# Comment Call (15-4)
# NCUA: Risk-Based Capital

**Impact:** Federal and State Chartered Credit Unions
**Relevant Department:** CEO/CFO/COO
**Priority Level:** ***High***

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**Background**
After much anticipation from the credit union industry the National Credit Union Administration (NCUA) is seeking comment on a second proposal that would amend NCUA's current regulations regarding prompt corrective action (PCA) to require that credit unions taking certain risks hold capital commensurate with those risks. The NCUA received over 2000 comment letters in response to the initial proposal with nearly 100 of letters received coming from the Michigan credit union delegation. The proposal, in response to public comments received, makes a number of changes to the original proposed rule published in the Federal Register on February 27, 2014.

The proposal can be found here.

Comments must be received on or before April 27, 2015.

**Summary and Request for Comment**
Based largely on comments received on the original proposal, the NCUA is proposing many improvements to Risk Based Capital 2, including: (1) amending the definition of "complex" credit union by increasing the asset threshold from $50 million to $100 million; (2) reducing the number of asset concentration thresholds for residential real estate loans and commercial loans (formerly classified as MBLs); (3) assigning one-to-four family non-owner-occupied residential real estate loans the same risk weights as other residential real estate loans; (4) eliminating Interest Rate Risk (IRR) from the proposed rule; (5) extending the implementation timeframe to January 1, 2019; and (6) eliminating the Individual Minimum Capital Requirement (IMCR) provision.

***Primary changes to RBC 2***
A federally insured credit union is covered under the proposal only if it is defined as "complex." The new proposal would define any federally insured credit union with more than $100 million is assets– an increase from the original proposal of $50 million – as complex. A credit union's quarter-end total assets would have to exceed $100 million, as reflected in its most recent call report.

The change in the definition will mean fewer credit unions will be subject to the NCUA's risk-based capital requirements. This approach is inconsistent with the Federal Credit Union Act which requires the NCUA to consider the "portfolio of assets and liabilities" of a credit union when determining whether they are to be defined as "complex." The NCUA has indicated that it will review the threshold every three years when it reviews one-third of its rules.

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In discussing the definition of complex, the agency indicated that it is aware that certain products and activities are “good indicators” of complexity such as:

- 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 (if greater than 1% of total assets);
- Non-agency mortgage-backed securities;
- Non-mortgage related securities with embedded options;
- Collateralized mortgage obligations/real estate mortgage investment conduits;
- Commercial mortgage-related securities;
- Borrowings;
- Repurchase transactions;
- Derivatives; or
- Internet banking.

In light of this list and concerns raised by the MCUL, CUNA and others, the NCUA is seeking specific comments on an alternative measure of “complex” that would involve a benchmark number of products and services.

***Request for Comment***

1. What specific products and services should the NCUA include in the list of products and services used to determine whether a credit union’s portfolio of assets and liabilities is “complex,” and why?
2. What number of complex products and services should a credit union be allowed to engage in before being designated as “complex,” and why?

***<u>Capital Measures, Capital Adequacy</u>***

Responding to concerns addressed in the original proposal the NCUA has eliminated the proposed provision regarding individual additional minimum capital. Under the previous provision, an examiner could have, at their discretion, imposed additional capital requirements on credit unions on a case-by-case basis. The proposal would continue the authority of the NCUA Board to reclassify a credit union and if below adequately capitalized, subject the credit union to supervisory actions because of safety and soundness concerns.

However, the new proposal would add a requirement that a covered credit union must maintain capital commensurate with the level and nature of all its risks and must have a process to determine its capital adequacy in light of its risk and a comprehensive written strategy to maintain “an appropriate level of capital.” Proposed new 701.101(b) will add a broader capital adequacy standard which will apply to “complex credit unions,” meaning those with quarter-end assets greater than $100 million. Proposed new 702.101(b) will require “complex” credit unions to maintain a comprehensive written strategy appropriate for their level of capital and risk profiles. During the supervisory process, the NCUA will assess whether these written plans adequately address a credit union’s activities and risk profile, as well as risks and other factors that can affect its financial condition.

The NCUA indicated that its assessment may include a review of the level and severity of problem assets and a credit union’s exposure to operational risk, IRR and significant asset concentrations. In addition to evaluating the appropriateness of a credit union’s capital plan, NCUA’s supervisory assessment will also take 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 MCUL is concerned about this proposed provision as it would potentially subject credit unions to higher capital requirements than what the proposal provides. This provision would invite examiners to continually demand additional capital from credit unions and potentially subject credit unions to additional scrutiny regarding not only their capital levels but also how they plan their capital strategies to balance their risks. Of course, credit unions do routinely develop and implement strategies to maintain adequate capital but addressing this issue as a regulatory requirement strengthens the ability of examiners to second-guess credit unions' efforts and plans in this area. NCUA has indicated that it plans to provide examiner guidance that would be available to credit unions as well on the use of this provision.

***Request for Comment***

1. Do you feel the new capital adequacy plan provision is necessary?
2. Has the NCUA justified the inclusion of this provision in the proposal?
3. If the NCUA can be persuaded to remove it, should complex credit unions be subject to any additional capital planning requirements or guidance from the NCUA?
4. If you credit union is state chartered, do you foresee any issues regarding how the NCUA would coordinate with state regulators on capital planning requirements?

***<u>Calculating the Risk Based Capital Ratio (Supplemental Capital)</u>***

The new proposal requires a covered credit union to calculate the percentage, rounded to two decimal places, of its RBC ratio numerator to its total risk-weighted assets as defined by the NCUA. The RBC numerator is the sum of the specific capital elements in the proposal with regulatory adjustments deducted, as specified by the NCUA. The elements of the RBC numerator are:

- Undivided earnings;
- Appropriation for non-conforming investments;
- Other reserves;
- Equity acquired in merger;
- Net income;
- ALLL, maintained in accordance with GAAP;
- Secondary capital accounts included in net worth for low-income designated credit unions; and
- Section 208 assistance included in net worth.

RBC ratio numerator deductions. The elements deducted from the sum of the capital elements of the risk-based capital ratio numerator are:

- NCUSIF Capitalization Deposit;
- Goodwill (special treatment is provided for goodwill in a supervisory merger until January 2025);
- Other intangible assets; and
- Identified losses not reflected in the risk-based capital ratio numerator

There are some issues regarding the numerator calculation that are of concern – supplemental capital and goodwill.

Supplemental (secondary) capital for all federally insured credit unions for RBC2 purposes should be included. While the NCUA is not including supplemental capital authority for all federally insured credit unions in the proposal it is seeking comments on this issue. Credit unions are urged to weigh in on this important issue.

***Request for Comment***

1. Should additional supplemental forms of capital be included in the risk-based capital ratio numerator and how would including such capital protect the NCUSIF from losses?

2. If yes, what specific criteria should such additional forms of capital reasonably be required to meet to be consistent with GAAP and the FCUA, and why?
3. If certain forms of certificates of indebtedness were included in the risk-based capital ratio numerator, what specific criteria should such certificates reasonably be required to meet to be consistent with GAAP and the FCUA and why?
4. In addition to amending NCUA's risk-based capital regulations, what additional changes to NCUA's regulations would be required to count additional supplement forms of capital in NCUA's risk-based capital ratio numerator?
5. For state-chartered credit unions, what specific examples of supplemental capital currently allowed under state law do you believe should be included in the risk-based capital ratio numerator, and why should they be included?
6. What investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital?

***Goodwill***

Unlike the initial Risk Based Capital Proposal, the new proposal would allow a credit union to factor goodwill in a supervisory merger into its risk based capital calculation. This provision would expire in January 2025. There are two issues to consider regarding the NCUA's treatment of goodwill. The agency has defined "supervisory merger" in a positive way to include mergers in which the agency or a state regulator has identified the continuing credit union and no actual assistance for the merger is necessary to meet the definition. The MCUL and CUNA are supportive of this definition, however, we question whether it is necessary to end the provision in January 2025 and continue to discuss this issue with affected credit unions.

In our initial response to RBC1 the MCUL voiced our concerns regarding the exclusion of the 1% NCUSIF deposit in both the numerator and denominator of the risk-based net worth calculation and urged for its inclusion. The NCUA did not accept this recommendation and the MCUL will continue to evaluate our position on the issue for our comments to RBC2.

***Risk Weighted Assets (denominator of RBC2 ratio calculation)***

The NCUA made the most changes to this area of the proposal as they are significantly more in line with the Federal Deposit Insurance Corporation (FDIC) in a number of areas. The NCUA has provided a chart comparing the proposed risk weights from the original proposal and the new proposal. The table can be found here.

The positive changes in the various risk weightings (RW) include:

- The removal of interest rate risk from the risk weighted assets
- Member Business Loans for RBC purposes are redefined as commercial loans and 1 to 4 family non-owner occupied real estate liens are treated as residential, not commercial loans and thus subject to lower risk-weightings generally;
- Concentration tiers for commercial loans, first residential and junior liens reduced from 3 to 1;
- Top risk weightings for commercial loans reduced from 200% to 150%
- Vehicles manufactured for personal use unless employed for a fare-based endeavor are treated as consumer loans;
- Compensating balances and government guarantees for any portion of a commercial loan would have a lower risk weight and will not count towards concentration risk thresholds;
- Threshold for delinquent loans increased from 60 to 90 days;
- Separate risk weights for fully share secured, secured and unsecured loans;
- FHL Bank and CLF stock RWs reduced from 50% to 20% and 0%, respectively;
- Corporate CU Perpetual Capital reduced from 200% to 150%;

- Investments in and loans to CUSOs that are consolidated into a CU's financial statement have no separate RW. Loans to unconsolidated CUSOs have a 100% RW and investments in unconsolidated CUSOs have a 150% RW.

While these changes are positive there are additional concerns with the risk weightings as proposed.

- Secured consumer loans would have a higher RW than for banks (75% vs. 100%);
- Unsecured consumer loan RWs increased to 100% from 75%;
- All of a commercial loan, not just the amount in excess of $50,000 would be subject to risk weighting;
- Unconsolidated CUSO investments have a higher RW than loans to such a CUSO (150% and 100%);
- CUSO investments could have a higher RW than banks (150% vs. 100-600%);
- First lien and junior lien residential real estate loans over 35% of assets and 20% of assets respectively would have higher RWs than for banks (75% vs. 50%; 150% vs. 100%); and
- Commercial loans over 50% of assets would also have a higher RW than banks (150% vs. 100%)

***Request for Comment***

1. Do you agree with the positive changes to risk-weightings? Has the NCUA reduced them enough, are any too low, etc.?
2. If you do not agree with one or more of the positive changes, what should the appropriate risk-weightings be for those assets?
3. In the areas of differences between credit union and bank risk-weightings for secured consumer loans, mortgage loans, commercial loans and CUSO investments as addressed above, do you support or oppose the changes?
4. If you do not agree with any of the differences in risk-weightings for credit unions versus banks, what should the risk-weightings be in those areas?
5. Are there other changes regarding the risk-weightings that you wish to address?

***<u>Interest Rate Risk</u>***

While weighted average life was not factored into the risk weightings the NCUA is still focusing on Interest Rate Risk.

***Request for Comment***

The Board is seeking comments on alternative approaches that could be taken in the future to address interest rate risk within Prompt Corrective Action.

The Supplementary Information accompanying the proposal indicates that the NCUA is considering adding a separate IRR as a subcomponent of RBC based on a comprehensive balance sheet measure, such as net economic value (NEV).

Some additional questions to consider:

1. Is the current interest rate risk rule that took effect in 2012 sufficient to address concerns with credit unions' management of IRR?
2. If a new supervisory tool for NCUA is needed regarding IRR, do you support a new regulatory requirement, which generally provides less discretion to examiners, or further guidance that can provide more flexibility to credit unions but also more discretion to examiners?
3. Do you support either new guidance on or a regulatory provision regarding NEV analysis of a credit union's balance sheet to monitor IRR?
4. If not, what other approach should be considered on IRR management?

***Additional Comments***

1. Do you have any additional comments as a whole on the proposal?

**Comment Letters**

Comments should be identified by RIN 3133-AD77, by any of the following methods.

**Please submit a mailed Comment Letter to:**
Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street, Alexandria, Virginia 22314-3428

**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: Risk-Based Capital" in the email subject line.

**Please submit to the MCUL a copy of your response to the attention of:**

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**We Appreciate Your Response**