Supervisory Letter

NCUA | Office of Examination & Insurance **SL No. 15-03**
1775 Duke Street, Alexandria, VA 22314 **October 1, 2015**
www.ncua.gov

TO: **All Field Staff**

SUBJECT: **Fixed Asset Management**

The NCUA Board revised §701.36 of NCUA's rules and regulations on July 23, 2015, with changes effective on October 2, 2015. These revisions removed the regulatory limit on the aggregate amount of fixed assets a federal credit union can hold. In the absence of a limit, NCUA's examination and supervision program will address credit unions' safe and sound management of fixed assets.[1]

This Supervisory Letter provides information about the effect fixed assets may have on a credit union's earnings and net worth, and establishes a consistent framework for the examination and supervision processes used to review credit union management of fixed assets. This letter also addresses the occupancy and prohibited transaction provisions that remain in the rule.

Section 701.36 of NCUA's rules and regulations applies only to federal credit unions. However, the safety and soundness guidance in this letter applies to all federally insured credit unions. You can direct questions about the following material to your immediate supervisor or regional management.

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[1] Several state supervisory authorities (SSAs) maintain an aggregate fixed asset limit. This guidance does not supersede these limits in any way.

I. Background

> For the purpose of this letter, ***fixed assets*** generally refers to premises, furniture, fixtures, and equipment. The revised regulation no longer defines fixed assets.

Section 107(4) of the Federal Credit Union Act authorizes a federal credit union to purchase, hold, and dispose of property necessary or incidental to its operations.[2] Section 701.36 of NCUA rules and regulations interprets and implements that provision by establishing occupancy, planning, and disposal requirements for acquired and abandoned premises, and by prohibiting certain transactions.

Between 1978 and 2015, NCUA limited the amount of investment in fixed assets for federal credit unions. This limitation was removed from the rule as of October 2, 2015, giving federal credit unions significant discretion to manage their investments in fixed assets.[3] NCUA will continue to address the safe and sound management of fixed assets for all federally insured credit unions through the examination and supervision process.

A. Existing and Pending Waivers

Existing and pending waivers of the five percent aggregate limit on fixed assets are rendered moot effective October 2, 2015, the effective date of the revised rule. However, any constraints imposed by an enforcement action (for example, a Letter of Understanding and Agreement, Preliminary Warning Letter, or formal enforcement action) on a federal credit union in connection with its investments in fixed assets will remain intact. Thus, any particular enforcement measure to which a federal credit union is uniquely subject takes precedence over the more general application of the regulation. In such cases, the constraint will remain in effect until cancelled or no longer applicable.

Waivers associated with other parts of the rule, such as the occupancy requirements, remain in effect.

B. Overview of §701.36, Effective October 2, 2015

Section 701.36 of NCUA's rules and regulations **applies only to federal credit unions.** The regulation addresses occupancy, planning and disposal requirements for federal credit unions regarding acquired and abandoned premises. It also includes prohibitions that forbid a federal credit union from acquiring or leasing premises from a member of the credit union's

[2] 12 U.S.C. 1757(4)
[3] The final rule approved by the NCUA Board on July 23, 2015 is effective on October 2, 2015.

board of directors, credit committee, supervisory committee, or senior management,[4] or an immediate family member (spouse or other family member living in the same household) of such individual.

1. **Premises Acquired for Future Expansion**[5]

   Full occupancy – If a federal credit union acquires premises for future expansion and does not fully occupy them within one year, it must have a board resolution in place by the end of that year with definitive plans for full occupation.[6] Premises are fully occupied when the federal credit union (or the federal credit union and a credit union service organization (CUSO) or a vendor) uses the entire space on a full-time basis. CUSOs and vendors must use the space primarily to support the federal credit union or to serve the federal credit union's members. The federal credit union must make its plans for full occupation available to NCUA upon request.

   Partial occupancy[7] – If a federal credit union acquires premises for future expansion, including unimproved land or unimproved real property,[8] it must partially occupy them within a reasonable period, but no later than **six years** from the date of acquisition.[9] NCUA may waive the partial occupation requirements. To seek a waiver, a federal credit union must submit a written request to its Regional Office and fully explain why it needs the waiver.[10] The Regional Director will provide the federal credit union a written response, either approving or disapproving the request. The Regional Director's decision will be based on safety and soundness considerations.[11]

[4] ***Senior management employee*** is defined as a credit union's chief executive officer, any assistant chief executive officers, and the chief financial officer. For example, these individuals typically hold the title of President or Treasurer/Manager, Assistant President, Vice President, or Assistant Treasurer/Manager, and Comptroller. See 12 C.F.R. §701.36(b).
[5] 12 C.F.R. §701.36(b) defines ***premises*** as "any office, branch office, sub-office, service center, parking lot, other facility or real estate where the federal credit union transacts or will transact business."
[6]12 C.F.R. §701.36(c)(2)
[7] 12 C.F.R. §701.36(b) defines ***partial occupancy*** to mean occupation, on a full-time basis, of a portion of the premises that is: (1) Consistent with the federal credit union's usage plan for the premises; (2) Significant enough that the federal credit union is deriving practical utility from the occupied portion, relative to the scope of the usage plan; and (3) Sufficient to show that the federal credit union will fully occupy the premises within a reasonable time.
[8] 12 C.F.R. §701.36(b) defines ***unimproved land*** or ***unimproved real property*** to mean: (1) Raw land or land without development, significant buildings, structures, or site preparation; (2) Land that has never had improvements; (3) Land that was improved at one time but has functionally reverted to its unimproved state; or (4) Land that has been improved, but the improvements serve no purpose for the federal credit union's planned use of the property.
[9]12 C.F.R. §701.36(c)(2)
[10] 12 C.F.R. §700.2 defines ***Regional Office*** as "the office of the Administration in the designated geographical area in which the office of the federal credit union is located or, for federal credit unions with $10 billion or more in assets, the Office of National Examinations and Supervision."
[11] See the *Regulatory Waivers and other Regulatory Actions* section of the NSPM for more information about how NCUA processes partial occupancy waiver requests.

2. Abandoned Premises[12]

A federal credit union must make diligent efforts to dispose of abandoned premises and any other real property it does not intend to use in transacting business. The federal credit union must seek fair market value for the property and record its efforts to dispose of abandoned premises. After premises have been abandoned for **four years**, the federal credit union must publicly advertise the property for sale. The federal credit union must complete the sale **within five years** of abandonment, unless NCUA waives this requirement.[13]

To seek a waiver, a federal credit union must submit a written request to its Regional Office and fully explain why it needs the waiver. The Regional Director will provide the federal credit union a written response, either approving or disapproving the request. The Regional Director's decision will be based on safety and soundness considerations.[14]

3. Prohibited Transactions[15]

A federal credit union must not acquire, or lease for one year or longer, premises from any of the following, unless NCUA waives this prohibition:[16]

- A member of the federal credit union's board of directors, credit committee, supervisory committee, or senior management, or an immediate family member of such individual;
- A corporation in which a member of the federal credit union's board of directors, credit committee, supervisory committee, or senior management, or an immediate family member of such individual, is an officer or director, or has a stock interest of 10 percent or more; or
- A partnership, limited liability company, or other entity in which a member of the federal credit union's board of directors, credit committee, supervisory committee, or senior management, or an immediate family member of such individual, is a general partner, or a limited partner or entity member with an interest of 10 percent or more.

[12] 12 C.F.R. §701.36(b) defines ***abandoned premises*** as "real property previously used to transact credit union business, but no longer used for that purpose. It also means real property originally acquired for future credit union expansion, but no longer intended for that purpose."
[13] 12 C.F.R. §701.36(c)(3)
[14] See the *Regulatory Waivers and other Regulatory Actions* section of the NSPM for more information about how NCUA processes waivers for abandoned premises.
[15] 12 C.F.R. §701.36(d)
[16] Consecutive lease contracts which in total exceed one year, as well as rental agreements without formal lease contracts, may not be used to circumvent the requirements of 12 C.F.R. §701.36(d).

A federal credit union must not lease for one year or longer premises from any of its employees if the employee is directly involved in acquiring fixed assets, unless the federal credit union's board of directors determines the employee's involvement is not a conflict of interest.

All transactions with business associates or family members not specifically prohibited by NCUA rules and regulation must be conducted at arm's length and in the best interest of the federal credit union.

To seek a waiver from any of these prohibitions, a federal credit union must submit a written request to its Regional Office and fully explain why it needs the waiver. Within 45 days of the receipt of the waiver request or all necessary documentation, whichever is later, the Regional Director will provide the federal credit union a written response, either approving or disapproving its request. The Regional Director's decision will be based on safety and soundness considerations and a determination as to whether a conflict of interest exists.[17]

II. Risks Associated with Fixed Assets

Credit unions invest in reasonable levels of fixed assets to serve their members. Acquiring premises, technology, and other equipment allows credit unions to deliver financial services conveniently, cost effectively, and enhance the value they provide to members. Credit unions often rely on tangible resources to achieve their strategic plan.

However, unsustainable levels of fixed assets can create risk to both credit unions and the Share Insurance Fund. Fixed assets typically require an increase in maintenance and depreciation expenses. They also tie up funds that could otherwise have been loaned out or invested to generate a return.

Historically, some credit unions have over-concentrated their balance sheet with non-earning fixed assets, which negatively impacts their earnings and ability to accumulate capital. High levels of fixed assets can also lead to the following conditions or practices, which may compound any associated financial and operational challenges:

- Increased risk-taking in lending or investing to compensate for lower operating efficiency levels.
- Reduced ability to adjust to future pressures on earnings (for example, interest rate risk).

[17] See the *Regulatory Waivers and other Regulatory Actions* section of the NSPM for more information about how NCUA processes waivers for prohibited transactions.

- Reduced flexibility in adapting to economic, technology, and population shifts that warrant changes in a credit union's facility needs.

A credit union's ability to afford a given level of fixed assets depends on a variety of factors including its level of net worth and earnings, the institution's operational efficiency, risks to its future earnings, and variations from growth projections. For example, a credit union may purchase a new main office based on optimistic member and share growth projections. If actual growth is significantly below projections the credit union may find it cannot afford the new office over the long term. This could lead to management attempting to unsafely increase the yield on assets by extending maturities or taking more credit risk. Management may also raise share rates or borrow funds to increase the size of the credit union to compensate for unrealized projected growth.

The purchase of a new office may also limit the credit union's future options in responding to changes in member preferences. For example, a credit union may not be in a position to relocate its premises to accommodate unanticipated shifts in the geographic location of its membership base, or be able to invest in emerging member service technologies. Any investment in a facility with limited marketability could further impede a credit union's ability to respond to such changes.

III. Examination Procedures

Field staff must ensure that credit unions effectively manage the level of fixed assets so as to operate in a safe and sound manner. Field staff will use professional judgment to assess the risk associated with fixed assets, considering both quantitative and qualitative factors. The primary objectives of supervisory reviews are to determine the risk to earnings and capital, and to assess the quality of management's planning and analysis with respect to major fixed assets acquisitions.

NCUA considers policies or practices that represent a material threat to earnings and net worth as unsafe and unsound.[18] Any lack of sufficient oversight or due diligence for fixed assets will be reflected in the Earnings and Management CAMEL component ratings and the composite CAMEL rating, as necessary. Operational weaknesses will also be reflected in relevant risk ratings assigned by field staff.

[18] For guidance determining the adequacy of a credit union's plan to preserve earnings and net worth, refer to Supervisory Letter 06-01, *Evaluating Earnings* and NCUA Supervisory Letter 09-03, *Reviewing Adequacy of Earnings*.

A. Risk Analysis Trending and Evaluation (RATE)[19]

During RATE reviews, examiners should note any significant changes in the level of fixed assets or related expenses to determine if additional follow-up is necessary.

B. Examination Scope

Field staff will generally only complete the exam procedures in Part C of this section if any of the following are applicable:

- There are unresolved Document of Resolution (DOR) items, enforcement actions, or outstanding waivers concerning fixed assets;
- The credit union is experiencing weak earnings or has other structural earnings weaknesses (for example, high operating expenses), **regardless of the concentration level of fixed assets;**
- Fixed (non-earning) assets are **greater than 5 percent of assets;[20] or**
- The credit union made, or has board approved plans to make a major acquisition of premises since the last exam.[21]

C. Examination Procedures

Examiners will review the following relevant areas when required to do so based on the criteria in the *Examination Scope* section of this letter.

1. **Analyze earnings** to diagnose the root cause(s) of any weaknesses.
    - Field staff's review of earnings should be consistent with NCUA Supervisory Letter 06-01, *Evaluating Earnings* and NCUA Supervisory Letter 09-03, *Reviewing Adequacy of Earnings*.
    - If the root cause(s) includes a lack of planning for, or over-investment in, fixed assets, field staff will reflect this in the management and any other applicable CAMEL component ratings.

[19] The RATE process is a means to identify and evaluate existing or emerging risk, highlight supervision needs, adjust supervision plans if necessary, and provide for a more effective allocation of examiner resources.
[20] The Financial Performance Report and AIRES Risk Report will be updated to reflect the following fixed asset ratio, computed using data from the following Call Report fields: (Land and Building + Other Fixed Assets) / Total Assets.
[21] For purposes of the examination scope for fixed assets, a major acquisition generally is defined as more than 1% of total assets. For federal credit unions, examiners retain the discretion to review fixed asset investments for compliance with the occupancy provisions of §701.36 as part of the risk focused examination process.

- Field staff will work with management to identify and evaluate strategies to address any earnings weaknesses.
  - The specific corrective action necessary to achieve a safe and sound level of earnings should generally be left to credit union management's discretion.
  - **Field staff must consult with their supervisor** if they intend to issue a DOR requiring the credit union cease additional investment in fixed assets or dispose of fixed assets to address an unsafe or unsound condition.

2. **Review the credit union's governance** over fixed assets and analyze how the concentration of fixed assets (and other non-earning assets) affects the credit union's current and future financial performance.

- Review fixed asset acquisition policies and limits. Field staff expectations in this area will scale with the size and sophistication of the credit union. A sound fixed-asset acquisition policy should generally:
  - Demonstrate adequate consideration for preserving credit union earnings and net worth.
  - Establish a reasonable threshold for the aggregate amount of fixed assets.[22]
  - Be consistent with the credit union's strategic plan, risk tolerance, and financial condition.
  - State actions and authorities required for exceptions to policy, limits, and authorizations.

- Ensure the credit union conducted prudent planning and pre-purchase analysis for newly acquired fixed assets. The extent of field staff's review will be commensurate with the credit union's size and complexity, as well as the stated purpose for the investment. Investments in fixed assets which are for routine replacements or necessary upgrades in the normal course of business generally do not warrant review. However, **for all other fixed asset investments**, field staff should determine whether:
  - Fixed asset acquisitions were made in compliance with credit union board-approved policy, and that the board approved any investment in fixed assets that materially affects the credit union's earnings.
  - Due diligence and pre-acquisition analysis supports the decision to acquire any fixed assets of a material size, and the resulting impact on the credit union. This may include reviewing copies of all bids considered in the process, direct and

[22] In order to be considered reasonable, the credit union's financial projections need to demonstrate it can afford the impact of that level of fixed assets on earnings and capital relative to the credit union's risk profile, growth patterns, and strategic plans.

indirect costs associated with each acquisition, the credit union's strategic plan, pro-forma financial statements, including capital expenditure projections, and financial analysis prepared by management. The financial analysis should document the projected effect on earnings and capital under both baseline (expected) and stressed scenarios. Generally, field staff will consider any instance where reliance on rental income was the primary or only way the credit union could demonstrate it could afford the acquisition of the fixed asset(s) as unsafe and unsound.

  - The credit union considered future marketability of unique or limited purpose premises to determine resale potential
  - Proper oversight was provided for material improvements not necessary to deliver services to members (for example, nonfunctional architectural details that do not improve the market value of a property).

- Determine whether the credit union is properly managing ongoing risk to earnings and capital.
  - Ongoing risk management processes need to be adequate to effectively monitor and measure investments in fixed assets.
  - Credit unions with a significant investment in branches should have branch accounting procedures to provide profitability and efficiency measures by location.
  - Processes need to be appropriate for the size of the credit union and level of fixed assets.
  - Internal reporting needs to be adequate with regard to fixed assets (for example, inventory by fixed asset type, physical location of assets, transaction history, comparison of actual versus budgeted cost and projections).
  - Safeguards (such as appropriate insurance coverage) are sufficient to protect against misappropriation and financial loss due to damage or an unforeseen event.

3. **For <u>federal credit unions</u>, review any recent major acquisition of premises** to ensure they were acquired in compliance with regulation.

- Review any board resolutions, board minutes, or both related to material fixed asset acquisitions.
- Review the acquisition for compliance with prohibited transactions and confirm the transaction was conducted with a non-prohibited counterparty and at arm's length.

- If premises are less than fully occupied for more than one year, ensure the credit union has a plan to occupy the premises.[23]
- Review progress towards partial occupancy within six years (or any applicable timeframe provided by a waiver).
- If the credit union has premises which have been abandoned for less than four years, assess whether the credit union has made diligent efforts to dispose of the property. The credit union must seek market value and record its efforts to dispose of the premises. If the premises has been abandoned for more than four years, confirm the credit union has publicly advertised the property for sale and completes the sale within five years, or has obtained a waiver.

D. Addressing Problems with Fixed Assets

For most supervisory concerns, field staff should work directly with credit union management and officials to communicate concerns, allowing credit union officials to determine the appropriate corrective action. If a credit union's earnings are insufficient or operating expenses are excessive, fixed assets are usually not the sole factor causing the problem. Field staff should work with management to identify all factors contributing to the problem and develop appropriate corrective action with management.

If field staff determine that a credit union's fixed assets have a material negative impact on the institution's earnings and net worth, they should reflect this as warranted in the Capital Adequacy, Earnings, and Management CAMEL component ratings, and the composite CAMEL rating.

For cases involving significant risk, administrative remedies and corrective actions should be considered and issued in accordance with the *National Supervision Policy Manual* and Supervisory Letter 10-04, *Administrative Remedies*.

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[23] If the federal credit union's timetable for full occupancy is longer than 10 years, or the federal credit union has not fully occupied the premises within 10 years from date of acquisition, field staff will refer the matter to the appropriate Regional Director for a determination as to the reasonableness of the plan to ensure the credit union is not speculating on real estate. The Regional Director will consult with E&I and OGC before taking any action.

IV. Additional Guidance Relevant to Fixed Asset Management

This Supervisory Letter is based on the revised NCUA rule, 12 C.F.R. §701.36, and builds on the following:

- Federal Credit Union Act
    - 12 U.S.C. §1766(b)(1)
    - 12 U.S.C. §1787(a))
- NCUA Supervisory Letter 06-01, *Evaluating Earnings*
- NCUA Supervisory Letter 09-03, *Reviewing Adequacy of Earnings*
- NCUA Supervisory Letter 10-04, *Administrative Remedies*
- NCUA *National Supervision Policy Manual*
- NCUA *Examiner's Guide*
    - General Ledger (Chapter 8)
    - Prompt Corrective Action (Chapter 17)
    - Shared Branch (Chapter 24)

If you have questions on the material in this letter, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

Larry Fazio
Director
Office of Examination & Insurance