



NCUA
National Credit Union Administration

Updated Principles of Capital Planning

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NCUA

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Introduction

In 2014, the NCUA Board approved Part 702, Subpart E - Capital Planning and Stress Testing (the rule), for credit unions with assets of \$10 billion or more (covered credit unions). The principles of capital assessment discussed in this paper apply to the credit unions covered by this rule and serve as high-level guidelines.

In 2014, capital planning, stress testing, and related enterprise functions were new areas of emphasis for covered credit unions. As a companion to the rule, the NCUA issued guidance, in consultation with credit unions, to facilitate implementation of the rule.¹ The guidance established the following core principles for capital planning:

- sound risk management fundamentals;
- effective capital policy and governance; and
- comprehensive capital planning and analysis.

This document, *Updated Principles of Capital Planning*, complements the original guidance, *Principles of Capital Policy and Planning*, with observations and examples the NCUA collected over the last five years. The first two principles (sound risk management and effective capital policy and governance) are organized under Section 1 – “Foundational Enterprise Functions,” which became mainstream practices for financial institutions with \$10 billion or more in total assets, including credit unions, since the issuance of the original guidance. Section 2 of this document further develops and discusses the third principle - comprehensive capital planning and analysis.

¹ In September 2014, NCUA issued a whitepaper entitled *Principles of Capital Policy and Planning* that provided an overview of elements essential to the implementation of sound capital assessments as well as the governing controls and risk fundamentals informing and supporting the assessments.



Section 1 – Foundational Enterprise Functions

Capital management and planning consists of the policy and governance framework to ensure capital is sufficient to sustain normal operations even under adverse conditions. Capital planning and sound risk management fundamentals represent the core enterprise functions credit unions should have in place to safeguard the safe and sound operation of the institution. Weakness within these functions may affect the soundness of the credit union’s activities. Such deficiencies may lead to supervisory action and, ultimately, for tier III credit unions, the NCUA’s rejection of the credit union’s capital plan.

The NCUA’s assessment of these enterprise functions consistently maintains the core principles for capital planning, and scales expectations to fit the size, complexity, and financial condition of the credit union. The capital planning and stress-testing rule provides for this calibration through the introduction of three tiers of covered credit unions.² Categorizing credit unions into tiers recognizes the iterative nature of the capital planning and stress testing process, and acknowledges that covered credit unions get better at developing and implementing their capital plans over time and through repetition. Tier I credit unions are encouraged to experiment and develop enterprise functions best suited to their business needs and relative overhead capacity. The NCUA expects tier II credit unions to refine their enterprise functions and remediate identified gaps. By the time a credit union becomes a tier III credit union, the NCUA expects enterprise functions to be mature and continuously operating.

² See 12 CFR § 702.502 for the definition of each tier.



Sound Risk Management Fundamentals

Independent Risk Management Oversight

As part of effective governance, a credit union should incorporate independent risk management oversight. Independent risk management oversight could include a separate group headed by a Chief Risk Officer, or a cross-functional enterprise risk management committee. Independent risk oversight enables credit union leadership to centralize monitoring the management and reporting of risk across business lines and separate from the potential conflicts inherent in business lines performing risk assessments.

Credit union lines of business engage in risk-taking activities where tactical identification, measurement, and control of risk should occur. The lines of business also originate data used to identify and assess threats to capital. The risk oversight process should evaluate the full set of exposures stemming from a credit union's business line activities and collect relevant data for managing these risks. Independent risk oversight is a concept that exists on a continuum based on the credit union's size, complexity, and financial condition. For example, smaller tier I credit unions with lower-risk profiles may compensate for the lack of independent risk oversight through layered management committees. However, as the credit union grows its assets and complexity, or engages in higher-risk activities, it should develop an independent and properly resourced risk oversight function with stature sufficient to challenge line of business risk management.

Effective Policy and Governance

Board of Directors and Senior Management Oversight of Capital Assessment

Together, the credit union's board and senior management team should establish a capital-planning framework across enterprise functions. At the same time, the output from the capital planning process helps enhance enterprise functions. For example, sound capital analysis works



in concert with a board approved capital-planning policy.³ This policy guides management’s implementation of capital analysis and specifies the roles and responsibilities of enterprise functions in the process (such as model risk management and data governance, and internal audit for capital assessment reporting). Subsequently, the board and executive management can use the output from capital analysis to inform the capital limits embedded in various policies.

The board of directors is ultimately responsible for the credit union’s general direction. Besides defining the corporate culture and strategic direction of the credit union, the board provides oversight to ensure risk management and internal controls are suitable for sound capital planning. To meet these responsibilities, the board should know the material risks inherent in the credit union’s activities, such that it can challenge management to develop plausible and transparent presentations of risk. For example, the board should discuss the capital analysis to ensure capital levels and actions are consistent with policy and aligned with higher-level strategic plans. Additionally, the board may use information gained through its other oversight activities to challenge aspects of capital planning and to identify where gaps in practice may exist. For example, this may occur through the board’s internal audit committee having knowledge of internal control weakness in a supporting enterprise function and requesting a discussion on how management mitigates the matter within the capital planning process.

Senior management is responsible for implementing the capital policy approved by the board, adhering to limits, and ensuring the integrity of capital planning activities.⁴ Layering enterprise functions provides the support for sound operations of the credit union, including capital planning. For example, the business unit uses data and models to identify and manage risk, the enterprise risk management (ERM) function’s data governance and model risk management

³ See 12 CFR §702.503 for capital policy requirements.

⁴ See, 12 CFR 702.503(a) stating that senior management must establish a comprehensive, integrated, and effective process that fits into the broader risk management of the credit union. Senior management responsible for capital planning and analysis must provide regular reports on capital planning and analysis to the credit union's board of directors (or a designated committee of the board).



provides oversight, and the internal audit group tests data and modeling controls at the business unit and ERM levels.

Internal Control Review and Audit

A capital policy must include the internal controls that govern capital planning, including review by internal audit.⁵ Internal audit provides assurance that controls related to capital planning are functioning and useful. Internal audit's risk-focused review of the capital assessment process, not just the individual components, ensures the entire end-to-end process is working as expected and following the credit union's policies and procedures. Additionally, the effectiveness of the full process is not merely a sum of the individual components. Internal audit's assessment of the capital assessment process supports the ability of senior management and the board of directors to challenge analysis, results, and related capital recommendations.

For credit unions recently crossing the \$10 billion total asset threshold, capital planning may be a new process with several components still under development. Initially, this circumstance may limit the internal audit review of the capital assessment's adherence to credit union policy and compliance with NCUA regulations. As the capital assessment process matures, however, internal audit's oversight of the framework should expand to evaluate the strength and effectiveness of specific components such as scenario design, data integrity, and assumption selection.

⁵ See, 12 CFR 702.503(b) stating that the capital policy must specify the internal controls that govern capital planning, including review by internal audit, control of changes in capital planning procedures, and required documentation.



Documentation and Reporting

The credit union's corporate governance process must include proper documentation to provide clarity to all participants and to document positions and decisions.⁶ Documentation should reflect the two-way flow of expectations and information regarding credit union operations.

Regarding the capital assessment, the credit union's documentation and reporting framework certifies the internal controls ensure the integrity of published results and records the review and approval of capital assessment at each stage of the process.

Stakeholder communication

Communication of capital analysis activities across relevant internal and external stakeholders has benefits for credit unions. Sharing the results provides essential perspectives on risks that would not otherwise be available to the stakeholder.

Section 2 – Comprehensive Capital Planning and Analysis

The principle of comprehensive capital planning and analysis includes the credit union's specific governance, policies, tolerances, and analysis of capital adequacy. A credit union's capital planning process is a high-level function complementing the credit union's strategic and business planning activities.

Sound capital analysis is a crucial part of the capital planning process and is a critical element of risk management for credit unions. Capital analysis informs the board and senior management of the credit union's viability through uncertain times, helps establish enterprise risk appetites and associated risk limits, and provides an opportunity to assess strategic and business decisions on a forward-looking basis.

⁶ See, 12 CFR 702.503(b) stating that the capital policy must specify the internal controls that govern capital planning, including the required documentation.



The following fundamentals are not new for credit unions. Their specific application to capital analysis in this paper, however, provides principle-level guidance. The credit union may meet the principles in different ways, depending on the circumstances of the credit union. These principles presuppose the credit union's enterprise functions are sufficient to support sound capital planning and capital analysis, given the credit union's size, complexity, and financial condition.

Capital Analysis Policy and Governance

To ensure safe and sound operations, large credit unions should have enterprise-level governance and oversight. The capital analysis framework should function within, and be supported by, the enterprise-level governance and oversight structure. At the highest level, the capital policy establishes how management should maintain operations under normal circumstances and continue to serve member credit and deposit needs under times of stress. It is, thus, essential that the analysis of capital captures the array of risks inherent in the credit union's activities and supports plausible and conservative risk assessments under adverse conditions.

Clearly stated and formally approved objectives

A capital analysis can serve many purposes within the credit union's strategic and decision-making process. The credit union's board must clearly articulate the intended uses of the capital analysis and establish clear objectives of the capital analysis framework in the credit union's capital policy.⁷ The objectives serve as the basis for designing the analysis framework requirements and expectations. Capital analysis objectives and foundational enterprise functions should mutually support each other. Capital analysis objectives may include:

- calibrating risk appetite statements and related limits relative to capital;
- supporting contingency, recovery, and resolution plans;

⁷ See, 12 CFR 702.503(b) stating that the capital policy must state capital analysis roles and responsibilities and how capital analysis results are used and by whom.



- supporting forecasting, budgeting, financial and strategic planning;
- informing internal capital adequacy, attribution and performance assessments;
- reporting liquidity assessments; and
- producing supervisory stress test results using the NCUA's specifications.⁸

Effective governance structure

A capital analysis framework should include a clear and compelling governance structure that is comprehensive and documented.⁹ This structure should consist of how enterprise governance oversees this framework and specify the roles and responsibilities of senior management and staff responsible for the ongoing capital analysis operation. This framework should identify all key stakeholders and ensure full and consistent oversight, accountability, and monitoring of the actions taken at the different stages of the capital analysis process.

Adequate functions and resources

Enterprise support functions are necessary for capital analysis frameworks to meet stated objectives. Governance processes should ensure adequate resources for capital analysis, including human resources with proper skills, and systems with the sufficient capabilities to execute the framework. Over time, capital analysis may incorporate greater sophistication as risk profiles evolve, market conditions change, competition transforms, or the financial state of the credit union changes.

Accurate data and robust IT systems

For reliable risk identification and capital analysis, a data governance function establishes and maintains an oversight framework that supports the production of accurate, complete, and

⁸ In accordance with Part 702, Subpart E, objectives related to supervisory stress testing only apply to tier II and tier III credit unions.

⁹ See, 12 CFR 702.503(b) stating that the capital policy must state the governance over the capital analysis process.



promptly available data of sufficient granularity. The granularity of the data should align with the objectives of the capital analysis framework.

Credit unions should have a robust data infrastructure capable of retrieving, processing, and reporting information used in the capital analysis to ensure information quality is adequate to meet the objectives of the capital analysis framework. Processes should be in place to address any identified material data deficiencies.

New product analysis and merger analysis should include data and data system considerations. To be useful, the data governance function should ensure data are sufficient to support the capital analysis framework and other enterprise data use and reporting functions.

Critical challenge and regular review

Regular review and challenge of models and fundamental assumptions are essential steps in the capital analysis process. Critical challenge improves the reliability of analysis results, aids in an understanding of analytical limitations, identifies areas for improvement in the capital analysis framework, and ensures the use of capital analysis results are consistent with the framework's objectives. Such reviews should provide coverage of all aspects of the capital analysis framework periodically and ensure regular maintenance and updates of the structure.

Forward-Looking Capital Analysis

Capturing material risks and assessing stressful conditions

Capital analysis frameworks should capture material and relevant risks, as determined by a robust enterprise identification process. The risk identification process must contain a comprehensive assessment of risks, which include those from balance sheet exposures, earnings vulnerabilities, operational risks, and should include other factors affecting the capital adequacy



or liquidity position of the credit union.¹⁰ The unfavorable conditions should be sufficiently severe and varied, given the objective of the exercise, to provide a meaningful test of capital adequacy. The scenarios and sensitivities used in a capital analysis should be periodically reviewed to ensure they remain relevant. Historical events and hypothetical future events should consider new information and incorporate continuous monitoring of emerging risks.

Conservatism

The fundamental concept of conservatism is critical for ensuring decision-makers have a plausible array of risks arising from credit union activities and their effect on the capital analysis. The quality of governance practices is a crucial element determining the conservatism of capital analysis, and best applied through culture. A conservative culture is led by the board of directors and supports independent risk oversight and critical challenge at various points within the capital analysis framework.

Data that embeds management actions may diminish conservatism. A credit union's loan data history, for example, may only cover a period when management acted to minimize accounting loss and assist members. Using such data to develop and tune models used in capital analysis results in an immoderate forecast of inherent risk. Adding immediate mitigating actions in the analysis process further erodes conservatism; however, mitigating measures added in subsequent analysis increases transparency and cultivates critical challenges.

At times, available data may be limited to a timeframe when management took explicit actions to mitigate losses during stress. Analysis results relying on these data should identify this to stakeholders. The credit union should conduct additional analysis to understand the extent to

¹⁰ See, 12 CFR 702.504(b)(2) stating that the capital plan must discuss how the credit union will, under expected and unfavorable conditions, maintain stress test capital commensurate with all of its risks, including reputational, strategic, legal, and compliance risks.



which these actions mitigated loss and adequately document model overlays applied to ensure conservatism.

Fitness of models and methodologies

The models and methodologies used to derive estimates should fit the purpose and intended use of the capital analysis. Model fitness implies:

- suitable data are available for models given the capital analysis framework's objectives;
- models are sufficiently sophisticated for both the objectives of the process and the materiality of the portfolios; and
- models and methodologies used for capital analysis are well justified and documented.

Sound enterprise functions check the appropriateness of models at multiple places within the governance structure. For example, model risk management, points of critical challenge, and internal audit's policy and effectiveness checks review model appropriateness.

Strategic Inclusion of Capital Analysis

Risk management tool and business decisions

As a forward-looking risk management tool, capital analysis is a key input related to risk identification, monitoring, and evaluation. As such, the capital analysis framework must contribute to the credit union's strategic and business objectives.¹¹

As an essential risk management tool, the capital analysis framework must operate according to a defined schedule.¹² An appropriate plan will depend on the objectives of the capital analysis framework, the size, complexity, and financial condition of the credit union, as well as changes

¹¹ See, 12 CFR 702.504(b)(4) stating that the capital plan must discuss expected changes to the credit union's business plan that are likely to have a material impact on the credit union's capital adequacy and liquidity.

¹² See, 12 CFR 702.503(b) stating that the capital policy must describe the frequency with which capital analyses will be conducted.



in the macroeconomic environment. Ad hoc capital analysis is helpful in specific situations, such as when management considers new products or mergers, or unforeseen economic events arise.

Conclusion

Since the implementation of the NCUA's Capital Planning and Stress Testing rule, fundamental enterprise functions are required for credit unions with \$10 billion or more of total assets.

During the same time, several principles coalesced regarding credit union capital analysis. The NCUA's regulations and supervisory approach have accordingly changed, and this paper recognizes these advancements. The agency's approach recognizes credit unions may meet these principles in different ways, and each credit union must do so in a manner that is right for them.

The NCUA is committed to principle-based assessment based on the size, complexity, and financial condition of the credit union.