percent risk weight for unsecured consumer loans.

Table 9: Credit Card and Total Loan Charge-Offs in Credit Unions and Banks

	7-Year Average				3-Year Average			
	Credit Unions above \$100 million	Banks \$100 million to \$1 billion	Banks \$1 billion to \$10 billion	Banks \$100 million to \$10 billion average	Credit Unions above \$100 million	Banks \$100 million to \$1 billion	Banks \$1 billion to \$10 billion	Banks \$100 million to \$10 billion average
Credit Card Loans	2.97%	6.13%	4.88%	5.51%	2.46%	4.40%	3.32%	3.86%
Total Loans and Leases	0.87%	0.72%	1.06%	0.89%	0.75%	0.62%	0.76%	0.69%

Source: FDIC Quarterly Banking Profiles and NCUA Financial Performance Reports

Additionally, unsecured credit card loans account for more than 60 percent of all unsecured loans in credit unions, as shown in the Table 10.

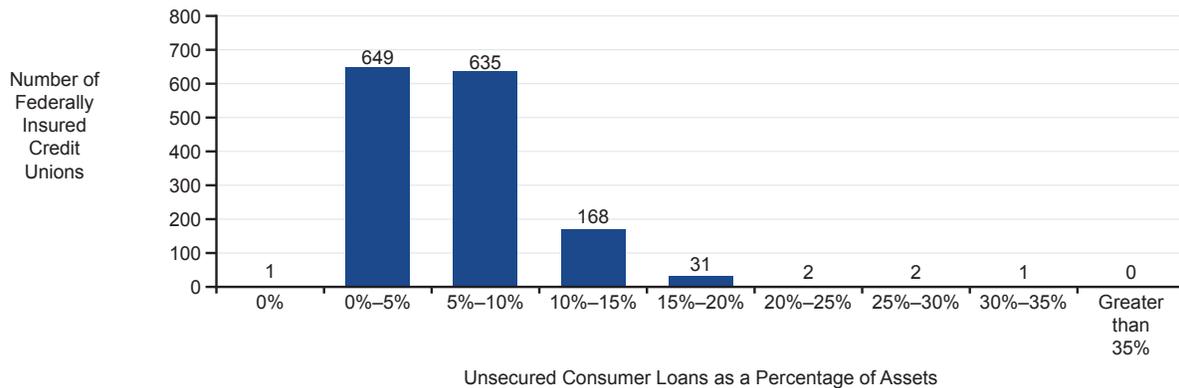
⁸³ See 12 CFR 324.32(1)(5).

Table 10: Summary of Unsecured Consumer Loans in Credit Unions

Categories of Unsecured Loans	Dollar Value as of December 2014	Percent of Total Unsecured Loans
Unsecured Credit Card Loans	\$43.2 Billion	61.6%
All Other Unsecured Loans and Lines of Credit	\$26.9 Billion	38.3%
Payday Alternative Loans (Federal Credit Unions Only)	\$16.7 Million	0.1%
Total Unsecured Loans	\$70,126,751,359	100.0%

Source: Dec. 31, 2014, Call Report data

Of the 1,489 credit union with assets greater than \$100 million as of December 31, 2014, 1,488 (93.93 percent) report unsecured consumer loans totaling \$70.1 billion in aggregate. Figure 12 shows the distribution of credit unions by unsecured consumer loans as a percentage of assets.

Figure 12: Unsecured Consumer Loans in Complex Credit Unions

Source: Dec. 31, 2014, Call Report data

b. Current Secured Consumer Loans

Secured consumer loans, as defined in the final rule, are loans associated with collateral or another item or items of value to protect against loss where the creditor has a perfected security interest in the collateral or other item of value. This security makes these loans less risky than unsecured loans.

Secured consumer loans generally have lower credit risk than unsecured consumer loans.

Unsecured consumer loans reflect higher levels of delinquency and charge-offs, as reported on the quarterly Call Report. Therefore, they expose the credit union to higher risk than secured consumer loans.

The substantial difference between unsecured and secured consumer loan charge-offs within the credit union system warrants different risk weights for unsecured and secured consumer loans. As shown in Tables 11 and 12 below, delinquency and charge-off ratios among credit unions for unsecured credit card loans are consistently higher than for secured vehicle loans.

Table 11: Unsecured and Secured Loan Delinquency Ratios

	06/30/13	09/30/13	12/31/13	03/31/14	06/30/14	9/30/14	12/31/14
Credit Card Loans	0.83%	0.90%	0.93%	0.86%	0.82%	0.87%	0.92%
Vehicle Loans	0.54%	0.60%	0.68%	0.54%	0.56%	0.54%	0.61%

Source: NCUA Call Report data

Table 12: Unsecured and Secured Loan Charge-Off Ratios

	06/30/13	09/30/13	12/31/13	03/31/14	06/30/14	9/30/14	12/31/14
Credit Card Loans	2.04%	1.96%	1.94%	1.98%	1.93%	1.92%	1.92%
Vehicle Loans	0.43%	0.40%	0.46%	0.52%	0.49%	0.49%	0.52%

Source: NCUA Call Report data

While there is generally no significant difference in historical total consumer loan losses between credit unions and banks, when credit cards, which account for a majority of unsecured consumer loans, are excluded, credit union performance is somewhat better. Table 13 shows the historical charge-off ratios for banks and credit unions on secured consumer loans (categorized as loans to individuals in banks) from 2009 to 2014.

Table 13: Consumer Loan (Excluding Credit Cards) Charge-Off Ratios

	2009	2010	2011	2012	2013	2014
All Banks	3.03%	1.93%	1.34%	1.13%	0.95%	0.82%
All Credit Unions	1.65%	1.35%	0.97%	0.61%	0.60%	0.62%

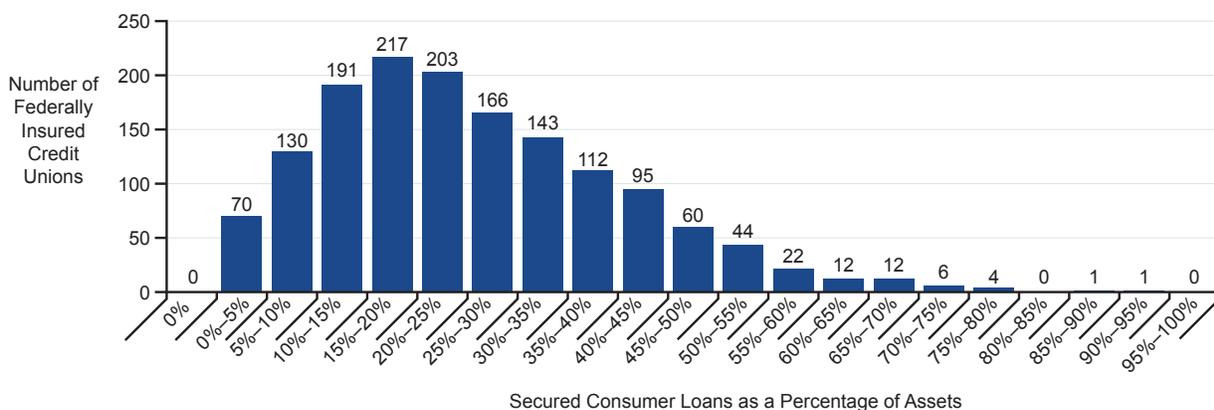
Source: NCUA Financial Performance Report and Federal Reserve Data Release, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks

NCUA assigns a risk weight of 75 percent for current secured consumer loans, which varies from

the other banking agencies' risk weight of 100 percent, to reflect credit unions' lower losses from these loan types. The 75 percent risk weight is, however, consistent with Basel's treatment of retail credits.⁸⁴

As of December 31, 2014, for complex credit unions holding secured consumer loans, the average percentage to total assets is 25.65 percent. Unlike with unsecured consumer loans, all complex credit unions report secured consumer loans that total \$238.7 billion in aggregate. As shown in Figure 13 below, a majority of complex credit unions hold between 5 and 35 percent of their assets in secured consumer loans. Additionally, multiple credit unions have more than 50 percent of assets in secured consumer loans.

Figure 13: Secured Consumer Loans in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

10. Government-Guaranteed Portion of Loan Balances

Government guarantees provide enhanced credit protection, particularly to loans. NCUA's final rule therefore assigns a risk weight of 20 percent to the portion of loans with a government guarantee. While a government guarantee protects against credit losses on the guaranteed portion of the loan, the guarantee is typically subject to various conditions including representations and warranties related to loan underwriting and servicing. If any of these conditions are violated it can invalidate the guarantee. Therefore, a low, but not zero, risk weight

⁸⁴ See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, pt. II, sec. 7, para. 69 (June 2006).

is warranted.

Under the final rule, the government-guaranteed portion of all loan balances are included in the 20 percent risk weight category. This treatment is consistent with the other banking agencies' capital rules.⁸⁵ Additionally, for real estate and commercial loans, the portion that is insured or guaranteed by the U.S. Government, U.S. Government agency, or a public sector entity does not count toward the concentration thresholds for residential real estate and commercial loans.⁸⁶

11. Share-Secured Consumer Loans

Share-secured loans are collateral based loans guaranteed by deposits held at the credit union or another depository institution. In the event of default, the credit union uses the pledged collateral (that is, shares) to pay off the loan.

Under the final rule, the balance of share-secured loans, where the shares securing the loan are on deposit with the credit union, are assigned a risk weight of zero. A risk weight of zero for these types of loan balances is appropriate because the risk of loss is a function of operational risk, not credit risk. This treatment is the same as deposit-secured loans at banks, where the deposit is held at the bank.

The final rule assigns a 20 percent risk weight for share-secured loans where the deposit serving as the collateral is at another depository institution due to the added credit risk of the other depository institution. If the deposit is held at a federally insured depository institution and within the insured limit, the risk stems from the other institution not properly executing the hold on the account used as collateral.

If the deposit is held at a non-federally insured depository institution or the account at a federally insured depository institution exceeds the insured limit, there is additional risk of loss of the collateral. Hence, the 20 percent risk weight reflects the risk weight assigned to a credit union's investment in an uninsured deposit or non-federally insured institution. This treatment is comparable to deposit-secured loans at banks, where the deposit is held at another financial

⁸⁵ See 12 U.S.C. 324.32(a).

⁸⁶ See "Current First-Lien Residential Real Estate Loans, Current Junior-Lien Residential Real Estate Loans" and "Current Commercial Loans" within this section for additional discussion of the concentration thresholds.

institution.

12. Non-Current Consumer Loans

For purposes of risk-based capital, NCUA defines a non-current loan as one that is more than 90 days past due. The final rule assigns non-current consumer loans a risk weight of 150 percent. This definition and risk weight are consistent with the approach used by the other banking agencies in their capital rules.⁸⁷

Loans that are past due more than 90 days (non-current) have a much higher incidence of default than current loans. To reflect the impaired credit quality of non-current loans, the risk weight for non-current consumer loans is therefore higher than for current consumer loans.

Like the other banking agencies, NCUA assigned a higher risk weight on non-current loans to ensure sufficient capital for the increased probability of unexpected losses on these loans. This results in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio.

As of December 31, 2014, complex credit unions report an average consumer loan delinquency ratio of 0.79 percent. There are 21 credit unions that report a consumer loan delinquency ratio greater than three percent. On average, past-due consumer loans account for 0.26 percent of complex credit union assets.⁸⁸

13. Current First-Lien Residential Real Estate Loans

The final rule defines first-lien residential real estate loans as a loan or line of credit primarily secured by a first lien on a one-to-four family residential property where the credit union made a reasonable and good-faith determination at or before consummation of the loan that the member will have a reasonable ability to repay the loan according to its terms. Additionally, the credit union must hold the first lien and junior lien(s), and no other party may hold an intervening lien. In such transactions, for purposes of this part, the combined balance will be treated as a single

⁸⁷ See 12 CFR 324.32(k).

⁸⁸ Loans that were 60-days or more past due were used for these calculations, as NCUA does not currently collect data on loans that are 90 days or more past due.

first-lien residential real estate loan.

This definition allows that if a credit union holds both the first and junior liens on a residential real estate loan without an intervening lien holder and the loan otherwise meets the definition of a first-lien residential real estate loan, the entire combined balance of the loans can be assigned the risk weight for a first-lien residential real estate loan. This treatment is consistent with the other banking agencies' capital rules.⁸⁹ It also is appropriate because, when combined, these loans have similar risk characteristics to a first-lien residential real estate loan.

First-lien residential real estate loans place the loan holder—that is the credit union—in the first priority for payment in the event of default. For risk-based capital purposes, both owner-occupied and non-owner occupied first-lien residential real estate loans are classified and risk weighted the same.⁹⁰ This treatment is appropriate because the credit risk for all first-lien residential real estate loans, in which the credit union has conducted a reasonable analysis of the ability of the borrower to repay, are sufficiently similar to justify the same risk weight.

The final rule assigns a risk weight of 50 percent to the balance of first-lien residential real estate loans that are less than 35 percent of assets. The portion of the first-lien residential real estate loan portfolio that is greater than 35 percent of assets is assigned a risk weight of 75 percent to account for the additional credit concentration risk.⁹¹ As discussed in detail below, the majority of credit union first-lien residential real estate loans will receive a risk weight of 50 percent, which is comparable to the risk weight assigned by the other banking agencies.⁹² Only outliers will be subject to the higher risk weight for concentration risk.

Using comparable data to match the asset breakouts within the FDIC Quarterly Banking Profile, credit unions' real estate loss experience is similar to community banks after adjusting for asset size. Table 14 below outlines the three-year average loss history on real estate loans for banks

⁸⁹ See 12 CFR 324.32(g)(3).

⁹⁰ While the definition of a first-lien residential real estate loan would include first-lien residential real estate loans that are not owner occupied, first-lien residential real estate loans that are over \$50,000 and not the primary residence of the borrower would continue to count toward the credit union's total of member business loans for the purpose of compliance with the statutory limit.

⁹¹ The section of this report entitled *Rationale for Risk-Based Capital Treatment* contains an additional discussion of the inclusion of concentration risk in the risk-based capital ratio calculation.

⁹² See 12 CFR 324.32(g)(1).

and credit unions.

Table 14: Three-Year Average Real Estate Loss History

	Credit Unions over \$100 Million in Assets	Banks \$100 Million to \$10 Billion in Assets	Banks \$1 Billion to \$10 Billion in Assets
All real estate loans	0.33%	0.36%	0.38%
Other 1-4 family residential loans	Not Applicable	0.30%	0.37%
First mortgage loans	0.24%	Not Applicable	Not Applicable

Source: FDIC Quarterly Banking Profiles and NCUA Financial Performance Reports

As credit union and bank real estate loan losses are similar, the same risk weight for first-lien residential real estate loans held by credit unions is warranted.

While most first-lien residential real estate loans will receive a 50 percent risk weight, the balance that exceeds 35 percent of a complex credit union's assets will receive a 75 percent risk weight. Higher capital requirements for concentrations of real estate loans exist in NCUA's current prompt corrective action rule, and completely eliminating them would be a step backwards in matching risks with minimum risk-based capital requirements. Credit unions with high real estate loan concentrations are particularly susceptible to changes in the economy and housing market.

A single concentration risk threshold for first-lien residential real estate loans of 35 percent of assets is higher than the concentration risk threshold in the current rule of 25 percent of assets. NCUA set the concentration threshold for first-lien residential real estate loans at two standard deviations from the mean, which is calibrated to only pick-up credit unions with material concentrations. This means that most credit unions will operate at a level where the risk weight is identical to the other banking agencies' risk weight.⁹³ Only outlier credit unions will be subject to a higher capital requirement.

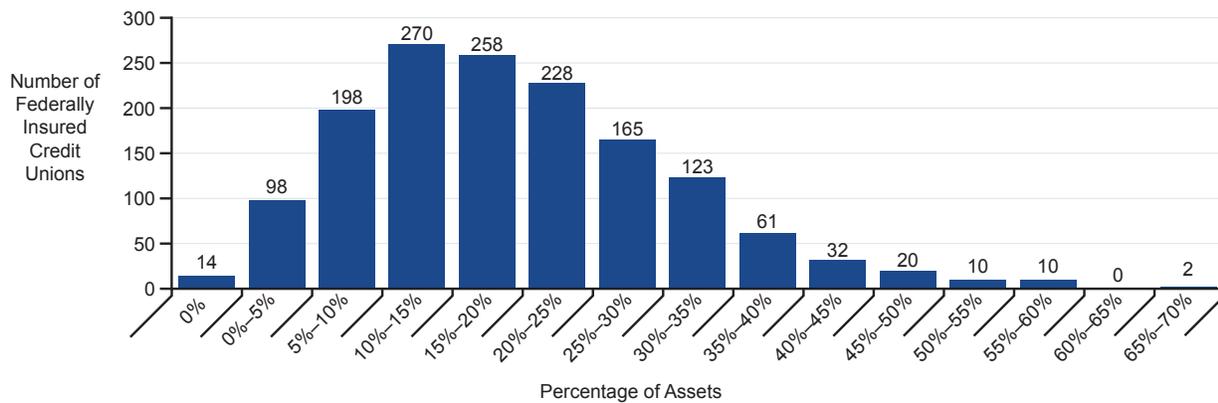
As of December 31, 2014, there were 135 complex credit unions that held first-lien residential real estate loans in excess of 35 percent of assets, as shown in Figure 14.⁹⁴ This means that

⁹³ The FDIC risk weight for current first-lien residential real estate is set at 50 percent.

⁹⁴ Given the difference in Call Report data and risk-based capital categorization, first mortgage loans less member business loans are most comparable to first-lien residential real estate loans, newly created in the final rule.

over 90 percent of credit unions with more than \$100 million in assets operate at levels below the concentration threshold for first-lien residential real estate. Additionally, only 1.19 percent of aggregate complex credit union assets will be subject to the higher risk weight for first-lien residential real estate loan concentrations. As intended, this will require certain credit unions with material concentrations to hold additional capital on a small portion of their assets, but it will not impact the system as a whole either in number of institutions or assets.

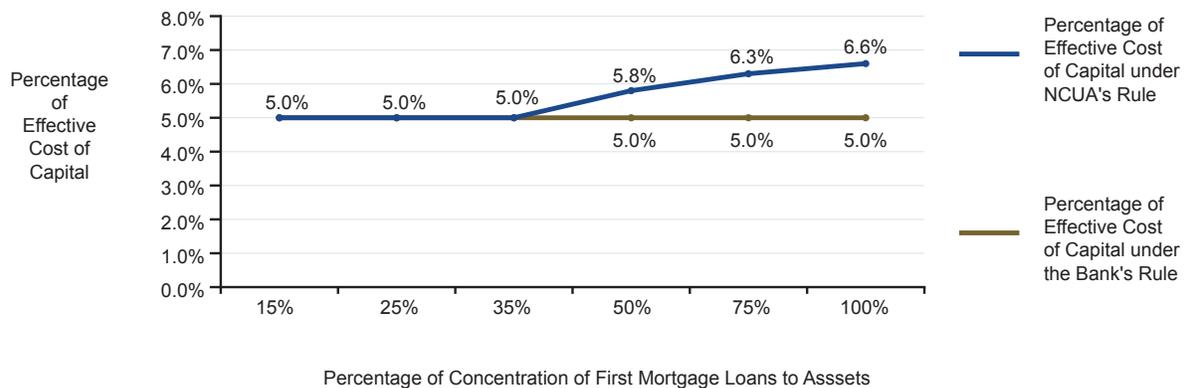
Figure 14: First Mortgage Loans (Less Member Business Loans) in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

Figure 15 depicts the effective increased cost of capital for credit unions that hold first-lien residential real estate loans in various concentrations under NCUA's final rule.

Figure 15: First Mortgage Loans Effective Cost of Capital



Source: Dec. 31, 2014, Call Report data

This treatment satisfies NCUA's statutory requirement to take into account any material risks as it revises the risk-based net worth requirement. It also is the best balance between being faithful to the Federal Credit Union Act to address all material risks (consistent with historical approach), but limiting the concentration risk dimension of the risk weights for residential real estate secured loans to outliers.

14. Non-Current First-Lien Residential Real Estate Loans

For purposes of risk-based capital, NCUA defines a non-current loan as one that is more than 90 days past due. The final rule assigns non-current first-lien residential real estate loans a risk weight of 100 percent. This definition and risk weight are consistent with the approach used by the other banking agencies in their capital rules.⁹⁵ Given the similarity in real estate loan loss history between credit unions and banks, NCUA has elected to retain comparability in the risk weight for non-current first-lien residential real estate loans.

Loans that are past due more than 90 days (non-current) have a much higher incidence of default than current loans. To reflect the impaired credit quality of non-current loans, the risk weight for non-current first-lien residential real estate loans is therefore higher than for current first-lien residential real estate loans.

Like the other banking agencies, NCUA assigned a higher risk weight on non-current loans to ensure sufficient regulatory capital for the increased probability of unexpected losses on these loans. This results in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio.

As of December 31, 2014, credit unions report an average first-lien residential real estate loan delinquency ratio of 1.26 percent. There are 107 complex credit unions that report a first-lien residential real estate loan delinquency ratio greater than 3 percent. On average, past-due first-lien residential real estate loans account for 0.21 percent of complex credit union assets.⁹⁶

⁹⁵ See 12 CFR 324.32(g)(2).

⁹⁶ Loans that were 60 days or more past due were used for these calculations, as NCUA does not currently collect data on loans that are 90 days or more past due.

15. Current Junior-Lien Real Estate Loans

The final rule allows credit unions to treat junior-lien residential real estate loans, if the credit union holds both the first and junior liens on a residential real estate loan without an intervening lien holder, as first-lien residential real estate for risk weight purposes and be assigned to a lower risk-weight category than other junior-lien residential real estate.⁹⁷ This treatment is comparable to that applied by the other banking agencies.⁹⁸

This treatment effectively reduces a credit union's risk-based capital requirement for junior-lien residential real estate loans that meet this definition. NCUA believes this treatment is appropriate because these loans, when combined, essentially become first-lien residential real estate loans.

For all junior-lien residential real estate loans that are not treated as first-lien residential real estate loans, the final rule assigns a risk weight of 100 percent to the balance of junior-lien residential real estate loans that are less than 20 percent of assets. The portion of the junior-lien residential real estate loan portfolio that is greater than 20 percent of assets is assigned a risk weight of 150 percent to account for the additional credit concentration risk.

Junior-lien residential real estate loans continue to warrant a higher risk weight than first-lien residential real estate loans based on loss history and given the lien holder—that is the credit union—is in a subordinated payout position in the event of default. Call Report data indicate complex credit unions reported nearly three times the rate of loan losses (0.63 percent) on other real estate loans when compared to first mortgage real estate loans (0.24 percent) during the past three years.^{99, 100}

The base risk weight for junior-lien residential real estate loans is comparable to the risk weight assigned by the other banking agencies.¹⁰¹ Comparison data demonstrates there is not a material enough difference to warrant a lower risk weight than banks. As shown in Table 15, residential real estate loan loss history is nearly the same in the last three years when the data from the

⁹⁷ This applies only as long as the loan otherwise meets the definition of a first-lien residential real estate loan.

⁹⁸ See 12 CFR 324.32(g)(3).

⁹⁹ Junior-lien real estate loans are currently reported on the Call Report as part of “other real estate loans.”

¹⁰⁰ See FDIC Quarterly Banking Profiles, (year-end 2012, 2013, and 2014), p. 11, and NCUA Financial Performance Report using year-end data for credit unions with assets greater than \$100 million.

¹⁰¹ See 12 CFR 324.32(g)(2).

largest banks is not considered. Losses on home equity loans are actually higher for credit unions, as shown in the table below.

Table 15: Three-Year Average Real Estate Loss History for 2011 through 2013

	Credit Unions over \$100 Million	Banks \$100 Million to \$1 Billion	Banks \$1 Billion to \$10 Billion	Banks \$100 Million to \$10 Billion Average
All Real Estate Loans	0.58%	0.59%	0.71%	0.65%
Home Equity and Other Real Estate	0.96%	0.69%	0.77%	0.73%
Other 1-4 Family Residential	0.34%	0.44%	0.54%	0.49%
Total Loans and Leases	0.75%	0.62%	0.76%	0.69%

Source: FDIC Quarterly Banking Profiles and NCUA Financial Performance Report

Based on this data, the risk weight for junior-lien residential real estate loans for credit unions remains on par with the other banking agencies' capital rules.

While the vast majority of junior-lien residential real estate loans will receive a 100 percent risk weight, the balance that exceeds 20 percent of a complex credit union's assets will receive a 150 percent risk weight.

Higher capital requirements for concentrations of real estate loans exist in the current rule, and completely eliminating them would be a step backwards in matching risks with minimum risk-based capital requirements. Credit unions with high real estate loan concentrations are particularly susceptible to changes in the economy and housing market. The concentration threshold for junior-lien residential real estate loan is two standard deviations from the mean, which is calibrated only to pick up credit unions with material concentrations.

As of December 31, 2014, there were 57 complex credit unions that held junior-lien residential real estate loans in excess of 20 percent of assets.¹⁰² This means that just over 96 percent of credit unions with more than \$100 million in assets operate at levels below the concentration threshold for junior-lien residential real estate. Most credit unions will operate at a level where the risk weight is identical to FDIC's treatment.¹⁰³ Only outlier credit unions will be subject to a

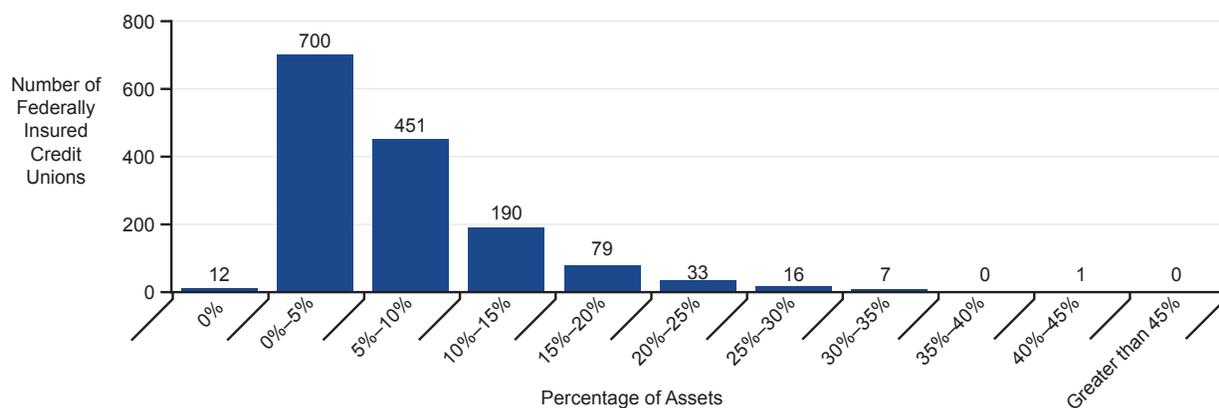
¹⁰² Junior-lien residential real estate loans are included in the other real estate loan category on the Call Report.

¹⁰³ FDIC's risk weight for current junior-lien residential real estate is 100 percent.

higher capital requirement.

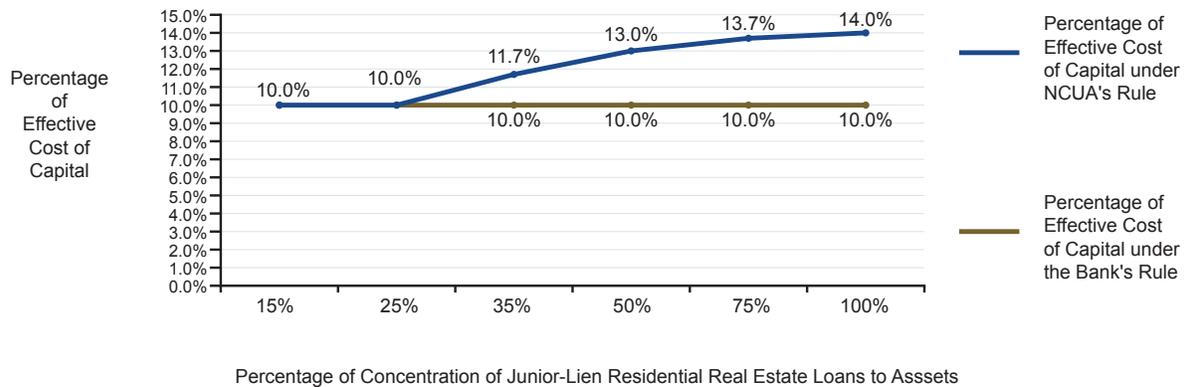
Additionally, only 0.11 percent of complex credit union assets will be subject to the higher risk weight for junior-lien residential real estate loan concentrations. As intended, this will require certain individual credit unions with material concentrations to hold additional capital on a small portion of their assets, but will not impact the system as a whole either in number of institutions or assets. Figure 16 illustrates the concentration of complex credit unions in other real estate loans.

Figure 16: Other Real Estate Loans in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

Figure 17 depicts the effective cost of capital for credit unions that hold junior-lien residential real estate loans in various concentrations under NCUA's final rule.

Figure 17: Junior-Lien Residential Real Estate Loan Effective Cost of Capital

Source: Dec. 31, 2014, Call Report data

16. Non-Current Junior Lien Real Estate Loans

For purposes of risk-based capital, NCUA defines a non-current loan as one that is more than 90 days past due. The final rule assigns non-current junior-lien residential real estate loans a risk weight of 150 percent.

Loans that are past due more than 90 days have a much higher incidence of default than current loans. To reflect the impaired credit quality of non-current loans, the risk weight for non-current junior-lien residential real estate loans is therefore higher than for current junior-lien residential real estate loans.

Like the other banking agencies, NCUA assigned a higher risk weight on non-current loans to ensure sufficient regulatory capital for the increased probability of unexpected losses on these loans. This results in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio.

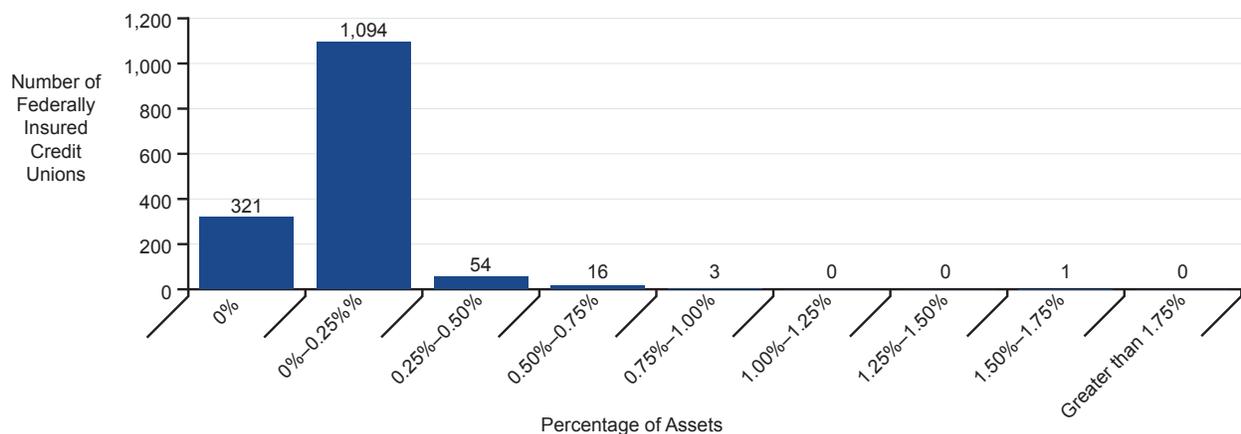
Under the final rule, junior-lien residential real estate loans that are not current are assigned a 150 percent risk weight to reflect the increased credit risk. This risk weight is higher than the risk weight for similar loans held by banks under the other banking agencies' regulations.¹⁰⁴ The other banking agencies assign the same risk weight of 100 percent for both current and non-

¹⁰⁴ See 12 CFR 324.32(g)(2).

current junior-lien residential real estate loans, unlike all other loan categories where the non-current loans are assigned a higher risk weight than the current loans. NCUA believes a higher risk weight for non-current loans is warranted because such loans have a higher probability of default when compared to current loans, and this preserves consistency with how other loan categories are treated.

Based on December 31, 2014, Call Report data, only 0.02 percent of complex credit union assets will be subject to the higher 150 percent risk weight for non-current junior-lien residential real estate. This treatment helps ensure those credit unions with non-performing loans hold sufficient capital, but will have a minimal impact on the credit union system. Figure 18 details the delinquency rate of other real estate loans in complex credit unions.

Figure 18: Delinquent Other Real Estate Loans in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

17. Current Commercial Loans

Credit union business lending is limited by statute and further governed by part 723 of NCUA's rules. The Federal Credit Union Act limits a credit union's aggregate member business loan balance to the lesser of 1.75 times the credit union's net worth or 1.75 times the amount to be well capitalized under prompt corrective action.

In accordance with the Federal Credit Union Act, part 723 of NCUA's rules and regulations defines a member business loan as any loan, line of credit, or letter of credit (including any

unfunded commitments) where the borrower uses the proceeds for commercial, corporate, other business investment property or venture, or agricultural purposes.¹⁰⁵ There are five exceptions to this rule:

- A loan fully secured by a lien on a one- to four-family dwelling that is the member's primary residence;
- A loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions;
- A loan to a member or an associated member which, when the net member business loan balances are added together, are equal to less than \$50,000;
- A loan where a federal or state agency (or its political subdivision) fully insures repayment, or fully guarantees repayment, or provides an advance commitment to purchase in full; and
- A loan granted by a corporate credit union to another credit union.¹⁰⁶

In the final risk-based capital rule, NCUA differentiates between a “commercial loan” for risk-based capital purposes, and “member business loan” for purposes of the statutory limit. The final risk-based capital rule defines commercial loans as any loan, line of credit, or letter of credit (including any unfunded commitments) for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. A commercial loan excludes loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans.

Using the term commercial loan and its definition more accurately captures the risks these loans present. It also better identifies loans that are made for a commercial purpose and have similar risk characteristics. Commercial loans may take the form of direct or purchased loans and generally include the following types of loans:¹⁰⁷

- Loans for commercial, industrial and professional purposes to:

¹⁰⁵ See 12 CFR 723.1(a).

¹⁰⁶ See 12 CFR 723.1(b).

¹⁰⁷ Many of the descriptions below overlap and are not intended to be an all-inclusive list.

- Mining, oil- and gas-producing, and quarrying companies;
 - Manufacturing companies of all kinds, including those which process agricultural commodities;
 - Construction companies;
 - Transportation and communications companies and public utilities;
 - Wholesale and retail trade enterprises and other dealers in commodities;
 - Cooperative associates including farmers' cooperatives;
 - Service enterprises such as hotels, motels, laundries, automotive service stations, and nursing homes and hospitals operated for profit;
 - Insurance agents; and
 - Practitioners of law, medicine and public accounting.
- Loans for the purpose of financial capital expenditures and current operations.
- Loans to finance agricultural production and other loans to farmers, including:
- Loans and advances made for the purpose of financing agricultural production, including the growing and storing of crops, the marketing or carrying of agricultural products by the growers thereof, and the breeding, raising, fattening, or marketing of livestock;
 - Loans and advances made for the purpose of financial fisheries and forestries, including loans to commercial fishermen;
 - Agricultural notes and other notes of farmers that the credit union has discounted, or purchased from, merchants and dealers, either with or without recourse to the seller;

- Loans and advances to farmers for purchase of farm machinery, equipment, and implements;
 - Loans and advances to farmers for all other purposes associated with the maintenance or operations of the farm.
- Loans secured by multi-family residential properties with five or more dwelling units in structures (including apartment buildings and apartment hotels) used primarily to accommodate a household on a more or less permanent basis and cooperative-type apartment buildings containing five or more dwelling units.¹⁰⁸
 - Loans secured by real estate as evidenced by mortgages or other liens on business and industrial properties, hotels, churches, hospitals, educational and charitable institutions, dormitories, clubs, lodges, association buildings, “homes” for aged persons and orphans, golf courses, recreational facilities, and similar properties.
 - Loans to finance leases for fleets of vehicles used for commercial purposes.

The risk weights assigned to commercial loans are generally consistent with those assigned by other banking agencies and with the objectives of the Basel Committee on Banking Supervision.¹⁰⁹ Applicable commercial loans less than 50 percent of a complex credit union’s assets are assigned a 100 percent risk weight, and the portion of commercial loans over 50 percent of a complex credit union’s assets are assigned a 150 percent risk weight.

However, the amount of a contractual compensating balance associated with a commercial loan and on deposit in the credit union would receive a 20 percent risk weight and not count toward the 50 percent of assets concentration threshold because the credit union has the ability to

¹⁰⁸ Under the final rule, loans secured by one- to four-family residential property are defined as first- or junior-lien residential real estate loans.

¹⁰⁹ This is comparable with the other banking agencies’ capital rules—such as 12 CFR 324.32—which maintain a 100 percent risk weight for commercial real estate and includes a 150 percent risk weight for loans defined as high volatility commercial real estate. See 78 FR 55339 (Sept. 10, 2013). The Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (June 2006) notes “[i]n view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, [the] Committee holds to the view that mortgages on commercial real estate do not, in principle, justify other than a 100% risk weight of the loans secured.” Available at <http://www.bis.org/publ/bcbs128.htm>.

apply the compensating balance against the amount owed, lowering the potential loss exposure. This provision is not included in the other banking agencies' capital rule. Also, banks must apply a 150 percent risk weight to commercial loans that meet the definition of "high volatility commercial real estate." NCUA's final rule does not include a separate, higher risk weight for high volatility commercial real estate.

The contemporary variances between bank and credit union losses on commercial loans are not substantial enough to warrant assigning lower risk weights to commercial loans held by credit unions. Credit unions' member business loan loss experience is comparable to community banks after adjusting for asset size.¹¹⁰ The recent loss experience for credit unions and banks is very similar, as shown in Table 16.

Table 16: Three-Year Average Loss History of Commercial and Industrial Loans for 2011 through 2013

	Credit Unions over \$100 Million in Assets	Banks \$100 Million to \$10 Billion in Assets
Commercial and Industrial Loans	0.75%	0.78%

Source: FDIC Quarterly Banking Profile and NCUA Financial Performance Report

Further, credit unions' long-term historical business loan losses are somewhat understated because the NCUA's Call Report did not collect separate member business loan data until 1992. Thus, significant member business loan losses experienced in the late 1980s and early 1990s are not included in the long-term historical credit union member business loan loss data.¹¹¹

The concentration threshold for commercial loans is well over two standard deviations from the mean. As shown in Table 17 below, the 50 percent threshold and the risk weights of 100 percent and 150 percent result in nearly identical capital requirements, as compared to the current prompt corrective action rule, for high concentrations of commercial loans. This treatment is comparable to the other banking agencies' rules for virtually all complex credit unions, and it

¹¹⁰ For all commercial loan analysis, NCUA used member business loan data because the current Call Report does not capture "commercial loan" data as defined in the final rule.

¹¹¹ Share Insurance Fund losses from member business loans are a recurring historical trend. The U.S. Treasury report on credit union member business lending discusses 16 credit union failures from 1987 to 1991 that cost the Share Insurance Fund over \$100 million. See U.S. Dep't of Treasury, *Credit Union Member Business Lending* (Jan. 2001).

allows credit unions exempt from the member business loan cap (with very high concentration levels) to continue to operate under effectively the same capital requirements of the current rule.¹¹²

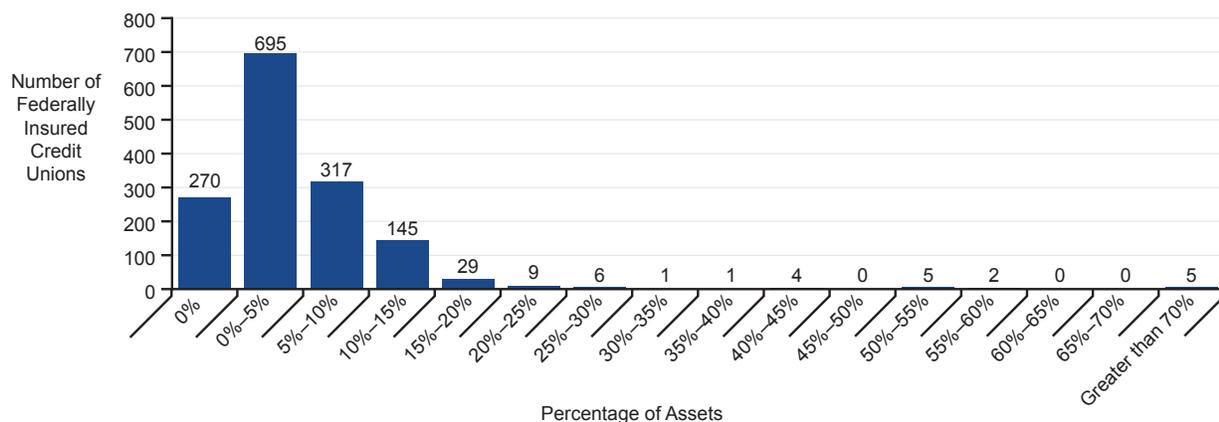
Table 17: Effective Capital Rate of Commercial Loan Concentrations*

	Commercial Loan Concentration (Percent of Total Assets)				
	15%	20%	50%	75%	100%
Current Rule	6.0%	6.5%	10.4%	11.6%	12.2%
Final rule	10.0%	10.0%	10.0%	11.7%	12.5%

* The effective capital rate represents the blended percentage of capital necessary for a given level of commercial loan concentration. The calculation uses 10 percent as the level of risk-based capital to be well capitalized under the final rule.

As of December 31, 2014, there were 12 complex credit unions that held member business loans in excess of 50 percent of assets, as shown in Figure 19 below. Based on this data, just 0.81 percent of complex credit unions operate at levels above the concentration threshold for commercial loans. Additionally, only 0.13 percent of complex credit union assets will be subject to the higher risk weight for commercial loan concentrations. As intended, this will require certain individual credit unions with material concentrations to hold additional capital on a small portion of their assets, but it will not impact the system as a whole either in number of institutions or assets at risk.

Figure 19: Member Business Loans as a Percentage of Assets in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

¹¹² See 12 CFR 324.32(f).

Higher capital requirements for concentrations of member business loans exist in the current rule and completely eliminating them would be a step backwards in matching risks with minimum risk-based capital requirements. Credit unions with high commercial loan concentrations are particularly susceptible to changes in business conditions that can affect borrower cash flow, collateral value, and other factors increasing the probability of default.

18. Non-Current Commercial Loans

For purposes of risk-based capital, NCUA defines a non-current loan as one that is more than 90 days past due. The final rule assigns non-current commercial loans a risk weight of 150 percent.¹¹³ This definition and risk weight are consistent with the approach used by the other banking agencies in their capital rules.¹¹⁴

Loans that are past due more than 90 days have a much higher incidence of default than current loans. To reflect the impaired credit quality of non-current loans, the risk weight for non-current commercial loans is therefore higher than for current commercial loans.

Like the other banking agencies, NCUA assigned a higher risk weight on non-current loans to ensure sufficient regulatory capital for the increased probability of unexpected losses on these loans. This results in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio.

As of December 31, 2014, complex credit unions report an average member business loan delinquency ratio of 0.84 percent. There are 95 complex credit unions that report a member business loan delinquency ratio greater than 3 percent. On average, past-due member business loans account for 0.04 percent of complex credit union assets.¹¹⁵

¹¹³ Additionally, because the final rule applies risk weights to commercial loans instead of member business loans, non-current first-lien residential real estate loans will be assigned a risk weight of 100 percent resulting in a lower risk-based capital requirement.

¹¹⁴ See 12 CFR 324.32(k).

¹¹⁵ Loans that were 60 days or more past due were used for these calculations, as NCUA does not currently collect data on loans that are 90 days or more past due.

19. Loans to and Equity Investments in Credit Union Service Organizations

A credit union service organization is a corporation, limited liability corporation, or limited partnership that provides services primarily to credit unions or members of affiliated credit unions and in which at least one credit union has some ownership interest.¹¹⁶ CUSOs are separate legal entities chartered under state law (except that a corporation may also be established under relevant federal law) and must comply with all applicable state and federal laws, including state licensing and regulated activities' laws. NCUA neither charters nor insures CUSOs, and NCUA does not have examination or enforcement authority over CUSOs or their subsidiaries.¹¹⁷

In addition, while a CUSO must predominantly serve credit unions or their members (more than 50 percent), it can be owned and controlled primarily by persons and organizations other than credit unions. Therefore, it may serve non-credit unions and can perhaps be majority controlled by a party or parties with interests not necessarily aligned with the credit union's interests.

The Federal Credit Union Act only permits federal credit unions to invest up to one percent of unimpaired capital and surplus in CUSOs or to loan up to an aggregate of one percent of unimpaired capital and surplus to CUSOs or both.¹¹⁸ A federally insured credit union may invest in or loan to a CUSO by itself, with other credit unions, or with non-credit union parties. While there are statutory limits on how much a federal credit union can loan to and invest in CUSOs, the limitations are not as stringent for some state charters, and only binding for federal credit unions at the time the loan or investment is made—thus, the position can grow in proportion to assets over time.¹¹⁹

¹¹⁶ A state credit union regulator may allow other types of legal entities based on applicable state law.

¹¹⁷ NCUA again requests that the House Financial Services Committee consider legislation to provide the agency with examination and enforcement authority over third-party vendors and CUSOs. NCUA is the only federal financial institutions regulator without vendor authority, and the Gov't Accountability Office and the Financial Stability Oversight Council have each recommended that NCUA receive this authority. This authority would protect the safety and soundness of the credit union system and provide a small measure of regulatory relief for credit unions. NCUA has developed a legislative proposal to examine vendors and examine and take enforcement actions at CUSOs, and the agency stands ready to work with Congress on this issue. This legislative request is NCUA's top legislative priority.

¹¹⁸ Federally insured, state-chartered credit unions may have different limits based on state law.

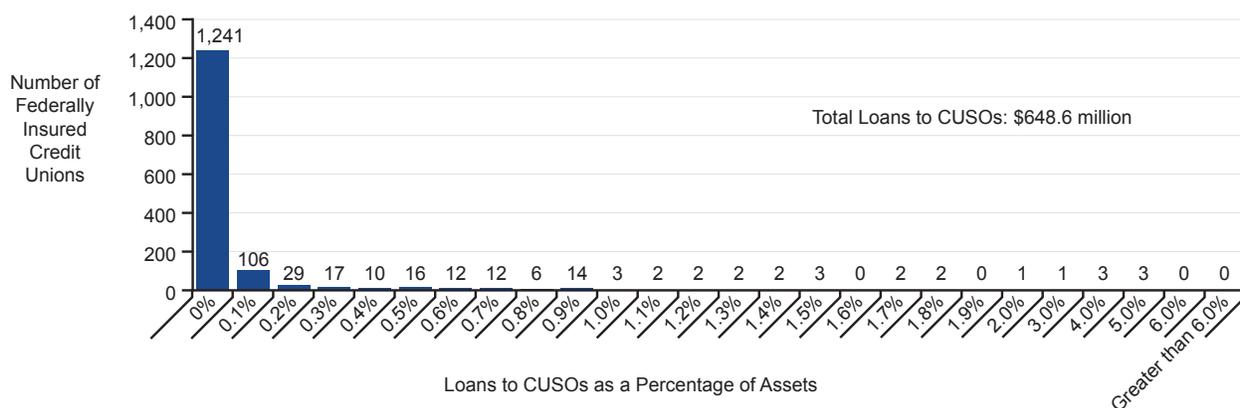
¹¹⁹ In setting capital standards, the risk of loss—not the size of the exposure—is central to determining the risk weight.

a. Loans to a CUSO

The final rule assigns a risk weight of 100 percent for loans to an unconsolidated CUSO.¹²⁰ A loan to a CUSO is a loan to a commercial entity and is assigned the same risk weight as a commercial loan, which is the same treatment these loans would receive under the other banking agencies' capital rules. A loan to a CUSO has a higher payout priority in the event of a bankruptcy than an equity investment in a CUSO. As a result, a lower risk weight for a loan to a CUSO is appropriate.

Figure 20 shows the total distribution of loans to CUSOs as a percent of assets in complex credit unions as of December 31, 2014. There are 23 (1.54 percent) credit unions that report loans to a CUSO greater than 1 percent of assets.

Figure 20: Loans to CUSOs in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

b. Equity Investments in CUSOs

An equity investment in a CUSO is an unsecured, at-risk equity investment or first-loss position, which is generally comparable to an investment in a non-publicly traded entity. There is no price transparency and extremely limited marketability associated with CUSO equity exposures. Unlike federal banking regulators, NCUA has no enforcement authority over third-party vendors.

¹²⁰ When wholly owned CUSOs are consolidated, loans are eliminated through consolidation entries that deal with inter-company transactions. As a result, only the remaining consolidated assets of the CUSO are assigned risk-based capital treatment as if they were assets of the credit union.

If the credit union's equity exposure does not meet the requirement to be considered "non-significant," the equity investment in an unconsolidated CUSOs receives a 150 percent risk weight.¹²¹ See the Non-Significant Equity Exposure subsection for additional information.

Under the other banking agencies' capital rules, all equity exposures are matched up against a complex risk-weighting framework that runs from a minimum of 250 percent to 600 percent, with some subsidiary equity having to be deducted from capital. Under the other banking agencies' rules, the equity investment in a CUSO is most analogous to an equity investment in a non-publicly traded entity, receiving a 400 percent risk weight unless the cumulative level of all equity exposures held by the institution were "non-significant."¹²²

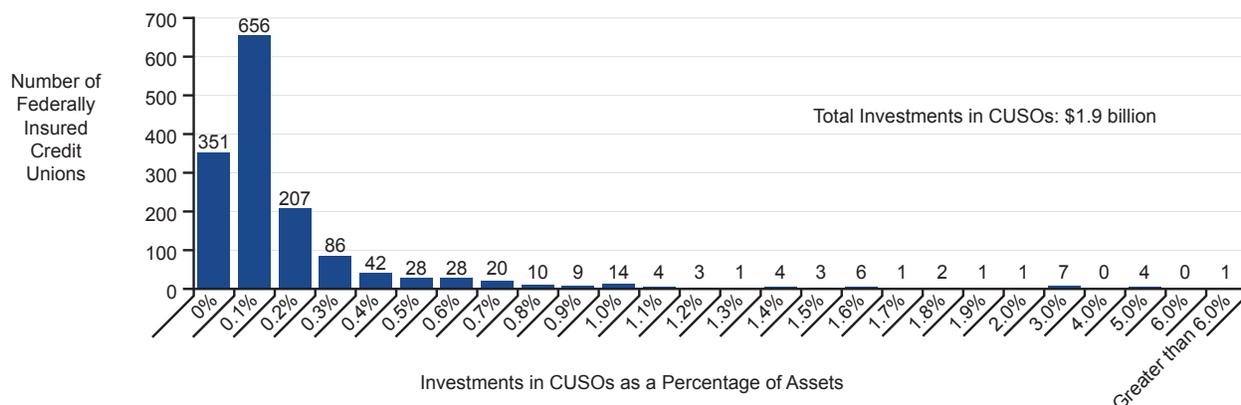
CUSOs pose potentially widespread financial risks to credit unions and the Share Insurance Fund. Between 2008 and 2012, CUSOs caused credit unions more than \$300 million in direct losses and led to failures of credit unions with combined assets of more than \$2 billion.¹²³ Given the history of losses to credit unions from CUSOs, equity investments in CUSOs warrant a higher risk weight than 100 percent if significant. However, in recognition of the value CUSOs provide in achieving economies of scale for some credit unions, the equity investments in CUSOs are assigned a 150 percent risk weight, unless they are "non-significant." Also, NCUA's final rule does not require CUSO equity investments to be deducted from capital like some subsidiary equity under the other banking agencies' capital rules.

As of December 31, 2014, 1,138 or 76.4 percent complex credit unions report an equity investment in a CUSO. There are 38 (2.6 percent) complex credit unions that report investments in CUSOs greater than 1 percent of assets. Figure 21 provides more details about complex credit union investments in CUSOs as a percentage of assets.

¹²¹ When wholly owned CUSOs are consolidated, equity investments are eliminated through consolidation entries that deal with intercompany transactions. As a result, only the remaining consolidated assets of the CUSO are assigned risk-based capital treatment as if they were assets of the credit union.

¹²² See 12 CFR 324.52.

¹²³ See NCUA Letter to Credit Unions 13-CU-13 (Nov. 2013).

Figure 21: Investments in CUSOs by Complex Credit Unions

Source: Dec. 31, 2014, Call Report data

20. Mortgage Servicing Assets

The final rule defines mortgage servicing assets as those assets, maintained in accordance with GAAP, 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.

Mortgage servicing asset valuations are highly sensitive to unexpected shifts in interest rates and prepayment speeds. Mortgage servicing assets are also sensitive to the costs associated with servicing. These risks contribute to the high level of uncertainty regarding the ability of credit unions to realize value from these assets, especially under adverse financial conditions. Thus, the final rule assigns a risk weight of 250 percent to mortgage servicing assets.

The 250 percent risk weight is appropriate in light of the relatively greater risks inherent in these assets, such as the high sensitivity to unexpected shifts in interest rates and prepayment speeds. These risks contribute to the high level of uncertainty about the ability of credit unions to realize value from these assets, especially under adverse financial conditions, and support a 250 percent risk weight for mortgage servicing assets. Credit unions will use the carrying value of the asset, as determined by GAAP, to calculate the risk-based capital requirement for mortgage servicing assets.

The other banking agencies also assign a 250 percent risk weight to mortgage servicing assets.¹²⁴ However, under the other banking agencies' capital regulations, a bank is required to deduct from common equity Tier 1 capital the amount of mortgage servicing assets that exceed 10 percent of the sum of the bank's common equity Tier 1 capital elements, less all required adjustments and deductions.¹²⁵ This provision is being phased-in through 2018.¹²⁶ The amount of mortgage servicing assets that are not deducted will be included in the risk-weighted assets of the bank and assigned a risk weight of 250 percent.¹²⁷ NCUA did not adopt the requirement to deduct any mortgage servicing assets from capital in calculating the risk-based capital ratio to simplify the regulation in light of the fact this is a relatively small asset class for credit unions.

The risk weight on this relatively small asset class would not discourage credit unions from granting and servicing loans. Banks have been under at least as stringent, if not more stringent, treatment for some time and continue to sell loans with servicing retained.

Given there is no difference between the risk as it relates to mortgage servicing assets for credit unions versus banks, NCUA believes the treatment for mortgage servicing assets should generally maintain comparability with the other banking agencies' capital regulations.

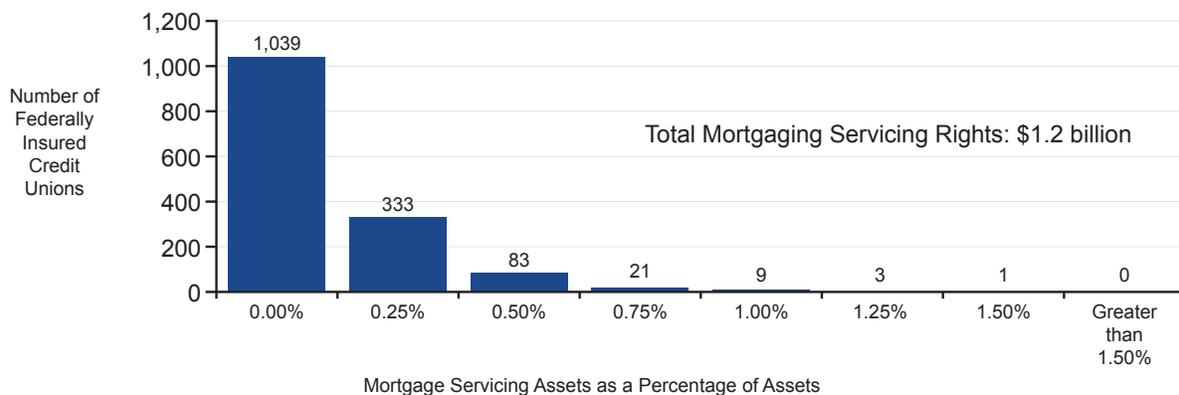
As of December 31, 2014, 450 complex credit unions reported mortgage servicing assets totaling nearly \$1.2 billion in aggregate. The average ratio of mortgage servicing assets to assets is 0.06 percent. The distribution of complex credit unions reporting mortgage servicing assets is included in Figure 22 below.

¹²⁴ See 12 CFR 324.32(l)(4)(i).

¹²⁵ See 12 CFR 324.22(d)(1)(ii).

¹²⁶ See 12 CFR 324.300(b).

¹²⁷ See 12 CFR 324.32(l)(4)(i).

Figure 22: Mortgage Servicing Assets in Complex Credit Unions

Source: Dec. 31, 2014, Call Report data

As the data in Figure 22 reveal, 69.8 percent of complex credit unions do not hold mortgage servicing assets. Of the remaining 30.2 percent, all but four report mortgage servicing assets less than one percent of total assets.

21. Off-Balance Sheet Items (Unfunded Commitments and Loan Recourse Arrangements)

Off-balance sheet items, such as unfunded commitments and recourse arrangements, can easily and quickly become on-balance sheet items and thus should be included in a credit union's risk-based capital requirement. The risk exposure associated with recourse loans and unfunded commitments are analogous to those associated with similar on-balance sheet loans. Therefore, the final rule includes a risk-based capital requirement for off-balance sheet exposures that applies a credit equivalent amount to the same risk weights for the on-balance sheet equivalents.

The other banking agencies also acknowledge the potential risk off-balance sheet items pose to a financial institution and include these items in the risk-based capital requirement for banks. NCUA has incorporated slight differences from the other banking agencies to account for the variations related to loan transfer activities in credit unions compared to banks.

The application of risk weights to off-balance sheet items is consistent with findings from NCUA's Office of the Inspector General and the U.S. Department of the Treasury. Multiple

material loss reviews conducted by NCUA's Office of the Inspector General include unfunded loan commitments in loan concentrations as a contributing factor in the credit union's failure.¹²⁸ The 1997 Treasury report on credit unions also states:

*Fourth, we recommend that Congress require the NCUA to develop an appropriate risk-based net worth requirement for larger, more complex credit unions. This risk-based net worth requirement would supplement the simple 6 percent net worth requirement and permit the NCUA to take account of risks—such as off-balance sheet risks or interest rate risk (from, for example, a large mortgage portfolio)—that may exist only for a small subset of credit unions.*¹²⁹

Further, the risk-based net worth methodology for credit unions in place since 2000 includes off-balance sheet items in the calculation. Given the risks associated with off-balance sheet items, NCUA has incorporated a risk-based capital requirement for them in the final rule that is comparable to the approach taken by the other banking agencies.

a. Methodology for Determining the Risk-Based Capital Requirement

Under the final rule, the risk-weighted amounts for all off-balance-sheet items is determined by multiplying the off-balance-sheet exposure amount by the appropriate credit conversion factor and the assigned risk weight as follows:

- For the outstanding balance of loans transferred to a Federal Home Loan Bank under the Mortgage Partnership Finance program, a 20 percent credit conversion factor and a 50 percent risk weight.
- For other loans transferred with limited recourse, a 100 percent credit conversion factor applied to the off-balance-sheet exposure and:
 - For commercial loans, a 100 percent risk weight.

¹²⁸ See NCUA, *Material Loss Review of Chetco Federal Credit Union*, OIG-13-10 (Oct. 1, 2013); NCUA, *Material Loss Review of Cal State 9 Credit Union*, OIG-10-03 (Apr. 14, 2010); NCUA, *Material Loss Review of Norlarco Credit Union*, OIG-09-01 (May 11, 2009); and NCUA, *Material Loss Review of Huron River Area Credit Union*, OIG-08-10 (Nov. 26, 2008), each available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

¹²⁹ See U.S. Dep't of Treasury Rep., *Credit Unions*, 1997, p. 71 (emphasis added).

- For first-lien residential real estate loans, a 50 percent risk weight.
 - For junior-lien residential real estate loans, a 100 percent risk weight.
 - For all secured consumer loans, a 75 percent risk weight.
 - For all unsecured consumer loans, a 100 percent risk weight.
- For unfunded commitments:
- For commercial loans, a 50 percent credit conversion factor with a 100 percent risk weight.
 - For first-lien residential real estate loans, a 10 percent credit conversion factor with a 50 percent risk weight.
 - For junior-lien residential real estate loans, a 10 percent credit conversion factor with a 100 percent risk weight.
 - For all secured consumer loans, a 10 percent credit conversion factor with a 75 percent risk weight.
 - For all unsecured consumer loans, a 10 percent credit conversion factor with a 100 percent risk weight.

This methodology is similar to the approach taken by the other banking agencies for unused commitments. However, the other banking agencies consider loans transferred with credit-enhancing representations and warranties (or sold with recourse) as securitizations and include these off-balance sheet assets in the risk-based capital securitization framework which allows banks to account for the exposure in one of three ways:

- Assigning the exposure amount a 1,250 percent credit conversion factor and 100 percent risk weight,

- Using the gross-up method, or

- Using the Simplified Supervisory Formula Approach.

NCUA's risk-based capital calculation does not account for securitizations because it is not an activity in which many credit unions are engaged. To avoid adding unnecessary complexity to the methodology for calculating the risk-based capital requirement for loans sold with recourse, NCUA applies the same methodology for other off-balance sheet exposures of multiplying the exposure amount by a credit conversion factor, and then applying an applicable risk weight. Under this approach, a credit union is not burdened with calculating the risk-based capital requirement through either the gross-up method or a Simplified Supervisory Formula Approach.

b. Definition of Off-Balance Sheet Exposure

The following is the final rule's definition of "off-balance sheet exposure:"

- For loans sold under the Federal Home Loan Bank Mortgage Partnership Finance program, the outstanding loan balance as of the reporting date, net of any related valuation allowance.

- For all other loans transferred with limited recourse or other seller-provided credit enhancements and that qualify for true sales accounting, the maximum contractual amount the credit union is exposed to according to the agreement, net of any related valuation allowance.

- For unfunded commitments, the remaining unfunded portion of the contractual agreement.

This definition results in a slightly different approach than that taken by the other banking agencies, which require institutions to multiply the notional amount (or face value) of the off-balance sheet item by the credit conversion factor. The treatment for unfunded commitments for credit unions and other depository institutions is the same. This is appropriate because the risk of off-balance sheet items is the same regardless of institution type. The risk is derived from the contractual requirement to fund the commitment, which could be unique to each institution regardless of whether it is a credit union or bank.

However, NCUA believes that a credit union's risk-based capital requirement relating to loans transferred with limited recourse should be limited to the amount of the credit union's contractual exposure. The FDIC's rule does not address this issue because loans transferred with limited recourse are treated as securitizations for risk-based capital purposes. To ensure a credit union is only subject to a risk-based capital requirement for the amount of the contractual exposure, the final rule requires the credit equivalent amount that is applied to the appropriate risk weight category for all off-balance sheet items be determined by multiplying the off-balance sheet exposure, as defined in the first paragraph above, by the appropriate credit conversion factor.

Loans sold under the Federal Home Loan Bank's Mortgage Partnership Finance and other similar programs should be categorized and risk weighted separately from other types of loans transferred with limited recourse because of the different credit enhancements offered with these programs. Applying the credit conversion factor to the outstanding loan balance reduces the risk-based capital requirement as the loan balance declines. This methodology and credit conversion factor results in a risk-based capital requirement consistent with historic credit losses in this program. NCUA believes such treatment is appropriate because a credit union incurring higher than normal levels of losses from loans in the Mortgage Partnership Finance or similar programs would have to record a reserve for losses that would reduce the credit union's retained earnings.

c. Credit Conversion Factors and Risk Weights

Specific off-balance sheet items have a probability of becoming an actual credit exposure and shifting on to the balance sheet. The credit conversion factor is an estimate of this probability. The final rule defines "credit conversion factor" as the percentage used to assign a credit exposure equivalent amount for selected off-balance sheet accounts.

The credit conversion factor for each off-balance sheet item was carefully considered and assigned based on the specific characteristics of each off-balance sheet item. Table 18 below outlines the credit conversion factor, risk weight, and effective risk weight for each type of off-balance sheet exposure.

Table 18: Off-Balance Sheet Item Risk-Based Capital Treatment

Type of Off-Balance Sheet Exposure	Credit Conversion Factor	Risk Weight*	Effective Risk Weight
Unfunded Commitment - Commercial Loans**	50%	100%	50%
Unfunded Commitment - First-Lien Residential Real Estate Loans	10%	50%	5%
Unfunded Commitment - Junior-Lien Real Estate Loan Commitments	10%	100%	10%
Unfunded Commitment - Non-Federally Guaranteed Student Loans	10%	100%	10%
Unfunded Commitment - Secured Consumer Loans	10%	75%	7.5%
Unfunded Commitment - Unsecured Consumer Loans	10%	100%	10%
Loans Transferred Limited Recourse - Commercial Loans	100%	100%	100%
Loans Transferred Limited Recourse - First-Lien Residential Real Estate Loans	100%	50%	50%
Loans Transferred Limited Recourse - Junior-Lien Real Estate Loan Commitments	100%	100%	100%
Loans Transferred Limited Recourse - Non-Federally Guaranteed Student Loans	100%	100%	100%
Loans Transferred Limited Recourse - Secured Consumer Loans	100%	75%	75%
Loans Transferred Limited Recourse - Unsecured Consumer Loans	100%	100%	100%
Loans Transferred Limited Recourse - Loans Sold to a Federal Home Loan Bank under the Mortgage Partnership Finance Program	20%	50%	10%

* Refer to the specific loan category section for a detailed discussion on the individual risk weights for each loan category.

** Commercial loans have been defined to more closely align with the other banking agencies' definition of business loans to capture risk associated with the loans rather than the statutory definition of member business loans. See the discussion of commercial loans for a complete analysis of the definition and rationale for adoption in the final rule.

The credit conversion factor for unfunded commercial loans is consistent with the credit conversion factor applied in the other banking agencies' rules for commitments that are not unconditionally cancelable and have an original maturity greater than one year. These characteristics are similar to unfunded commitments for commercial loans granted by credit unions, which are often not unconditionally cancelable, warranting a similar credit conversion factor as applied by the other banking agencies.

The small credit conversion factor for all other types of unused non-commercial lines of credit—secured, unsecured, and real estate, among others—provides for the potential swift shift in credit risk that can occur when consumers access the lines. Open lines of credit to consumers, even

those that are unconditionally cancelable, can quickly result in a credit union shifting assets from low risk-weight investments to higher risk-weight loans.

Credit unions can be hesitant to cancel or reduce consumer lines of credit due to the potential for negative reputation risk. The 10 percent credit conversion factor for unused non-commercial lines of credit would encourage credit unions to manage open consumer lines of credit through active monitoring and review of trends and exposures. The 10 percent credit conversion factor is consistent with the calculation of off-balance sheet exposure measures contained in Basel III.¹³⁰ However, the other banking agencies apply a risk weight of zero percent to these off-balance sheet exposures. Unfunded commitments for non-commercial loans account for only 1.46 percent of complex credit union assets based on December 31, 2014, data. The small capital requirement will not have a material impact on individual credit unions or the system.

Based on the structure of the credit enhancement provided through the Federal Home Loan Bank's Mortgage Partnership Finance program or similar programs, loans sold under these programs should be categorized and risk weighted separately from other types of loans transferred with limited recourse. For loans transferred under the Federal Home Loan Bank's Mortgage Partnership Finance program, applying a 20 percent credit conversion factor to the net outstanding loans balance and then applying a 50 percent risk weight results in a risk-based capital requirement consistent with historical losses in the program.

For all other loans transferred with limited recourse, applying a credit conversion factor to the maximum contractual exposure amount, net of any valuation allowance, results in a risk-based requirement that covers the credit union's actual risk exposure.

22. All Other Assets

The final rule assigns a 100 percent risk weight to all other balance sheet assets not specifically assigned a different risk weight, but reported on the statement of financial condition. The final rule catalogs and assigns specific risk weights to the vast majority of assets credit unions can hold.

¹³⁰ Basel III was published in Dec. 2010 and revised in June 2011. The text is available at <http://www.bis.org/publ/bcbs189.htm>

However, the risk-weight framework does include a provision to capture any miscellaneous assets that have not been specifically risk weighted. This treatment is comparable to the treatment in the other banking agencies' capital regulations.¹³¹ The majority of current complex credit union assets that would fall into this risk weight category are land, building, and equipment.

The 100 percent risk weight is appropriate for this class of assets because the difference between the book balance of some particular fixed assets and the value of the assets in the event of liquidation can be substantial. For example, in an area that has experienced a decline in the value of real estate, the book value of a fairly recently constructed credit union headquarters could be well below the fair value. The 100 percent risk weight is appropriate when considering that most assets in this group are predominately non-earning assets, which can hinder a credit union's ability to increase capital. As of December 31, 2014, other assets represent less than 2.5 percent of complex credit union assets.

23. Non-Significant Equity Exposures

Under the other banking agencies' capital regulations, banks are permitted to assign a 100 percent risk weight to equity exposures when the aggregate amount of the exposures does not exceed 10 percent of the bank's total capital. NCUA's final rule includes a similar provision.

The final rule provides that a credit union has non-significant equity exposures if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union's capital elements in the risk-based capital ratio numerator. When determining the aggregate amount of its equity exposures, a credit union must include the total amounts (as recorded on the statement of financial condition in accordance with GAAP) of the following:

- Equity investments in CUSOs,
- Perpetual contributed capital at corporate credit unions,
- Non-perpetual capital at corporate credit unions, and
- Equity investments subject to a risk weight in excess of 100 percent.

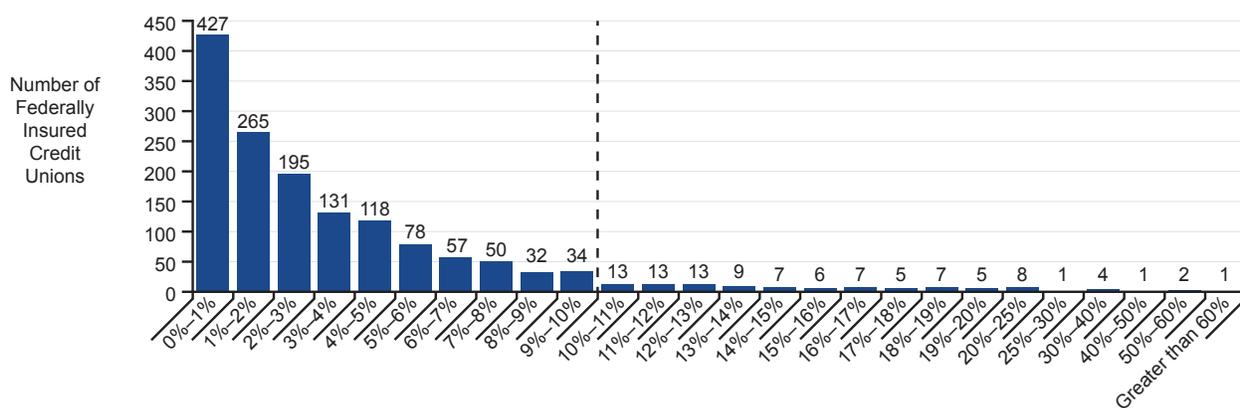
The assets identified above encompass the extent of funds invested in stock, equities, or

¹³¹ See 12 CFR 324.32(l).

debts associated with an ownership interest and are normally in a loss position subordinate to unsecured creditors. Non-perpetual capital at corporate credit unions, despite receiving a 100 percent risk weight, is included in the calculation of equity exposure because its priority in liquidation is subordinate to shareholders and the Share Insurance Fund. Limiting the sum of these higher credit risk accounts to 10 percent or less of the sum of a credit union's capital elements of the risk-based capital ratio numerator receiving a 100 percent risk weight ensures that the related loss exposure does not present a significant risk to the credit union or the Share Insurance Fund.

Figure 23 below shows the distribution of equity exposures to the risk-based capital ratio numerator in complex credit unions as of December 31, 2014. On average, equity exposures account for 3.7 percent of the risk-based capital numerator. In all, 102 complex credit unions, with a total equity exposure of \$720 million, have an estimated equity exposure greater than 10 percent of the risk-based capital ratio numerator. This analysis does not attempt to estimate which credit unions will consolidate CUSO investments under accounting rules.

Figure 23: Equity Exposure to Risk-Based Capital Ratio Numerator in Complex Credit Unions



Source: Dec. 31, 2014, Call Report data

24. Derivatives

At its January 2014 open meeting, the NCUA Board finalized the agency's rule to allow credit unions to engage in a limited use of derivatives transactions, such as plain-vanilla interest rate swaps, purchased interest rate caps, and Treasury futures. The final rule permits federal credit

unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk.¹³²

Derivatives are contracts between two parties that transfer risks related to one or more underlying market factors, such as interest rates. For example a swap is a bilateral agreement to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the transaction (maturity or tenor). It requires one or both parties to make agreed upon payments or deliveries of assets to the other party upon the occurrence of a specified event or on a specified date.

Derivatives transactions covered under clearing arrangements are treated differently than non-cleared transactions. This treatment is appropriate because of the varying risk among these two distinct types of transactions. Specifically, clearing provides a valuable risk-reducing component to a derivatives transaction. For cleared derivatives transactions, each party to the swap submits the transaction to a derivatives clearing organization for clearing.¹³³ This reduces counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the intermediary derivatives clearing organization as their counterparty. In addition, derivatives clearing organizations exist for the primary purpose of managing credit exposure from the swaps being cleared. Therefore, they are effective at standardizing transactions and mitigating counterparty risk through the use of exchange-based risk management frameworks.

Finally, swap clearing requires both counterparties to post collateral—an initial margin—with the clearinghouse when they enter into a swap. The clearinghouse can use the posted collateral to cover defaults in the swap. As the valuation of the swap changes, the clearinghouse determines the fair market value of the swap and may collect additional collateral—a variation margin—from the counterparties in response to fluctuations in market values. The clearinghouse can apply this collateral to cover defaults in payments under the swap.

NCUA adopted an approach to assign risk weights to derivatives that is consistent with the approach adopted by the other banking agencies regarding capital treatment of derivatives.¹³⁴

¹³² State law dictates derivatives authority for state-chartered credit unions.

¹³³ The term “derivatives clearing organization” has the same meaning as defined by the Commodity Futures Trading Commission. *See* 17 CFR 1.3(d).

¹³⁴ The final rule separates derivatives into its own section, section 702.105, and includes a cross reference in the general risk weight category that indicates that all derivatives must be risk weighted in accordance with section 702.105. This section of the final rule addresses cleared transactions, provides further authority for recognizing the credit risk mitigation benefits of collateral, and addresses derivatives transactions by federally insured, state-chartered credit unions that are impermissible for federal credit unions under NCUA's rules.

¹³⁵ Since the transactions done by credit unions will be the same as those done by banks, there is no difference in the risk and these transactions should be handled the same for risk-based capital purposes.

NCUA elected to focus only on interest rate-related derivatives in the final rule and to refer credit unions to FDIC's rules for all non-interest rate-related derivatives. NCUA made this distinction because federal credit unions are restricted to interest rate-related contracts under the final derivatives rule approved in January 2014; however, federally insured, state-chartered credit unions may have broader authorization to use non-interest rate contracts if approved by the respective state banking authorities. As of June 30, 2015, NCUA is not aware of any non-interest rate derivative contracts being used by federally insured, state-chartered credit unions (as reported on the Call Report) for derivative contracts.

¹³⁵ See 78 FR 55339 (Sept. 10, 2013).

Section IV

Other Differences in Capital Requirements

1. Inclusion of Material Risks

The Federal Credit Union Act requires NCUA to “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.”¹³⁶

The Senate Report on the Credit Union Membership Access Act of 1998 specifically notes in designing the risk-based requirement: “NCUA should, 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.”¹³⁷

Since initial regulatory implementation in 2000 of the Credit Union Membership Access Act’s changes to the Federal Credit Union Act, NCUA’s risk-based net worth requirement has included in various assets classes—primarily investments, real estate, and member business loans—tiered and increased risk weighting to account for interest rate, concentration, and liquidity (albeit indirectly) risks.¹³⁸

The other banking agencies handle risks beyond credit risk—for example interest rate risk and concentration risk—outside of their capital rules through the supervision process. In fact, while FDIC does depend on the exam and supervision process for identifying such risks, it specifically provides in its prompt corrective action rule the ability to tie idiosyncratic risk determinations into a bank’s capital ratio. Under the reservation of authority section, which is on the first page of the FDIC’s prompt corrective action regulation, FDIC can do “manual overrides” to its standard risk weights and capital ratio calculations that have the force and effect of regulation.¹³⁹

¹³⁶ 12 U.S.C. 1790d(d)(2) (emphasis added).

¹³⁷ S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998).

¹³⁸ Per the July 20, 2000, final rule’s preamble: The [risk-based net worth] 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 requirement should reflect a reasoned judgment about the actual risks involved.” *Id.* at p. 14.

¹³⁹ See 78 FR 55472 (Sept. 10, 2013).

This power is incorporated into the FDIC's rules and regulations.¹⁴⁰

NCUA's final risk-based capital rule continues to address credit and credit concentration risk. However, interest rate risk will now be addressed through the supervision process.

a. Concentration Risk

The final rule includes a tiered risk-weight framework for high concentrations of residential real estate loans and commercial loans in NCUA's risk-based capital ratio measure.¹⁴¹ As a credit union's concentration in these asset classes increases, incrementally higher levels of capital are required. This approach addresses concentration risk as it relates to minimum required capital levels through a transparent, standardized regulatory requirement.

The concentration thresholds do not limit a credit union's lending activity; rather, the thresholds merely require the credit union to hold additional capital to account for the elevated concentration risk. The inclusion of concentration risk in the final rule does not put credit unions at a competitive disadvantage to banks because most real estate and commercial loans, except for loans held in high concentrations, would still be assigned risk weights similar to those applicable to banks.

NCUA has also been advised by its Office of the Inspector General and the GAO to address credit concentration risk in any revised risk-based capital measure. NCUA's Inspector General completed several material loss reviews that determined multiple failed credit unions had large real estate loan concentrations, which contributed to Share Insurance Fund losses. The Share Insurance Fund incurred losses of at least \$25 million in each of these cases. The credit unions reviewed held substantial residential real estate loan concentrations in either first-lien mortgages,

¹⁴⁰ See 12 CFR 324.1(d) and 341.10(d).

¹⁴¹ The tiered framework would provide for an incrementally higher capital requirement resulting in a blended rate for the corresponding portfolio. That is, the portion of the portfolio below the threshold would receive a lower risk weight, and the portion above the threshold would receive a higher risk weight. The higher risk weight would be consistent across asset categories as a 50 percent increase from the base rate. Some suggested NCUA should have combined similar exposures across asset classes, such as investments and loans. For example, residential mortgage-backed security concentrations could have been included with the real estate loan thresholds due to the similarity of the underlying assets. However, given the more liquid nature and price transparency of a security, including this with the risk thresholds for real estate lending is not necessary.

home equity lines of credit, or both.¹⁴²

In 2012, GAO recommended that NCUA address the credit concentration risk concerns raised by NCUA's Inspector General.¹⁴³ The 2012 GAO report notes credit concentration risk contributed to 27 of 85 credit union failures that occurred between January 1, 2008, and June 30, 2011. The report also indicated that the NCUA Board should revise NCUA's prompt corrective action regulation so that the minimum net worth levels required under the rule emphasize credit concentration risk. The report documents NCUA's agreement to revise prompt corrective action so that minimum net worth levels emphasize credit concentration risk. Eliminating the concentration risk dimension for risk weights would be inconsistent with the concerns raised by the GAO and NCUA's Inspector General.

Significant Share Insurance Fund losses from high concentrations of commercial loans are a recurring historical trend. The U.S. Treasury report on member business lending by credit unions discusses 16 credit union failures from 1987 to 1991 costing the insurance fund over \$100 million.¹⁴⁴ GAO found in its 2012 report that credit unions that failed had more member business loans as a percentage of total assets than peers and the system average.¹⁴⁵ In addition, the failures of many small banks between 2008 and 2011 were largely driven by high concentrations of commercial loans.¹⁴⁶

Basel II states, “[r]isk concentrations are arguably the single most important cause of major problems in banks.”¹⁴⁷ In addition, the GAO specifically recommended that the NCUA Board continue to address concentration risk in the risk-based capital requirement and advised the

¹⁴² See NCUA, *Material Loss Review of Cal State 9 Credit Union*, OIG-10-03 (Apr. 14, 2010); NCUA, *Material Loss Review of Beehive Credit Union*, OIG-11-07 (July 7, 2011); and NCUA, *Material Loss Review of Ensign Federal Credit Union*, OIG-10-15 (Sept. 23, 2010), each available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

¹⁴³ See U.S. Gov't Accountability Office, *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO-12-247 (2012), available at <http://www.gao.gov/products/GAO-12-247>.

¹⁴⁴ See U.S. Dep't of Treasury, *Credit Union Member Business Lending* (Jan. 2001)

¹⁴⁵ See U.S. Gov't Accountability Office, GAO-12-247, *Earlier Actions Are Needed to Better Address Troubled Credit Unions* 17 (Jan. 2012) available at <http://www.gao.gov/products/GAO-12-247>.

¹⁴⁶ See U.S. Gov't Accountability Office, GAO-13-704T, *Causes and Consequences of Recent Community Bank Failures* 4 (June 12, 2013), available at <http://www.gao.gov/assets/660/655193.pdf>.

¹⁴⁷ Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (June 2006).

NCUA Board to revise NCUA's prompt corrective action requirements to take into account credit unions with a high percentage of member business loans to total assets. NCUA's Inspector General recommended in multiple material loss reviews that the Board increase the risk weights assigned to member business loans, citing numerous and excessive Share Insurance Fund losses related to member business loans, including a number of large credit unions with high concentrations of member business loans.¹⁴⁸

Based on December 31, 2014, Call Report data, if this final rule were effective today, NCUA estimates that the additional capital required for concentration risk would apply to less than 10 percent of complex credit unions and less than 1.5 percent of complex credit union assets. Table 19 shows the number of complex credit unions that would be covered by the concentration risk requirements.

Table 19: Complex Credit Unions Covered under Concentration Risk Requirements

Concentration Threshold	Number of Complex Credit Unions	Percentage of Complex Credit Unions
First-Lien Residential Real Estate (above 35% of Total Assets)	135	9.1%
Junior-Lien Residential Real Estate (above 20% of Total Assets)	57	3.8%
Commercial Loans - using Member Business Loans as a proxy* (above 50% of Total Assets)	12	0.8%

* Using member business loan data as the current Call Report does not capture "commercial loan" data as defined in the final risk-based capital rule.

Source: Dec. 31, 2014, Call Report data

b. Interest Rate Risk

NCUA's risk-based net worth requirement has included some aspect of interest rate risk since inception in 2000. The report on the Credit Union Membership Access Act specifically cites interest rate risk as one of the material risks the NCUA Board should consider in the design

¹⁴⁸ See NCUA, *Office of Inspector General Capping Report on Material Loss Reviews*, OIG-10-20 (Nov. 23, 2010), and NCUA, *Material Loss Review of Telesis Community Credit Union*, OIG-13-05 (Mar. 15, 2013), each available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

of the risk-based net worth requirement.¹⁴⁹ Further, NCUA's top risk concern and supervisory priority for the past several years has been interest rate risk. Interest rate risk, if not adequately addressed through regulatory, statutory, or supervisory means, or some combination thereof, can represent a material risk.

Measures of interest rate risk are best based on the entire balance sheet to take into account offsetting risk effects between assets and liabilities, including benefits from derivative transactions. The use of asset-duration risk weights in the current risk-based net worth requirement is simplistic and does not take into account potential risk-mitigation benefits, such as liabilities and derivatives.

The use of capital-at-risk methodologies to identify, measure, and control interest rate risk is a long-standing practice in larger credit unions and a standard expectation among financial institutions supervisors, including NCUA. NCUA has had a supervisory expectation for the use of asset-liability management modeling by large credit unions for decades. In 2012, NCUA also updated part 741 of its rules requiring federally insured credit unions to develop and adopt a written policy on interest rate risk management and a program to effectively implement that policy, as part of their asset-liability management responsibilities. This rulemaking elevated the significance of interest rate risk policies and programs within the prudential regulatory framework for credit unions.

Therefore, the Board concluded that NCUA can adequately address interest rate risk through its other regulations and supervisory processes. Accordingly, the final rule excludes interest rate risk from the calculation of the risk-based capital ratio.

2. Reservation of Authority

The other banking agencies' capital regulations enable the regulator to direct a bank to hold an amount of regulatory capital greater than otherwise is required under the rule if the regulator determines that the institution's capital requirements are not commensurate with the supervised institution's credit, market, operational, or other risks.¹⁵⁰

¹⁴⁹ See S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998).

¹⁵⁰ See 12 CFR 324.1(d).

NCUA considered, but elected not to include, an individual minimum capital requirement provision, similar to the one included in the capital rule for corporate credit unions and the other banking agencies, in its final rule.¹⁵¹ Instead, NCUA will address individual consumer credit unions that do not hold sufficient capital through other mechanisms.

Specifically, NCUA would be able to address any deficiencies in a credit union's capital levels relative to its risk by:¹⁵²

- Reclassifying the credit union into a lower net worth category under the NCUA's rules and the Federal Credit Union Act;¹⁵³
- Determining in relation to NCUA's rules that capital levels are not commensurate with the level or nature of the risks to which the credit union is exposed;¹⁵⁴ or
- Using other supervisory authorities to address unsafe or unsound conditions or practices as noted in the final and current risk-based capital rules.¹⁵⁵

3. Capital Adequacy Plan

Under the final rule, complex credit unions are required to have a written capital adequacy plan.¹⁵⁶ This provision is within the Board's legal authority under the Federal Credit Union Act and is based on a similar provision in the other banking agencies' rules.¹⁵⁷ The Federal Credit Union Act grants NCUA broad authority to take action to ensure the safety and soundness of

¹⁵¹ See 12 CFR 704.3(d).

¹⁵² As a practical matter, in using these authorities, NCUA may provide specific metrics for necessary reductions in risk levels, increases in capital levels beyond those otherwise required under the final rule, and some combination of risk reduction and increased capital so it is clear how the credit union can address NCUA's supervisory concerns. Then it would be up to the credit union to decide which particular option to pursue to remedy NCUA's enforcement action.

¹⁵³ See 12 CFR 703.102(b) and 12 U.S.C. 1790d(h), *respectively*.

¹⁵⁴ See 12 CFR 702.101(b).

¹⁵⁵ See 12 CFR 702.1(d).

¹⁵⁶ See 12 CFR 702.101(b).

¹⁵⁷ See, e.g., 12 CFR 324.10(d)(1) *and* (2).

credit unions and the Share Insurance Fund and to carry out the powers granted to the Board.¹⁵⁸ Section 206 of the law provides the Board with broad authority to intervene and require credit unions to take actions to correct unsafe or unsound practices, including requiring individual credit unions to hold capital above that required under NCUA's prompt corrective action regulation.¹⁵⁹ And section 209 of the Federal Credit Union Act specifically authorizes the Board to prescribe such rules and regulations as it may deem necessary or appropriate to carry out the provisions of Subchapter II of the law, which includes section 206.

Requiring credit unions to maintain capital adequacy is fundamental to ensuring safety and soundness. It is not a new concept.¹⁶⁰ As a prudential matter, NCUA has a long-established policy that federally insured credit unions hold capital commensurate with the level and nature of the risks to which they are exposed. In some cases, this may entail holding capital above the minimum requirements, depending on the nature of the credit union's activities and risk profile. NCUA's long-standing practice has been to monitor and enforce this policy through the supervisory process. The new capital adequacy provision does not affect credit unions' prompt corrective action capital category, but does support the assessment of capital adequacy in the supervisory process—that is assigning CAMEL and risk ratings.

The supervisory evaluation of a complex credit union's capital adequacy, including the requirement to maintain a written capital strategy, is focused on the credit union's own process and strategy for assessing and maintaining its overall capital adequacy in relation to its risk profile. The supervisory evaluation includes various factors—such as whether the credit union is engaged in merger activity, entering into new activities, introducing new products, operating in a challenging economic environment, engaged in nontraditional activities, or exposed to other risks like interest rate risk or operational risks. The assessment evaluates the comprehensiveness and effectiveness of the capital planning in light of its activities.

An effective capital planning process involves an assessment of the risk to which a credit union is exposed and its process for managing and mitigating those risks, an evaluation of capital relative to those risks, and consideration of the potential impact on earnings and capital from current and prospective economic conditions. The evaluation of an individual credit union's

¹⁵⁸ See 12 U.S.C. 1786; and 1789.

¹⁵⁹ See 12 U.S.C. 1786.

¹⁶⁰ See, e.g., 78 FR 55340, 55362 (Sept. 10, 2013).

risk-management strategy and process will be commensurate with the credit union's size, sophistication, and risk profile—which is similar to the current supervisory process for credit unions.

NCUA also subjects complex credit unions with more than \$10 billion in assets to capital planning and stress testing.¹⁶¹ For this subset of complex credit unions, compliance with the capital planning and stress testing requirements will satisfy the final rule's requirement to have a written capital adequacy plan.¹⁶² Thus, those credit unions subject to the stress testing regulation will not be expected to write redundant capital plans.

For other complex credit unions that must have written capital plans, supervisory guidance will be issued to help those credit unions evaluate their compliance with this requirement.¹⁶³ The supervisory guidance will also be designed to provide consistency in the examination process.

4. Restrictions on Dividend Payments

NCUA's final rule maintains a restriction on dividend payments and interest refunds if the payment would result in the credit union being less than adequately capitalized, unless the credit union obtains approval from NCUA.

By statute, an FDIC-insured depository institution may not pay a dividend if, after the payment of the dividend, the institution would be undercapitalized pursuant to the other banking agencies' prompt corrective action regulations.¹⁶⁴ Moreover, banks that are poorly rated or subject to written supervisory actions often are specifically directed not to pay dividends to ensure adequate capital exists to support their risk profiles.

The FDIC's capital rules include requirements for a capital conservation buffer that limits the amount of dividends a bank can pay when the bank's capital ratios are below the threshold levels of the buffer. The Basel III capital rules place additional regulatory limits on the distributions and discretionary bonus payments that an adequately capitalized bank, or a bank whose capital

¹⁶¹ See 12 CFR 702, subpt. E.

¹⁶² See 12 CFR 702.101(b).

¹⁶³ See *id.*

¹⁶⁴ See 12 U.S.C. 1831o(d)(1)(A).

ratios exceed by less than 0.5 percentage points any of its well-capitalized risk-based capital ratio thresholds, may potentially pay.¹⁶⁵ The capital conservation buffer is designed to encourage banks to maintain capital ratios well above regulatory minimums and to remain well capitalized.

Thus, FDIC-supervised institutions may request, and the FDIC may approve, dividend payments despite the restrictions imposed by the capital conservation buffer if the FDIC determines that the circumstances warrant the payment of dividends, that the payment is not contrary to the purposes of the buffer, and that the payment of dividends would not be detrimental to the safety and soundness of the bank.

¹⁶⁵ See 12 CFR 324.11(a).

Section V

Impact of Final Rule

The final rule changes the minimum risk-based regulatory capital requirement for credit unions to be more reflective of risk. It also improves the calibration of the risk weights to result in a more meaningful risk-based standard that more accurately identifies outliers—those credit unions with insufficient capital relative to their risk. This will result in more emphasis on the risk-based requirement, thereby encouraging credit unions to more actively manage risk in relation to the minimum required capital levels.

The final risk-based capital rule achieves a reasonable balance between requiring credit unions posing an elevated risk of failure to hold more capital while not over burdening lower-risk credit unions. Further, NCUA evaluated the performance of the rule through various scenarios to ensure the rule provided balanced performance.

Also, the relatively lengthy implementation period will minimize any adverse impact of the rule. The Macroeconomic Assessment Group, established by the Financial Stability Board and the Basel Committee on Banking Supervision, released several reports which support the benefits and lessened adverse impact from a longer implementation period.¹⁶⁶

1. Scope and Effect of the Final Rule

The final rule only applies to complex credit unions, newly defined as those credit unions with \$100 million or greater in total assets.¹⁶⁷ As of December 31, 2014, there were 1,489 credit unions (23.7 percent of all credit unions) with assets of \$100 million or greater. As a result, approximately 76 percent of all credit unions will be exempt from the risk-based capital requirement, but the requirement will cover 90 percent of assets in the credit union system.¹⁶⁸

¹⁶⁶ See Bank for International Settlements, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements* (Dec. 2010), p. 9, available at <http://www.bis.org>.

¹⁶⁷ NCUA estimated the impact of the final rule using existing Call Report data. However, several data elements needed to implement the final rule are not currently collected on the NCUA Call Report. To compensate, certain conditions were included in NCUA calculations in order to estimate unavailable data. Although some data was estimated, the analysis overall yields reliable results for estimating the impact of the final rule.

¹⁶⁸ The risk-based capital requirement applies only to credit unions with assets of \$100 million or more, compared to the other banking agencies' rules that apply to banks of all sizes. There were 1,872 FDIC-insured banks with assets less than \$100 million as of Dec. 2014.

The final rule is not intended to increase capital levels on a systematic basis across the credit union system. In fact, the vast majority of covered credit unions have very healthy risk-based capital ratios, well over the 10 percent well-capitalized level. The aggregate and average risk-based capital ratios for complex credit unions are 17.9 and 19.2 percent, respectively. Thus, complex credit unions would have on average risk-based capital ratios 900 basis points above the 10 percent required threshold to be well capitalized in the final rule. In fact, 85 percent of complex 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.

Figure 24: Distribution of Complex Credit Unions by Risk-Based Capital Ratio



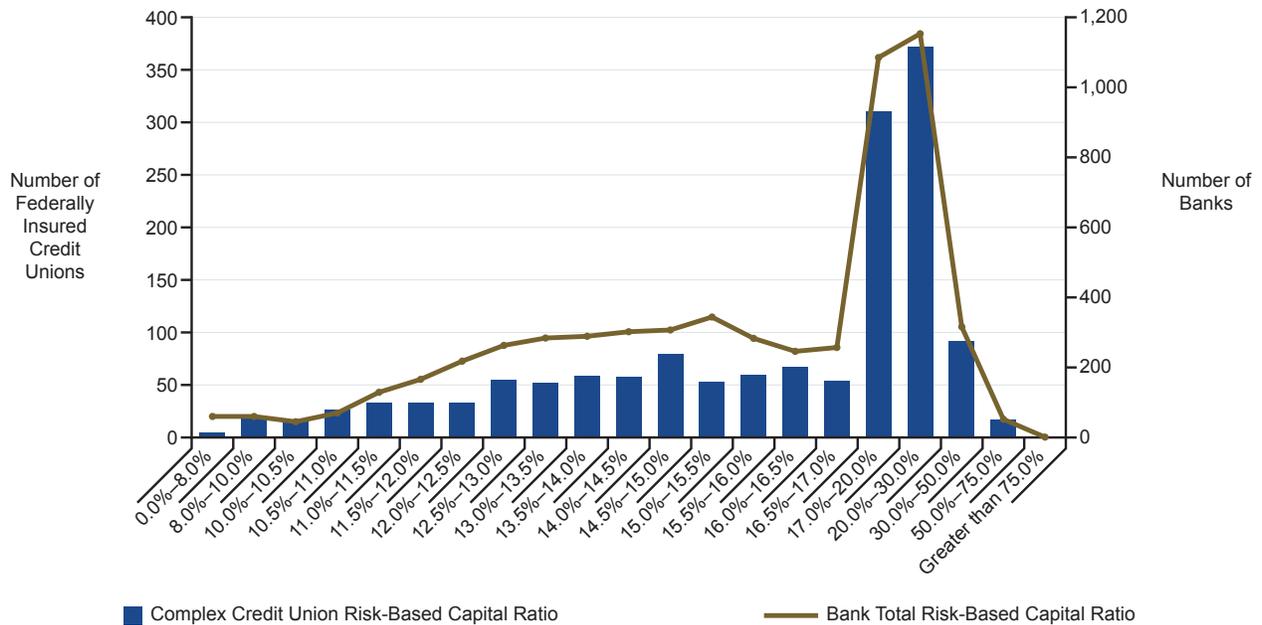
Source: Dec. 31, 2014, Call Report data

As shown in Figure 24, there are only 23 complex credit unions that fall below the risk-based capital threshold of 10 percent to be well capitalized. Seven of these 23 credit unions have a net worth ratio of less than 7 percent and are already classified as less than well capitalized under prompt corrective action. This leaves a net of 16 complex credit unions that would be subject to a decrease in their prompt corrective action classification based on December 31, 2014, Call Report data. Thus, approximately 98.5 percent of all complex credit unions will remain well capitalized.

The 16 complex credit union outliers with insufficient capital under the risk-based requirement have total assets of \$9.8 billion and a capital shortfall of approximately \$67 million. While they are a relatively small subset of the number of credit unions, their total assets are a material risk to the Share Insurance Fund, which has approximately \$12 billion in assets.

Figure 25 below shows the distribution of all credit unions by risk-based capital ratio ranges compared to a distribution of federally insured bank total risk-based capital ratios. Although the scales differ between the number of credit union and banks, the graph demonstrates the similarities between the overall distributions.

Figure 25: Comparison of Risk-Based Capital Ratio to Bank Total Risk-Based Capital Ratio



Source: FDIC Quarterly Banking Profiles as of Dec. 31, 2013, and NCUA Financial Performance Reports as of Dec. 31, 2014

As indicated in Table 20, according to the impact measure used in the second risk-based capital proposed rule, 72 complex credit unions would have higher capital requirements due to the risk-based capital ratio requirement based on December 31, 2014, data.^{169, 170}

¹⁶⁹ The method used in the second proposed rule was calculated by taking 10 percent of estimated risk assets divided by total assets with results exceeding 7.5 percent indicating the risk-based capital requirement is the higher minimum-capital requirement.

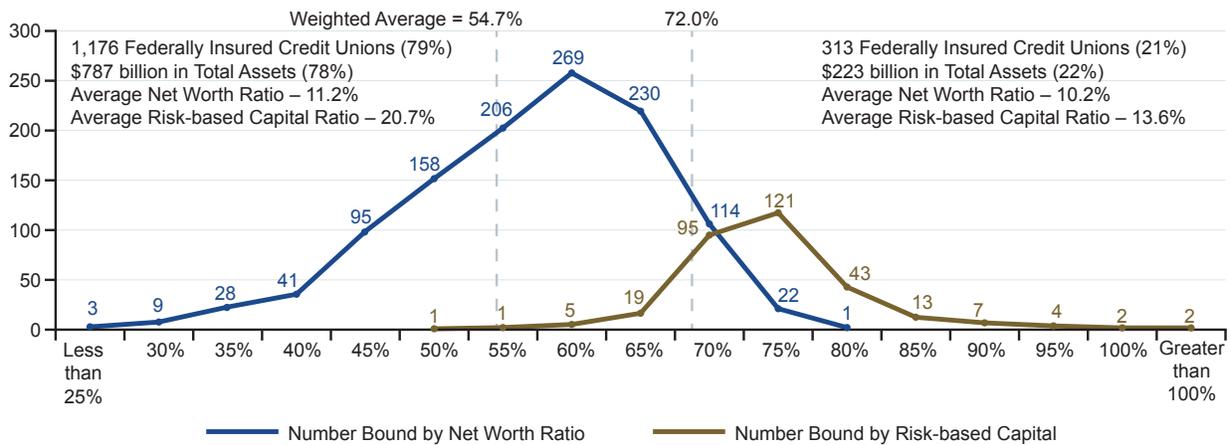
¹⁷⁰ The 72 is calculated by adding 57 + 11 + 4 in Table 20.

Table 20: Distribution of Risk-Based Leverage Equivalent Ratio

	Risk-Based Leverage Equivalent Ratio						Average
	Less than 6%	6% to 7.5%	7.5% to 8.5%	8.5% to 9.5%	9.5% to 11%	Above 11%	
Number of Credit Unions	816	601	57	11	4	0	5.90%

Using another more conservative measure, NCUA identified 313 complex credit unions, or 20 percent of all complex credit unions, that are likely to have a higher minimum capital requirement in terms of dollars under the risk-based capital ratio than the leverage ratio.¹⁷¹ Those 313 complex credit unions have a higher risk profile relative to qualifying capital, thus necessitating more net worth in dollars to be considered well capitalized than what is required by the net worth ratio. While those 313 complex credit unions may have to hold more dollars in capital due to the risk-based capital ratio as opposed to the leverage ratio, the vast majority (292) already hold more than enough capital to meet the new risk-based requirement. Only 21 of those 313 credit unions currently have an estimated risk-based capital ratio below 10 percent.¹⁷²

Figure 26: Distribution of Risk Assets to Total Assets Ratios for Complex Credit Unions by Governing Capital Requirement



Source: Dec. 31, 2014, Call Report data

¹⁷¹ Calculated based on a positive result to the following formula: [(risk-weighted assets times 10 percent) - allowance for loan losses – equity acquired in merger – total adjusted retained earnings acquired through business combinations + NCUA share insurance capitalization deposit + goodwill + identifiable intangible assets] – (total assets x 7 percent).

¹⁷² Also, given the new treatment of non-significant equity exposures, which could not be estimated due to existing data limitations, this impact may be further reduced.

All but 21 of the 313 complex credit unions with the risk-based capital ratio as the binding constraint have more than sufficient capital to meet the requirement. However, as shown in Figure 26, the 313 risk-based capital bound complex credit unions have a notably higher risk profile than the remaining 1,176 complex credit unions bound by the net worth ratio. In addition, despite a higher risk profile, the risk-based capital bound group of 313 complex credit unions also have on average 100 basis points less in net worth relative to assets. Thus, the final rule's risk-based requirement will be more meaningful in that it will be more relevant to more credit unions than the current risk-based requirement.

2. Estimated Impact of the Final Rule on Credit Unions' "Excess" Capital

In general, most credit unions hold capital well above the well-capitalized threshold for the net worth ratio. Tables 21 and 22 include a distribution of complex credit unions by net worth ratio levels.

Table 21: Number of Complex Credit Unions by Net Worth Ratio

Net Worth Ratio	2006	2007	2008	2009	2010	2011	2012	2013	2014
Less than 6%	3	5	10	42	35	16	11	7	5
6% to 7%	8	7	32	63	44	35	17	9	9
7% to 8%	39	42	109	188	162	152	138	103	83
8% to 9%	123	109	185	248	243	256	269	234	211
9% to 10%	193	197	213	244	289	299	293	305	300
10% to 11%	205	217	212	192	192	213	231	257	274
Greater than 11%	628	642	522	388	404	430	478	540	604
Total	1,199	1,219	1,283	1,365	1,369	1,401	1,437	1,455	1,489

Source: NCUA Call Report data

Table 22: Percentage Distribution of Total Assets of Complex Credit Unions by Net Worth Ratio

Net Worth Ratio	2006	2007	2008	2009	2010	2011	2012	2013	2014
Less than 6%	0.1%	0.2%	1.4%	2.6%	2.6%	0.5%	0.4%	0.3%	0.2%
6% to 7%	0.8%	1.0%	5.9%	7.5%	1.6%	2.5%	0.5%	0.2%	0.2%
7% to 8%	4.9%	5.8%	10.9%	13.6%	15.3%	12.6%	9.1%	6.8%	5.2%
8% to 9%	12.5%	12.4%	15.7%	19.2%	18.5%	16.7%	19.1%	12.5%	11.1%
9% to 10%	18.2%	21.6%	23.2%	24.8%	28.1%	24.5%	21.1%	22.9%	18.3%
10% to 11%	16.3%	18.2%	15.3%	12.3%	12.3%	20.4%	23.9%	19.0%	19.8%
Greater than 11%	47.1%	40.8%	27.6%	20.0%	21.6%	22.8%	25.8%	38.3%	45.2%
Total Assets (in billions)	\$582.4	\$628.0	\$686.3	\$760.1	\$790.2	\$839.4	\$901.7	\$945.4	\$1,011

Source: NCUA Call Report data

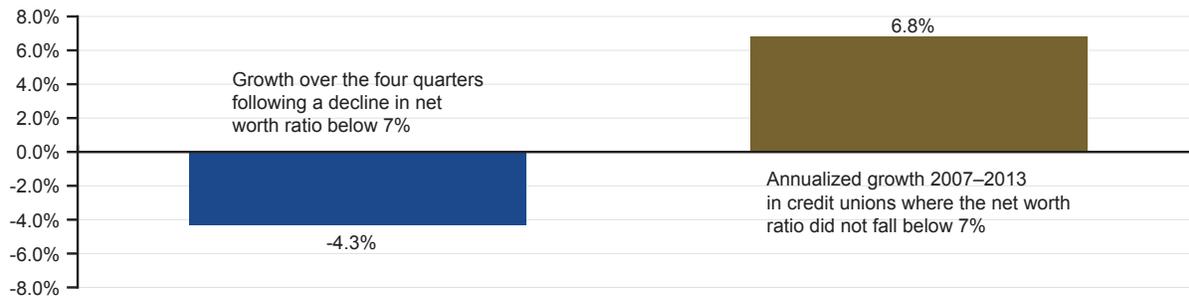
Many credit unions hold additional capital as a buffer against an unexpected adverse shock that might drive their net worth ratios below the well-capitalized level. Because credit unions primarily generate capital through retained earnings, there is an added incentive to hold higher levels of capital. However, many banks also hold capital in excess of well-capitalized thresholds despite having the ability to raise capital outside of retained earnings. Higher capital levels are maintained—despite the associated cost of capital—on a strategic basis.

Tables 21 and 22 above also reveal not all credit unions hold large capital surpluses. At year-end 2014, 6.5 percent of all credit unions greater than \$100 million in assets exhibited net worth ratios below 8 percent. These credit unions were either already below the 7 percent threshold or were only slightly above, so that they were vulnerable to falling below the well-capitalized level with only a modest shock to their income. Credit unions with more than \$100 million in assets and a net worth ratio of less than 8 percent accounted for more than 5.5 percent all credit union assets held at credit unions with at least \$100 million—roughly \$57 billion—as of year-end 2014. Despite their relatively small number, in a period of financial stress, potential failures at these credit unions pose a risk to the Share Insurance Fund.

Recent evidence suggests that credit unions that fall below the 7 percent well-capitalized standard tend to contract their asset base. As shown in Figure 27, assets declined over the year following the quarter in which a credit union fell below the 7 percent standard during 2007–2013. In contrast, annualized asset growth over the same period at credit unions that have not

fallen below the 7 percent standard is almost 7 percent.

Figure 27: Growth in Assets at Complex Credit Unions by Net Worth Ratio



Source: NCUA Call Report data

As shown in Table 23, there are 1,025 complex credit unions operating with a 500 basis point or greater margin above the 10 percent risk-based ratio threshold to be well capitalized. This is two-and-a-half times greater than the 395 covered credit unions operating 500 basis points above the 7 percent net worth ratio threshold to be well capitalized.

Table 23: Distribution of Credit Unions by Net Worth and Risk-Based Capital Ratios

Net Worth RBC Ratio	Less than Well Capitalized	Well Capitalized to Well Capitalized Plus 2 Percentage Points	Well Capitalized Plus 2 to 3.5 Percentage Points	Well Capitalized Plus 3.5 to 5 Percentage Points	Greater than Well Capitalized Plus 5 or More Percentage Points
	Less than 7% Less than 10%	7%–9% 10%–12%	9%–10.5% 12%–13.5%	10.5%–12% 13.5%–15%	Greater than 12% Greater than 15%
Net Worth Ratio	14	297	449	334	395
Final RBC Ratio	23	107	140	194	1,025

Source: Dec. 31, 2014, Call Report data

In fact, there are only 105 (about 7 percent) complex credit unions that have a lower surplus for their actual net worth ratio compared to the 7 percent requirement for the net worth ratio than for their risk-based capital ratio compared to the 10 percent requirement for the risk-based capital

ratio.¹⁷³ These 105 complex credit unions experience a modest average reduction in their surplus of less than 100 basis points.¹⁷⁴

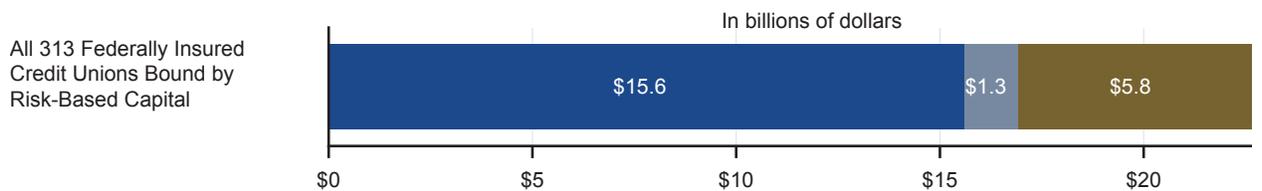
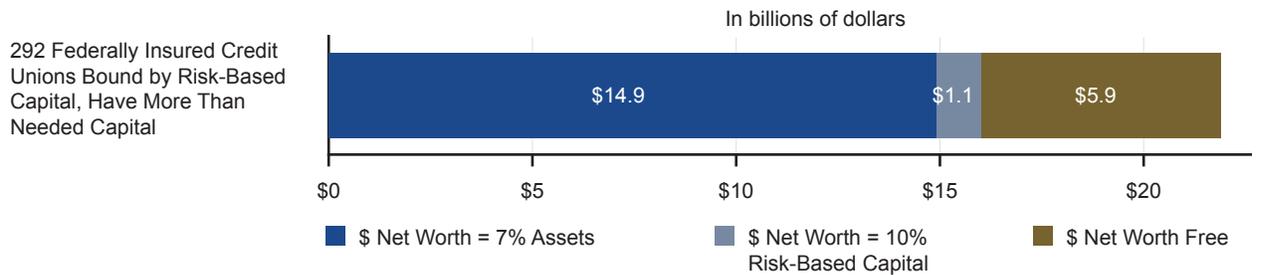
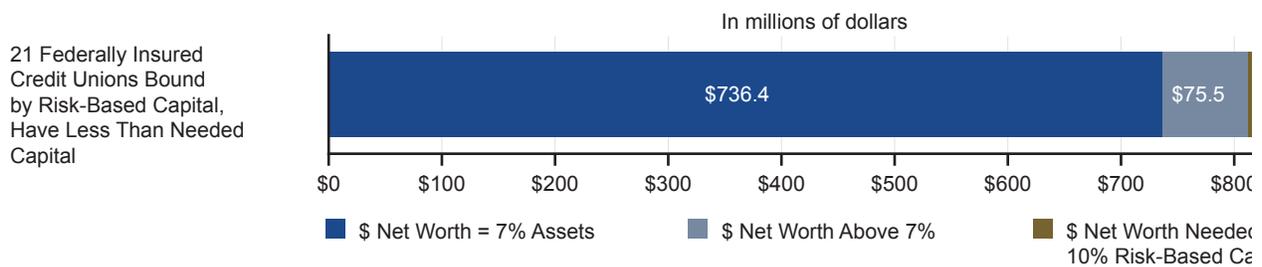
In terms of dollars of capital, the net worth ratio is the binding constraint for eight out of ten (1,176) complex credit unions. Thus, the risk-based capital requirement does not alter the excess capital maintained by these complex credit unions. Figure 28 below shows how the final rule affects the excess capital levels in dollars for the 313 complex credit unions with the risk-based capital ratio as the binding constraint.

¹⁷³ This measure compared the basis points the credit union's net worth ratio is above the 7 percent requirement for well capitalized to the basis points the credit union's projected risk-based capital ratio is above the 10 percent requirement for well capitalized.

¹⁷⁴ Assuming no adjustment to their risk profiles, an estimated aggregate of \$483.7 million in additional qualifying risk-based capital would be necessary to achieve the same level of surplus as these 105 credit unions have over the net worth ratio.

Figure 28: Summary of Complex Credit Unions Bound by Net Worth and Risk-Based Capital Ratios

	Number of Federally Insured Credit Unions	Less Than 7% Net Worth Ratio	Less Than 10% Risk-Based Capital	Net Prompt Corrective Action Change Due to Risk-Based Capital
Risk-Based Capital Bound	313	5	21	16
Net Worth Ratio Bound	1,176	9	2	0
Total	1,489	14	23	16



Out of the 313 RBC ratio bound complex credit unions, 21 have risk-based capital ratios less than 10 percent. These 21 complex credit unions in aggregate have excess capital of \$75.5 million above the 7 percent net worth ratio requirement. However, they are deficient by an aggregate of \$84 million in meeting the risk-based capital requirement of 10 percent assuming no

changes to their current risk profile.¹⁷⁵

For the remaining 292 of the 313 complex credit unions in which the risk-based capital ratio is the governing ratio, the risk-based capital ratio results in a higher level of regulatory capital in aggregate of about \$1.1 billion than what is required by the 7 percent net worth ratio requirement, assuming no changes to their current risk profile. However, these 292 complex credit unions already have \$5.9 billion more than the minimum level of capital required by the 10 percent risk-based requirement.

Thus, the amount of existing excess capital constrained by the final rule is less than 20 percent of the existing excess for the 313 bound by the risk-based capital ratio, and less than 4.3 percent of the excess capital of all complex credit unions.

Another measure of the rule's impact included evaluating how much asset growth could occur in complex credit unions, assuming the current composition of assets, with no increase in the amount of capital needed to be well capitalized. Under the current net worth requirement, complex credit unions could sustain asset growth of \$542 billion, or 55 percent of complex credit union's combined total assets, before total capital would be less than needed to be well capitalized. Under the final rule, complex credit unions could sustain asset growth of \$523 billion, or 53 percent of complex credit union's combined total assets, before total capital would be less than needed to be well capitalized. Thus, the final rule has very little impact on the growth capacity of complex credit unions in total.

3. Estimated Impact of the Final Rule on Credit Union Lending

a. How Changes in Capital Surpluses and Deficiencies under the Final Rule Could Affect Lending

Estimating the impact of the final rule on lending is subject to a fair degree of uncertainty. In general, such analysis depends upon a number of factors, many of which involve either forecasts

¹⁷⁵ Of the 21 complex credit unions bound by risk-based capital and with risk-based capital ratios less than 10 percent, five have a net worth ratio less than 7 percent. These five are already operating short of the regulatory minimum to be well capitalized by a total of \$15 million. That leaves the 16 credit unions driven by the risk-based capital ratio that have a net worth ratio in excess of 7 percent. These 16 credit unions need an additional \$67 million to be well capitalized, assuming they take no action to reduce the level of risk-weighted assets.

of future activity, or projecting changes in behavior as a result of the rule. Either is speculative and answers that rely on a complicated chain of analyses may introduce unwanted “hidden” assumptions that may color the final results.

For the vast majority of credit unions, their risk-adjusted measure of capital indicates they are extraordinarily well capitalized relative to their risk profiles. A more intuitive and credible risk-based capital ratio than the current risk-based requirement could lead to more lending in very well capitalized, but to date unduly cautious institutions.¹⁷⁶

In terms of complex credit unions identified under the final rule as less than well capitalized, NCUA conservatively measures the impact of the final rule on credit union lending by taking the \$67 million in additional capital needed for the 16 downgraded credit unions to be well capitalized and multiplying that number by the overall system ratio of loans to net worth—which is 5.789. This measurement estimates that the 16 downgraded credit unions could react by reducing their loan levels by about \$380 million, which is less than 0.05 percent of outstanding loans in the credit union system.

Of the remaining credit unions with the risk-based capital ratio as the governing constraint, their surplus capital is so far above (\$5.9 billion) the risk-based capital requirement. It would take more than an 84 percent drop in existing excess capital levels, or commensurate increase in growth and risk profile, for there to be any impact on lending—a highly unlikely scenario that would no doubt represent a safety and soundness concern if it did occur.¹⁷⁷

In regard to the impact on lending, NCUA took note that many of the concerns raised by credit union commenters were consistent with the concerns raised by banks to the other banking agencies when they revised the capital requirements for banks. The concerns raised by banks were addressed in the preamble to the other banking agencies’ final rule.

The concerns raised by community banks specifically addressed their lower level of access

¹⁷⁶ The current requirement is calculated where a low ratio is an indicator of financial strength, which is counter-intuitive and difficult to relate to in terms of magnitude of any surplus. All other U.S. and international systems, and the risk-based capital ratio under NCUA’s final rule, have a high ratio as an indicator of financial strength.

¹⁷⁷ Even if the 292 credit unions where the risk-based capital ratio results in a higher level of regulatory capital of about \$1.1 billion somehow approached the point where they had to reduce lending because of the risk-based capital requirement, the reduction in loans is estimated at only 0.90 percent of total outstanding loans in the credit union system.

to capital markets relative to larger banking organizations and the fact that they could only increase capital by accumulating retained earnings. These commenters cited the same potential consequences of the higher capital requirements, including:

- Reduced or higher cost lending,
- Limited products,
- Reduced investor demand for bank equity,
- Higher compliance cost, increased merger activity, and
- An uneven playing field between banking organizations and other financial service providers, including credit unions.

While the new capital regulation did not become effective until January 2015, Table 24 which shows the financial performance and lending activity of community banks, and particularly banks between \$100 million and \$10 billion in assets, indicates no reduction in lending or other noteworthy performance consequences.

Table 24: Bank Loan Trends

	Banks \$100 Million to \$1 Billion			Banks \$1 Billion to \$10 Billion		
	2012	2013	2014	2012	2013	2014
Return on Assets	0.81	0.92	1.00	1.14	1.18	1.08
Return on Equity	7.47	8.44	9.08	9.68	9.89	9.12
Noninterest Expense to Assets	3.18	3.19	3.16	3.06	3.16	3.00
Tier 1 Risk-Based Capital Ratio	15.57	15.73	15.75	15.23	14.88	14.36
Total Risk-Based Capital Ratio	16.76	16.91	16.89	16.49	16.06	15.45
Leverage Ratio	10.33	10.63	10.80	10.43	10.61	10.63
Net Loans to Total Assets	61.27	62.67	64.12	62.16	64.38	66.77
Institutions Absorbed by Mergers	108	130	162	16	20	22

Source: FDIC Quarterly Banking Profile, pg. 7 (Dec. 2012, 2013, & 2014).

b. How Differences in Risk Weights between the Current Risk-Based Requirement and the Final Risk-Based Capital Rule Could Affect Lending

Table 25 compares the risk weights for loans in the current risk-based measure to those in the final rule. Overall the risk weights on loans did not change substantially, except in loan products that contain higher levels of credit risk. The final rule's risk weights are lower than the current rule for share-secured loans, government-guaranteed loans, portions of commercial loans backed by contractual compensating balances, and first-lien residential real estate loans.¹⁷⁸ Secured consumer loans receive a marginally higher risk weight. Non-current loans, unsecured consumer loans, and lower concentrations of commercial loans receive higher risk weights than under the current rule.¹⁷⁹

While the final rule is better calibrated than the current rule to recognize the varying credit risk associated with types of loans, the changes in risk weights are not significant enough to result in a need for credit unions to revise their loan product offerings to members.

Table 25: Loan Risk-weight Comparisons

Loan Type	Current Rule***	Final Rule
Share Secured (Shares on Deposit at the Credit Union)	60%	0%
Share Secured (Shares on Deposit at Another Financial Institution)	60%	20%
Government-Guaranteed Portion	60%	20%
Current Secured Consumer	60%	75%
Current Unsecured Consumer	60%	100%
Current Non-Federally Insured Student	60%	100%
Non-Current Consumer	60%	150%
Current First-Lien Residential Real Estate Less than 25 Percent of Assets*	60% to 140%	50%
Current First-Lien Residential Real Estate 25 to 35 Percent of Assets*	140%	50%
Current First-Lien Residential Real Estate Greater than 35 Percent of Assets*	140%	75%
Non-Current First-Lien Residential Real Estate*	60% to 140%	100%

¹⁷⁸ Because the current rule groups first- and junior-lien residential real estate together, both first- and junior-lien residential real estate loans in total are likely to receive a lower overall risk weighting under the final rule as compared to the current rule.

¹⁷⁹ Except for one- to four-family non-owner occupied real estate defined as a member business loan but not a commercial loan, which will receive a lower risk weight of 50 percent.

Loan Type	Current Rule***	Final Rule
Current Junior-Lien Real Estate Less than 20 Percent of Assets*	60% to 140%	100%
Current Junior-Lien Real Estate 20 to 25 Percent of Assets*	60% to 140%	150%
Current Junior-Lien Real Estate Greater than 25 Percent of Assets*	140%	150%
Non-Current Junior-Lien Real Estate*	60% to 140%	150%
Current Commercial Less than 15 Percent of Assets**	60%	100%
Current Commercial 15 to 25 Percent of Assets**	80%	100%
Current Commercial 25 to 50 Percent of Assets**	140%	100%
Current Commercial Greater than 50 of Assets**	140%	150%
Non-Current Commercial**	60% to 140%	150%
Commercial Loan Compensating Balance**	60% to 140%	20%

* The current rule combines all real estate loans defined as long term and applies an inferred risk weight of 60 percent for concentrations below 25 percent of assets and 140 percent if over 25 percent of assets. Real estate not defined as "long term" receives an inferred 60 percent risk weight. The final rule separates first- and junior-lien real estate, current from non-current, and does not separate long-term real estate from other real estate. The final rule includes concentration thresholds of 35 percent and 20 percent for first and junior liens, respectively.

** The current rule applies an inferred risk weight of 60 percent to total member business loans less than 15 percent of assets, an inferred risk weight of 80 percent to total member business loans between 15 percent and 25 percent of assets, and an inferred rate of 140 percent for total member business loans over 25 percent of assets. The final rule separates contractual compensating balances and current from non-current. The final rule includes a concentration thresholds of 50 percent. Also, there are slight variations in the definitions between member business loan in the current rule and commercial loan in the final rule.

*** For comparison purposes, the inferred risk weights are calculated by dividing the current rule's capital charge by the 10 percent threshold in the final rule.

c. How Variances in Risk Weights between NCUA and the Other Banking Agencies Could Affect Lending

The vast majority of loan products offered by credit unions will receive virtually identical risk-based capital treatment under NCUA's final rule relative to that of the other banking agencies. There are only four types of loans with noteworthy variances, as follows:

i. Current Secured Consumer Loans

NCUA assigns a risk weight of 75 percent for current secured consumer loans, which varies from the other banking agencies' risk weight of 100 percent, to reflect credit unions' lower losses from these loan types. The 75 percent risk weight is, however, consistent with Basel's treatment of retail credits.¹⁸⁰

¹⁸⁰ See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, pt. II, sec. 7, para. 69 (June 2006).

As of December 31, 2014, for complex credit unions holding secured consumer loans, the average percentage to total assets is 25.65 percent. Unlike with unsecured consumer loans, all complex credit unions report secured consumer loans that total \$238.7 billion in aggregate. A majority of complex credit unions hold between 5 and 35 percent of their assets in secured consumer loans. Additionally, multiple credit unions have more than 50 percent of assets in secured consumer loans.

Given the lower risk weight assigned by NCUA, there may be some incentive for credit unions to place more emphasis on secured consumer lending than banks. If so, then consumers would likely experience some benefit from the increased access to credit.

ii. First-Lien Residential Real Estate Loans

As noted earlier, concentration risk is a material risk addressed in NCUA's risk weights framework but not in that of the other banking agencies. Based on December 31, 2014, Call Report data, NCUA estimates that the additional capital required for concentration risk would affect a small subset of credit unions as shown in Table 26.

Table 26: Impact of Concentration Thresholds on Complex Credit Union

Concentration Threshold	Number of Complex Credit Unions	Percent of 1,489 Complex Credit Unions
First-Lien Residential Real Estate (Above 35% of Total Assets)	135	9.1%
Junior-Lien Residential Real Estate (Above 20% of Total Assets)	57	3.8%
Commercial Loans* (Above 50% of Total Assets)	12	0.8%

* The calculation of commercial loan impact uses member business loan data as a proxy for commercial business loan data as the current Call Report does not capture "commercial loan" data as defined in the final rule.

Source: Dec. 31, 2014, Call Report data

A single concentration risk threshold for first-lien residential real estate loans of 35 percent of assets is higher than the concentration risk threshold in the current rule of 25 percent of assets. Also, the effective risk weights are lower under the final rule. Most credit unions will operate

at a level where the risk weight is identical to the other banking agencies' risk weight.¹⁸¹ As of December 31, 2014, there were 135 complex credit unions that held first-lien residential real estate loans in excess of 35 percent of assets.¹⁸² This means that over 90 percent of credit unions with more than \$100 million in assets operate at levels below the concentration threshold for first-lien residential real estate. Additionally, only 1.19 percent of aggregate complex credit union assets will be subject to the higher risk weight for first-lien residential real estate loan concentrations. Combined with the fact the effective risk weights are lower under the final rule, the final rule is not expected to have a material effect on first-lien residential real estate lending.

iii. Junior-Lien Residential Real Estate Loans

As of December 31, 2014, there were 57 complex credit unions that held junior-lien residential real estate loans in excess of 20 percent of assets.¹⁸³ This means that just over 96 percent of credit unions with more than \$100 million in assets operate at levels below the concentration threshold for junior-lien residential real estate. Most credit unions will operate at a level where the risk weight is identical to the other banking agencies' risk weights.¹⁸⁴ Additionally, only 0.11 percent of complex credit union assets will be subject to the higher risk weight for junior-lien residential real estate loan concentrations. Thus, the final rule is not expected to have a material effect on first-lien residential real estate lending.

iv. Commercial Loans

As shown below, the 50 percent threshold and the risk weights of 100 percent and 150 percent for commercial loans result in nearly identical capital requirements, as compared to the current prompt corrective action rule, for high concentrations of commercial loans. For virtually all complex credit unions, this treatment is comparable to the other banking agencies' rules.¹⁸⁵ It also allows credit unions exempt from the statutory member business lending cap (with very high concentration levels) to continue to operate under effectively the same capital requirements of

¹⁸¹ FDIC risk weights current first-lien residential real estate at 50 percent

¹⁸² Given the difference in Call Report data and risk-based capital categorization, first mortgage loans less MBLs are most comparable to first-lien residential real estate loans, newly created in the final rule.

¹⁸³ Junior-lien residential real estate loans are include in the other real estate loan category on the Call Report.

¹⁸⁴ FDIC's risk weight for current junior-lien residential real estate is 100 percent.

¹⁸⁵ See 12 CFR 324.32(f).

the current rule. The effective capital rate of commercial loan concentrations for complex credit unions is summarized in Table 27.

Table 27: Effective Capital Rate of Commercial Loan Concentrations*

	Commercial Loan Concentration (Percent of Total Assets)				
	15%	20%	50%	75%	100%
Current Rule	6.0%	6.5%	10.4%	11.6%	12.2%
Final Rule	10.0%	10.0%	10.0%	11.7%	12.5%

* The effective capital rate represents the blended percentage of capital necessary for a given level of commercial loan concentration. The calculation uses 10 percent as the level of risk-based capital to be well capitalized under the final rule.

As of December 31, 2014, there were only 12 complex credit unions that held member business loans in excess of 50 percent of assets. Based on this data, just 0.81 percent of complex credit unions operate at levels above the concentration threshold for commercial loans. Additionally, only 0.13 percent of complex credit union assets will be subject to the higher risk weight for commercial loan concentrations. As intended, this will require certain individual credit unions with material concentrations to hold additional capital on a small portion of its assets, but will not impact the system as a whole either in number of institutions or assets at risk. Combined with the fact most credit unions operate under the statutory cap on member business lending, the final rule is not expected to have a significant effect on business lending in credit unions.

Section VI

Impact on Examinations

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. NCUA performs this 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 members' accounts at federally insured credit unions.¹⁸⁶

The introduction of the new risk-based capital ratio in place of the existing risk-based net worth requirement will not have any material impact on examinations. The risk-based capital ratio provides the examiner, the credit union, and stakeholders with a measure of a credit union's capital strength relative to its risk profile.

A complex credit union is already expected to have internal processes for assessing capital adequacy that reflect a full understanding of its risks and to ensure that it holds capital corresponding to those risks to maintain overall capital adequacy.¹⁸⁷ The nature of such capital adequacy assessments should be commensurate with the credit union's size, complexity, and risk-profile.

Consistent with longstanding NCUA practice, the 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 its financial condition. These include the level and severity of problem assets and its exposure to operational risk, interest rate risk, and significant asset concentrations. Guidance provided in the NCUA's Examiner's Guide, Letters to Credit Unions, and Supervisory Guidance has included statements requiring credit unions to operate with adequate levels of capital, including the following:

¹⁸⁶ Within the nine states that allow privately insured credit unions, approximately 129 state-chartered credit unions are privately insured and are not subject to NCUA regulation or oversight.

¹⁸⁷ The Basel framework incorporates similar requirements under Pillar 2.

- Chapter 16 of the NCUA Examiner Guide which covers net worth and other equity accounts with the examination objective to “determine the credit union has sufficient net worth for its degree of risk.”
- NCUA Letter to Credit Unions No. 161, December 1994, stating, “Credit unions which maintain a level of capital fully commensurate with their risk profiles and can absorb any present or anticipated losses are accorded a [CAMEL] rating of 1 for capital. Such credit unions generally maintain capital levels well in excess of NCUA regulatory requirements.”
- Supervisory Letter No 05-01, August 2005, Examiner Guidance – Evaluating Capital Adequacy, states “credit unions are expected to maintain capital commensurate with the nature and extent of current and potential risks to the institution and the ability of management to identify, measure, monitor, and control these risks.... A credit union must demonstrate that its process for determining capital adequacy is well supported, reasonable and amply sophisticated commensurate with its current and projected risk profile and operational environment.”
- NCUA Letter to Credit Unions No. 07-CU-12, December 2007, CAMEL Rating System, states, “A credit union is expected to maintain capital commensurate with the nature and extent of risk to the institution and the ability of management to identify, measure, monitor, and control these risks... A capital adequacy rating of 1 indicates sound capital relative to the credit union’s current and prospective risk profile.”

In addition to evaluating the appropriateness of a credit union’s capital level given its overall risk profile, the supervisory assessment takes into account the quality and trends in a credit union’s capital composition, whether the credit union is entering new activities or introducing new products. The assessment also considers whether a credit union is receiving special supervisory attention, has or is expected to have losses resulting in capital inadequacy, has significant exposure due to risks from nontraditional activities, or has significant exposure to interest rate risk or operational risk. For these reasons, NCUA’s supervisory assessment of capital adequacy may differ from conclusions that might be drawn solely from the calculation of a complex credit union’s regulatory capital ratios.

An effective capital planning process involves an assessment of the risks to which a credit union

is exposed and its processes for managing and mitigating those risks, an evaluation of its capital adequacy relative to its risks, and consideration of the potential impact on its earnings and capital base from current and prospective economic conditions. While elements of a supervisory review of capital adequacy would be similar across credit unions, evaluation of the level of sophistication of an individual credit union's capital adequacy process should be commensurate with the institution's size, sophistication, and risk profile, similar to the current supervisory practice. NCUA will develop and publish supervisory guidance for examiners on how to apply this provision.

Section VII

Legal Authority of the NCUA Board to Prescribe a Two-Tiered System

In 1998, Congress enacted the Credit Union Membership Access Act.¹⁸⁸ Section 301 of this law added a new section 216 to the Federal Credit Union Act.¹⁸⁹ This new section requires the NCUA Board to maintain, by regulation, a system of prompt corrective action to restore the net worth of credit unions that become inadequately capitalized.

Specifically, section 216(b)(1)(A) requires that NCUA's system of prompt corrective action for federally insured credit unions be "*consistent with*" section 216 of the Federal Credit Union Act, and "*comparable to*" section 38 of the Federal Deposit Insurance Act.¹⁹⁰ Section 216(b)(1)(B) also requires that the Board, in designing the prompt corrective action system, take into account credit unions' cooperative character: that credit unions are not-for-profit cooperatives that do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers.¹⁹¹

Section 216(d)(1) of the Federal Credit Union Act further requires that NCUA's system of prompt corrective action include, in addition to the statutorily defined net worth ratio requirement, "a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board"¹⁹² Unlike the terms "net worth" and "net worth ratio," which are specifically defined in section 216(o), the term "risk-based net worth" is not defined in the Federal Credit Union Act.¹⁹³

While Congress prescribed the net worth ratio requirement in detail in section 216, it elected not to define the term "risk-based net worth," leaving the details of the risk-based net worth

¹⁸⁸ See Public Law 105–219, 112 Stat. 913 (1998).

¹⁸⁹ See 12 U.S.C. 1790d.

¹⁹⁰ See 12 U.S.C. 1790d(b)(1)(A); see also 12 U.S.C. 1831o (section 38 of the Federal Deposit Insurance Act setting forth the prompt corrective action requirements for banks).

¹⁹¹ See 12 U.S.C. 1790d(b)(1)(B).

¹⁹² 12 U.S.C. 1790d(d)(1).

¹⁹³ See 12 U.S.C. 1790d(o) (Congress specifically defined the terms "net worth" and "net worth ratio" in the Federal Credit Union Act, but did not define the statutory term "risk-based net worth.>").

requirement to be filled in by the Board through the notice and comment rulemaking process. Accordingly, section 216, when read as a whole, grants the Board broad authority to design reasonable prompt corrective action regulations, including a risk-based net worth requirement, so long as the regulations are comparable to the other banking agencies' prompt corrective action requirements, are consistent with the requirements of section 216 of the Federal Credit Union Act, and take into account the cooperative character of credit unions.

In addition, section 216(d)(2) specifies that the risk-based net worth 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 [(six percent)] may not provide adequate protection.”¹⁹⁴ In the Senate Report on the Credit Union Membership Access Act, Congress expressed its intent with regard to the design of the risk-based net worth requirement and the meaning of section 216(d)(2) by providing:

*The NCUA must design the risk-based net worth requirement to take into account any material risks against which the 6 percent net worth ratio required for a credit union to be adequately capitalized may not provide adequate protection. Thus the NCUA should, 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 risk-based net worth requirement should reflect a reasoned judgment about the actual risks involved.*¹⁹⁵

As indicated by the language above, Congress intended the Board, in designing the risk-based net worth requirement, to address any risks that may not be adequately accounted for by the statutory 6 percent net worth ratio requirement. The legislative history is silent, however, on why Congress chose to tie the provision in section 216(d)(2) to the statutory 6 percent net worth ratio requirement for adequately capitalized credit unions and not the 7 percent net worth ratio requirement for well capitalized credit unions.

Section 216(c) of the Federal Credit Union Act provides that, if a credit union meets the definition of “complex” and it meets or exceeds the net worth ratio requirement to be classified as either adequately capitalized or well capitalized, the credit union must also satisfy the

¹⁹⁴ 12 U.S.C. 1790d(d)(2) (emphasis added).

¹⁹⁵ S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998).

corresponding risk-based net worth requirement to be classified as either adequately capitalized or well capitalized.¹⁹⁶ Accordingly, under the separate risk-based net worth requirement, a complex credit union must, in addition to meeting the statutory net worth ratio requirement, also meet or exceed the corresponding minimum risk-based net worth requirement in order to receive a capital classification of adequately capitalized or well capitalized, as the case may be.

During the risk-based capital rulemaking, some have questioned whether the Board has the legal authority to impose a risk-based net worth requirement on both well-capitalized and adequately capitalized credit unions. Section 216 of the Federal Credit Union Act, however, gives the Board clear legal authority to impose the risk-based net worth requirement on both “well capitalized” and “adequately capitalized” complex credit unions, and to prescribe different risk-based capital thresholds for each category. Section 216(c)(1)(A) specifically provides that, to be classified as well capitalized, a complex credit union must meet the statutory net worth ratio requirement and any applicable risk-based net worth requirement.

Sections 216(c)(1)(A)–(C) provide in relevant part:

(c) Net worth categories.

(1) In general. For purposes of this section the following definitions shall apply:

(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) of this section.*

(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*

¹⁹⁶ See 12 U.S.C. 1790d(c)(1)(A) & (c)(1)(B).

(ii) *it meets any applicable risk-based net worth requirement under subsection (d) of this section.*

(C) Undercapitalized. An insured credit union is “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) of this section.*¹⁹⁷

As stated in the italicized language above, sections 216(c)(1)(A)(ii) and (c)(1)(B)(ii), a credit union must meet *any* applicable risk-based net worth requirement under section 216(d) of this section to be classified as well capitalized or adequately capitalized. The plain language in these paragraphs, read in conjunction with the language in section 216(d), indicates Congress’s intent to authorize the Board to impose risk-based net worth requirements on both well capitalized and adequately capitalized credit unions.

Section 216(d)(2) of the Federal Credit Union Act sets forth specific requirements for the design of the risk-based net worth requirement mandated under section 216(d)(1).¹⁹⁸ Specifically, section 216(d)(2) requires that the Board “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.”¹⁹⁹ Under section 216(c)(1)(B) of the Federal Credit Union Act, the *net worth ratio* required for an insured credit union to be adequately capitalized is six percent.²⁰⁰ The plain language of section 216(d)(2) supports NCUA’s interpretation that Congress intended for the Board to design a risk-based net worth requirement to take into account any material risks that may not be addressed adequately through the statutory 6 percent *net worth ratio* required for a credit union to be adequately

¹⁹⁷ 12 U.S.C. 1790d(c)(1)(A)–(C) (emphasis added).

¹⁹⁸ See 12 U.S.C. 1790d(d).

¹⁹⁹ 12 U.S.C. 1790d(d)(2) (emphasis added).

²⁰⁰ See 12 U.S.C. 1790d(c)(1)(B).

capitalized.²⁰¹

In other words, the language in section 216(d)(2) of the Federal Credit Union Act simply identifies the types of risks that NCUA's risk-based net worth requirement should address (that is, those risks not already addressed by the statutory six percent net worth ratio requirement). It is a misinterpretation of section 216(d)(2) to argue, as some have, that Congress's use of the term "adequately capitalized" in section 216(d)(2) somehow limits the Board's authority to require that complex credit unions maintain a higher risk-based capital ratio level to be classified as well capitalized. Rather than prohibiting the Board from imposing a higher risk-based capital ratio level for credit unions to be classified as well capitalized, section 216(d)(2) simply requires that the Board design the risk-based net worth requirement to take into account those risks that may not adequately be addressed by the statute's six percent *net worth ratio* requirement. Thus, the plain language of section 216(d) does not support those interested parties' interpretation.

The Board's legal authority to impose a risk-based net worth requirement on both well-capitalized and adequately capitalized credit unions is further supported by the other banking agencies' prompt corrective action statute and regulations.²⁰² Some have argued that Congress's use of the singular noun "*requirement*" in section 216(d) of the Federal Credit Union Act indicates its intent that there be only one risk-based net worth ratio level tied to the adequately capitalized level. Section 38(c)(1)(A) of the Federal Deposit Insurance Act, upon which section 216 of the Federal Credit Union Act was modeled, however, requires that the other banking agencies' "relevant capital measures" include "(i) a leverage limit; and (ii) a risk-based capital requirement."^{203, 204} Despite Congress's use of the singular noun "requirement" in section 38 of the Federal Deposit Insurance Act, the other banking agencies' prompt corrective action regulations, which went into effect before Congress passed the Credit Union Membership Access Act, have long required that their regulated institutions meet different risk-based capital ratio levels to be classified as well capitalized, adequately capitalized, undercapitalized, or

²⁰¹ See S. Rep. No. 193, 105th Cong., 2d Sess. (1998) (providing in relevant part: "The NCUA must design the risk-based net worth requirement to take into account any material risks against which the 6 percent net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.").

²⁰² See 12 U.S.C. 1831o, and, e.g., 12 CFR 324.403(b).

²⁰³ See S. Rep. No. 193, 105th Cong., 2d Sess., 12 (1998) (Providing in relevant part: "New section 216 [of the Federal Credit Union Act] is modeled on section 38 of the Federal Deposit Insurance Act, which has applied to FDIC-insured depository institutions since 1992.").

²⁰⁴ 12 U.S.C. 1831o(c)(1)(A) (emphasis added).

significantly undercapitalized.

Moreover, the U.S. Code addresses the singular-plural question in its rules of statutory construction: “In determining the meaning of any Act of Congress, unless the context indicates otherwise... words importing the singular include and apply to several persons, parties, or things; words importing the plural include the singular”²⁰⁵ Therefore, setting different risk-based capital ratio thresholds for credit unions to be adequately and well capitalized is consistent with the requirements of section 216 of the Federal Credit Union Act and is “comparable” to the other banking agencies’ prompt corrective action regulations.

Because the issue of creating a two-tiered risk-based capital framework was so fundamental to the risk-based capital rulemaking, NCUA Board Chairman Debbie Matz also requested an independent legal opinion analyzing NCUA’s legal authority to create such a system. The Global Banking and Payment Systems practice of Paul Hastings LLP in Washington, D.C., was selected to perform this review.²⁰⁶

In its opinion, the Paul Hastings law firm notes the U.S. Supreme Court’s 1984 decision in *Chevron, U.S.A. v. NRDC, Inc.*, requires courts to apply a two-pronged test when deciding whether an agency has the authority to issue a particular rule.²⁰⁷ A court must first determine if Congress has “directly spoken to the precise question at issue.”²⁰⁸ If congressional intent is clear in addressing the question at issue, the court must “give effect to the unambiguously expressed intent of Congress.”²⁰⁹ If the court finds that Congress was silent or ambiguous on the agency’s authority, the agency’s regulations generally “will be given controlling weight unless [they are] arbitrary, capricious, or manifestly contrary to the statute.”²¹⁰

The law firm’s opinion also notes that section 216 of the Federal Credit Union Act “is, at best, ambiguous with respect to the statutory authority of the NCUA to implement a two-tier [risk-

²⁰⁵ 1 U.S.C. 1.

²⁰⁶ The legal opinion is available online at <http://www.ncua.gov/newsroom/Pages/NW20150120Opinion.aspx> and incorporated into Appendix D of this report.

²⁰⁷ *See* 467 U.S. 837 (1984).

²⁰⁸ *Id.* at 842.

²⁰⁹ *Id.* at 842-43.

²¹⁰ *Id.* at 844.

based net worth] requirement for complex credit unions, as the language can be interpreted in multiple ways”²¹¹ The section “does not prevent NCUA from imposing higher requirements on ‘well-capitalized’ credit unions to provide greater protection against [material] risks.”²¹² And the section does not show “congressional intent to preclude the NCUA from implementing different [risk-based net worth] requirements for different capital categories.”²¹³

Based on facts described in the opinion and an analysis of case law and section 216 of the Federal Credit Union Act, the Paul Hastings law firm found NCUA’s proposed rule “would withstand a court challenge alleging the agency’s approach is arbitrary, capricious, or manifestly contrary to the statutory language of Section 216” and 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 NCUA’s statutory authority permits the NCUA to establish the proposed two-tier RBNW requirement set forth in the Proposed Rule.”²¹⁴

In sum, the Paul Hastings law firm found the thresholds of 8 percent to be adequately capitalized and 10 percent to be well capitalized contained in the revised proposed rule are not arbitrary, capricious, or manifestly contrary to the statute. As such, NCUA adopted the two-tiered framework with the 8 and 10 percent thresholds in the risk-based capital final rule.

The Paul Hastings law firm’s full legal opinion supporting the legality of NCUA adopting a two-tiered risk-based capital structure is incorporated into Appendix D.

²¹¹ *Paul Hastings Legal Op.*, dated Dec. 30, 2014, p. 6.

²¹² *Id.*

²¹³ *Id.* at p. 7.

²¹⁴ *Id.* at pp. 11-12.

Section VIII

Legislative Recommendations

As reported by the House Financial Services Committee, H.R. 2769 contains language directing NCUA to provide the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee with any legislative recommendations to improve the capital system for credit unions or establish a risk-based capital system for credit unions. In this regard, NCUA recommends that Congress amend the Federal Credit Union Act to permit credit unions without the low-income designation to count supplemental capital as net worth. NCUA also recommends several technical changes related to prompt corrective action standards for federally insured credit unions.

1. Supplemental Capital

While supplemental capital may only be used by low-income credit unions for purposes of determining net worth and calculating the net worth ratio, current law allows all types of credit unions—both those with the low-income designation and those without it—to include supplemental capital in the risk-based capital numerator.^{215, 216} As part of modernizing NCUA's risk-based capital rule, the NCUA Board was unanimous in its commitment to move forward with a separate rulemaking to allow supplemental capital to be counted toward the risk-based capital ratio. The effective date of this proposed change would coincide with implementation of NCUA's modernized risk-based capital rule scheduled for January 1, 2019.

Nevertheless, commenters during the risk-based capital rulemaking noted the differential treatment for supplemental capital for low-income credit unions and non-low-income credit unions. They also generally acknowledged that counting supplemental capital as part of a credit union's net worth requirement (for all but low-income credit unions) would require an authorizing amendment to the Federal Credit Union Act. NCUA agrees and recommends that Congress consider legislation to allow healthy and well-managed credit unions to issue

²¹⁵ See 12 U.S.C. 1757a(c)(2). Under the Federal Credit Union Act, federally insured credit unions generally may only count retained earnings, as determined under GAAP, for purposes of determining net worth. However, a credit union that serves predominantly low-income members, as defined by the NCUA Board, may include secondary capital that is uninsured and subordinated to all other claims against the credit union, including the claims of creditors, shareholders, and the Share Insurance Fund within the calculation of net worth.

²¹⁶ See *Appendix B: Supplemental Capital* of this report for additional information about supplemental and secondary capital.

supplemental capital that will count as net worth.

To allow more credit unions to access supplemental capital, NCUA supports H.R. 989, the Capital Access for Small Businesses and Jobs Act. Reintroduced by Congressmen Peter King and Brad Sherman in the 114th Congress, this bipartisan bill would allow healthy and well-managed credit unions to issue supplemental capital that will count as net worth. This legislation would result in a new layer of capital, in addition to retained earnings, to absorb losses at credit unions.

The high-quality capital that underpins the credit union system is a bulwark of its strength and key to its resiliency during the recent financial crisis. However, most federal credit unions only have one way to raise capital—through retained earnings, which can grow only as quickly as earnings. Thus, fast-growing, financially strong, well-capitalized credit unions may be discouraged from allowing healthy growth out of concern it will dilute their net worth ratios and trigger mandatory prompt corrective action-related supervisory actions.

A credit union's inability to raise capital outside of retained earnings limits its ability to grow its field of membership and to offer greater options to eligible consumers. Consequently, NCUA has previously supported efforts and will continue to encourage Congress to authorize healthy and well-managed credit unions to issue supplemental capital that will count as net worth under conditions determined by the NCUA Board. Enactment of H.R. 989 would lead to a stronger capital base for credit unions and greater protection for taxpayers.

2. Changes to Prompt Corrective Action Standards Requiring Legislation

As outlined in Appendix E, NCUA also seeks several technical changes to section 1790d of the Federal Credit Union Act to improve the operation of the system of prompt corrective action for federally insured credit unions.

The first technical change to the Federal Credit Union Act would replace the earnings retention requirement for adequately capitalized credit unions in section 1790d(e) with the authority of the NCUA Board to require a net worth restoration plan if the situation so warrants.²¹⁷ The earnings retention requirement of 0.4 percent in the statute is arbitrary and impractical. Most declines in a

²¹⁷ Federally insured banks that are adequately capitalized are not subject to an earnings retention requirement.

credit union's net worth ratio that result in it being adequately capitalized occur due to financial problems resulting in a net operating loss for the institution.

In following GAAP, credit unions must recognize losses properly, often making it unfeasible in the recognition year to achieve a 0.4 percent increase to net worth through retained earnings. Thus, NCUA must routinely waive the earnings retention requirement. A discretionary net worth restoration plan requirement would allow NCUA to forgo action on adequately capitalized credit unions that do not need supervisory intervention, while allowing for a supervisory intervention tailored specifically to the credit union's circumstances if such intervention is warranted.

An additional change to section 1790d(i) of the Federal Credit Union Act would make it clear that "other corrective action" is not an action the NCUA Board itself undertakes, but an action NCUA orders a critically undercapitalized credit union to take. Also, it would make clear that the Board determined the appropriate prompt corrective action and not the credit union.

Finally, NCUA recommends that Congress replace "calendar quarter" with "90 calendar days" within section 1790d(i). The calendar quarter reference potentially delays measurement and subsequent action until a calendar quarter has lapsed. This would apply to situations where the 18 months after the date on which the credit union first became critically undercapitalized ends a month into a calendar quarter, which adds an additional two months to the timeframe upon which measurements and subsequent action would occur.

Draft legislative language to effectuate the recommendations related to supplemental capital is available in Appendix E of this report. NCUA stands ready to assist the House Financial Services Committee in advancing these recommended legislative changes.

Section IX

Conclusion

The risk-based capital final rule incorporates a more modern approach to calculating the risk-based capital ratio, allowing for better comparability amongst all federally insured financial institutions. It also will help ensure that credit unions maintain sufficient capital to continue functioning as financial intermediaries during times of stress without government intervention or assistance.

In moving forward with a final rule on risk-based capital, the NCUA Board was complying with the Federal Credit Union Act which requires NCUA's risk-based capital standards to be comparable with the other banking agencies.²¹⁸ The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued new risk-based capital rules in 2013.²¹⁹ So, to be comparable, NCUA needed to update its risk-based capital rule for federally insured credit unions, as well.

The final rule also meets Congress's express purpose of prompt corrective action "...to resolve the problems of insured credit unions at the least possible long-term cost to the [Share Insurance] Fund," by establishing a risk-based capital requirement which will reduce the likelihood that a credit union will become undercapitalized and eventually fail at a cost to the Share Insurance Fund.²²⁰

In addition, both the Government Accountability Office and NCUA's Inspector General found that the existing NCUA rule on risk-based net worth failed to prevent credit union losses as a result of the financial crisis. GAO concluded that NCUA should propose "additional triggers for Prompt Corrective Action that would require early and forceful regulatory action."²²¹ The Inspector General noted that NCUA needs a prompt corrective action framework that will

²¹⁸ See 12 U.S.C. 1790d(b)(1)(A); see also 12 U.S.C. 1831o (section 38 of the Federal Deposit Insurance Act setting forth the prompt corrective action requirements for banks).

²¹⁹ See 78 FR 62017 (Oct. 11, 2013) (for the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System); and 78 FR 55339 (Sept. 10, 2013) (for the Federal Deposit Insurance Corporation).

²²⁰ See 12 U.S.C. 1790d(a)(1).

²²¹ U.S. Gov't Accountability Office, *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO-12-247 (2012), available at <http://www.gao.gov/products/GAO-12-247>.

identify increasing risks on a timely basis, before losses occur.²²²

However, even if NCUA were not compelled to do so by law, or by GAO, or by the Inspector General, there was another compelling reason to finalize the rule: It will protect the entire credit union system. Requiring those credit unions that are high-risk outliers to hold sufficient capital to offset their risks will minimize losses within the credit union system.

During the rulemaking process, NCUA made appropriate efforts to target the impacts and reduce the burdens of the risk-based capital final rule. The final rule exempts 76 percent of credit unions, those with less than \$100 million in assets.²²³ And the final rule only targets outlier credit unions with insufficient capital relative to their risk. Of the 1,489 complex credit unions covered by the final rule, only 313 will have the risk-based capital ratio as the binding constraint.

Moreover, there are only 23 complex credit unions that fall below the final rule's risk-based capital threshold of 10 percent to be well capitalized.²²⁴ Seven of these 23 credit unions have a net worth ratio of less than 7 percent and are already classified as less than well capitalized under prompt corrective action. This leaves a net of 16 complex credit unions that would be subject to a decrease in their prompt corrective action classification based on December 31, 2014, Call Report data. Thus, approximately 98.5 percent of all complex credit unions will remain well capitalized.

The 16 complex credit union outliers with insufficient capital under the risk-based requirement have total assets of \$9.8 billion and a capital shortfall of approximately \$67 million. While they are a relatively small subset of the number of credit unions, their total assets are a material risk to the Share Insurance Fund, which has approximately \$12 billion in assets.

Sound capital levels are vital to the long-term health of all financial institutions. Credit unions are already expected to incorporate into their business models and strategic plans provisions for maintaining prudent levels of capital. The final rule ensures minimum regulatory capital levels for complex credit unions will be more accurately correlated to risk.

²²² Material Loss Review of Telesis Community Credit Union (OIG-13-05), March 2013, available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>

²²³ The data cited in this paragraph is as of Dec. 31, 2014.

²²⁴ The data in this paragraph is as of Dec. 31, 2014.

Consistent with NCUA's legal authority to create a two-tiered risk-based capital system, the final rule achieves a reasonable balance between requiring credit unions posing an elevated risk to hold more capital, while not overburdening lower-risk credit unions. Improved capital standards will provide more protection to the Share Insurance Fund which should reduce the cost of future failures and protect taxpayers from losses.

Appendix A

Benefits of an Effective Risk-Based Capital Requirement

1. Role and Benefits of Capital for Financial Institutions

Capital is the buffer that depository institutions, including credit unions, use to prevent institutional failure or dramatic deleveraging during times of stress. As evidenced by the 2007–2009 recession, during a financial crisis a buffer can mean the difference between the survival or failure of a financial institution.

Financial crises are very costly, both to the economy in general and to individual depository institutions.²²⁵ While the onset of a financial crisis is inherently unpredictable, a review of the historical record over a range of countries and recent time periods has suggested that a significant crisis involving depository institutions occurs about once every 20 to 25 years, and it has a typical cumulative discounted cost in terms of lost aggregate output relative to the pre-crisis trend of about 60 percent of precrisis annual output.²²⁶ In other words, the typical crisis results in losses over time, relative to the precrisis trend economic growth, that amount to more than half of the economy's output before the onset of the crisis.

The 2007–2009 financial crisis and the associated economic dislocations during the Great Recession were particularly costly to the United States in terms of lost output and jobs. Real gross domestic product declined more than four percent, almost nine million jobs were lost,

²²⁵ Credit unions play a sizable role in the U.S. depository system. Assets in the credit union system amount to more than \$1.1 trillion, roughly 8 percent of U.S. chartered depository institution assets. (Source: NCUA Calculation using the financial accounts of the United States, Federal Reserve Statistical Release Z.1, Table L.110, Sept. 18, 2014). Data from the Federal Reserve indicate that credit unions account for about 12 percent of private consumer installment lending. (Source: NCUA calculations using data from the Federal Reserve Statistical Release G.19, Consumer Credit, Sept. 2014. Total consumer credit outstanding (not mortgages) was \$3,246.8 billion of which \$826.2 billion was held by the federal government and \$293.1 billion was held by credit unions. The 12 percent figure is the \$293.1 billion divided by the total outstanding less the federal government total). Just over a third of households have some financial affiliation with a credit union. (Source: NCUA calculations using data from the Federal Reserve 2013 survey of Consumer Finance.) All Federal Reserve Statistical Releases are available at <http://www.federalreserve.gov/econresdata/statisticsdata.htm>.

²²⁶ See Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* 3-4 (Aug. 2010), available at <http://www.bis.org/publ/bcbs173.pdf>. These losses do not explicitly account for government interventions that ameliorated the observed economic impact. This is the median loss estimate.

and the unemployment rate rose to 10 percent.²²⁷ The cited figures are just the direct losses. Compared to where the economy would have been had it followed the pre-crisis trend, the losses in terms of GDP and jobs would be higher. For example, using the results described in the previous paragraph as a guide, the cumulative loss of output from the 2007–2009 financial crisis is roughly \$10 trillion in 2014 dollars.²²⁸ Other estimates of the total loss, derived using approaches different than described in the previous paragraph, are similar. For example, researchers at the Federal Reserve Bank of Dallas, using a different approach that achieved results within the same range, estimated a range of loss of \$6 trillion to \$14 trillion due to the crisis.²²⁹

Research using bank data across several countries and time periods indicates that higher levels of capital insulate financial institutions from the effects of unexpected adverse developments in their asset portfolio or their deposit liabilities.²³⁰ For the financial system as a whole, research on the banking sector has shown that higher levels of capital can reduce the probability of a systemic crisis.²³¹ By reducing the probability of a systemic financial crisis and insulating individual financial institutions from failure, higher capital requirements confer very large

²²⁷ The National Bureau of Economic Research Business Cycle Dating Committee defines the beginning date of the recession as Dec. 2007 (2007, Fourth Quarter) and the ending date of the recession as June 2009 (2009, Second Quarter). See the National Bureau of Economic Research website: <http://www.nber.org/cycles/cyclesmain.html>. The real GDP decline was calculated by NCUA using data for the fourth quarter of 2007 and the second quarter of 2009 from the National Income and Product Accounts, Bureau of Economic Analysis, U.S. Dep't of Commerce; see Table 1.1.3. Data are available at <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1>. Data accessed Nov. 11, 2014. The jobs lost figure was calculated by NCUA using data from the Bureau of Labor Statistics, U.S. Dep't of Labor, Current Employment Statistics, CES Peak-Trough Tables. The statistic cited is the decline in total nonfarm employees from Dec. 2007 through Feb. 2010, which the bureau defines as the trough of the employment series. Data available at: <http://www.bls.gov/ces/cespeaktrough.htm> and accessed on Nov. 11, 2014. The unemployment rate was taken from the Bureau of Labor Statistics, U.S. Dep't of Labor, Current Population Survey, series LNS14000000. Accessed Nov. 11, 2014 at <http://data.bls.gov/pdq/SurveyOutputServlet>. The unemployment rate peaked at 10 percent in Oct. 2009.

²²⁸ NCUA calculations based on from the National Income and Product Accounts, Bureau of Economic Analysis, U.S. Dep't of Commerce. Data from Table 1.1.6 show real GDP at \$14.992 trillion in the fourth quarter of 2007 in chained 2009 dollars. Adjusting to 2014 dollars using the GDP price index and using the 60 percent loss figure cited yields an estimated loss of approximately \$10 trillion in 2014 dollars. Data are available at <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1>.

²²⁹ See Tyler Atkinson, David Luttrell & Harvey Rosenblum, Fed. Reserve Bank of Dall, *How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis* (July 2013), available at <https://dallasfed.org/assets/documents/research/staff/staff1301.pdf>.

²³⁰ See Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements*, (Aug. 2010), pp. 14-17. The study indicates that the seven percent TCE/RWA ratio is equivalent to a five percent ratio of equity to total assets. The average ratio of equity to total assets for the 14 largest OECD countries from 1980 to 2007 was 5.3 percent.

²³¹ See *id.*

benefits to the overall economy.²³² With the median long-term output loss associated with a crisis in the range of 60 percent of precrisis GDP, a one percentage point reduction in the probability of a crisis would add roughly 0.6 percent to GDP each year (permanently).²³³

While higher levels of capital can insulate depository institutions from adverse shocks, holding higher levels of capital does have costs, both to individual institutions and to the economy as a whole. For the most part, the largest cost associated with holding higher levels of capital, in the long term, is foregone opportunities; that is, from the loss of potential earnings from making loans, from the cost to bank customers and credit union members of higher loan rates and lower deposit rates, and the downstream costs from the customers' and members' reduced spending.²³⁴

Estimating the size of these effects is difficult. However, despite limitations on the ability to quantify these effects, the annual costs appear to be significantly smaller than the losses avoided by reducing the probability of a systemic crisis. For example, research using data on banking systems across developed countries indicates that a one percentage point increase in the capital ratio increases lending spreads (the spread between lending rates and deposit rates) by 13 basis points.²³⁵ The research also shows that the long-run reduction in output (real GDP) consistent with a one percentage point increase in the Tier 1 common equity to risks assets ratio would be on the order of 0.1 percent.^{236, 237} Thus, it is clear that the relatively large potential long-term benefits of holding higher levels of capital outweigh the relatively small long-term costs.

The 2007–2009 financial crisis revealed a number of inadequacies in the current approach to capital requirements. Banks, in particular, experienced an elevated number of failures and the

²³² *See id.*

²³³ *See id.*

²³⁴ *See id.* at pp. 21-27.

²³⁵ *See id.* There are a number of simplifying assumptions involved in the calculation, including the assumption that banks fully pass through the increase in the cost of capital to their borrowers.

²³⁶ Tier 1 common equity is made up of common stock, retained earnings, accumulated other comprehensive income, and some miscellaneous minority interests and common stock as part of an employee stock ownership plan.

²³⁷ To be clear, the 0.1 percent figure represents the one-time, long-term loss, which should be compared with the 60 percent loss potentially avoided by reducing the probability of a financial crisis by a little more than one percentage point. *See* Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* 21-27 (Aug. 2010).

need for federal intervention in the form of capital infusions.²³⁸

Credit unions also experienced elevated losses and the need for government intervention. From 2008 through 2012, five corporate credit unions failed. Had NCUA not intervened in 2009 and 2010 by providing over \$20 billion in liquidity assistance, over \$100 billion in guarantees, and borrowing over \$5 billion from the U.S. Treasury, the resulting losses to consumer credit unions on their uninsured funds invested at these institutions would have exceeded \$30 billion. NCUA estimates as many as 2,500 consumer credit unions would have failed at additional cost to the Share Insurance Fund.

In addition, during that same period, 27 consumer credit unions with assets greater than \$50 million failed at a cost of \$728 million to the Share Insurance Fund.²³⁹ NCUA performed back-testing of the nine complex credit unions that failed during this period to determine whether the final rule would have resulted in earlier identification of emerging risks and reduced losses to the Share Insurance Fund. The back-testing revealed that maintaining a risk-based capital ratio in excess of 10 percent would have required eight of the nine complex credit unions that failed to hold additional capital.

The failure of the 27 consumer credit unions was due in large part to holding inadequate levels of capital relative to the levels of risk associated with their assets and operations. In many cases, the capital deficiencies relative to elevated risk levels were identified by examiners and communicated through the examination process to officials at these credit unions.²⁴⁰ Although the credit union officials were provided with notice of the capital deficiencies, they either ignored the supervisory concerns or did not act in a timely manner to address the concerns raised. Furthermore, NCUA's ability to take enforcement actions to address supervisory concerns in a

²³⁸ For a readable overview of the 2007–2009 financial crisis and the government's response see, *The Final Report of the Congressional Oversight Panel*, Congressional Oversight Panel (Mar. 16, 2011). See also Ben S. Bernanke, "Some Reflections on the Crisis and the Policy Response," speech at the Russell Sage Foundation and The Century Foundation Conference on "Rethinking Finance," New York, New York (Apr. 13, 2012) available at <http://www.federalreserve.gov/newsevents/speech/2012speech.htm>.

²³⁹ These figures are based on data collected by NCUA throughout the crisis, and do not include the costs associated with failures of corporate credit unions.

²⁴⁰ See NCUA, *Material Loss Review of Chetco Federal Credit Union*, OIG-13-10 (Oct. 1, 2013); NCUA, *Material Loss Review of Telesis Community Credit Union*, OIG-13-05 (Mar. 15, 2013); NCUA, *Material Loss Review of Ensign Federal Credit Union*, OIG-10-15 (Sept. 23, 2010); and NCUA, *Material Loss Review of Cal State 9 Credit Union*, OIG-10-03 (Apr. 14, 2010), each available at <http://www.ncua.gov/About/pages/inspector-general/material-loss-reviews.aspx>.

timely manner was cited by GAO as limited under NCUA's current regulations.²⁴¹

From 2008 to 2012, over a dozen very large consumer credit unions, and numerous smaller ones, also were in danger of failing and required extensive NCUA intervention, financial assistance, or both, along with increased reserve levels for the Share Insurance Fund.²⁴² NCUA estimates these actions saved the Share Insurance Fund over \$1 billion in losses.

The clear implication from the impact of the 2007–2009 recession on the credit unions noted above is that capital levels in these cases were inadequate, especially relative to the riskiness of the assets that some institutions were holding on their books.

Unlike banks that can issue other forms of capital like common stock, credit unions that need to raise additional capital when faced with a capital shortfall generally have no choice except to reduce member dividends or other interest payments, raise lending rates, or cut non-interest expenses in an attempt to direct more income to retained earnings.²⁴³ Thus, the first round impact of falling or low capital levels at credit unions is likely a direct reduction in credit union members' access to credit or interest bearing accounts. Hence, an important policy objective of capital standards is to ensure that financial institutions build sufficient capital to continue functioning as financial intermediaries during times of stress without government intervention or assistance.

NCUA's analysis of credit union Call Report data from 2006 forward, as detailed below, also makes it clear that higher capital levels keep credit unions from becoming undercapitalized during periods of economic stress. Table 28 below summarizes the changes in the net worth ratio that occurred during the recent economic crisis. Of credit unions with a net worth ratio of less than 8 percent in the fourth quarter of 2006, 80 percent fell below 7 percent at some time during the 2007–2009 financial crisis and its immediate aftermath. Of credit unions with a net worth ratio of 8 percent to 10 percent in the fourth quarter of 2006, just under 33 percent fell below

²⁴¹ See U.S. Gov't Accountability Office, *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO-12-247 (2012), available at <http://www.gao.gov/products/GAO-12-247>.

²⁴² As most of these credit unions are still active institutions, or have merged into other active institutions, NCUA cannot provide additional details publicly.

²⁴³ Low-income designated credit unions can issue secondary capital accounts that count as net worth for prompt corrective action purposes. As of Dec. 31, 2014, there were 2,134 low-income designated credit unions. Given the size of these credit unions and the types of instruments they can offer, however, there is often a very limited market for these accounts.

7 percent during the crisis period. However, of credit unions that entered the crisis with a net worth ratio of at least 10 percent, less than 5 percent fell below the 7 percent well-capitalized standard during the crisis or its immediate aftermath.

Table 28: Distribution of Net Worth Ratios of Complex Credit Unions by Lowest Net Worth Ratio During the Financial Crisis

Net Worth Ratio at Year-End 2006	Lowest Net Worth Ratio between 2007 and 2010						Number of Credit Unions
	Under 6%	6 to 7%	7 to 8%	8 to 10%	Above 10%	Total	
Less than 8 Percent	44.0	36.0	20.0	0.0	0.0	100.0	50
8 to 10 Percent	13.0	19.6	38.0	29.4	0.0	100.0	316
Above 10 Percent	1.9	2.8	9.4	38.8	47.1	100.0	830

Source: NCUA Call Report data

Similarly, Table 29 below shows how credit unions with at least \$100 million in assets in the fourth quarter of 2006 fared during the five years after the fourth quarter of 2007, which was the period that encompassed the 2007–2009 recession. The table shows that the credit unions that survived the crisis and recession had higher net worth ratios going into the Great Recession. In particular, credit unions with more than \$100 million in assets before the crisis began, but failed during the crisis, had a median pre-crisis net worth ratio of less than 9 percent, while similarly sized institutions that survived the crisis had, on average, pre-crisis net worth ratios in excess of 11 percent.

Table 29: Characteristics of Complex Credit Unions at the End of 2006 by Five-Year Survival Beginning in the Fourth Quarter of 2007

	Number of Institutions	Median				
		Assets (millions)	Net Worth Ratio (percent)	Loan to Asset Ratio (percent)	Real Estate Loan Share (percent)	Member Business Loan Share (percent)
Failed	27	\$162.7	8.97	84.0	58.0	8.3
Survived	1,138	\$237.9	11.20	71.0	49.0	0.7

Survivorship is determined based on whether a federally insured stopped filing a Call Report over the five years starting in the fourth quarter of 2007. Failures exclude credit unions that merged or voluntarily liquidated. Note: All failures had pre-crisis net worth ratios in excess of 7 percent.

Source: NCUA Call Report data

Aside from demonstrating the differences in the capital positions of credit unions that failed from those that did not fail, Table 29 above highlights two additional considerations. First, it shows that other performance indicators were different between the two groups of credit unions. In particular, the survivors had a lower median loan-to-asset ratio, a lower median share of total loans in real estate loans, and a lower share of member business loans in their overall loan portfolio.

2. Limitations of the Leverage Ratio

A key limitation of the leverage ratio is that it is a lagging indicator because it is based largely on accounting standards. Accounting figures are point-in-time values largely based on historical performance to date. Further, the leverage ratio does not discriminate between low-risk and high-risk assets or changes in the composition of the balance sheet. A risk-based capital ratio measure is more prospective in that, as a credit union makes asset allocation choices, it drives capital requirements before losses occur and capital levels decline. The differences in indicators between the failure group and the survivors in Table 29 above demonstrate that factors in addition to capital levels play an important role in preventing failure. For example, all of the failures listed in Table 29 above had net worth ratios in excess of the well-capitalized level at the end of 2006.

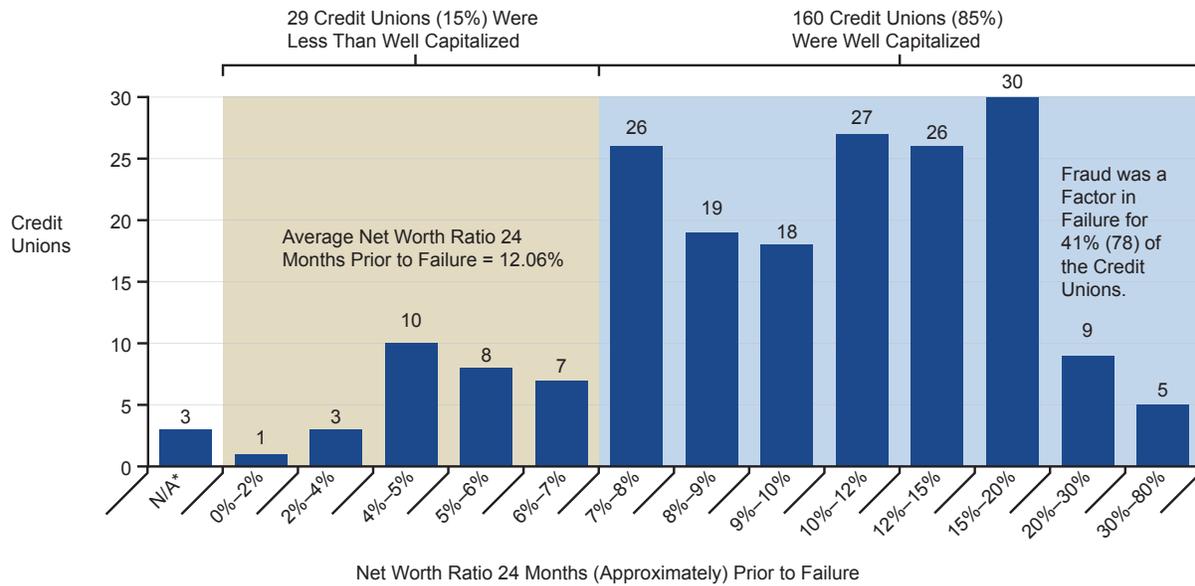
The severe weakness of NCUA's current risk-based net worth requirement is further demonstrated by the fact that, of the 27 credit unions that failed during the Great Recession, only two of those credit unions were considered less than well capitalized due to the existing risk-based net worth requirement. A well designed risk-based capital ratio standard would have been more successful in helping credit unions avoid failure precisely because such standards are targeted at activities that result in elevated risk.²⁴⁴

The need for a risk-based capital standard beyond a leverage ratio is further supported when considering a more comprehensive review of credit union failures. Figures 29 and 30 below present data from NCUA's review of the 192 credit union failures that occurred over the past 10 years and indicates that 160 failed credit unions had net worth ratios greater than 7 percent two years prior to failure. Further, the failed credit unions exhibited a 12 percent average net worth

²⁴⁴ See Appendix F for a summary of the results of the empirical simulations NCUA conducted on risk-based capital variants under stressed economic scenarios.

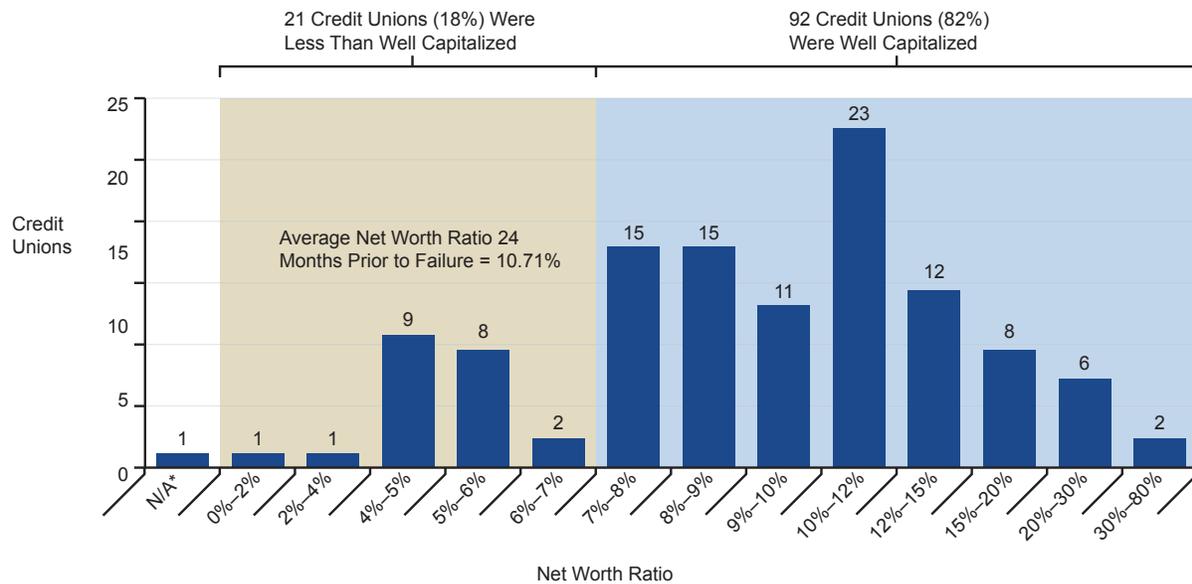
ratio two years prior to failure.

Figure 29: Net Worth Ratio 24 Months Prior to Failure for All Credit Union Failures in the Last 10 Years



Source: NCUA Call Report Data
 *Three credit unions were outliers as they had limited or no history 24 months ago

Figure 30: Net Worth Ratio 24 Months Prior to Failure for Non-Fraud Related Failures in the Last 10 Years



Source: NCUA Call Report Data
 *One credit union was an outlier with limited history 24 months ago

The figures above show that credit unions with high net worth ratios can and have failed, demonstrating that a leverage ratio alone has not always proven to be an adequate predictor of a credit union's future viability. However, a more robust risk-based capital standard would reflect the presence of elevated balance-sheet risk sooner, and in relevant cases would improve a credit union's odds of survival.

A recession or other source of financial stress poses more difficulties for credit unions with limited capital options and with capital levels lower than what their risks warrant. A capital shortfall reduces a credit union's ability to effectively serve its members. At the same time, the shortfall can cascade to the rest of the credit union system through the Share Insurance Fund, potentially affecting an even broader number of credit union members.

Credit unions are an important source of consumer credit and a capital shortfall that affects the credit union system could reduce general consumer access to credit for millions of credit union members. Accordingly, a risk-based capital rule that is effective in requiring credit unions with low capital ratios and a large share of high-risk assets to hold more capital relative to their risk profile, while limiting the burden on already well-capitalized credit unions, should provide positive net benefits to the credit union system and the U.S. economy. Improved resilience enhances credit unions' ability to function during periods of financial stress and reduce risks to the Share Insurance Fund.

3. Benefits of the Risk-Based Capital Ratio

In a risk-based capital system, institutions that are holding assets that have historically shown higher levels of risk are generally required to hold more capital against those assets. At the same time, an institution's leverage ratio, which does not account for the riskiness of assets, can provide a baseline level of capital adequacy in the event that the approach to assigning risk weights does not capture all risks. A system including well-designed and well-calibrated risk-based capital standards is generally more efficient from the point of view of the overall economy, as well as for individual institutions.

In general, risk-based capital standards increase capital requirements at those institutions whose asset portfolios have, on average, higher risk. Conversely, risk-based capital standards generally decrease the cost of holding capital for institutions whose strategies focus on lower risk activities. In that way, risk-based capital standards generate the benefits of helping to insulate

the economy from financial crises, while also preventing some of the potential costs that would occur from holding unnecessarily high levels of capital at low-risk institutions.

The final rule replaces the current method for calculating a credit union's risk-based net worth ratio with a new method for calculating a credit union's risk-based capital ratio. Under the current risk-based net worth ratio measure, a lower ratio is reflective of financial strength. Therefore, the current measure is not intuitive. More importantly, it cannot be compared against the risk-based capital measures of other financial institutions. The new risk-based capital ratio, however, is more commonly applied to depository institutions worldwide. Generally, the new risk-based capital ratio is the percentage of equity and accounts available to cover losses divided by risk-weighted assets. Under this approach, a higher risk-based capital ratio is an indicator of financial strength.

The new risk-based capital ratio is designed to complement the statutory net worth, or leverage, ratio. The net worth ratio is a measure of statutorily defined capital divided by total assets. The net worth ratio does not assign relative risk weights among asset classes, making it more difficult to manipulate and provides a simple picture of a financial institution's ability to absorb losses, regardless of the source of the loss.

In contrast, the new risk-based capital ratio is a measure of loss absorption ability to assets weighted based on the associated risk. It is intended to be more forward looking and reactive to changes in the risk profile of a credit union. In general, a risk-based capital requirement increases capital requirements at those institutions with asset portfolios that are, on average, higher risk. Conversely, risk-based capital standards generally decrease capital requirements at institutions with lower risk profiles. In that way, risk-based capital standards generate the benefits of helping to insulate the economy from financial crises, while also preventing some of the potential costs that would occur from holding unnecessarily high levels of capital at low-risk institutions.

During the risk-based capital rulemaking, many commenters suggested that the NCUA Board withdraw the revised proposed rule and retain the existing risk-based capital requirement and the related risk weights, which are based largely on interest rate risk and liquidity risk. Ironically, most of the commenters objected to the original proposed rule because it included interest rate risk and liquidity risk in the proposed risk weights. As discussed in the original proposed rule,

since its implementation, the current risk-based net worth requirement has required less than a handful of credit unions to hold higher levels of capital than required by the net worth ratio. Under the current risk-based net worth requirement, those credit unions that invest in longer-term, low-credit risk investments experience a higher risk-based net worth requirement and thus have a lower buffer above the net worth ratio than they will have under the final rule.

The risk weights in the final rule are calibrated to appropriately balance the impact on credit unions while also providing meaningful improvement to the risk-based capital standards to which credit unions will be held in the future.

If the risk-based capital rule is effective in requiring credit unions with low capital ratios and a large share of high-risk assets to hold more capital relative to their risk profile, while limiting the additional capital burden on already well-capitalized credit unions, this will lower costs relative to potential benefits of the rule. This is especially important for the credit union system because the share of well-capitalized credit unions is large relative to the total population of all federally insured credit unions.

4. Back Testing of Risk-Based Capital Ratio

a. Back-Testing Methodology and Limitations

NCUA analyzed failed credit unions spanning the past six years that reported assets greater than \$100 million and that cost the Share Insurance Fund more than \$5 million in losses. The risk-based capital ratios for these failed credit unions were calculated to determine whether they would have been identified as less than “well capitalized” prior to failure. If the risk-based capital result was less than well capitalized, the analysis then determined the amount of capital required to meet the well-capitalized threshold under the risk-based capital rule. This amount of capital was applied to reduce the amount of loss absorbed by the Share Insurance Fund (limited to the actual loss amount).

Further, for all year-end periods since 2007, NCUA determined which credit unions would have been rated “well capitalized” based on their leverage ratio while simultaneously falling below “well capitalized” under the proposed risk-based capital rule. Each period was reviewed to determine whether the credit unions downgraded demonstrated higher-risk characteristics

warranting additional capital and closer supervisory attention. This was done to identify whether the rule provides for early identification of emerging risk in institutions.

b. Results of Testing on Failed Credit Unions

The analysis determined a probable reduction of approximately \$58 million, or 12.6 percent, of incurred Share Insurance Fund losses. Table 30 lists the nine credit unions in the sample, their associated losses, and the estimated reduction in losses if the credit unions had been holding higher levels of capital.

Table 30: Summary of Failed Credit Unions' Actual Loss and Estimated Loss Reduction

Action Date	Name	State	Last Call Report Assets	Share Insurance Fund Loss	Estimated Reduction in Losses
6/30/2008	Cal State 9	CA	\$285,372,898	\$204,499,851	\$28,656,696
6/30/2009	Eastern Financial	FL	\$1,623,575,224	\$36,116,137	\$16,765,458
8/11/2009	Community One	NV	\$159,181,112	\$6,791,411	\$255,626
9/25/2009	Clearstar Financial	NV	\$150,136,747	\$12,186,087	\$448,174
8/31/2010	First American	WI	\$136,892,301	\$6,024,350	\$133,889
12/14/2010	Beehive	UT	\$145,451,557	\$26,133,617	0*
2/15/2011	Family First	UT	\$119,371,315	\$20,935,903	\$2,155,430
5/31/2012	Telesis	CA	\$301,317,385	\$67,115,911	\$7,634,191
12/31/2012	Chetco	OR	\$247,921,898	\$79,779,908	\$2,010,599
				\$459,583,175	\$58,060,062

* Beehive held substantial capital prior to experiencing losses in the Utah real estate market, and it appears they would not have been subject to an additional capital requirement.

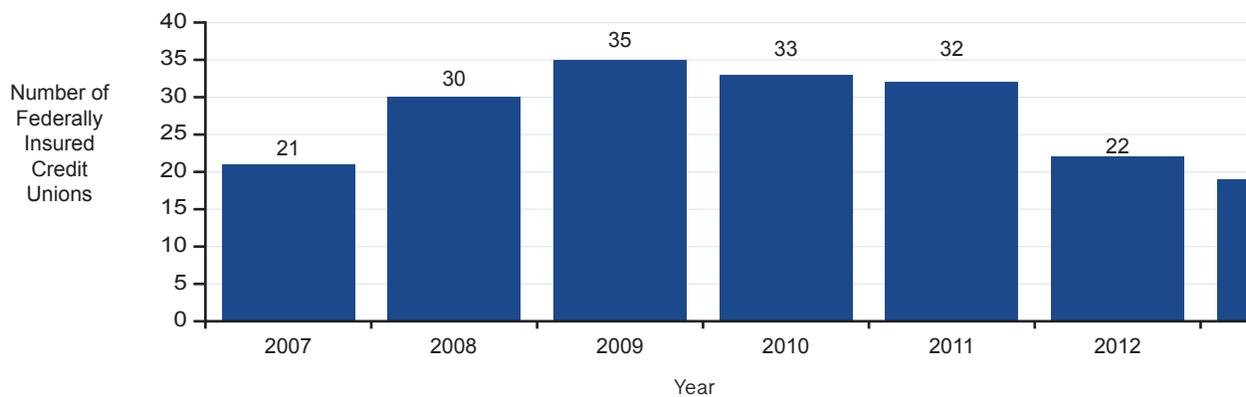
Source: NCUA Failure Data

Applying the revised risk-based capital measure would have triggered the need to build additional capital in eight of the nine failed credit unions with more than \$100 million assets.

c. Results of Back Testing (Downgrades between Leverage and Risk-Based Capital Ratios)

In addition to reviewing specific credit union failures, NCUA also reviewed credit unions that would have been downgraded to less than well capitalized under the revised risk-based capital rule for each year-end period between 2007 and 2013. Figure 31 summarizes the total credit unions downgraded at each year-end period.

Figure 31: Downgraded Credit Unions with More than 7 Percent Leverage Ratio and Less than 10 Percent Risk-Based Capital Ratio



While there were 192 downgrades calculated over the past seven year-end periods, only 79 unique credit unions appeared. Of these 79 credit unions, the following four credit unions resulted in material losses:

- Chetco – Downgraded in 2007 and 2008 (failed in 2012)
- Community One – Downgraded in 2007 (failed in 2009)
- First American – Downgraded in 2008 (failed in 2010)
- Eastern Financial – Downgraded in 2007 (failed in 2009)

The fact these credit unions would have been downgraded at least one year prior to failure provides further evidence the final risk-based capital rule proactively signals elevated balance sheet risk relative to net worth levels.

The list of downgrades also includes several credit unions that have not caused a loss to the Share Insurance Fund. However, our review indicates these credit unions demonstrate higher-risk elements and warrant additional capital. For example, four credit unions appear on the downgrade list six or seven times (meaning their risk-based capital ratio fell below 10 percent). These credit unions maintained very large concentrations of member business loans, real estate loans, or non-federally guaranteed student loans resulting in an elevated credit risk profile.

d. Back-Testing Limitations

There are limitations in the ability to achieve precise results as the revised risk-based capital

calculation utilizes some data elements not collected on the Call Report in prior periods. Table 31 below summarizes the availability of data.

Table 31: Summary of Data Availability

Data not available = x	2007	2008	2009	2010	2011	2012	2013
Equity in Merger	x	x					
Goodwill	x	x					
Intangible Assets	x	x					
Agency Securities*	x						
Agency Mortgage-Backed Securities*	x						
Municipals	x	x	x	x			
Private Mortgage-Backed Securities	x						
Bank Issued FDIC Bonds	x	x	x	x			
Member Business Loan Delinquency	x	x	x	x	x	x	
Non-Federally Guaranteed Student Loans	x	x	x	x			
Investments in CUSOs	x	x					
Loans to CUSOs	x	x					
Unfunded Commitments (Non- Business Loans)	x	x	x	x			

* The risk-based capital calculation was adjusted in this instance to resolve potential imbalances in the 2007 risk-based capital query. It is included in the table above for information purposes related to data limitations in the current risk-based capital query.

Some of the missing data elements would improve the risk-based capital ratio for some credit unions, while other elements would likely reduce the risk-based capital ratio if included in the calculation. Considering many of the missing data elements carry higher risk weights, the risk-based capital ratio would likely be less sensitive (less likely to capture higher risk assets) in prior periods where data was unavailable.

e. Final Summary of Back Testing

Although subject to some limitations, the back testing NCUA performed reveals the risk-based capital rule does signal the need for additional capital in higher-risk credit unions that are prone to failure. Further, the risk-based capital rule requires additional capital for credit unions with higher risk profiles compared to the current capital regime.

Appendix B

Supplemental Capital

While the NCUA Board cannot redefine the statutory definition of net worth, NCUA's Office of General Counsel did determine that NCUA has broad authority in establishing what can be included in the numerator when defining risk-based capital. This authority could include expanding the inclusion of supplemental capital for all federally insured credit unions, and not solely for low-income designated federally insured credit unions, into the numerator of the risk-based capital ratio.

The ability to include supplemental capital authorized by state law for federally insured, state-chartered credit unions in the risk-based capital ratio was evaluated. For instance, a state legislature could authorize all federally insured, state-chartered credit unions in their particular state to accept non-member deposits, secondary capital accounts, or both. In that scenario, while federally insured, state-chartered credit unions that are not low-income designated could be allowed under state laws to accept secondary capital deposits, these accounts are not considered net worth or equity under the current rule, in accordance with the Federal Credit Union Act.

NCUA could revise the risk-based capital ratio to allow federally insured, state-chartered credit unions permitted under state law to accept supplemental capital to include that in the risk-based capital numerator. However, only federally insured, state-chartered credit unions located in a state that provides the expanded authority to accept supplemental capital (not permitted under the current rule) would be able to include this. Without also changing the designation of low-income status and the secondary capital rule (section 701.34), this would result in disparate treatment for federal credit unions, which cannot include secondary capital deposits in net worth without a low-income designation, and federally insured, state-chartered credit unions located in a state with no expanded authority to accept supplemental capital.

NCUA could redefine secondary capital to include other supplemental capital accounts, such as borrowings, or secondary capital from natural person members regardless of whether low-

income designated, as secondary capital for all federally insured credit unions.²⁴⁵ Any changes to alter the form of secondary capital that is acceptable for risk-based capital purposes would also necessitate a change to section 701.34 of NCUA's rules.

For instance, allowing all federally insured credit unions to accept secondary capital from natural person members or include some borrowings as supplemental capital would require a change to NCUA's regulations to permit these to be included in the numerator for risk-based capital purposes. While this could be included for risk-based capital, without legislative changes the Federal Credit Union Act still would not permit this to count as net worth unless the credit union had a low-income designation.

Changing the rules about supplemental capital would be a separate rule-making event. While these rule changes could occur, permitting federally insured credit unions to use borrowings or secondary capital from natural person members as capital for risk-based capital purposes raises a host of complicated issues that must be addressed first. These include, but are not limited to:

- **Consumer Protections.** This would include appropriate disclosures and advertisement restrictions aimed at making sure the member or non-member (consumer or non-natural person) was fully aware of the nature and the riskiness of the transaction.
- **Share Insurance Fund Payout Priorities.** These would have to be changed to ensure any form of supplemental capital remains in the same priority as current secondary capital and are not elevated to normal creditor priorities afforded to credit union borrowings. The form of supplemental capital would have to be in sync with the payout priorities for them to count as capital.
- **Limits on Credit Unions with Existing Problems.** Prudent limitations on the ability of a credit union less than adequately capitalized, or with other known or pending losses, to raise capital from this type of transaction must be considered and codified in the regulations.

²⁴⁵ See 12 U.S.C. 1757(9). The powers in the Federal Credit Union Act include the power “to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III of this chapter, 50 per centum of its paid-in and unimpaired capital and surplus: Provided, that any federal credit union may discount with or sell to any federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital.”

- **Capital Contribution Limitations.** A determination of the total amount of capital that can be raised from this type of transaction needs to be considered. Basel considers supplemental capital to be a Tier 2 level of capital, and it is limited to no more than 50 percent of Tier 1 capital. Because Tier 1 is required to be 4 percent, Tier 2 level capital could be no more than 2 percent of risk-based assets.
- **Cost of Capital.** Strict guidelines must be set, outlining what qualifies as regulatory capital and other parameters such as a minimum five-year term, uninsured, and subordinate to Share Insurance Fund, among others. The cost of this type of capital in the current market would be very high, perhaps even prohibitive. Because these would have to be long-term obligations, the cost to bring in the capital over the long term could cause more problems than are solved with the short-term capital boost this would bring in.

NCUA plans to address additional forms of supplemental capital in a separate proposed rule, with the intent to finalize a new supplemental capital rule before the effective date of the risk-based capital final rule. The second risk-based capital proposed rule invited general comment on supplemental capital much in the way an advanced notice of proposed rulemaking would do. A notice of proposed rulemaking on supplemental capital with specific criteria and requirements is necessary under the Administrative Procedure Act before the Board could issue a final rule. Issuing a new, more specific and detailed proposed rule on supplemental capital will give interested parties full opportunity to comment on it.

NCUA has formed a working group that consulted with stakeholders to develop a separate proposed rule regarding supplemental forms of capital that could be included in the numerator of the risk-based capital ratio. The working group has reviewed the comments received on this issue, studied the alternative forms of capital used internationally and within the cooperative system, and obtained additional insight from practitioners who were highly interested or experienced with alternative forms of capital.

In the near future, the working group plans to present its recommendations to the NCUA Board for revisions that could be made to NCUA's regulations through a separate rulemaking to allow additional supplemental forms of capital to be included in the risk-based capital ratio. Again, the NCUA Board's intent is to finalize a new supplemental capital rule before the effective date of this risk-based capital final rule.

As discussed in the section of this report on legislative recommendations, NCUA also continues to support amending the Federal Credit Union Act to provide all credit unions access to additional supplemental forms of capital that, subject to certain reasonable restrictions and consumer protections, could be counted toward a credit union's net worth ratio requirement and risk-based capital requirement.

Appendix C

Alternative Risk Weights for Certain On-Balance Sheet Assets

The final rule allows for alternative risk weighting measurements (compared to the standard risk weight percentages discussed in section of this report entitled Rationale for Risk-Based Capital Treatment) for certain types of investments. This treatment is consistent with the other banking agencies' approach. Credit unions may use these alternative methods to apply lower risk weights for non-subordinated tranches, subordinated tranches, and investment funds.

1. Gross-up Approach

A credit union may use the gross-up approach to determine the risk weight of the carrying value of any non-subordinated and subordinated tranche of any investment. As noted above, NCUA is allowing for the use of the gross-up approach when applying risk weights to non-subordinated and subordinated tranches of any investment.

The basic logic behind the gross-up approach is that the risk weight should reflect the entire amount of exposure the subordinated tranche is supporting. Said another way, the credit union must hold capital for the subordinated tranche, as well as all the senior tranches for which the subordinated tranche provides credit support.

When calculating the risk weight using the gross-up approach, the credit union must have the following information:

- Exposure amount of the subordinated tranche;
- Current outstanding par value of the credit union's subordinated tranche;
- Current outstanding par value of the total amount of the entire tranche where the credit union has exposure;
- Current outstanding par value of the more senior positions in the securitization that are supported by the subordinated tranche the credit union owns; and

- The weighted-average risk weight applicable to the assets underlying the securitization.

Consider the following example of the application of the gross-up approach on a subordinated tranche. A credit union owns \$4 million (exposure amount and outstanding par value) of a subordinated tranche of a private label mortgage-backed security backed by first-lien residential mortgages. The total outstanding par value of the subordinated tranche that the credit union owns part of is \$10 million. The current outstanding par value for the tranches that are senior to and supported by the credit union's tranche is \$90 million.

Table 32 applies this information and the gross-up approach to determine the amount the credit union would need to risk weight the subordinated tranche.

Table 32: Sample Calculation of Gross-Up Approach

		Calculation	Result
A	Current outstanding par value of the credit union's subordinated tranche divided by the current outstanding par value of the entire tranche where the credit union has exposure	$\$4,000,000 / \$10,000,000$	40%
B	Current outstanding par value of the senior positions in the securitization that are supporting the tranche the credit union owns		\$90,000,000
C	Proportional share of the more senior positions outstanding in the securitization that is supported by the credit union's subordinated tranche: (A) multiplied by (B)	40% times \$90,000,000	\$36,000,000
D	Current exposure amount for the credit union's subordinated tranche		\$4,000,000
E	Enter the sum of (C) and (D)	$\$36,000,000 + \$4,000,000$	\$40,000,000
F	The higher of the weighted average risk weight applicable to the assets underlying the securitization or 20%	50% primary risk weight for first-lien residential real estate loan	50%
G	Risk-weighted asset amount of the credit union's purchased subordinated tranche: (E) multiplied by (F)	$\$40,000,000 \text{ times } 50\%$	\$20,000,000

In this example, under the gross-up approach, the credit union would be required to risk weight the subordinated tranche at \$20,000,000. Conversely, under the 1,250 percent risk-weight approach, the credit union would be required to risk weight the subordinated tranche at \$50 million (1,250 percent times \$4 million). NCUA believes this example shows the benefit to credit unions of using the gross-up approach.

In the case of master trust type structures and structured products, credits unions should calculate the proportional share of the more senior positions using the prospectus and current servicing and reference pool reports.^{246, 247}

2. Look-through Approaches

The final rule allows for a credit union to use one of the look-through approaches to determine the risk weight of the fair value of mutual funds that are not in compliance with part 703, the recorded value of separate account insurance; or part 703-compliant mutual funds.

The first of the three full look-through approaches would require a credit union to look at the underlying assets owned by the investment fund and apply an appropriate risk weight. The other two approaches would require a credit union to use the information provided in the investment fund's prospectus. The minimum risk weight for any investment fund asset would be 20 percent, regardless of which approach was used.

The following examples outline each of the three look-through approaches:

a. Full Look-through Approach

The full look-through approach will allow credit unions to weight the underlying assets in the investment fund as if they were owned separately, with a minimum risk weight of 20 percent for all underlying assets. Credit unions will be required to use the most recently available holdings reports when utilizing the full look-through approach. An example of the application of the full look-through approach for a \$10,000,000 credit union investment is included in Table 33 below.

²⁴⁶ Master trust subordinated tranches do not support any particular senior tranche in the trust. The subordinated tranche supports an amount of senior tranches as defined in the prospectus and the current servicing reports.

²⁴⁷ Structured products may allocate losses based on other securities or a reference pool. The credit union should calculate the pro-rata senior tranche based on the amount the subordinated tranche would support if it were an actual tranching security.

Table 33: Sample Full Look-Through Approach

Fund Investment	Fund Holding (percent of fund)	Credit Union Exposure*	Risk Weight	Dollar Risk Weight
U.S. Treasury Notes	50%	\$5,000,000	20%**	\$1,000,000
Fannie Mae Planned Amortization Classes	30%	\$3,000,000	20%	\$600,000
Public Sector Entity Revenue Bonds	17.5%	\$1,750,000	50%	\$875,000
Subordinated Mortgage-Backed Securities***	2.5%	\$250,000	1,250%	\$3,125,000
Totals		\$10,000,000	56%**** (Weighted Average Risk Weight)	\$5,600,000 (Amount of Risk Assets)

*Fund holdings (percent of fund) multiplied by the credit union investment.

**Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

***Use 1,250 percent risk weight or gross-up calculation.

**** The weighted-average risk weight was calculated by dividing the amount of risk assets (\$5,600,000) by the credit union exposure (\$10,000,000).

Using the above example, the investment fund would have a weighted-average risk weight of 56 percent, which would be lower than the 100 percent standard risk weight for part 703-compliant investment funds or the standard 300 percent risk weight for investment funds not compliant with part 703.

b. Simple Modified Look-through Approach

The simple modified look-through approach would allow credit unions to risk weight their holdings in an investment fund by the highest risk weight of any asset permitted by the investment fund's prospectus. Credit unions should use the most recently available prospectus to determine investment permissibility for an investment fund. An example of the application of the simple modified look-through approach for a \$10,000,000 credit union investment is included in Table 34 below.

Table 34: Sample Simple Modified Look-Through Approach

Permissible Investments	Fund Limits (percent of fund)	Risk Weight
U.S. Treasury Notes	100%	20%*
Agency Mortgage-Backed Security (non-interest only):	50%	20%
Private Sector Entity General Obligation Bonds:	20%	20%
Private Sector Entity Revenue Bonds:	20%	50%
Non-Government/Subordinated/Interest-Only Mortgage-Backed Security	30%	50%
Subordinated Mortgage-Backed Security	10%	1,250%**

*Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent

** Use 1,250 percent risk weight unless the prospectus limits gross-up risk weight.

Using the above example, the investment fund would have a risk weight of 1,250 percent using the simple modified look-through approach because the investment fund can hold 1,250 percent risk-weighted subordinated mortgage-backed securities. In this case, the credit union would most likely use a 100 percent standard risk weight for the part 703-compliant investment fund or the standard 300 percent risk weight for investment funds not in compliance with part 703.

c. Alternative Modified Look-through Approach

The alternative modified look-through approach will allow credit unions to risk weight their holdings in an investment fund by applying the risk weights to the limits in the prospectus. In the case where the aggregate limits in the prospectus exceed 100 percent, the credit union must assume the fund will invest in the highest risk-weighted assets first. An example of the application of the simple modified look-through approach for a \$10,000,000 credit union investment is outlined in Table 35 below.

Table 35: Sample Alternative Modified Look-Through Approach

Permissible Investments	Fund Limits (percent of fund)	Risk Weight	Credit Union Exposure	Dollar Risk Weight
U.S. Treasury Notes	100%	20%*	\$0	
Agency Mortgage-Backed Securities (non-interest only)	50%	20%	\$2,000,000	400,000
Private Sector Entity General Obligation Bonds	20%	20%	\$2,000,000	400,000
Private Sector Entity Revenue Bonds	20%	50%	\$2,000,000	1,000,000
Non-Government/ Subordinated/Interest-Only Mortgage-Backed Securities	30%	50%	\$3,000,000	1,500,000
Subordinated Mortgage-Backed Securities	10%	1,250%**	\$1,000,000	12,500,000
Total		158%*** (Weighted Average Risk Weight)	\$10,000,000	15,800,000 (Amount of Risk Assets)

* Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

** Use 1,250 percent risk weight unless the prospectus limits gross-up risk weights.

*** The weighted-average risk weight was calculated by dividing the amount of risk assets (\$15,800,000) by the credit union exposure (\$10,000,000).

Using the example above, the investment fund would have a weighted-average risk weight of 158 percent using the alternative modified look-through approach. In this case, the credit union would most likely use a 100 percent standard risk weight for part 703-compliant investment funds or the alternative modified look-through approach for risk weights for investment funds that are not compliant with part 703.

Appendix D
Paul Hastings Legal Opinion on a Two-Tiered System

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.

65 Fed. Reg. 44950, 44951 (July 20, 2000).

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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 842-842 (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., *Nat'l 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 black ink that reads "Paul Hastings LLP". The signature is written in a cursive, flowing style.

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. Brodin, 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 to 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

⁴ 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.

⁵ Public Law 105-219, 112 Stat. 913 (1998).

⁶ 12 U.S.C. 1790d.

⁷ 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 78 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].”⁸ 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 [(6 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% .....	.06
	over 25.00% .....	.14
(b) MBLs outstanding	0 to 15.00% .....	.06
	>15.00% to 25.00% .....	.14
	over 25.00%	
(c) Investments	<i>By weighted-average life:</i>	
	0 to 1 year .....	.03
	>1 year to 3 years .....	.06
	>3 years to 10 years .....	.12
	>10 years .....	.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).	(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.

⁸ 12 U.S.C. 1790d(a)(1).

⁹ Section 1790d(c).

¹⁰ Section 1790d(o)(2).

¹¹ Section 1790d(o)(3).

¹² Section 1790d(c)–(g); 12 CFR 702.204(a)–(b).

¹³ Section 1790d(d).

¹⁴ *Id.*

¹⁵ Section 1790d(d)(2).

¹⁶ S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).

¹⁷ 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)(ii) 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 72688 (Dec. 1, 2008).

²³ 76 FR 16234 (Mar. 23, 2011).

²⁴ 78 FR 4033 (Jan. 18, 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(o)(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(o)(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.”²⁹ 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.³⁰

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.”³¹ The

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.³²

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

²⁹ 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).

³⁰ 12 U.S.C. 1790d.

³¹ 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

³² 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.³³ 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

³³ 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.

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

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 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)(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.³⁴

³⁴ 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. Dessa, 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.⁴³ 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). • Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency.
Category 2	20 percent	<ul style="list-style-type: none"> • 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.

⁴³ 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>.

⁴⁵ 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. Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets.
Category 8	200 percent	<ul style="list-style-type: none"> 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. The total value of mortgage servicing assets.
Category 10	1,250 percent	<ul style="list-style-type: none"> 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	20
Cash equivalents	20
Total investments with WAL ≤ 1-year	20
Total investments with WAL >1-year and ≤ 3-years	50
Total investments with WAL >3-year and ≤ 5-years	75
Corporate credit union nonperpetual capital	100
Total investments with WAL >5-year and ≤ 10-years	150
Total investments with WAL > 10-years	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 6 percent risk-weighting, which is equivalent to a 75 percent risk-weight under this proposal (6% 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

⁵³ This 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 55339 (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

⁵⁴ In 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.⁵⁶ 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

⁵⁶ The 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 need 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 55339 (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., 78 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	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

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 50.51.

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(e)(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.

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

⁷¹ 12 U.S.C. 1790d(b)(2)(B)(iii).

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 RBPs 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 RBPs 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. 1601
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)(ii)(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 ($8\% \times 1,250\% = 100\%$) 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)(ii)(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 it's 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 uncanceled 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 uncanceled new credit union that remains uncanceled one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as uncanceled; 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 uncanceled, 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 uncanceled federal credit union.* In lieu of paragraph (c) of this section, an uncanceled 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 the-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, 1761b, 1766(a), 1766(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.

* * * * *

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, 1766, 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. 1766, 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. 1966.

§ 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

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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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Appendix E

Draft Legislative Language for NCUA Recommendations

As discussed in section entitled Legislative Recommendations of this report, NCUA supports legislation to allow credit unions without the low-income designation to obtain access to supplemental capital for purposes of net worth. NCUA also supports technical amendments to the Federal Credit Union Act related to the system of prompt corrective action for federally insured credit unions. Draft text for each of NCUA's legislative recommendations is found below.

1. Supplemental Capital Legislation

SEC. 1. IMPROVING CREDIT UNION SAFETY AND SOUNDNESS.

The Federal Credit Union Act (12 U.S.C. 1751 et seq.) is amended—

(1) in section 107—

(A) in paragraph (16), by striking “and” at the end;

(B) in paragraph (17), by striking the period and inserting “; and”; and

(C) by adding at the end of the following:

“(18) to receive payments on uninsured non-share accounts described under section 216(o)(2)(D), subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board.”; and

(2) in section 216—

(A) in subsection (b)(1)(B)(ii), by striking “must rely” and inserting “rely predominantly”; and

(B) in subsection (o)(2)—

(i) in subparagraph (B), by striking “and” at the end;

(ii) in subparagraph (C)(ii), by striking the period and inserting “; and”; and

(iii) by adding at the end of the following:

“(D) with respect to any insured credit union other than a low-income credit union, includes uninsured non-share accounts as authorized by the Board, that—

“(i) do not alter the cooperative nature of the credit union;

“(ii) are subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund;

“(iii) are available to be applied to cover operating losses of the credit union in excess of its retained earnings and, to the extent so applied, will not be replenished;

“(iv) have an initial maturity of at least 5 years, if they have a stated maturity;

“(v) may have their net worth value discounted at the discretion of the Board when the remaining maturity is less than 5 years, if they have a stated maturity;

“(vi) are subject to disclosure and consumer protection requirements as determined by the Board;

“(vii) are offered by a credit union that is determined by the Board to be sufficiently capitalized and well-managed; and

“(viii) are subject to such rules and regulations as the Board may establish.”.

2. Prompt Corrective Action Technical Amendments

SEC. 1. CHANGE TO EARNINGS RETENTION REQUIREMENT.

The Federal Credit Union Act (12 U.S.C. 1751 et seq.) is amended—

(1) by striking section 216(e) and replacing it with the following:

“(e) Net Worth Restoration Plan requirement applicable to credit unions that are not well capitalized.—The Board may require an insured credit union to submit a net worth restoration plan, as required under subsection (f) of this section, if—

“(1) material safety and soundness concerns caused the credit union to become less than well capitalized; and

“(2) the safety and soundness concerns remain unresolved.”

SEC. 2. CLARIFICATION OF BOARD AND CREDIT UNION ROLES.

The Federal Credit Union Act (12 U.S.C. 1751 et seq.) is amended in section 216(i)(1)(B)—

(1) by adding “order the credit union to” at the beginning; and

(2) by adding “, in its sole discretion,” after the word “Board”.

SEC. 3. CLARIFICATION OF TIMELINE.

The Federal Credit Union Act (12 U.S.C. 1751 et seq.) is amended in section 216(i)(3)(A)—

(1) by striking “calendar quarter” and inserting in its place “90 calendar days”;

(2) by inserting “first” before “became critically undercapitalized.”

Appendix F

Empirical Simulations

To analyze the risk-based capital standards on the credit union sector, among the many tools used, NCUA also used an empirical framework to simulate the potential effects of different risk-based capital variants on credit union performance. The framework is an empirical model of key interactions of credit union indicators like assets, delinquency, net income, and capital, along with their relationship with economy-wide indicators.

Simulating the framework highlights the interaction of components of each rule variation. In particular, the framework was used to compare the efficacy the capital rule in a stressed macroeconomic environment, when the insulating effects of higher levels of capital will be most needed.²⁴⁸ The framework was applied to a research database of federally insured credit unions using merger-adjusted Call Report data for all credit unions above \$50 million filing a report in every fourth quarter from 2000 through 2013.²⁴⁹

As a first step, the analysis estimated the number of credit unions and the amount of capital needed to bring all credit unions up to at least the well-capitalized level, given the varying capital requirements of each rule. The amount of capital needed to bring all credit unions into compliance can be thought of as a one-time increase in capital, though the effects will be spread over the implementation period.²⁵⁰

The amount of initial capital required is a useful first step in evaluating the effects of a risk-based capital rule. A more comprehensive set of evaluation measures, however, was used to better understand both the workings of the rule and the potential effects. For example, risk-based capital rules are intended to boost capital at those institutions that have invested in assets whose

²⁴⁸ The framework developed here is similar to the Capital and Loss Assessment under Stress Scenarios model developed by the staff of the Federal Reserve Bank of New York. The credit union framework is somewhat simpler, however, for many reasons. In particular, the credit union framework does not have to account for the effects of stock price changes on institution behavior.

²⁴⁹ The database includes credit unions that were not active in 2013 if they did report in 2000 and it was not their last fourth-quarter filing prior to closing, and excludes credit union-quarter observations if either return on average assets or asset growth was in highest or lowest 1 percent of observations with assets greater than \$50 million in that quarter. After these adjustments, the research database includes 2,216 federally insured credit unions with more than \$50 million in merger-adjusted assets in 2013, including 1,453 credit unions with more than \$100 million in merger-adjusted assets.

²⁵⁰ The choice of the implementation period itself presents a balancing of the costs and benefits.

values are more volatile than average in response to changing events. This more comprehensive view begins by creating a simulation of the current credit union system in a stressed economic environment—one that is likely to precipitate capital shortfalls at a number of institutions. Each risk-based capital variant is then assessed against this simulation to highlight the effectiveness of the rule in preventing institutions from falling into some measure of under-capitalization.

The effectiveness of risk-based capital variants can be judged using several major considerations. For example, the ideal rule would:

- Require additional capital to be held at credit unions that are at risk of undercapitalization. That is, the rule should target the appropriate institutions.
- Require additional capital to be held at a significant share of the credit unions that are at risk of undercapitalization. In other words, the rule should have a wide scope, evidenced by capturing a large share of the potentially at-risk institutions or a large proportion of the capital needed at potentially at-risk institutions.
- Be efficient, in the sense that, of the additional capital required by the rule, a relatively high proportion should be targeted at credit unions that are at risk of undercapitalization, or the amount of capital they need to remain well capitalized.

Evaluating rule variants also requires a standard by which to judge credit unions that are at risk of under-capitalization. The prompt corrective action framework identifies credit unions with net worth ratios of at least 6 percent as “adequately capitalized,” while credit unions with net worth ratios of at least 7 percent are “well capitalized.” In general, in a well-targeted rule, higher amounts of initial capital can help to insure institutions against falling below the vulnerability standard in a downturn.

The simulated performance of the risk-based capital final rule suggests it is efficient in the sense that a high proportion of the additional capital it requires is used to keep credit unions from falling below the vulnerability standard. However, the rule is not especially wide in scope, because it does not target a high proportion of credit unions that are vulnerable to becoming undercapitalized in a severe recession.

Appendix G

Referenced Materials

Basel Committee on Banking Supervision

- *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010
- *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*, December 2010
- *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (rev June 2011)
- *International Convergence of Capital Measurement and Capital Standards*, June 2004
- *International Convergence of Capital Measurement and Capital Standards, (A Revised Framework)*, June 2006

Congressional Oversight Panel

- *Final Report of the Congressional Oversight Panel*, March 16, 2011

Dallas Federal Reserve Bank

- *Staff Papers, How Bad Was It? The Cost and Consequences of the 2007–2009 Financial Crisis*, July 2013

National Credit Union Administration

- NCUA Examiner's Guide – Chapter 16
- NCUA Letter to Credit Unions No. 07-CU-12, CAMEL Rating System, December 2007
- NCUA Letter to Credit Unions No. 161, December 1994
- NCUA Supervisory Letter No. 05-01, Examiner Guidance – Evaluating Capital Adequacy, August 2005

NCUA Office of Inspector General

- Material Loss Review of Beehive Credit Union (OIG-11-07), July 2011
- Material Loss Review of Cal State 9 Credit Union (OIG-10-03), April 2010
- Material Loss Review of Chetco Credit Union (OIG-13-10), October 2013
- Material Loss Review of Ensign Federal Credit Union (OIG-10-15), September 2010
- Material Loss Review of Huron River Area Credit Union (OIG-08-10), November 2008
- Material Loss Review of Norlarco Credit Union (OIG-09-01), May 2009
- Material Loss Review of Telesis Community Credit Union (OIG-13-05), March 2013
- OIG Capping Report on Material Loss Reviews (OIG-10-20), November 2010

U.S. Senate

- Senate Report 105-193, Credit Union Membership Access Act, May 1998

U.S. Department of the Treasury

- Credit Union Member Business Lending, January 2001
- Report on Credit Unions, December 1997

U.S. Government Accountability Office

- Report to Congressional Committees, *National Credit Union Administration Earlier Actions Are Needed to Better Address Troubled Credit Unions*, January 2012
- Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Financial Institutions Causes and Consequence of Recent Community Bank Failures*, June 2013
- Report to Congress, *Credit Unions Reforms for Ensuring Future Soundness*, July 1991



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