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Part II

National Credit Union Administration

12 CFR Parts 700, 701, 702 et al.
Risk-Based Capital; Proposed Rule

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 700, 701, 702, 703, 713, 723, and 747

RIN 3133–AD77

Risk-Based Capital

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The NCUA Board (Board) is seeking comment on a second proposed rule 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 proposal would restructure NCUA's PCA regulations and make various revisions, including amending the agency's current risk-based net worth requirement by replacing the current risk-based net worth ratio with a new risk-based capital ratio for federally insured natural person credit unions (credit unions). The proposal would also, in response to public comments received, make a number of changes to the original proposed rule that the Board published in the **Federal Register** on February 27, 2014. These changes include, among other things, exempting credit unions with up to $100 million in total assets from the new rule, lowering the risk-based capital ratio level required for an affected credit union to be classified as well capitalized from 10.5 percent to 10 percent, lowering the risk weights for various classes of assets, removing interest rate risk components from the risk weights, and extending the implementation timeframe to January 1, 2019. These changes would substantially reduce the number of credit unions subject to the rule, reduce the impact on affected credit unions, and afford affected credit unions sufficient time to prepare for the rule's implementation.

The proposed risk-based capital requirement set forth in this proposal would be more consistent with NCUA's risk-based capital measure for corporate credit unions and more comparable to 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 Banking Agencies).

In addition, the proposed revisions would amend the risk weights for many of NCUA's current asset classifications; require higher minimum levels of capital for credit unions with concentrations of assets in real estate loans or commercial loans or higher levels of non-current loans; and set forth how NCUA can address a credit union that does not hold capital that is commensurate with its risk.

The proposed revisions would also eliminate several provisions in NCUA's current PCA regulations, including provisions relating to the regular reserve account, risk-mitigation credits, and alternative risk weights. (For clarity, the ''current'' PCA regulations would remain in force until the effective date of a final risk-based capital rule.)

DATES: Comments must be received by April 27, 2015.

ADDRESSES: You may submit written 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: 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: Larry Fazio, Director, Office of Examination and Insurance, at (703) 518–6360; JeanMarie Komyathy, Director, Division of Risk Management, Office of Examination and Insurance, at (703) 518–6360; Steven Farrar, Loss/Risk Analyst, Division of Risk Management, Office of Examination and Insurance, at (703) 518–6393; John Shook, Loss/Risk Analyst, Division of Risk Management, Office of Examination and Insurance, at (703) 518–3799; Tom Fay, Senior Capital Markets Specialist, Division of Capital and Credit Markets, Office of Examination and Insurance, at (703) 518–1179; Rick Mayfield, Senior Capital Markets Specialist, Division of Capital and Credit Markets, Office of Examination and Insurance, at (703) 518–6501; or by mail at National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314.

SUPPLEMENTARY INFORMATION:

I. Introduction

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.[1] In its role as administrator of the National Credit Union Share Insurance fund (NCUSIF), NCUA insures and regulates approximately 6,400 federally insured credit unions, holding total assets exceeding $1.1 trillion and representing approximately 99 million members.

At its January 2014 meeting, the Board issued a proposed rule (the Original Proposal)[2] to amend NCUA's PCA regulations, part 702. The Original Proposal sought to enhance risk sensitivity and address weaknesses in the existing regulatory capital framework for credit unions. The revisions in the Original Proposal included a new method for computing NCUA's risk-based requirement that would be more consistent with the risk-based capital ratio measure used for corporate credit unions[3] and more comparable to the risk-based capital ratio measures used by the Other Banking Agencies.[4] In general, this new method for computing NCUA's risk-based requirement would have adjusted the risk weights for many asset

[1] 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.

[2] 79 FR 11183 (Feb. 27, 2014).

[3] *See* 12 CFR part 704.

[4] *See* 78 FR 55339 (Sept. 10, 2013).

classifications to lower the minimum risk-based capital ratio requirement for credit unions with lower-risk operations. Conversely, this new method would have required higher minimum levels of risk-based capital for credit unions with concentrations of assets in residential real estate loans or commercial loans, or high levels of non-current loans.

In addition, due to the inherent limitations of any widely applied risk-based capital measurement system, the Original Proposal also included procedures for the Board to require an individual credit union to hold a higher level of risk-based capital where NCUA staff raised specific supervisory concerns regarding the credit union's condition. Finally, the Original Proposal eliminated the provisions of current § 702.401(b) relating to transfers to the regular reserve account, current § 702.106 regarding the standard calculation of the RBNW ratio requirement, current § 702.107 regarding alternative components for the standard calculation, and current § 702.108 regarding the risk-mitigation credit.

In response to the Original Proposal, the Board received over 2,000 comments with many suggestions on how to improve the Original Proposal. The Board has reviewed the comments and determined that it was appropriate to issue a second proposed rule. The Board notes that, because this is a new proposed rule, it is not required to respond to any comments received on the Original Proposal. However, the Board believes it is important to address those comments, and has, therefore, included comment summaries and responses throughout the preamble to this proposal.

The Board is now requesting comment on this second proposed rule regarding risk-based capital. Based largely on comments it received on the Original Proposal, the Board is proposing many improvements to the Original Proposal, 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 IRR from this proposed rule; (5) extending the implementation timeframe to January 1, 2019; and (6) eliminating the Individual Minimum Capital Requirement (IMCR) provision. Among other things, these changes would substantially reduce the number of credit unions subject to the rule, and would afford affected credit unions sufficient time to prepare for the rule's full implementation. A full discussion of the impact of these and other changes in this proposed rule is contained in Impact of the Proposed Regulation part of the preamble below.

As discussed in more detail below, the revisions in the Original Proposal and this proposal are intended to implement the statutory requirements of the Federal Credit Union Act (FCUA) and follow recommendations made by the Government Accountability Office (GAO).

II. Legal Authority

In 1998, Congress enacted the Credit Union Membership Access Act (CUMAA).[5] Section 301 of CUMAA added new section 216 to the FCUA,[6] which requires the Board to adopt by regulation a system of PCA to restore the net worth of credit unions that become inadequately capitalized.[7] Section 216(b)(1)(A) requires the Board to adopt by regulation a system of PCA for federally insured credit unions that is ''consistent with'' section 216 of the FCUA and ''comparable to'' section 38 of the Federal Deposit Insurance Act (FDI Act).[8] Section 216(b)(1)(B) requires that the Board, in designing the PCA system, also take into account the ''cooperative character of credit unions'' (*i.e.,* 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).[9] In 2000, the Board implemented the required system of PCA, primarily in part 702 of NCUA's regulations.[10]

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].'' [11] 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 focuses primarily on principal components (1) and (3), although amendments to part 702 of NCUA's regulations relating to principal component (2) are also included as part of this proposal.

Among other things, section 216(c) of the FCUA requires NCUA to use a credit union's net worth ratio to determine its classification among five ''net worth categories'' set forth in the FCUA.[12] Section 216(o) generally defines a credit union's ''net worth'' as its retained earnings balance,[13] and a credit union's ''net worth ratio'' [14] as the ratio of its net worth to its total assets.[15] 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.[16]

Section 216(d)(1) of the FCUA requires that NCUA's system of PCA include, in addition to the statutorily defined net worth ratio requirement applicable to federally insured natural-person credit unions, ''a risk-based net worth [17] requirement for insured credit

[5] Public Law 105–219, 112 Stat. 913 (1998).

[6] 12 U.S.C. 1790d.

[7] The risk-based net worth 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. 65 FR 44950 (July 20, 2000). NCUA's risk-based net worth requirement has been largely unchanged since its implementation, with the following limited exceptions: Revisions were made to the rule in 2003 to amend the risk-based net worth requirement for MBLs, 68 FR 56537 (Oct. 1, 2003); revisions were made to the rule in 2008 to incorporate a change in the statutory definition of ''net worth,'' 73 FR 72688 (Dec. 1, 2008); revisions were made to the rule 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, 76 FR 16234 (Mar. 23, 2011); and revisions were made in 2013 to exclude credit unions with total assets of $50 million or less from the definition of ''complex'' credit union, 78 FR 4033 (Jan. 18, 2013).

[8] 12 U.S.C. 1790d(b)(1)(A); *see also* 12 U.S.C. 1831o (Section 38 of the FDI Act setting forth the PCA requirements for banks).

[9] 12 U.S.C. 1790d(b)(1)(B).

[10] 12 CFR part 702; *see also* 65 FR 8584 (Feb. 18, 2000) *and* 65 FR 44950 (July 20, 2000).

[11] 12 U.S.C. 1790d(a)(1).

[12] Section 1790d(c).

[13] Section 1790d(o)(2).

[14] Throughout this document the terms ''net worth ratio'' and ''leverage ratio'' are used interchangeably.

[15] Section 1790d(o)(3).

[16] Section 1790d(c) through (g); 12 CFR 702.204(a) and (b).

[17] For purposes of this rulemaking, the term ''risk-based net worth requirement'' is used in reference to the statutory requirement for the Board to design a capital standard that accounts for variations in the risk profile of complex credit union. The terms ''risk-based capital ratio'' and ''risk-based capital ratio'' are used to refer to the specific standards this rulemaking proposes to function as criteria for the statutory risk-based net worth requirement. For example, this rulemaking's proposed risk-based capital ratio would replace the risk-based net worth ratio in the current rule. The term ''risk-based capital ratio'' is also used by the Other Banking Agencies and the international banking community

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unions that are complex, as defined by the Board . . . .'' [18] Unlike the terms ''net worth'' and ''net worth ratio,'' the term ''risk-based net worth'' is not defined in the FCUA.[19] Accordingly, when read together, sections 216(b)(1) and 216(d)(1) grant the Board broad authority to design PCA regulations, including a risk-based net worth requirement, so long as the regulations are comparable to the Other Banking Agencies' PCA requirements and consistent with the requirements of section 216 of the FCUA and the cooperative character of credit unions.

The FCUA directs NCUA to base its definition of ''complex'' credit unions ''on the portfolios of assets and liabilities of credit unions.'' [20] It also requires NCUA to design a risk-based net worth requirement to apply to such ''complex'' credit unions.[21] 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 net worth ratio)] may not provide adequate protection.'' [22] In the Senate Report on CUMAA, Congress expressed its intent with regard to the design of the risk-based 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.[23]

Section 216(c) of the FCUA requires that, if a credit union meets the definition of ''complex'' and its net worth ratio initially indicates that it meets or exceeds the net worth ratio requirement to be either ''adequately capitalized'' or ''well capitalized,'' the credit union must still satisfy the separate risk-based net worth requirement.[24] Under the separate risk-based net worth requirement, the complex credit union must, in addition to meeting the statutory net worth ratio requirement, also meet or exceed the minimum risk-based net worth requirement that corresponds to either the adequately capitalized or well capitalized capital category in order to receive a capital classification of adequately capitalized or well capitalized, as the case may be.[25] For example, if a complex credit union meets or exceeds the net worth ratio requirement to be classified as well capitalized, then it must also meet or exceed the corresponding risk-based net worth requirement to be well capitalized.

If any complex credit union meets or exceeds the net worth ratio requirement to be classified as well capitalized or adequately capitalized, but fails to meet the corresponding risk-based net worth requirement to be well capitalized or adequately capitalized, then the credit union's capital classification is determined based on the risk-based net worth requirement. For example, if a complex credit union is classified as well capitalized based on its net worth ratio, but only meets the risk-based net worth requirement that corresponds with the adequately capitalized capital category, then that credit union's capital classification would be adequately capitalized. Similarly, if a complex credit union meets the risk-based net worth requirement to be well capitalized, but only meets the net worth ratio requirement to be undercapitalized, then that credit union's overall capital classification is undercapitalized. In either case, the credit union would be subject to any mandatory and discretionary supervisory actions applicable to its lowest capital classification category.[26]

In response to the Original Proposal, some commenters questioned NCUA's legal authority to impose a risk-based net worth requirement on both well capitalized and adequately capitalized credit unions. NCUA's position is that the Board is authorized to do so under the FCUA. 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. Section 216(c)(1) provides, in relation to ''net worth categories,'' that: (1) An insured credit union is ''well capitalized'' if it has a net worth ratio of not less than 7 percent; *and* it meets *any applicable risk-based net worth requirement* under subsection (d) of this section; (2) an insured credit union is ''adequately capitalized'' if it has a net worth ratio of not less than 6 percent; *and* it meets *any applicable risk-based net worth requirement* under subsection (d) of this section; and (3) an insured credit union is ''undercapitalized'' if it has a net worth ratio of less than 6 percent; *or* it fails to meet *any applicable risk-based net worth requirement* under subsection (d) of this section.[27] The language in components (1) and (2), when read in conjunction with the language in section 216(d), authorizes NCUA to impose risk-based net worth requirements on both well capitalized and adequately capitalized credit unions.

In addition, section 216(d)(2) of the FCUA sets forth specific requirements for the design of the risk-based net worth requirement mandated under section 216(d)(1).[28] 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.'' [29] Under section 216(c)(1)(B) of the FCUA, the *net worth ratio* required for an insured credit union to be adequately capitalized is six percent.[30] 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 beyond those already addressed through the statutory 6 percent *net worth ratio* required for a

when referring to the types of risk-based requirements that are addressed in this proposal. This change in terminology throughout the proposal would have no substantive effect on the requirements of the FCUA, and is intended only to reduce confusion for the reader.

[18] 12 U.S.C. 1790d(d)(1).

[19] *See* 12 U.S.C. 1790d(o) (Congress specifically defined the terms ''net worth'' and ''net worth ratio'' in the FCUA, but did not define the statutory term ''risk-based net worth.'').

[20] 12 U.S.C. 1790d(d).

[21] *Id.*

[22] 12 U.S.C. 1790d(d)(2).

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

[24] 12 U.S.C. 1790d(c).

[25] The risk-based net worth 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. *See* 12 U.S.C. 1790d(f)(5) *and* 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 six percent or the credit union's risk-based net worth 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) *and* 12 U.S.C. 1790d(c)(1)(A)(ii) and (c)(1)(B)(ii).

[26] 12 U.S.C. 1790d(c)(1)(c)(ii).

[27] 12 U.S.C. 1790d(c)(1)(A)–(C) (emphasis added).

[28] *Id.* at section 1790d(d).

[29] *Id.* at section 1790d(d)(2).

[30] *Id.* at section 1790d(c)(1)(B).

credit union to be adequately capitalized.[31]

In other words, the language in section 216(d)(2) of the FCUA simply identifies the types of risks that NCUA's risk-based net worth requirement must address (*i.e.,* 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 commenters have in response to the Original Proposal, that Congress' use of the term ''adequately capitalized'' in section 216(d)(2) somehow limits the Board's authority to impose a higher risk-based capital ratio level for well capitalized credit unions. Rather than prohibiting the Board from imposing a higher risk-based capital ratio level for well capitalized credit unions, section 216(d)(2) simply requires that the Board design the risk-based net worth requirement to take into account those risks not adequately addressed by the statute's six percent *net worth ratio* requirement. Thus, the plain language of section 216(d) does not support these commenters' interpretation.

NCUA's interpretation of its 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' PCA statute and regulations.[32] Section 38(c)(1)(A) of the FDI Act, upon which section 216 of the FCUA was modeled,[33] requires that the Other Banking Agencies' ''relevant capital measures'' ''include (i) a leverage limit; and (ii) *a risk-based capital requirement.''*[34] Despite Congress' use of the singular noun ''requirement'' in section 38 of the FDI Act, the Other Banking Agencies' PCA regulations, which went into effect before Congress passed CUMAA, have long required that their regulated institutions meet different risk-based capital ratio levels to be classified as well capitalized, adequately capitalized, undercapitalized, or significantly undercapitalized. Therefore, by setting different risk-based capital ratio levels for credit unions to be adequately and well capitalized, NCUA's risk-based capital requirement would be consistent with the requirements of section 216 of the FCUA and would be ''comparable'' to the Other Banking Agencies' PCA regulations.

III. Summary of the Original Proposal and this Second Proposal

A. The Important Role and Benefit of Capital

Capital is the buffer that depository institutions, including credit unions, use to prevent institutional failure or dramatic deleveraging during times of strees. As evidenced by the recent recession, during a financial crisis a buffer can mean the difference between the survival or failure of a financial insitution. Financial crises are very costly, both to the economy in general and to individual depository institutions.[35] 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 has a typical cumulative discounted cost in terms of lost aggregate output relative to the precrisis trend of about 60 percent of precrisis annual output.[36] 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 GDP declined more than four percent, almost nine million jobs were lost, and the unemployment rate rose to 10 percent.[37] The cited figures are just the direct losses. Compared to where the economy would have been had it followed the precrisis 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 recent financial crisis is roughly $10 trillion (2014 dollars).[38] 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.[39]

Research using bank data across several countries and time periods indicates that higher levels of capital insulate financial institutions from the

[31] *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.'').

[32] *See* 12 U.S.C. 1831o, *and, e.g.,* 12 CFR 324.403(b).

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

[34] 12 U.S.C. 1831o(c)(1)(A) (emphasis added).

[35] 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, September 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, September 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.*

[36] Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* 3–4 (August 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.

[37] The National Bureau of Economic Research Business Cycle Dating Committee defines the beginning date of the recession as December 2007 (2007Q4) and the ending date of the recession as June 2009 (2009Q2). See the National Bureau of Economic Research Web site: *http://www.nber.org/cycles/cyclesmain.html.* The real GDP decline was calculated by NCUA using data for 2007Q4 and 2009Q2 from the National Income and Product Accounts, Bureau of Economic Analysis, U.S. Department 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 November 11, 2014. The jobs lost figure was calculated by NCUA using data from the Bureau of Labor Statistics (BLS), U.S. Department of Labor, Current Employment Statistics, CES Peak-Trough Tables. The statistic cited is the decline in total nonfarm employees from December 2007 through February 2010, which BLS defines as the trough of the employment series. Data available at: *http://www.bls.gov/ces/cespeaktrough.htm* and accessed on November 11, 2014. The unemployment rate was taken from the Bureau of Labor Statistics, U.S. Department of Labor, Current Population Survey, series LNS14000000. Accessed November 11, 2014 at *http://data.bls.gov/pdq/SurveyOutputServlet.* The unemployment rate peaked at 10 percent in October 2009.

[38] NCUA calculations based on from the National Income and Product Accounts, Bureau of Economic Analysis, U.S. Department of Commerce. Data from Table 1.1.6 show real GDP at $14.992 trillion in 2007Q4 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.*

[39] 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.*

effects of unexpected adverse developments in their asset portfolio or their deposit liabilities.[40] 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.[41] By reducing the probability of a systemic financial crisis and insulating individual institutions from failure, higher capital requirements confer very large benefits to the overall economy.[42] 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).[43]

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.[44] 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.[45] 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[46] to risks assets ratio would be on the order of 0.1 percent.[47] 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 recent 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 need for federal intervention in the form of capital infusions.[48] As discussed in more detail below, credit unions also experienced elevated losses and the need for government intervention. The clear implication 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.

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.

B. Why did the Board issue the Original Proposal?

The Original Proposal would have amended NCUA's risk-based net worth requirements to be more comparable to the Other Banking Agencies' regulations, as required by the FCUA.[49] In 2013, the Other Banking Agencies issued final rules materially updating the risk-based capital requirements for insured banks.[50] These changes to the Other Banking Agencies' risk-based capital requirements, the weaknesses in NCUA's current risk-based net worth ratio requirement exposed by the recession of 2007–2009, and the fact that NCUA's risk-based net worth requirement had not been meaningfully updated since 2002, prompted the Board to reconsider NCUA's current risk-based net worth ratio requirement and other aspects of NCUA's current PCA regulations. In so doing, the Board was also guided by specific recommendations to update NCUA's PCA regulations made by GAO in its January 2012 review of NCUA's system of PCA.[51]

The Board issued the Original Proposal to enhance risk sensitivity and address weaknesses in the existing regulatory capital framework for credit unions. Under the current rule, only two credit unions are required to hold more capital as a result of the required risk-based net worth ratio measure. The Board emphasized that capital and risk operate synchronously, and that 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 Original Proposal reflected the Board's initial effort to establish a system for assigning risk

[40] *See* An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements, Basel Committee on Banking Supervision, August 2010. Pages 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.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *See* An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements, Basel Committee on Banking Supervision, August 2010. Pages 21–27.

[45] 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. *See* Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* 21–27 (Aug. 2010).

[46] 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.

[47] 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 *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements,* Basel Committee on Banking Supervision, August 2010. Pages 21–27.

[48] For a readable overview of the 2007–2008 financial crisis and the government response see, *The Final Report of the Congressional Oversight Panel,* Congressional Oversight Panel, March 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, April 13, 2012. Available at: *http://www.federalreserve.gov/newsevents/speech/2012speech.htm.*

[49] *See* 12 U.S.C. 1790d(b)(1)(A)(ii) (Requiring that the NCUA's system of PCA be ''comparable'' to the PCA requirements in section 1831o of the Federal Deposit Insurance Act).

[50] 78 FR 55339 (Sept. 10, 2013) (The FDIC published an interim final rule regarding regulatory capital for their regulated institutions separately from the Other Banking Agencies.) *and* 78 FR 62017 (Oct. 11, 2013) (The Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System later published a regulatory capital final rule for their regulated institutions, which is consistent with the requirements in the FDIC's IFR.).

[51] *See* U.S. Govt. Accountability Office, GAO–12–247, *Earlier Actions Are Needed to Better Address Troubled Credit Unions,* (Jan. 2012) *available at http://www.gao.gov/products/GAO-12-247.*

weights that was more indicative of the potential risks existing within credit unions. Accordingly, the Original Proposal was intended to help credit unions better absorb losses and establish a safer, more resilient, and more stable credit union system that could weather periods of financial stress, thereby reducing risks to the NCUSIF.

The recent economic crisis highlighted the need for a sound system of capital requirements to address risk. From 2008 through 2012, 27 credit unions with assets greater than $50 million (the current threshold for applicability of the risk-based net worth requirement) failed at a cost of $728 million to the NCUSIF,[52] 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.[53] Although the credit union officials were provided with notice of the capital deficiencies, they 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 timely manner was cited by GAO as limited under NCUA's current regulations. As a result, over a dozen very large consumer credit unions, and numerous smaller ones, were in danger of failing and required extensive NCUA intervention, financial assistance, or both, along with increased reserve levels for the NCUSIF.[54] The Original Proposal sought to incorporate the lessons learned from those failures, and near failures, and better account for risks not addressed by NCUA's current PCA rule.

The Board notes that, in general, most credit unions with over $100 million in assets (the proposed new threshold for applicability of the risk-based capital ratio measure) hold capital well above the statutory net worth ratio for credit unions to be classified as well capitalized, as shown in the following table.[55]

NUMBER OF CREDIT UNIONS WITH ASSETS OF AT LEAST $100 MILLION, BY NET WORTH RATIO

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

Many credit unions hold additional capital as a cushion against an unexpected adverse shock that might drive their net worth ratios below the well capitalized level. Because credit unions primarily generate capital only through retained earnings, there is an added incentive to hold higher levels of capital. Most banks, however, also hold capital in excess of their required well capitalized thresholds and on par with total capital levels held by credit unions, despite having the ability to raise capital outside of retained earnings.[56] This suggests that strong capital levels serve an important purpose for financial institutions despite any associated cost of the capital.

As shown in the table below, at year end 2013, 119 credit unions, or 7.3 percent of all credit unions with assets greater than $100 million in assets, exhibited a net worth ratio below eight percent. Of that 7.3 percent of credit unions, all were either already below the seven percent well capitalized threshold or were only slightly above, so they were vulnerable to falling below the well capitalized level with only a modest shock to their net income. Call report data as of December 31, 2013, indicates that these 119 credit unions hold assets of $68.7 billion, which is more than seven percent of all credit union assets (see table below).

PERCENTAGE DISTRIBUTION OF TOTAL ASSETS OF CREDIT UNIONS WITH ASSETS OF AT LEAST $100 MILLION, BY NET WORTH RATIO[57]

	2006	2007	2008	2009	2010	2011	2012	2013
	Percent							
Net Worth Ratio:								
Less than 6 percent	0.1	0.2	1.4	2.6	2.6	0.5	0.4	0.3
6 percent to 7 percent	0.8	1.0	5.9	7.5	1.6	2.5	0.5	0.2
7 percent to 8 percent	4.9	5.8	10.9	13.6	15.3	12.6	9.1	6.8
8 percent to 9 percent	12.5	12.4	15.7	19.2	18.5	16.7	19.1	12.5
9 percent to 10 percent	18.2	21.6	23.2	24.8	28.1	24.5	21.1	22.9

[52] 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.

[53] *See, e.g.,* OIG–13–10, Material Loss Review of Chetco Federal Credit Union (October 1, 2013), OIG–13–05, Material Loss Review of Telesis Community Credit Union (March 15, 2013), OIG–10–15, Material Loss Review of Ensign Federal Credit Union, (Sept. 23, 2010), OIG–10–03, Material Loss Reviews of Cal State 9 Credit union (April 14, 2010).

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

[55] This statement and the majority of the related analysis in this section is specific to credit unions with $100 million in assets or greater, unless otherwise noted, as this proposed rule would only apply to credit unions at or above this level.

[56] The aggregate core capital (leverage) ratio for all FDIC-insured institutions as of December 2013 was 9.41 percent. FDIC Quarterly, 2014, Volume 8, No. 1.

PERCENTAGE DISTRIBUTION OF TOTAL ASSETS OF CREDIT UNIONS WITH ASSETS OF AT LEAST $100 MILLION, BY NET WORTH RATIO [57]—Continued

	2006	2007	2008	2009	2010	2011	2012	2013
	Percent							
10 percent to 11 percent	16.3	18.2	15.3	12.3	12.3	20.4	23.9	19.0
Greater than 11 percent	47.1	40.8	27.6	20.0	21.6	22.8	25.8	38.3
Total Assets, billions $	582.4	628.1	686.3	760.1	790.2	839.4	901.7	945.4

The table below shows that credit unions falling below the seven percent well capitalized net worth ratio requirement tend to contract their asset base. By contrast, over the same period, credit unions that did not fall below the seven percent well capitalized net worth ratio requirement experienced annualized asset growth of almost seven percent.

GROWTH IN ASSETS AT CREDIT UNIONS WITH MORE THAN $100 MILLION IN ASSETS [58]

Growth over the four quarters after a decline in the net worth ratio below 7%	Growth over the four quarters where the net worth ratio did not fall below 7%
−4.3%	+6.8%

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.[59] 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. The table 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 eight percent in the fourth quarter of 2006, 80 percent fell below seven percent at some time during the financial crisis and its immediate aftermath. Of credit unions with 8 percent to 10 percent net worth ratios in the fourth quarter of 2006, just under 33 percent fell below seven percent during the crisis period. However, of credit unions that entered the crisis with at least 10 percent net worth ratios, less than five percent fell below the seven percent well capitalized standard during the crisis or its immediate aftermath.

DISTRIBUTION OF NET WORTH RATIOS OF CREDIT UNIONS WITH AT LEAST $100 MILLION IN ASSETS BY LOWEST NET WORTH RATIO DURING THE FINANCIAL CRISIS

	Lowest Net Worth Ratio between 2007Q1 and 2010Q4						
	<6%	6–7%	7–8%	8–10%	≥10%	*Total*	*Number of credit unions*
Net Worth Ratio in 2006Q4							
<8 percent	44.0	36.0	20.0	0.0	0.0	100.0	50
8–10 percent	13.0	19.6	38.0	29.4	0.0	100.0	316
≥10 percent	1.9	2.8	9.4	38.8	47.1	100.0	830

Similarly, the table 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 Great 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 precrisis net worth ratio of less than nine percent, while similarly sized institutions that survived the crisis had, on average, precrisis net worth ratios in excess of 11 percent.

[57] Data based on year end Call Report data.

[58] Based on Call Report data, using annualized growth 2007 Q4–2013 Q4.

[59] Low-income designated credit unions can issue secondary capital accounts that count as net worth for PCA purposes. As of June 30, 2014, there are 2,107 low-income designated credit unions. Given the nature (*e.g.,* size) of these credit unions and the types of instruments they can offer, however, there is often a very limited market for these accounts.

CHARACTERISTICS OF FICUS WITH ASSETS > $100 MILLION AT THE END OF 2006 BY FIVE YEAR SURVIVAL BEGINNING 2007 Q4

	Number of institutions	Median				
		Assets ($M)	Net Worth Ratio (percent)	Loan to Asset Ratio (percent)	Real Estate Loan Share (percent)	Member Business Loan Share (percent)
Failures	27	162.7	8.97	84.0	58.0	8.3
Survivors	1138	237.9	11.20	71.0	49.0	0.7

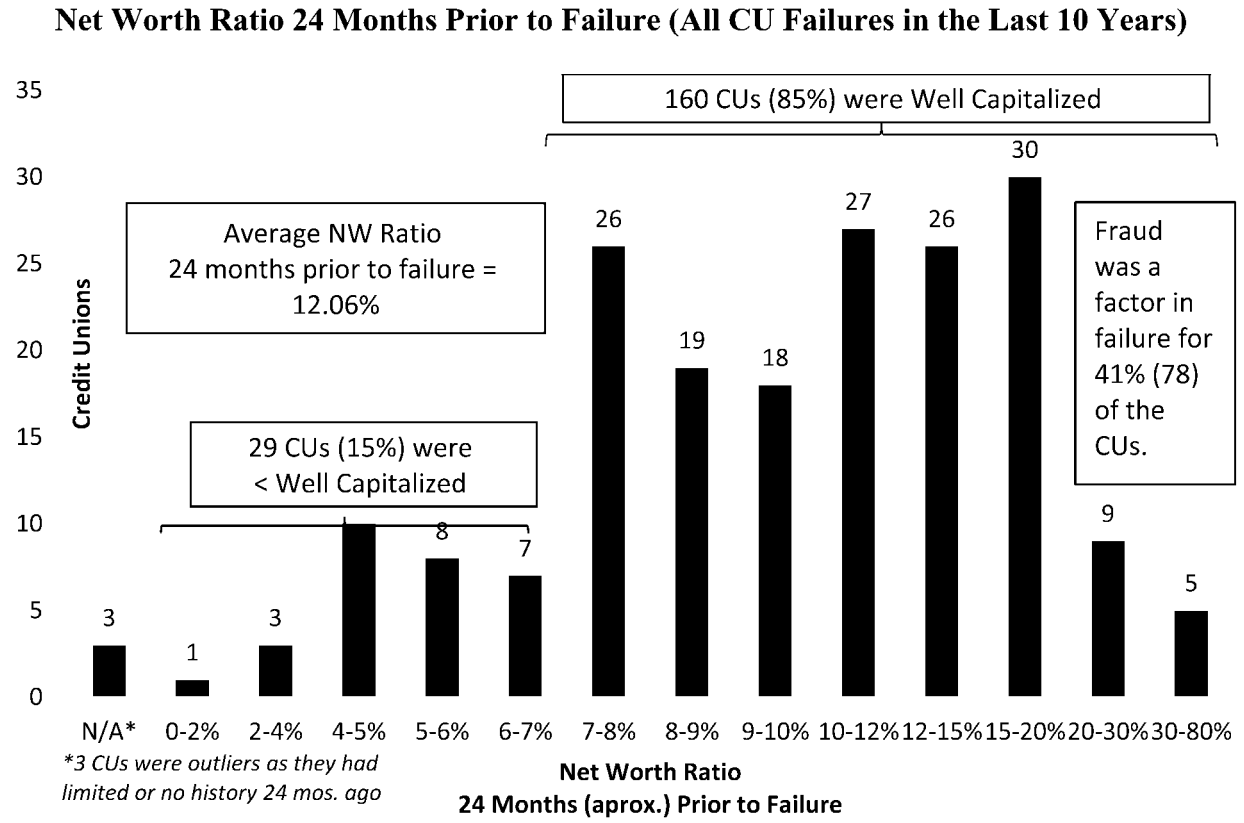
Survivorship is determined based on whether a FICU stopped filing a Call Report over the five years starting in the fourth quarter of 2007. Failures exclude credit unions that merged or voluntarily liquidated. Note: All failures had precrisis net worth ratios in excess of seven percent.

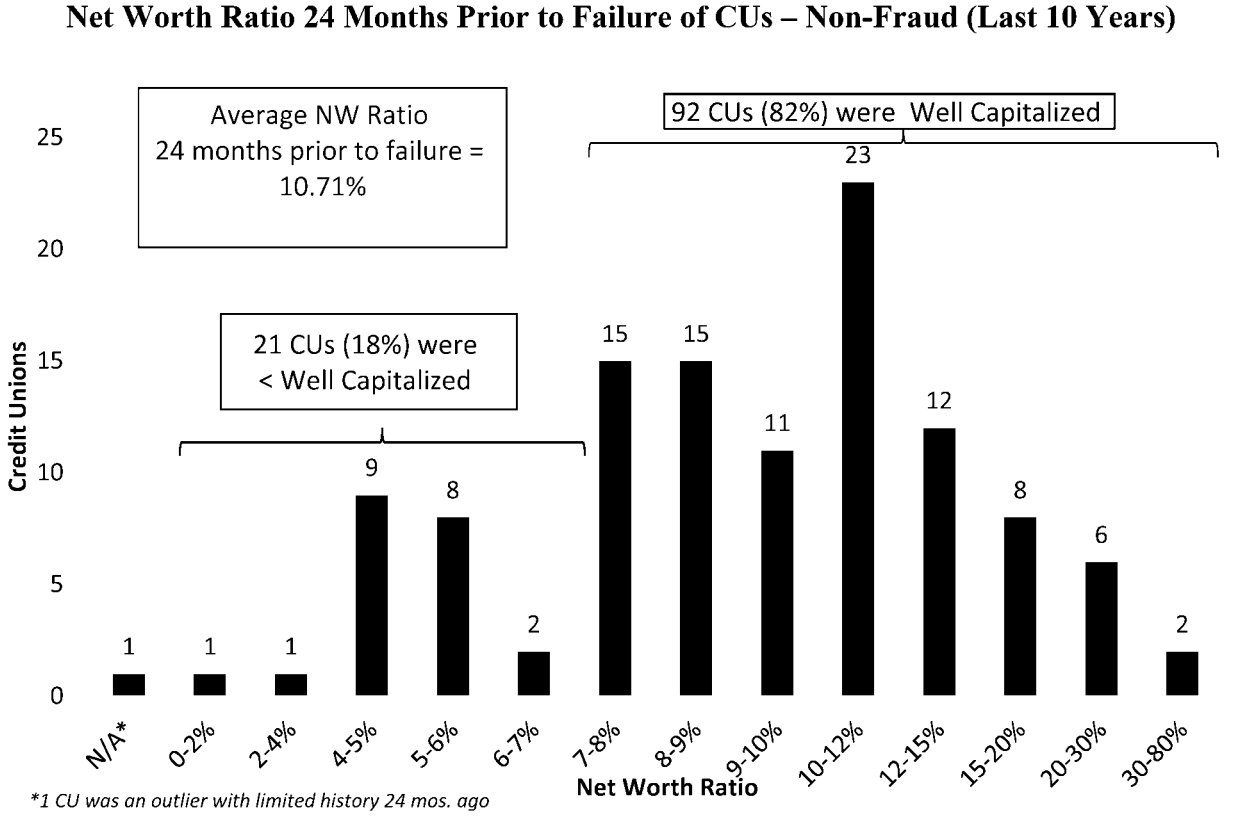
Aside from demonstrating the differences in the capital positions of credit unions that failed from those that did not fail, the table above highlights two additional considerations. First, the table shows that other performance indicators were different between the two groups of credit unions. In particular, 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.

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 the table above demonstrate that factors in addition to capital levels play an important role in preventing failure. For example, all of the failures listed in the table 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 RBNW requirement.[60] 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.

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. The figures 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 seven percent two years prior to their failure. Further, the failed credit unions exhibited a 12 percent average net worth ratio two years prior to their failure.

[60] See table above (referencing the 27 failures of credit unions over $100 million in assets).





The table above shows 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 NCUSIF, 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. [61] 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 United States economy. Improved resilience enhances credit unions' ability to function during periods of financial stress and reduce risks to the NCUSIF.

The Original Proposal reflected the Board's objective of modifying the existing system for assigning risk weights to make it more indicative of the risks in credit unions. The Board intended it to help credit unions better absorb losses and establish a safer, more resilient, and more stable credit union system. However, as noted below, the Board believes the Original Proposal can be improved and is, therefore, issuing this second proposal.

[61] 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 eight 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, September 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, September 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.*

C. What significant changes would the Original Proposal have made?

The Original Proposal would have changed the current risk-based net worth requirement applicable to complex credit unions (which was then defined as credit unions with more than $50 million in assets). In particular, the Original Proposal would have replaced the current risk-based net worth ratio measure with a new risk-based capital ratio measure that would have been more comparable to the risk-based capital requirement in the Other Banking Agencies' regulations. NCUA's capital requirements and PCA supervisory actions for ''new'' credit unions and credit unions with $50 million or less in assets would have remained largely unchanged, with a few exceptions.

The Board intended the change in the risk-based capital methodology in the Original Proposal to improve the comparability of risk-based capital ratios across financial institutions. Compared to the current risk-based net worth ratio measure, the methodology under the Original Proposal would have provided a more common measure both of credit union capital available to absorb losses and of asset risk. Moreover, the use of a consistent framework for assigning risk weights would have resulted in better comparability and improved understanding between all types of federally insured financial institutions, and would have increased the correlation between required capital levels and risk.

The Original Proposal would have replaced the current method used by credit unions to apply risk weights to their assets with a new risk-based capital ratio measure that is more commonly applied to depository institutions worldwide. The proposed risk-based capital ratio measure was the percentage of a credit union's capital available to cover losses, divided by the credit union's defined risk weighted asset base.

Under the current rule, the numerator of the RBNW ratio is ''net worth'' as defined in section 216(o)(2).[62] However, as discussed in the Legal Authority section of this preamble, the FCUA gives the Board broad discretion in designing the risk-based capital requirement.[63] Thus, the Original Proposal would have broadened the definition of the risk-based capital ratio numerator.

The Board chose to take this approach to provide a more comparable measure of capital across all financial institutions and to better account for those related elements of the financial statement that are available to cover losses and protect the NCUSIF. Under the Original Proposal, the risk-based capital ratio numerator essentially started with the generally accepted accounting principles (GAAP) definition of equity (which is broader than the statutory definition of ''net worth''), adding the allowance for loan and lease losses (ALLL) account subject to some limitations, and deducting goodwill, intangible assets, and the NCUSIF deposit. In addition, to more accurately reflect capital available to absorb losses, this broader definition of the risk-based capital ratio numerator would have contributed over 50 basis points, on average, to credit unions' risk-based capital ratio.

With regard to the denominator for the risk-based capital ratio, Congress recognized that operating a credit union involves taking and managing a variety of risks. As stated previously, the FCUA mandates that NCUA's risk-based net worth requirement ''take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized may not provide adequate protection.'' [64] In the Senate Report on CUMAA, Congress expressed its intent with regard to the design of the risk-based net worth requirement by directing NCUA to ''consider whether the 6 percent [net worth ratio] 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.'' [65]

The risk-based net worth ratio measure in NCUA's current PCA regulation, which has not been substantially updated since 2002, was designed to primarily address credit risk, concentration risk, interest rate risk (IRR), and liquidity risk. The current rule does this through the assignment of risk weights to different types of assets based on the predominant form of risk that is associated with the asset type. Loans and investments make up the vast majority (88 percent based on December 2013 Call Report data) of credit union assets and, therefore, are the primary variables for the denominator of a credit

[62] *See* the definition of ''net worth'' at 12 U.S.C. 1790d(o)(2)(A) through (C).

[63] *See* section 1790d(d)(2) (Recognizing the limitations of the net worth ratio, Congress directed the Board to develop a risk-based net worth requirement that ''take[s] account of any material risks against which the net worth ratio . . . may not provide adequate protection.'').

[64] *Id.*

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

union's current risk-based net worth ratio.

Under the current rule, most types of loans have risk weights based on credit risk. Concentration risk and IRR are incorporated for real estate loans and member business loans (MBLs) using a tiered risk weight framework. As a credit union's concentration in these loans increases, incrementally higher levels of capital are required. This requirement was intended to provide capital to protect against the concentration risk and IRR inherent in a long duration and/or complex whole loan portfolio with limited liquidity.[66]

The Original Proposal would have maintained a very similar risk weight structure for loans, with a few exceptions. The Original Proposal would have effectively reduced the capital required for a credit union to hold first-lien residential real estate loans, and raised the capital required to hold junior-lien residential real estate loans, consumer loans, and MBLs.

The current rule, as opposed to this second proposal, assigns risk weights to most types of investments based on their IRR and liquidity risk. The rationale for doing so was that most credit unions maintain liquidity in their investment portfolio. For credit unions with high loan volume involving long-term fixed rate products, the investment portfolio can exacerbate the interest rate and liquidity risks involved in meeting member lending and deposit preferences. NCUA's current rule, unlike this second proposal, assigns risk weights to most investments based on their weighted average life, with the weights generally calibrated to the projected loss in value of a U.S. Treasury security if interest rates increased by 300 basis points. The Original Proposal would have retained this approach to assigning investment risk weights. However, the Original Proposal would have effectively reduced the capital required for investments with weighted average lives of less than five years, and increased the capital required for investments with weighted average lives of greater than five years.

The Original Proposal was intentionally designed to parallel the current approach to applying risk weights to assets using existing information contained in the Call Report, thereby minimizing transition costs and associated reporting burdens. In comparison to the current risk-based net worth ratio method however, the originally proposed risk-based capital ratio method would have included a greater number of exposure categories for purposes of calculating a credit union's risk-weighted assets. Thus, the Original Proposal would have required that some additional data be collected on the Call Report. However, this additional data would not have represented a material increase to the burden of completing the Call Report. Further, under the Original Proposal, the rule would have provided an 18-month implementation period for credit unions to adjust their systems to account for the additional data items that would have been collected in the Call Report.

The way in which the risk-based net worth ratio functions in relation to the net worth categories under the current rule could result in a credit union's capital classification declining directly from well capitalized to undercapitalized if it fails to meet the required risk-based net worth ratio level.[67] The Original Proposal would have modified this approach by requiring credit unions to meet different risk-based capital ratio levels for the well capitalized (10.5 percent) and adequately capitalized (eight percent) categories. This formulation would have been comparable with the Other Banking Agencies' capital rules,[68] and would have encouraged (but did not require) credit unions to build capital sufficient to absorb losses and prevent precipitous declines in their overall capital classification. In addition to providing greater comparability with the Other Banking Agencies' rules, the different threshold levels also would have resulted in a risk-based net worth requirement that could have effectively addressed any ''outlier'' credit unions and encouraged them to accumulate additional capital.

The Original Proposal would have generally retained the definition of ''complex'' in the current rule so the proposed changes to the risk-based net worth requirement would have applied to all credit unions with over $50 million in total assets.[69]

D. Public Comments on the Original Proposal

The Board received 2,056 public comments on the Original Proposal from credit unions, trade associations, state credit union leagues, state supervisory authorities, public officials (including current and former members of the U.S. Congress), Federal Home Loan Banks, credit union members, and other interested parties. Because this is a new proposed rule, the Board notes it is not required to respond to any comments received on the Original Proposal. However, the Board believes it is important to address all relevant comments. Therefore, the Board has included comment summaries and responses throughout the preamble to this proposal.

Overall, while some commenters supported the concept of adopting risk-based capital standards for complex credit unions that were more comparable to those applicable to banks, most commenters opposed the Original Proposal, particularly those requirements that the commenters believed exceeded the requirements imposed on banks.

Most commenters also expressed concerns about the potential costs and burdens of various aspects of the Original Proposal. A significant number of commenters argued that new risk-based capital standards were not necessary at this time, particularly given the success of consumer credit unions during the recent financial crisis. A number of commenters also requested that the Board withdraw the Original Proposal and reissue a proposal for another round of public comments with significant revisions to the risk weights. Many commenters also asked for additional time to implement the new requirements and adjust their balance sheets.

The Board responds to the significant comments received on the Original Proposal throughout this preamble. More detailed discussions on the comments received on particular aspects of the Original Proposal, and NCUA's responses to those comments, are primarily provided in the section-by-section analysis part of the preamble.

General Comments on Application of Risk-Based Capital Standards to Credit Unions

The Board received over 2,000 comments regarding the application of risk-based capital standards to credit unions under the Original Proposal. A majority of the commenters stated that NCUA's current risk-based net worth ratio standard is working well,

[66] Concentration risk is mainly accounted for in commercial and real estate loans because, historically, this is where credit unions have experienced concentration and IRR problems. These types of assets are longer and/or provide fewer options and greater challenges in managing, restructuring, or selling such portfolios. Cash flows for shorter-term loans, like auto loans, are typically much less susceptible to changing rates; and portfolios customarily cash flow fast enough to mitigate concentration and IRR concerns.

[67] Per the FCUA, ''undercapitalized'' is the lowest PCA category in which a failure to meet the risk-based net worth requirement can result.

[68] *See, e.g.,* 12 CFR 324.10, 324.11 and 324.403.

[69] 78 FR 4032 (Jan. 18, 2013).

particularly given that the credit union industry survived the recent financial crisis, and that maintaining the current system is far preferable to adopting the Original Proposal. Some commenters stated they were opposed to imposing a more sophisticated risk-based capital framework on credit unions. Other commenters stated they appreciated NCUA's efforts to keep the new requirements relatively simple and to minimize the implementation burden on affected institutions. A substantial number of other commenters agreed that updates to NCUA's risk-based net worth regulations were necessary to keep up with what other financial institutions are doing, but did not agree with certain aspects of the Original Proposal. Other commenters stated that some form of risk-based capital calculation was prudent to reward those institutions that do not stretch too hard for earnings or put their members' deposits at extraordinary risk. A significant number of commenters specifically suggested that the rule be amended to match the risk-based capital requirement for banks, the Basel III risk-based capital standards, or both. Other commenters suggested that the structure and performance of credit unions suggests that the risk weights should be less stringent than the risk weights applied to banks. Still other commenters suggested that instead of focusing on the past failures of credit unions, the Board should be focused on the successes of credit unions and issue regulations that help credit unions achieve success.

The Board received a significant number of comments questioning whether the proposal would actually serve to protect the NCUSIF and make the industry safer and sounder. A number of commenters stated that the proposal essentially represented a de facto assumption of important balance sheet management decisions by NCUA for purposes of protecting the NCUSIF at the expense of the current prerogatives and interests of individual credit unions and their members. Commenters contended that since the implicit incentives in the proposal are the same for every credit union, over the long run, the Original Proposal would cause credit unions to become less financially diverse, which would increase the vulnerability of the industry and NCUSIF to some future widespread economic adversity. Commenters stated that credit unions are in the risk business by nature and that the proposal was too focused on a number-generated, one-size-fits-all solution. Other commenters requested that the Board be mindful that the risk weights that are adopted in the rule could ultimately drive which types of products and services are offered by credit unions.

Some commenters suggested NCUA include a risk-capital model calculation as part of the examination process, similar to NCUA requirements for other types of modeling such as the model required for IRR testing. Those commenters suggested that the results of the risk-based capital model could be used to identify ''potential risk'' by examiners and credit union boards, calling for additional scrutiny in the exam, instead of prescribing a rule that is assumed to quantify ''actual'' risk.

A small number of commenters suggested that the Other Banking Agencies are all leaning toward simply using a simplified leverage ratio to account for risks.

Justification and Supporting Analysis

A number of commenters commented on the Board's justification and analysis supporting the need for a proposed rule. Commenters suggested the proposal was arbitrary and developed without feedback from the credit union industry. Other commenters suggested that the Board should have provided stakeholders with a more thorough discussion of how the proposal would fit into NCUA's regulatory framework, including recently issued final rules regarding liquidity risk, IRR, and stress testing and capital planning. Commenters stated there was no credible analysis available in the Original Proposal to suggest credit unions overall are unlikely to perform well under the current PCA system, which already includes a risk-based net worth requirement. Others commented that the proposal provided no evidence that this rule would help members.

Commenters suggested the Board did not sufficiently take into account the unique nature of credit unions and the financial performance and distinctive structure of credit unions in developing the proposal. They argued this was problematic because the Board is required to take into account the unique nature of credit unions in designing a system of PCA, and that by failing to sufficiently account for credit union differences and the lower level of risk that credit unions demonstrate as a result led to a proposal that would require well-managed credit unions to hold too much capital. Others suggested that the proposal failed to consider how the use of bank style capital levels could adversely impact credit unions. There were those who felt that the Board should propose a rule only if NCUA has prepared a reasoned determination that the rule's benefits justify its costs. They suggested that any benefits in terms of reduced NCUSIF losses would be minor at best and the very real costs of unnecessarily high capital requirements would be substantial. Commenters also suggested that the proposal was not tailored to impose the least burden.

The Board received a number of comments on the basis provided for the proposed rule. Commenters suggested the proposal should have been based on historical perspectives, and stated that based on their own analysis the proposal would have avoided few if any past credit union failures. One commenter stated that only 1.1 percent of credit unions with more than $50 million in assets have failed in the six-and-a-half years since the beginning of the worst financial crisis and recession in 80 years. The commenter did, however, acknowledge that the proposed system would have been more effective than the current system in identifying credit unions that subsequently failed.

One commenter suggested that the Board's justification that the proposal seeks to incorporate lessons learned from past failures of credit unions to hold sufficient levels of capital despite warnings from NCUA examiners was unsupportable because NCUA and state officials have various supervisory enforcement measures at their disposal (*e.g.,* preliminary warning letters, letters of understanding and agreement, and cease and desist orders) to force a credit union to improve the alignment between its risk exposures and its available capital.

A significant number of commenters questioned the Board's supporting analysis for various aspects of the proposal. Commenters suggested that the empirical foundation provided for the proposed risk weights was not sufficient. Other commenters stated that the Board should provide additional justification and more clarity as to why the proposed risk weights differ from those for other community financial institutions. Many commenters stated they would like an opportunity to review and comment on empirical data, but that they were not provided sufficient information to understand how the metrics behind the proposal were determined and how historic losses contributed to each calculation. One commenter suggested that NCUA should expand its research horizons to include data-sourcing outside the natural-person credit union space, claiming the Original Proposal contained several examples where ''uncertain'' conclusions were drawn from insufficient data or those where

research was halted due to the burdensome process of data collection. The commenter suggested that often these data sources are limited to natural-person credit unions, many of which have little exposure to the asset classes in question.

Another commenter suggested that the stated purpose of the proposal was to mitigate losses to the NCUSIF that could result from inadequate capital, but that GAO and NCUA's Office of Inspector General (OIG) reports demonstrate that deficiencies in the examination process contributed substantially to losses during the financial crisis, and that such deficiencies continue to be a significant factor in more recent credit unions failures. That commenter suggested that instead of focusing on a risk-based capital requirement for credit unions to contain NCUSIF losses, the Board should be improving examiner training so that agency field staff can more readily identify material risks without increasing the agency's budget, which is funded by credit unions.

A significant number of commenters expressed concerns regarding the justification and explanation of how credit risks as well as interest rate, concentration, liquidity, operational, market risks, and other types of risk were addressed in the proposed rule. Commenters questioned the Board's justification for including IRR and concentration risk in the proposed risk weights for investments, real estate loans, and member business loans. A small number of commenters suggested that there was no explanation of which portion of the proposed risk weight is intended to address each of these risk elements, and that, as a result, the risk weights did not reflect a reasoned judgment about the actual risks involved.

Competitive Concerns and Concerns Related to the Unique Nature of Credit Unions

The Board received a significant number of comments expressing concerns that the proposed rule would have put credit unions at a competitive disadvantage to banks. A majority of the commenters suggested that the differences between NCUA's proposed risk weights and the Other Banking Agencies' capital rules would have constrained the healthy growth of the credit union industry. Commenters suggested that the statutory seven percent net worth requirement to be classified as well capitalized was set artificially high by Congress to slow the growth of credit unions and that the proposed rule would build on that artificially high net worth requirement and further slow the growth of credit unions, putting credit unions at a further disadvantage to banks. A significant number of commenters stated that the competitive disadvantages in the proposed rule could incentivize many credit unions to switch to bank charters. Other commenters suggested that NCUA's proposed risk-based capital ratios were much more volatile than the risk weights under the Other Banking Agencies' rule, and that the proposed risk weights for some investments were excessively punitive and should be changed to match the risk weights used in Basel [70] and the Other Banking Agencies' calculations. Still others suggested that it would be appropriate for NCUA to establish new risk-based capital ratio levels only when the leverage ratio requirements for credit unions to be adequately and well capitalized were lowered.

A small number of commenters stated that they appreciated that the Board kept the proposed risk-based capital calculation less complicated than the banking risk-based capital calculation.

A substantial number of commenters suggested that it was not appropriate for the Board to adopt the framework of the Basel system in the proposal and also take parts from NCUA's current PCA regulation that bear no relationship to Basel. A substantial number of commenters stated that neither Basel III nor the Other Banking Agencies rules attempt to capture IRR, liquidity risk, market risk, or operational risk in their risk weights, and that Basel III and the Other Banking Agencies' capital rules are only designed to take into account credit risk. Many commenters stated that adopting either the Basel III format or the Other Banking Agencies' risk weights accurately would give both NCUA and the credit union industry credibility to all outside parties. Other commenters suggested that, because of these and other differences, the proposal was not ''comparable'' with the Other Banking Agencies' rules, which is a requirement of the FCUA.

A substantial number of commenters stated that the structure and performance of credit unions suggests that the risk weights should be less stringent than the risk weights applied to banks. Other commenters suggested that the proposed risk-based capital standards for credit unions are comparable to FDIC standards, but that they fail to take into account the unique characteristics of the credit union system as required by the FCUA. Commenters noted that unlike banks, credit unions do not have capital stock and cannot go to outside investors to seek equity capital to fuel growth or shore up capital ratios in times of stress. They stated that the rule and associated risk weights should recognize that sources of capital within the credit union industry are not as easily acquired as capital sources for banks. A number of commenters stated that if Congress had intended credit unions to be subject to the same requirements as banks it would have said so, and suggested that the Board should stop treating credit unions like banks and judging them by return on investment, and instead judge them on how effectively they deliver on their mission and make a distinctive impact relative to their resources.

One commenter suggested that the rule should be based on three principles: (1) Risk weights should generally be similar to those applied to community banks in the United States; (2) for those assets where credit union loss experience is historically lower than bank loss rates, credit union risk weights should be at or below bank risk weights; and (3) concentration risk and IRR should not be incorporated into the risk-based capital system, but instead, should be addressed in the regulatory, examination and supervision process.

Another commenter claimed that the risk weights established by FDIC do not exceed 100 percent so NCUA's rule should not establish levels over 100 percent as it would impede growth and preclude credit unions from generating net income.

Commenters suggested that the differences between proposed risk weights and banks' rules would encourage credit unions to make consumer loans by discouraging credit unions from making other types of loans, such as mortgage loans, MBLs, or agricultural loans. Others suggested that the proposed rule would have forced all credit unions into a bank model that would have required them to pay less, charge more, and increase fees. Other commenters suggested that the proposed risk weights could drive many credit unions to a ''cookie cutter'' balance sheet where each credit union has the same percentage of total assets allocated to specific loan types, which could force a high percentage of credit unions into less profitable asset growth and make it challenging to differentiate themselves from competitors.

[70] Basel 1 (First Capital Accord) established minimum capital standards (1998). Basel II established the three pillar framework (first issued in 2004). Basel III is the most recent and builds upon Basel II pillars and enhances the core principles (first issued in 2010).

Commenters suggested that credit unions generally operate as portfolio lenders, making and holding high-quality consumer and residential real estate loans that serve their members and improve their communities, and that credit unions often carry significantly less exposure to volatile product lines such as acquisition development and construction loans, commercial real estate, and complex derivatives products.

Commenters added that credit unions also face stringent regulatory restrictions on their investment powers, and as a result, natural-person credit unions fared substantially better during the recent financial crisis than many other entities, including banks. Those commenters concluded that an appropriate risk-based capital requirement would reflect these important differences with a streamlined program that recognizes credit unions as strong counter-cyclical lenders while bolstering safety and soundness through meaningful benchmarks and access to supplemental capital.

Impacts

The Board received a substantial number of comments concerning the impact that the Original Proposal would have had on credit unions. In general, most of these commenters expressed concern that the Original Proposal would have had a material adverse impact on individual credit unions and the entire credit union industry. This section outlines these concerns.

A majority of commenters stated that the proposed risk-based capital requirement would weaken credit unions' ability to build the capital cushions they need to protect themselves against risk and would hamper credit unions' ability to grow and provide services to their members. Other commenters stated that the Original Proposal would constrain future investments by credit unions and, thus, would limit credit unions' ability to provide certain services, better loan rates, and dividends to their members. Others expressed concern that the proposal would impede growth and deter lending among credit unions, even those with demonstrated long-term ability to manage risk and net worth.

Many commenters stated that the Original Proposal seemed to be a reaction to the Great Recession and that the Board should further consider the Original Proposal's impact on the future of the credit union industry. Commenters suggested that the proposed requirement to hold a higher capital-to-asset ratio would cause credit union asset growth to stagnate and decline over the long term, for any given rate of return on assets, and that the Board should try to quantify these costs and weigh them against the uncertain benefits of minor reductions in the relative cost of credit union failures. Using the rule that the sustainable asset growth rate is equal to the return on equity, or Asset Growth Rate = ROA/Capital Ratio, some commenters estimated that asset growth for credit unions would slow to eight percent under the Original Proposal, or 1.1 percent lower than the asset growth rate would be without the Original Proposal.

Commenters stated that because credit unions can only build capital through retained earnings, the Original Proposal could severely limit credit unions' ability to grow, to increase the products and services they provide to their members, and to help their local communities prosper. They also suggested that the Original Proposal may actually reduce credit unions' ability to absorb losses, given their limited access to capital markets.

A number of commenters stated that the low risk weights applied to consumer loans and the high risk weights applied to first-lien mortgage loans, mortgage servicing rights, and subordinate-lien mortgage loans would push credit unions to make more consumer loans and fewer mortgage loans, despite a significant demand for real estate lending services at some credit unions. Other commenters stated that the Original Proposal would induce credit unions to focus on risk-based capital instead of growth in real capital. Still other commenters suggested the proposed risk weights would penalize non-consumer lending, which could force small credit unions to only make consumer loans on very low margins, a strategy that would not survive in the future.

One commenter suggested that the Original Proposal did not properly account for the effect of economic downturns on credit unions, and that it would be difficult or impossible for downgraded credit unions to rebuild following an economic downturn.

A substantial number of commenters suggested that NCUA underestimated the adverse effect of the Original Proposal. They maintained that the Board understated the number of credit unions whose net worth would have decreased to just barely over well capitalized or adequately capitalized levels. One commenter suggested that, under the Original Proposal, approximately 1,000 credit unions would be required to raise $4 billion in additional capital. Other commenters proffered that the Original Proposal would require the credit union industry to hold an additional $6.5 billion to $7 billion dollars in additional capital to retain the same buffers that exist today and still be considered well capitalized. Commenters suggested that the Board considered only the narrowest interpretation of the Original Proposal's impact, ignoring the immediate and long-term effects that it would have on individual credit unions and the entire credit union system. They stated that credit unions cannot easily manage their capital to the exact dollar level that equates to NCUA's proposed standards, and that credit unions typically strive to maintain sufficient space or buffers between their actual net worth ratios and the minimum required levels to be well capitalized because of the significant consequences of not meeting the net worth standards. According to the commenters, credit unions choosing to regain their buffer would only have three choices: (1) Rebalance their assets, recognizing an opportunity cost when they forego higher earnings, which would diminish their ability to grow; (2) ration services, stifling asset and membership growth; or (3) require members to pay more, resulting in fewer member benefits and increased competition from banks.

Commenters added that the Original Proposal would require many credit unions to adjust their capital levels to maintain current margins above the well capitalized threshold, at the same time as earnings at credit unions continue to be squeezed by low interest rates, downward pressure on other revenue streams, and moderate loan growth. They argued that these adjustments would pressure credit unions, already suffering from low to moderate loan-to-share ratios, to decrease their assets by curbing lending in an attempt to comply with the new requirements.

A significant number of commenters stated that the Original Proposal would cause the reallocation of credit union capital toward less productive uses. One commenter suggested that, for some credit unions, the Original Proposal would increase the amount of capital required to be well capitalized above the current level of seven percent of total assets, positing that 10.5 percent of risk assets amounts to more than seven percent of total assets for most credit unions, depending on the ratio of risk assets to total assets. The commenter assumed that, across all potentially affected credit unions, the total amount of capital necessary to be well capitalized would increase by $7.6 billion, or, in other words, that the Original Proposal would increase the

well capitalized net worth ratio requirement an average of 0.76 percent, from seven percent to 7.76 percent.

A number of commenters also noted their concern that the Original Proposal would force many credit unions out of business.

A significant number of commenters expressed concern that the Original Proposal would curtail MBL activities. They stated that the Original Proposal unfairly penalized credit unions that are exempt from the MBL limits in § 107A of the FCUA.[71] Other commenters suggested that the Original Proposal would stifle the strategic business plans of credit unions that specialize in MBLs to grow their assets with additional commercial and real estate loans. They also stated that the Original Proposal would drive down MBL activity in rural areas because credit unions specializing in MBLs, particularly in agricultural loans and/or loans secured by farm land, cannot diversify their portfolio by providing other types of loans not needed by their members. Others stated that the proposed risk weights for MBLs would discriminate against credit unions that serve underserved and credit-challenged Americans—taxi drivers, farmers, and those in faith-based credit unions. Commenters suggested that, in order to increase their risk-based capital ratios required under the Original Proposal, credit unions may feel forced to reduce mortgage and business lending or increase loan rates and fees. They stated that the Original Proposal would have a negative effect on agricultural lending, farming communities, and credit union members, particularly those in rural and low-income areas. A number of commenters urged the Board to further consider the economic impact and consequences of reduced liquidity and financing for families and small businesses. Others argued that the Original Proposal would eliminate credit unions' business models centering on mortgage lending.

Commenters suggested that the proposed risk weights would discourage well capitalized credit unions from engaging in mergers of undercapitalized credit unions because the Original Proposal would force credit unions into less profitable asset growth. Other commenters maintained that the reduction of credit unions' capital margin or cushion would negatively impact credit unions' ability to merge, and would permit only the largest credit unions to merge with smaller credit unions. Still others suggested that the Original Proposal would encourage mergers of credit unions not meeting the risk-based requirements.

A substantial number of commenters stated that the Original Proposal would have a direct negative impact on credit union service organizations (CUSOs) by discouraging investment in CUSOs, thereby forcing many credit unions to limit services to their members.

Commenters feared that the Original Proposal would result in stricter scrutiny by examiners, which would increase NCUA's examination and supervision costs and, therefore, the costs borne by credit union members. Other commenters suggested that NCUA already has a large examination and oversight budget to eliminate risk to the NCUSIF; they contended the Original Proposal did not sufficiently address the aggregate costs of these initiatives to credit union members. According to these commenters, the impact of the Original Proposal on credit union members, in the form of excessive supervision and lost earnings due to overcapitalization, could itself pose a risk to the NCUSIF.

Some commenters shared their belief that the Original Proposal would reduce lending in dramatic ways and stifle the economy. Other commenters asserted that the Original Proposal would decrease member benefits, such as patronage dividends and reduced expenses. A number of commenters stated that the Original Proposal failed to consider impacts on businesses and the economy, particularly on small businesses that rely on credit unions for credit. Several commenters suggested that the Original Proposal would force some credit unions away from their missions to serve member in predominantly rural and low-income fields of membership.

A small number of commenters encouraged the Board to follow the cost-benefit analysis blueprint established by Executive Orders 13563 and 13579. Doing so, they argued, would allow meaningful, cumulative analysis that would result in a more coherent rule with fewer harmful, unintended consequences for the American economy.

A number of commenters expressed significant concerns about the Original Proposal's negative impact on the growth and viability of small credit unions. They suggested that the Original Proposal would inhibit the growth of credit unions that are developing from small credit unions (less than $50 million) to medium-size credit unions ($50 million–$99 million). Other commenters suggested it would reduce the monetary and other support that larger credit unions historically have provided to their smaller counterparts. They noted that some small credit unions depend on grants, scholarships, and training opportunities funded by larger credit unions. If these larger credit unions were compelled to change their loan and investment portfolios, or are required to adjust their capital, those commenters concluded their income levels would decline, thereby rendering it more difficult for them to fund as many opportunities for small credit unions. One credit union with less than $10 million in assets asserted that it would be adversely affected by the proposed change in the capital reserves requirement.

Other commenters suggested that the Original Proposal imposed unnecessary regulatory burdens that would impede small credit unions' ability to serve their members. A substantial number of commenters stated that small credit unions not classified as ''complex'' and not subject to the risk-based capital requirement would still be negatively affected because the Original Proposal estimated the paperwork burdens include over 160 hours of work for credit unions, which is significant for small credit unions with limited resources. Other commenters suggested that small credit unions would suffer significantly due to the complexity of this regulation and its implementation costs. Many commenters stated that small credit unions cannot survive under the current regulatory burdens. Others foresaw potentially disastrous consequences if this regulation were pushed down to small credit unions. An official at one small credit union asserted that the Original Proposal would affect its strategic planning as it approached $50 million in assets. Another commenter stated that, as a credit union with under $50 million in assets, it was concerned about the uncertainty of how the Original Proposal would affect privately insured credit unions.

Other Concerns

Several commenters expressed concerns that the proposal did not provide for input from state regulators who may have a different view or approach from that of NCUA. Other commenters suggested that the proposal was developed with no involvement or dialogue with state regulators. Commenters suggested that the Board should ensure that NCUA properly implements directives in the FCU Act and coordinates with state officials in implementing risk-based requirements and PCA.

[71] 12 U.S.C. 1757a.

E. What are the primary changes the Board has included in this proposal?

Similar to the Original Proposal, this proposal would replace the method currently used by credit unions to apply risk weights to their assets with a new risk-based capital ratio measure that is more comparable to that applied to depository institutions worldwide. The proposed risk-based capital ratio measure would be the percentage of a credit union's capital available to cover losses, divided by the credit union's defined risk-weighted asset base.

As noted in the introduction, this proposed rule would make substantial modifications to the Original Proposal to address specific concerns that were raised by commenters regarding the proposal's cost, complexity, and burden. These changes would include: (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 IRR from this proposed rule; (5) extending the implementation timeframe to January 1, 2019; and (6) eliminating the Individual Minimum Capital Requirement (IMCR) provision. Among other things, these changes would substantially reduce the number of credit unions subject to the rule, and would afford affected credit unions sufficient time to prepare for the rule's full implementation. A full discussion of the impact of these and other changes in this proposed rule is contained in Impact of the Proposed Regulation part of the preamble below.

As discussed previously, the FCUA gives NCUA broad discretion in designing the risk-based net worth requirement. Thus, this proposal would incorporate a broadened definition of capital to be used as the numerator in calculating the proposed new risk-based capital ratio measure. The Board is proposing this change to provide a more comparable measure of capital across all financial institutions and to better account for related elements of the financial statement that are available to cover losses and protect the NCUSIF. This broader definition of capital would more accurately reflect the amount of capital that is available at a credit union to absorb losses. On average, it would increase a credit union's risk-based capital ratio by over 50 basis points as discussed in more detail below.

The Board agrees with the various comments received on the Original Proposal that suggested the allowance for loan and lease losses (ALLL) account should be included in its entirety in the risk-based capital ratio numerator (that is, not subject to a 1.25 percent cap), and that goodwill and other intangible assets specifically related to a supervisory merger that occurs before the Board finalizes its risk-based capital ratio rule should be included in the risk-based capital ratio numerator for some period of time before being excluded (approximately 10 years after any final rule is published in the **Federal Register**). For a more detailed discussion on these and the other proposed changes, and responses to the comments received on the Original Proposal, refer to the section-by-section analysis part of this preamble below.

In terms of the denominator for the risk-based capital ratio measure, section 216(d)(2) of the FCUA requires that the Board, in designing a risk-based net worth requirement, ''take account of *any material risks* against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized may not provide adequate protection.'' [72] Congress specifically listed IRR with respect to this provision in the Senate Report accompanying CUMAA, which added the aforementioned requirement to the FCUA.[73] Section 216(d)(2) of the FCUA differs from the corresponding provision in section 38 of the FDI Act,[74] which requires the Other Banking Agencies to implement risk-based capital requirements, because section 216(d)(2) specifically requires that NCUA's risk-based requirement address ''*any material risks.*'' Accordingly, despite the absence of an IRR component in the Other Banking Agencies' risk-based capital requirements,[75] the Board is still required to account for any material risks in the risk-based requirement unless the risk is deemed *immaterial* because of the existence of some other mechanism that the Board believes adequately accounts for the risk.

NCUA's risk-based net worth requirement has included some aspect of IRR since its inception in 2000. Further, the Board continues to believe that IRR, if not adequately addressed through some regulatory, statutory or supervisory mechanism, can represent a material risk for purposes of NCUA's risk-based requirement.[76] The Board noted its concerns about IRR in the preamble of the final IRR rule issued in January 2012 when it highlighted the need for federally insured credit unions to have an effective IRR management program.[77] NCUA's requirement to have an effective IRR management program was necessitated in part by the Board's concern over the steady lengthening in maturity of average credit union assets, an increase that in turn was fueled by a steady and extended expansion into mortgage loans and investments. At the same time credit unions were experiencing an increase in the weighted average maturity of their assets, much of their current portfolio was established in a period of record-low interest rates and at contractually fixed coupon amounts. These asset factors, coupled with a large influx of non-maturity shares also priced at historically low rates, has created a unique mismatch between assets and liabilities and a potentially volatile sensitivity in earnings and capital. Accordingly, the Board continues to view IRR as a major risk facing credit unions.

Based on long-term balance sheet trends at credit unions and NCUA's experiences dealing with problem institutions, the Board has concluded that NCUA's current regulations and supervisory process alone cannot adequately address IRR. However, the Board agrees with commenters on the Original Proposal who suggested that measures of IRR based comprehensively on assets and liabilities (including hedges) should be favored over measures that are based upon an asset-only approach, which is the approach taken in the current rule and was also the approach taken in the Original Proposal. Accordingly, the Board is now proposing to exclude consideration of IRR from the risk-based capital ratio measure, but in the future intends to consider alternative approaches for taking into account the IRR at credit unions.

The proposed methodology for assigning risk weights in this proposed rule, therefore, would account only for credit risk and concentration risk. The Board believes that a capital-at-risk methodology is more appropriate for

[72] 12 U.S.C. 1790d(d)(2) (emphasis added).

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

[74] 12 U.S.C. 1831o.

[75] 78 FR 55349, 55362 (Sept. 10, 2013) (''The risk-based capital ratios under these rules do not explicitly take account of the quality of individual asset portfolios or the range of other types of risk to which FDIC-supervised institutions may be exposed, such as interest rate, liquidity, market, or operational risks.'').

[76] IRR has been NCUA's top supervisory priority for the last few years, and has appeared as an issue of significant concern in the Financial Stability Oversight Council's 2012 and 2013 Annual Reports.

[77] 77 FR 5155 (February 2, 2012).

measuring the risks arising from the changes in interest rates. The use of capital-at-risk methodologies to identify, measure and control IRR is a long standing practice in larger credit unions and a standard expectation among depository institution supervisors, including NCUA. Net economic value (NEV) is the most prevalent tool credit unions use to measure capital-at-risk. NEV measures the effect of changes in interest rates on a credit union's economic value. NCUA has had a supervisory expectation for the use of asset liability management modeling by large credit unions for decades. In 2013, NCUA codified the requirement for IRR policies and management programs under section 741.3(b)(5).[78] Paragraph (b)(5) currently requires federally insured credit unions with over $50 million in assets to develop and adopt a written policy on IRR management, and a program to effectively implement that policy, as part of their asset liability management responsibilities.

Because IRR will no longer be included in this proposal, NCUA will consider what alternative approaches can be taken to account for IRR at credit unions. Alternative approaches that could be taken include adding a separate IRR standard as a subcomponent of the risk-based net worth requirement to complement the proposed risk-based capital ratio measure. Conceptually, a separate IRR standard should be based on a comprehensive balance sheet measure, like NEV, that takes into account offsetting risk effects between assets and liabilities (including benefits from derivative transactions). The intent of such a measure would be to measure IRR consistently and transparently across all asset and liability categories, to address both rising and falling rate scenarios, and to supplement the supervisory process with a measure calibrated to address severe outliers. This approach would also incorporate a forward-looking, proactive measure into NCUA's capital standards, as recommended by GAO.[79]

In light of the proposed elimination of IRR measures from the current rule, and GAO's recommendation for NCUA to incorporate a forward-looking measure into credit union's capital standards, the Board specifically requests comments on alternative approaches that could be taken in the future to reasonably account for IRR.

Because the Board has decided to exclude IRR from the computation of the risk weights for assets in this proposal, it was necessary to propose significant changes to how investments are currently risk-weighted. This proposal adopts a risk weight framework for investments based largely on the credit risk of the issuer or underlying collateral. This proposed approach would be substantially similar to the Other Banking Agencies' framework for investments.[80] Because the same types of investments generally perform identically on a credit risk basis for credit unions and banks, the variations in this proposal from the Other Banking Agencies' investment risk weights primarily involve credit union-specific type investments. For example, the proposed risk weights assigned to investments in capital instruments issued by corporate credit unions and credit union service organizations would differ from the corresponding risk-weights assigned to bank investments. While this approach to assigning risk weight to investments would require credit unions to report additional data on the Call Report, the Board believes such an approach would result in net benefits to credit unions in terms of the improved precision of the capital requirements. Further, the more granular data will improve NCUA's offsite supervision capabilities. The section-by-section analysis part of the preamble contains more detailed discussions on the specific changes being proposed to the investment risk weights.

Concentration risk can also be a material risk. As the Basel Committee on Banking Supervision explained in Basel II:

> Risk concentrations are arguably the single most important cause of major problems in banks. Risk concentrations can arise in a bank's assets, liabilities, or off-balance sheet items, through the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. Because lending is the primary activity of most banks, credit risk concentrations are often the most material risk concentrations within a bank. Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration.[81]

The concept of higher risk weights for concentrations of real estate loans and MBLs exists in the current risk-based requirement. Eliminating the concentration dimension for risk weights would be a step backward and is inconsistent with the concerns raised regarding concentration risk by GAO and in Material Loss Reviews (MLRs) conducted by NCUA's OIG. 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. Credit unions with high MBL concentrations are particularly susceptible to changes in business conditions that can affect borrower cash flow, collateral value, or other factors increasing the probability of default. GAO found in its 2012 report that credit unions who failed had more MBLs as a percentage of total assets than peers and the industry average. GAO advised NCUA to revise PCA taking into account credit unions with a high percentage of MBLs to total assets. The report documented NCUA's agreement to revise PCA regulations so that capital standards adequately address concentration risk.[82]

GAO also recommended NCUA address the real estate concentration risk concerns raised by NCUA's OIG, who completed several MLRs where failed credit unions had large real estate loan concentrations. The NCUSIF 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 mortgage loans, home equity lines of credit (HELOCS), or both.[83]

Accordingly, the Board is now proposing to include a tiered risk weight framework for high concentrations of residential real estate loans and commercial loans [84] in NCUA's risk-based capital ratio measure.[85] As a

[78] *See also* 78 FR 4032, 4037 (Jan. 18, 2013).

[79] *See* U.S. Govt. Accountability Office, GAO–12–247, *Earlier Actions Are Needed to Better Address Troubled Credit Unions,* (Jan. 2012) *available at http://www.gao.gov/products/GAO-12-247.*

[80] *See, e.g.,* 12 CFR 324.32.

[81] Basel Committee on Banking Supervision, ''International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version'' 214 (June 2006) *available at http://www.bis.org/publ/bcbs128.pdf* (*Basel II*).

[82] *See* U.S. Govt. Accountability Office, GAO–12–247, Earlier Actions are Needed to Better Address Troubled Credit Unions (2012), *available at http://www.gao.gov/products/GAO-12-247.*

[83] *See* Office of Inspector General, National Credit Union Administration, OIG–10–03, Material Loss Review of Cal State 9 Credit Union (April 14, 2010), available at *http://www.ncua.gov/about/Leadership/CO/OIG/Documents/OIG201003MLRCalState9.pdf;* Office of Inspector General, National Credit Union Administration, OIG–11–07, Material Loss Review of Beehive Credit Union (July 7, 2011), available at *http://www.ncua.gov/about/Leadership/CO/OIG/Documents/OIG201107MLRBeehiveCU.pdf;* Office of Inspector General, National Credit Union Administration, OIG–10–15, Material Loss Review of Ensign Federal Credit Union, (September 23, 2010), available at *http://www.ncua.gov/about/Leadership/CO/OIG/Documents/OIG201015MLREnsign.pdf.*

[84] The definition of commercial loans and the differences between commercial loans and MBLs are discussed in more detail in the section-by-section analysis.

[85] The tiered framework would provide for an incrementally higher capital requirement resulting

credit union's concentration in these asset classes increases, incrementally higher levels of capital would be required. This approach would address concentration risk as it relates to minimum required capital levels through a transparent, standardized, regulatory requirement. Considering concentration risk solely in the examination process would be less consistent and transparent, and would lack a strong enforcement framework.

The Board agrees with various commenters on the Original Proposal that the tiered risk weight system should be adjusted so as to focus on material outliers, thereby creating more consistency of capital treatment with banks. Accordingly, the Board proposes to use a single, higher concentration threshold to simplify the risk weight framework and calibrate it to be applicable only to credit unions that deviate significantly from the mean.[86] This single, higher concentration threshold would provide sufficient flexibility for the vast majority of credit unions to operate at a level where the risk weights are substantially similar to the risk weights applied to similar bank assets under the Other Banking Agencies' capital regulations.[87]

The concentration thresholds would not limit a credit union's lending activity; rather, the thresholds would merely require the credit union to hold capital for the elevated risk. The Board does not believe credit unions would be at a competitive disadvantage because most loans (except for loans at extremely high concentrations) would be assigned risk weights similar to those applicable to banks.

Consistent with section 216(b)(1)(A)(ii) of the FCUA, which requires NCUA's PCA requirement be comparable to the Other Banking Agencies' PCA requirements, the Board largely relied on the risk weights assigned to various asset classes under the Basel Accords and the Other Banking Agencies' risk-based capital rules, as well as the underlying principles, for this proposal.[88] NCUA has, however, tailored the risk weights in this proposal for certain assets that are unique to credit unions; where a demonstrable and compelling case exists, based on contemporary and sustained performance differences, to differentiate for certain asset classes between banks and credit unions; or where a provision of the FCUA required doing so. Thus, this proposal provides for even greater comparability to Other Banking Agencies' risk weights than the Original Proposal by adjusting asset classes and recalibrating risk weight, including for all loans changing the definition of ''current'' from less than 60 to less than 90 days past due.

The following is a table showing a summary of the risk weights included in this proposal. See the section-by-section analysis part of the preamble below for more detail on the proposed changes to the asset classes and risk weights.

SUMMARY OF PROPOSED RISK WEIGHTS

	0%	20%	50%	75%	100%	150%	250%	300%	400%	1250%
Cash/Currency/Coin	X									
Investments:.										
Unconditional Claims—U.S. Govt. (Treas./GNMA)	X									
Balances Due from Federal Reserve Banks	X									
Federally Insured Deposits in Financial Institutions	X									
Debt Instruments issued by NCUA and FDIC	X									
CLF Stock	X									
Uninsured deposits at U.S. Federally Insured Inst.		X								
Agency Obligations		X								
FNMA and FHLMC pass through MBS		X								
Gen. Oblig. Bonds Issued by State or Political Sub.		X								
FHLB Stock and Balances		X								
Senior Agency Residential MBS or Asset Backed Securities (ABS) Structured		X								
Revenue Bonds Issued by State or Political Sub.			X							
Senior Non-Agency Residential MBS Structured			X							
Corporate Membership Capital					X					
Senior Non-Agency ABS Structured Securities					X					
Industrial Development Bonds					X					
Agency Stripped MBS (Int. Only and Prin. Only)					X					

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 comments on the Original Proposal 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, the Board believes including this with the risk thresholds for real estate lending is not necessary.

[86] The concentration threshold for real estate loans is approximately two standard deviations from the mean. The concentration threshold for commercial loans is over five standard deviations from the mean.

[87] Based on NCUA's analysis of call report data, approximately 90 percent of complex credit unions operate at levels below the concentration thresholds proposed for residential real estate loans. Over 99 percent of complex credit unions operate at levels below the concentration thresholds proposed for commercial loans. *See also, e.g.,* 12 CFR 324.32(f) and (g) (corresponding FDIC risk weights).

[88] NCUA has attempted to simplify certain aspects of this proposed rule to take into account the cooperative character of credit unions while still imposing risk-based capital standards that are substantially similar and equivalent in rigor to the standards imposed on banks. *See* 12 U.S.C. 1790d(b)(1)(B).

SUMMARY OF PROPOSED RISK WEIGHTS—Continued

	0%	20%	50%	75%	100%	150%	250%	300%	400%	1250%
Mutual Funds Part 703 Compliant					X*					
Value of General Account Insurance (BOLI/CUOLI)					X*					
Corporate Perpetual Capital						X				
Mortgage Servicing Assets							X			
Separate Account Life Insurance								X*		
Publicly Traded Equity Investment (non CUSO)								X		
Mutual Funds Part 703 Non-Compliant								X*		
Non-Publicly Traded Equity Inv. (non CUSO)									X	
Subordinated Tranche of Any Investment										X**
Consumer Loans:										
Share-Secured		X								
Current Secured				X						
Current Unsecured					X					
Non-Current						X				
Real Estate Loans:										
Share-Secured		X								
Current First Lien < 35% of Assets			X							
Current First Lien > 35% of Assets				X						
Not Current First Lien					X					
Current Junior Lien < 20% of Assets					X					
Current Junior Lien > 20% of Assets						X				
Noncurrent Junior Lien						X				
Commercial Loans:										
Share-Secured		X								
Portion of Commercial Loans with Compensating Balance		X								
Commercial Loans < 50% of Assets					X					
Commercial Loans > 50% of Assets						X				
Non-current						X				
Miscellaneous:										
Loans to CUSOs					X					
Equity Investment in CUSO						X				
Other Balance Sheet Items not Assigned					X					

** With the option to use the look-through options.*[89]
*** With the option to use the gross-up approach.*[90]

The Board notes that FDIC's capital standards are the ''minimum capital requirements and overall capital adequacy standards for FDIC-supervised institutions . . . include[ing] methodologies for calculating minimum capital requirements . . .'' [91]

The FDIC may require an FDIC-supervised institution to hold an amount of regulatory capital greater than otherwise required under its capital rules if the FDIC determines that the institution's capital requirements under its capital rules are not commensurate with the institution's credit, market, operational, or other risks.[92]

Further, the September 10, 2013 preamble to part 324 of FDIC's regulations states that:

> The FDIC's general risk-based capital rules indicate that the capital requirements are minimum standards generally based on broad credit-risk considerations. The risk-based capital ratios under these rules do not explicitly take account of the quality of individual asset portfolios or the range of other types of risk to which FDIC-supervised institutions may be exposed, such as interest-rate risk, liquidity, market, or operational risks . . . In light of these considerations, as a prudent matter, an FDIC-supervised institution is generally expected to operate with capital positions well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the risks to which it is exposed, which may entail holding capital significantly above the minimum requirements.[93]

As indicated above, FDIC's approach to risk weights is calibrated to be the minimum regulatory capital standard. Similarly, this proposal is calibrated to be the minimum regulatory capital standard. Therefore, the Board believes it is necessary to incorporate a broader regulatory provision requiring complex credit unions to maintain capital commensurate with the level and nature of all risks to which they are exposed, and to maintain a written strategy for assessing capital adequacy and maintaining an appropriate level of capital.

Proposed new § 702.101(b) is based on a similar provision in the Other Banking Agencies' rules.[94] This provision would not affect a complex credit union's PCA classification. It would, however, support NCUA's assessment of complex credit unions' capital adequacy in the supervisory process (*e.g.,* assigning CAMEL and risk ratings). Following the publication of a final risk-based capital rule, NCUA would develop and publish supervisory guidance for examiners and credit unions on the application of this provision. Please refer to the section-by-

[89] The ''look-through'' approaches are discussed in more detail in part of the preamble discussing § 702.103(c)(4) of this proposal.

[90] The ''gross-up'' approach is discussed in more detail in part of the preamble discussing § 702.103(c)(4) of this proposal.

[91] *See, e.g.,* 12 CFR 324.1(a).

[92] *See, e.g.,* 12 CFR 324.1(d).

[93] 78 FR 55362, Tuesday, September 10, 2013.

[94] *See, e.g.,* 12 CFR 324.10(d)(1) and (2).

section analysis part of this preamble for a more detailed discussion of this new provision and the related supervisory process considerations.

Because of this proposed new capital adequacy provision, existing enforcement authority for unsafe and unsound conditions or practices,[95] NCUA's authority to reclassify an insured credit union into a lower net worth category,[96] and comments on the Original Proposal, the Board has decided to eliminate the provision in the Original Proposal for imposing an IMCR.

Under the Original Proposal, proposed § 702.105(a) would have introduced rules and procedures to permit the Board, on a case-by-case basis, to impose an IMCR that exceeds the risk-based capital requirement that otherwise would apply to a credit union under subpart A of part 702.

Under the Original Proposal, § 702.105(a) would have prescribed criteria to determine when a credit union's capital is, or may become, inadequate, making it appropriate to impose a higher capital requirement. It then would have prescribed standards to determine what heightened capital requirement to impose in such cases, based not only on mathematical and objective criteria, but on subjective judgment grounded in agency expertise.

Under the Original Proposal, a staff-level decision to impose a discretionary supervisory action (DSA) under part 702,[97] and a decision to impose an IMCR would have been treated as a ''material supervisory determination.'' [98] As such, proposed § 747.2006 would have required NCUA to provide the affected credit union with reasonable notice of a proposed IMCR, and it established an independent process by which to challenge the proposed IMCR, culminating in Board review.

With a few notable exceptions,[99] the comments addressing the IMCR were critical of the concept itself, NCUA's legal authority to impose an IMCR, the scope of an IMCR, the criteria and procedures for imposing it, the subjectivity and discretion involved, or the lack of an option for review by an independent third party.

Now that the IMCR provision in this proposal has been removed, the commenters' concerns with the various aspects of the IMCR are no longer relevant. NCUA would be able to address any deficiencies in a credit union's capital levels relative to its risk by: (1) Reclassifying the credit union into a lower net worth category under § 702.102(b) of this proposal and FCUA; [100] (2) determining in relation to proposed § 702.101(b) that capital levels are not commensurate with the level or nature of the risks to which the credit union is exposed; or (3) using other supervisory authorities to address unsafe or unsound conditions or practices as noted in § 702.1(d) of this proposal and the current rule. 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 this part, 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.

As discussed earlier in this preamble, the Original Proposal would have required that credit union meet different risk-based capital ratio levels for the adequately capitalized category (eight percent) and the well capitalized category (10.5 percent). Commenters on the Original Proposal questioned NCUA's legal authority to require complex credit unions to meet one risk-based capital ratio to be adequately capitalized and a different, higher risk-based capital ratio to be classified as well capitalized. As explained in the legal authority section of this preamble, the Board has the authority under the FCUA to take this approach.

However, the Board supports lowering the risk-based capital ratio level required for a complex credit union to be classified as well capitalized from 10.5 percent to 10 percent. The Board agrees with commenters that a 10 percent risk-based capital ratio level for well capitalized credit unions simplifies the comparison with the Other Banking Agencies' rules [101] by removing the effect of the capital conservation buffer.[102] Capital ratio thresholds are largely a function of risk weights. As discussed in other parts of this proposal, the Board is now proposing to more closely align NCUA's risk weights with those assigned by the Other Banking Agencies,[103] so it follows that the risk-based capital ratio thresholds should also align as much as possible. The proposed 10 percent risk-based capital ratio level for well capitalized credit unions, along with the eight percent risk-based capital ratio level for adequately capitalized credit unions, would be comparable to the total risk-based capital ratio requirements contained in the Other Banking Agencies' capital rules.[104]

The Original Proposal would have applied to all credit unions with over $50 million in total assets. Based on NCUA's analysis of the comments received on the Original Proposal, the Board is now proposing to define a credit union as ''complex'' if it has assets of more than $100 million.[105] Credit unions meeting this threshold have a portfolio of assets and liabilities that are complex, based upon the products and services in which they are engaged. Credit unions with $100 million in assets or less generally do not have a complex structure of assets and liabilities and are a small share of the overall assets in the credit union system, thereby limiting the exposure of the NCUSIF to these institutions. As discussed later in this document, the $100 million asset threshold is a clear demarcation above which all credit unions engage in complex activities, and where almost all such credit unions (99 percent) are involved in multiple complex activities, in stark contrast to credit unions with $100 million in assets or less.

The Board believes an asset threshold would be clear, logical, and easy to administer when compared to the more complicated formula credit unions are required to follow under the current rule [106] to determine if they are complex. Using a more straightforward proxy for complex credit unions would also help account for the fact that credit unions have boards of directors that consist primarily of volunteers. The $100 million dollar asset size threshold would exempt almost 80 percent of credit unions [107] from any regulatory burden associated with complying with this rule, while covering nearly 90 percent of the assets in the credit union system. The threshold would also be consistent with the fact that the majority

[95] See § 702.1(d) of this proposed rule and the current rule.

[96] See section 1790(d)(h) of the Federal Credit Union Act, and § 702.102(b) of this proposed rule and the current rule.

[97] *E.g.,* 12 CFR 702.202(b) and (c).

[98] 12 U.S.C. 1790d(k).

[99] Several trade association commenters advocated limiting the scope of the IMCR to IRR and concentration risk only, otherwise excluding those two risks from the scope of the proposed rule.

[100] 12 U.S.C. 1790d(h).

[101] *See, e.g.,* 12 CFR 324.403.

[102] The ''capital conservation buffer'' is explained in more detail in the discussion on proposed § 702.102(a) in the section-by-section analysis part of the preamble.

[103] *See, e.g.,* 12 CFR 324.32.

[104] *See, e.g.,* 12 CFR 324.403.

[105] There is no exemption for banks from the risk-based capital requirements of the other banking agencies. There are 1,975 FDIC-insured banks with assets less than $100 million as of June 2014.

[106] 12 CFR 702.106.

[107] Based upon December 31, 2013 Call Report data.

of losses (as measured as a proportion of the total dollar cost) to the NCUSIF result from credit unions with assets greater than $100 million. For a more detailed discussion of the rationale the Board considered in defining complex, see the discussion associated with proposed § 702.103 in the section-by-section analysis part of the preamble.

The Original Proposal would have provided an 18-month implementation period for credit unions to adjust to the new requirements. The Board agrees with the comments received on the Original Proposal that a longer implementation period is necessary due to the complexity of this rule and the changes needed in the Call Report. Therefore, the Board is proposing to more than double the implementation period by extending it to January 1, 2019, to provide both credit unions and NCUA sufficient time to make the necessary adjustments, such as systems, processes, and procedures, and to reduce the burden on affected credit unions in meeting the new requirements.

IV. Section-by-Section Analysis

Part 702—Capital Adequacy

Revised Structure of Part 702

Consistent with the Original Proposal, this proposed rule would reorganize part 702 by consolidating NCUA's PCA requirements, which are currently included under subsections A, B, C, and D, under proposed 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.'' [108] 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 that consolidating these sections would reduce confusion and save credit union staff from having to frequently flip back and forth through the four subparts of the current PCA rule.

In general, this 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. 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, this 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. 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.

Finally, this proposed rule would retain subpart E of part 702, Stress Testing, but would re-designate and re-number the current subpart as subpart C. Other than re-designating and re-numbering the subpart, the language and requirements of current subpart E would remain unchanged.

Section 702.1 Authority, Purpose, Scope, and Other Supervisory Authority

Consistent with the Original Proposal, 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 that are being proposed in other sections of part 702. No substantive changes to the section are intended.

The Board received a number of comments expressing concerns regarding the Boards authority to issue the Original Proposal. Several commenters stated that the Board lacks legal authority to issue a rule implementing the risk-based capital requirement as proposed. Other commenters suggested that the Board did not adequately account for the unique nature of credit unions in the Original Proposal. Another commenter suggested that the language of the FCUA does not mean that there should be one approach and one universal algorithm applied to all risk in the same fashion. Other commenters suggested that the Original Proposal was inconsistent with the statutory requirement for the Board to design a system of PCA that is comparable to that of FDIC. Other commenters argued that the proposed risk-based capital requirement was inconsistent with the FCUA because they believed it ignored the fact that most credit unions raise net worth only through retained earnings.

The Board has carefully considered these comments and generally disagrees with commenters' reading of the FCUA. Section 216(b)(1) of the FCUA requires the Board to adopt by regulation a system of PCA for insured credit unions that is ''comparable to'' the system of PCA prescribed in the FDI Act, that is also ''consistent'' with the requirements of section 216 of the FCUA, and that takes into account the cooperative character of credit unions.[109] Paragraph (d)(1) of the same section requires that NCUA's system of PCA include ''a risk-based net worth requirement for insured credit unions that are complex . . .'' When read together, these sections grant the Board broad authority to design reasonable risk-based capital regulations to carry out the stated purpose of section 216, which 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.'' [110] As explained in more detail below, the Board believes that this proposed rule is comparable, although not identical in detail, to the PCA and risk-based capital requirements for banks. In addition, as explained throughout the preamble to this proposed rule, this proposal deviates from the PCA and risk-based capital requirements applicable to banks as required by section 216 of the FCUA and takes into account the cooperative character of credit unions. Accordingly, the Board believes that this proposed rule would implement the risk-based net worth requirement consistent with section 216 of the FCUA.

Section 702.2—Definitions

Under the Original Proposal, proposed § 702.2 would have retained many of the definitions in current § 702.2 with no substantive changes. The Original Proposal would, however, have removed the paragraph number assigned to each of the definitions under current § 702.2 and would have reorganized the section so the new and existing definitions were listed in alphabetic order. This reformatting would have made § 702.2 more consistent with current §§ 700.2, 703.2 and 704.2 of NCUA's regulations.[111] In addition, the originally proposed § 702.2 would have added a number of new definitions, and amended some existing definitions in § 702.2. These changes were intended to help clarify the

[108] 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 below $10 million while it is still in operation for less than 10 years.''

[109] 12 U.S.C. 1790d(b)(1).

[110] Section 1790d(a)(1).

[111] 12 CFR 700.2; 12 CFR 703.2; 12 CFR 704.2.

meaning of terms used in the Original Proposal.

The Board received no comments on these technical changes to § 702.2 and has decided to retain the changes described above in this second proposal. Consistent with section 202 of the FCUA,[112] the Board has incorporated the phrase 'in accordance with GAAP' into many of the definitions to clarify that generally accepted accounting principles would be used determine how an item is recorded on the statement of financial condition from which it would be incorporated into the risk-based capital calculation. The following definitions, some of which were included in the Original Proposal, would be added, amended, or removed under this proposed rule:

Allowances for loan and lease losses (ALLL). Under the Original Proposal, the term ''allowance for loan and lease loss'' would have been defined as reserves that have been established through charges against earnings to absorb future losses on loans, lease financing receivables, or other extensions of credit.

The Board received no comments on the definition of ALLL in the Original Proposal and has decided to retain the term and definition in this second proposal with the following changes. As discussed in more detail below, the Board is now proposing to amend the definition of ALLL to address the importance of maintaining ALLL in accordance with GAAP since the integrity of the risk-based capital ratio is dependent upon an accurate ALLL, particularly now that this second proposal would allow the entire ALLL balance to be included in the risk-based capital ratio numerator. A credit union maintaining ALLL in accordance with GAAP will make timely adjustments to the ALLL including the timely charge off of loan losses. Accordingly, under this proposed rule, the term ''ALLL'' would be defined as valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables or other extensions of credit as determined in accordance with GAAP.

Amortized cost. Under this proposed rule, the new term ''amortized cost'' would be defined as the purchase price of a security adjusted for amortizations of premium or accretion of discount if the security was purchased at other than par or face value.

This proposed new term is being added because investments accounted for as held-to-maturity are reported on the balance sheet at amortized cost while investments accounted for as available-for-sale are reported on the balance sheet at fair value. As explained in more detail below, to ensure consistency in the measure of minimum capital for held-to-maturity or available-for-sale investments, the risk weights will be applied to the amortized cost.

Appropriate regional director. This proposed rule would amend the definitions section to remove the definition of the term ''appropriate regional director'' from the current rule. The definition is unnecessary and redundant because the term ''Regional Director'' is already defined for purposes of NCUA's regulations in § 700.2.

Appropriate state official. Under this proposed rule, the term ''appropriate state official'' would be defined as the state commission, board or other supervisory authority having jurisdiction over the credit union. The proposal would amend the current definition of ''appropriate state official'' to provide additional clarity by adding the italicized words above (''state'' and ''the'') to the definition, and by removing the words ''chartered by the state which chartered the affected credit union,'' which the Board believes are unnecessary.

Call Report. Under the Original Proposal, the term ''Call Report'' would have been defined as the Call Report required to be filed by all credit unions under § 741.6(a)(2).

The Board received no comments on the definition of ''Call Report'' and has decided to retain the definition unchanged in this proposal.

Carrying value. Under this proposed rule, the new term ''carrying value'' would be defined, with respect to an asset, as the value of the asset on the statement of financial condition of the credit union, determined in accordance with GAAP. Under this proposed rule, for many assets, the carrying value would be the amount subject to the application of the associated risk weight.

Central counterparty (CCP). Under this proposed rule, the new term ''central counterparty'' would be defined as a counterparty (for example, a clearing house) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts. The Board is proposing to add this term to coincide with amendments it is making in the derivatives section of this proposal.

Commercial loan. Under this proposed rule, the new term ''commercial loan'' would be defined as any loan, line of credit, or letter of credit (including any unfunded commitments) to individuals, sole proprietorships, partnerships, corporations, or other business enterprises for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. The definition would also provide that the term commercial loan excludes loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans.

The Board is proposing to adopt a different approach from the Original Proposal, in which it applied risk weights to assets that fell within the statutory definition of MBLs, and is now proposing to assign specific risk weights to all loans meeting the new definition of commercial loans provided above. The proposed definition of commercial loans is more reflective of the risk of these loans than the previously defined term MBL, which would no longer be used in proposed § 702.104, and, as discussed in more detail below, is intended to better identify the loans made for a commercial purpose and having similar risk characteristics. Classification of a loan as a commercial loan would be based upon the purpose of the loan, the use of the proceeds of the loan, and the type of underlying collateral. Commercial loans may take the form of direct or purchased loans.

For example, commercial loans would generally include the following types of loans:[113]

- Loans for commercial, industrial and professional purposes to:
  - 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:

[112] 12 U.S.C. 1782(a)(6)(C)(i).

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

○ 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.

• Loan secured by multifamily residential properties with 5 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 5 or more dwelling units.[114]

• 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.

Commitment. Under the Original Proposal, the term ''commitment'' would have been defined as any legally binding arrangement that obligated the credit union to extend credit or to purchase assets.

The Board received no comments on the definition of ''commitment'' and has decided to retain the definition in this proposal, but with a minor change. In this proposal, the term ''commitment'' would be defined as any legally binding arrangement that obligates the credit union to extend credit, to purchase *or sell* assets, *or enter into a financial transaction.* The italicized words would be added to expand the definition to provide additional clarity and to encompass a broader range of financial transactions than just extending credit or purchasing assets.

Consumer loan. Under this proposed rule, the new term ''consumer loan'' would be defined as a loan to one or more individuals for household, family, or other personal expenditures, including any loans secured by vehicles generally manufactured for personal, family, or household use regardless of the purpose of the loan. The proposed definition would provide further that the term consumer loan excludes commercial loans, loans to CUSOs, first- and junior-lien residential real estate loans, and loans for the purchase of fleet vehicles.

For example, under this proposed rule, consumer loans would include direct and indirect loans for the following purposes:

• Purchases of new and used passenger cars and other vehicles such as minivans, sport-utility vehicles, pickup trucks, and similar light trucks or heavy duty trucks generally manufactured for personal, family, or household use and not used as fleet vehicles or to carry fare-paying passengers;

• Purchases of household appliances, furniture, trailers, and boats;

• Repairs or improvements to the borrower's residence (that do not meet the definition of a loan secured by real estate);

• Education expenses, including student loans;

• Medical expenses;

• Personal taxes;

• Vacations;

• Consolidation of personal debts;

• Purchases of real estate or mobile homes to be used as the borrower's primary residence (that do not meet the definition of a loan secured by real estate); and

• Other personal expenses.

The Board is proposing to add this new term and definition to part 702 to distinguish loans made for a consumer purpose from real estate loans and commercial loans so each can be assigned to an appropriate risk weight category.

Contractual compensating balance. Under this proposed rule, the new term ''contractual compensating balance'' would be defined as the funds a commercial loan borrower must maintain on deposit at the lender credit union as security for the loan in accordance with the loan agreement, subject to a proper account hold and on deposit as of the measurement date.

The Board is proposing this new term because it recognizes that the portion of commercial loans covered by contractual compensating balances present a lower credit risk, and thus should be assigned a lower risk weight provided the credit union has a proper hold and maintains the compensating balance.

Credit conversion factor (CCF). Under this proposed rule, the new term ''credit conversion factor'' would be defined as the percentage used to assign a credit exposure equivalent amount for selected off-balance sheet accounts.

This definition is being proposed to help clarify the process used to calculate the credit exposure equivalent for off-balance sheet items. Specific off-balance sheet items have a probability of becoming an actual credit exposure and shifting on to the balance sheet. The CCF is an estimate of this probability.

Credit union. Under this proposed rule, the term ''credit union'' would be defined as a federally insured, natural-person credit union, whether federally or state-chartered. The proposal would amend the current definition of the term ''credit union'' to remove the words ''as defined by 12 U.S.C. 1752(6)'' from the end of the definition because they are unnecessary, and could mistakenly be read to limit the definition of ''credit unions'' to state-chartered credit unions.

Current. Under this proposed rule, the new term ''current'' would be defined to mean, with respect to any loan, that the loan is less than 90 days past due, not placed on non-accrual status, and not restructured.

Commenters suggested that loans carried on non-accrual status should not be included with delinquent loans, and that the Original Proposal did not take into consideration the balances in the ALLL if the credit union is able, under GAAP, to reserve for individual losses. Other commenters suggested that the definition of ''delinquent loans'' should be amended to match the Other Banking Agencies' regulations, which count loans as delinquent only if they are 90 days or more past due.

The Board is now proposing to count loans as non-current if they are 90 days past due (rather than 60 days past due), and, as explained in more detail below, to assign them to the higher risk weight category associated with past due loans. This change would better align this proposal with the definition of ''current loan'' under the Other Banking Agencies regulations.[115] The change to 90 days past due would also be consistent with § 741.3(b)(2), which specifies that a credit union's written lending policies must include ''loan workout arrangements and nonaccrual standards that include the discontinuance of interest accrual on loans past due by 90 days or more.''

In general, loans that are more than 90 days past due, or restructured, tend to

[114] Under this proposal, loans secured by one-to-four family residential property are defined as first or junior lien residential real estate loans.

[115] See, *e.g.,* 12 CFR 324.32(k).

have higher incidences of default resulting in losses. The Board is aware that the historical and individual loan losses are reflected in the balance of the ALLL, and believes that removal of the 1.25 percent of assets limit on the ALLL addresses the concerns expressed by commenters that, under the Original Proposal, there was a potential for negative consequences for maintaining an adequate ALLL for delinquent loans.

This definition would replace the term ''delinquent loans,'' which was used in the Original Proposal, when referring to whether a loan is past due, placed on non-accrual status, modified, or restructured. The Board believes using the term ''current'' when referring to loans will eliminate confusion caused by using the term ''delinquent loan'' in reference to regulatory reporting requirements or proper accounting treatment. Under this second proposed rule, loans are either current or non-current for purposes of determining their appropriate risk weight category.

CUSO. Under the Original Proposal, the term ''CUSO'' would have been defined as a credit union service organization as defined in parts 712 and 741.

The Board received no comments on the proposed definition of ''CUSO'' and has decided to retain the definition unchanged in this proposal.

Custodian. Under this proposed rule, the new term ''custodian'' would be defined as a financial institution that has legal custody of collateral as part of a qualifying master netting agreement, clearing agreement or other financial agreement. The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

Depository institution. Under this proposed rule, the new term ''depository institution'' would be defined as a financial institution that engages in the business of providing financial services; that is recognized as a bank or a credit union by the supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. The definition provides further that the term depository institution includes all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions and international banking facilities of domestic depository institutions, and all privately insured state-chartered credit unions.

The term depository institution would primarily be used to address the risk weights assigned to deposits in depository institutions.

Derivatives Clearing Organization (DCO). Under this proposed rule the term ''Derivatives Clearing Organization (DCO)'' would be defined as having the same definition as provided by the Commodity Futures Trading Commission in 17 CFR 1.3(d). The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

Derivative contract. Under this proposed rule, the term ''derivative contract'' would be defined as a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. The definition would provide further that the term derivative contract includes interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, and credit derivative contracts. The definition would also provide that the term derivative contract also includes unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument.

The Board received no comments on the proposed definition of ''derivatives contract.'' This proposal, however, includes a slightly modified definition of derivative contract to state derivative means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, and credit derivative contracts. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument. The Board believes this modification will make this proposal more clear and accurate.

Equity investment. Under this proposed rule, the new term ''equity investment'' would be defined as investments in equity securities, and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

This term would be primarily used to address the risk weights assigned to equity exposures. The Board recognizes that equity investments contain significant credit risk as they are generally in the first loss position and depend upon continued profitable operations of a business entity to retain value. The liquidity of equity investments can vary depending upon if the investment is publicly traded or closely held.

Equity investment in CUSOs. The Original Proposal would have defined 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 Board received no comments on the definition of ''investments in CUSO.'' However, the Board has decided to change the term and the definition as follows. Under this proposed rule, the new term ''equity investment in CUSOs'' would be defined as the unimpaired value of the credit union's equity investments in a CUSO as recorded on the statement of financial condition in accordance with GAAP.

The Board renamed this term and amended the definition in this proposal to emphasize the importance of recording equity investments in CUSOs in accordance with GAAP and clarify how the equity investment in a CUSO for the assignment of risk weights is determined. By following GAAP:

- For an unconsolidated CUSO, a credit union must assign the risk weight to the unimpaired value of the equity investment as presented on the statement of financial condition;
- For a consolidated CUSO, a credit union's equity investment is normally zero since the consolidation entries eliminate the intercompany transaction.

Exchange. Under this proposed rule the new term ''exchange'' would be defined as a central financial clearing market where end users can trade derivatives. The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

Excluded goodwill, and excluded other intangible assets. Under this proposed rule, the new term ''excluded goodwill'' would be defined as the outstanding balance, maintained in accordance with GAAP, of any goodwill originating from a supervisory merger or combination that was completed no more than 29 days after publication of this rule in final form in the **Federal**

Register. The definition would provide further that the term excluded goodwill and its accompanying definition will expire on January 1, 2025.

This proposed rule would also define the new term ''excluded other intangible assets'' as the outstanding balance, maintained in accordance with GAAP, of any other intangible assets such as core deposit intangibles, member relationship intangibles, or trade name intangible originating from a supervisory merger or combination that was completed no more than 29 days after publication of this rule in final form in the **Federal Register**. The definition would provide further that the term excluded other intangible assets and its accompanying definition will expire on January 1, 2025.

The Board added these two definitions as part of a response to certain comments on the Original Proposal and seeks to take into account the impact goodwill or other intangible assets recorded from transactions defined as supervisory mergers or combinations has on the calculation of the risk-based capital ratio upon implementation. This proposed exclusion would apply to supervisory mergers or combinations that are completed prior to a date that is 30 days from the date of publication of this rule in final form in the **Federal Register**. The Board intends to allow this additional time (until approximately 2024) for supervisory mergers or combinations related goodwill and other intangible assets to be absorbed under the proposed risk-based capital ratio. Under this proposal, the amount of goodwill deducted from the risk-based capital ratio numerator would be reduced by the balance of excluded goodwill or excluded other intangible assets recorded in accordance with GAAP as of the measurement date. However, credit unions would still need to conform to GAAP in the measurement and disclosure of goodwill and other intangible assets. This proposed exclusion would end on January 1, 2025 so the last quarter-end date with this exclusion will be December 31, 2024. This means that any remaining goodwill or other intangible assets would be required to be deducted from the risk-based capital ratio numerator after January 1, 2025.

Exposure amount. Under this proposed rule, the new term ''exposure amount'' would be defined as:

- The amortized cost for investments classified as held-to-maturity and available-for-sale, and the fair value for trading securities.
- The outstanding balance for Federal Reserve Bank Stock, Central Liquidity Facility Stock, Federal Home Loan Bank Stock, nonperpetual capital and perpetual contributed capital at corporate credit unions, and equity investments in CUSOs.
- The carrying value for non-CUSO equity investments, and investment funds.
- The carrying value for the credit union's holdings of general account permanent insurance, and separate account insurance.
- The amount calculated under § 702.105 of this part for derivative contracts.

This definition would be used to ensure the specific assets are assigned consistent risk weights based on the treatment of the specific assets.

Fair value. Under this proposed rule, the new term ''fair value'' would be defined as having the same meaning as provided in GAAP. This definition is important because the proper accounting for some specific assets subject to risk weights are recorded on the statement of financial condition at fair value.

Financial collateral. Under this proposed rule, the new term ''financial collateral'' would be defined as collateral approved by both the credit union and the counterparty as part of the collateral agreement in recognition of credit risk mitigation for derivative contracts. The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

First-lien residential real estate loan. Under this proposed rule, the new term ''first-lien residential real estate loan'' would be defined as a loan or line of credit primarily secured by a first-lien on a one-to-four family residential property where: (1) 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; and (2) in transactions where the credit union holds the first-lien and junior-lien(s), and no other party holds an intervening lien, for purposes of this part the combined balance will be treated as a single first-lien residential real estate loan.

Under the Original Proposal, the term ''first mortgage real estate loan'' would have been defined 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.

A number of commenters stated that they believed the proposed definition of first mortgage real estate loan would conflict with rules promulgated by the Consumer Financial Protection Bureau (CFPB), which may prevent credit unions from originating mortgage loans that qualify as ''qualified mortgages'' under CFPB's regulations, or are otherwise permitted under those rules, without incurring an additional capital charge. One commenter suggested that the proposed definition of first mortgage real estate loan should be amended to read as follows: ''A loan on realty with the benefit of a senior security interest to all others.'' Other commenters stated that the definition of first mortgage real estate loan is overbroad and should be revised to exclude home equity lines of credit because the risks associated with 30-year fixed-rate first-lien mortgages and HELOCs are vastly different and should not be assigned the same risk weight.

In response to the comments received on the Original Proposal, the Board is now proposing to eliminate the term ''first mortgage real estate loan'' and the accompanying definition and instead use the new term ''first-lien residential real estate loan'' for purposes of this proposal.

The Board believes that 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 a lower risk weight than most other types of loans. Accordingly, the Board is proposing to remove from the definition of first-lien residential real estate loans the requirement that such loans not have an amortization period exceeding 30 years.

The Board also believes, however, that first-lien residential real estate loans with amortizations longer than 30 years contain additional risks and must be underwritten with great care and monitored closely. Accordingly, the low risk weight assigned to first-lien residential real estate loans should not be viewed as encouraging certain real estate loan features which can be harmful to the credit quality of the loan, including an interest-only period, negative amortization, balloon payments, or excess upfront points and fees.

Credit unions must continue to make a good-faith effort to determine before the loan is made whether a borrower is likely to be able to repay the loan. In practice this means credit unions must generally ascertain, consider, and document a borrower's income, assets, employment status and stability, credit history and current and proposed monthly expenses.[116] NCUA does not intend for this definition to conflict with rules promulgated by CFPB. Rather, the Board believes the requirement that the credit union make a reasonable and good-faith effort that the member has the ability to repay the loans is consistent with CFPB regulations and ensures the grouping of loans receiving this relatively low risk weight would be substantially similar in credit quality.

The definition of 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 monitoring and compliance with the statutory limitation on MBLs. However, they would be included in the definition of first-lien residential real estate loans for the purpose of this part and would be risk-weighted accordingly.

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 this definition, the entire combined balance of the loans would be assigned the risk weight for first-lien residential real estate loans.

GAAP. Under the Original Proposal, the term ''GAAP'' would have been defined as generally accepted accounting principles as used in the United States.

The Board received no comments on the definition of ''GAAP'' and has decided to retain the term in this proposal with the following changes. Under this proposed rule, the term ''GAAP'' would be defined as generally accepted accounting principles in the United States as set forth in the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC).

The Board is proposing to define ''GAAP'' narrowly to retain its conventional meaning. However, credit unions should also follow joint accounting issuances by the chief accountants' of the federal financial institution regulatory agencies (including NCUA) that provide implementation guidance consistent with GAAP practice. The guidance issued jointly by the federal financial institution regulatory agencies' chief accountants' does not add to or modify existing financial reporting requirements under GAAP but often narrows GAAP practice to address supervisory considerations related to financial institutions. The federal financial institution regulatory agencies' chief accountants have a practice of clearing such guidance implementing GAAP through the FASB and the SEC's Office of the Chief Accountant.

General account permanent insurance. Under this proposed rule, the new term ''general account permanent insurance'' would be defined as an account into which all premiums, except those designated for separate accounts are deposited, including premiums for life insurance and fixed annuities and the fixed portfolio of variable annuities, whereby the general assets of the insurance company support the policy.

Under this proposal, general account permanent insurance would include direct obligations to the insurance provider. This would mean that the credit risk associated with general account permanent insurance is to the insurance company, which generally makes these insurance accounts have a lower credit risk than separate account insurance, which is a segregated accounting and reporting account held separately from the insurer's general assets.

General obligation. Under this proposed rule, the new term ''general obligation'' would be defined as a bond or similar obligation that is backed by the full faith and credit of a public sector entity.

The Board is proposing to add this definition to clarify that general obligation bonds or debt are generally backed by the credit and ''taxing power'' of the issuing jurisdiction rather than the revenue from a given project.

Goodwill. Under the Original Proposal, the term ''goodwill'' would have been defined 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 Board received no comments on the definition of ''goodwill'' and has decided to retain the definition in this proposed rule, with the addition that goodwill must be maintained in accordance with GAAP and does not include a new term ''excluded goodwill.'' Accordingly, under this proposal, the term ''goodwill'' would be defined as an intangible asset, maintained in accordance with GAAP, 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. Goodwill does not include excluded goodwill. These proposed changes are intended to clarify the definition and make it consistent with other changes being made in this proposal.

Government guarantee. Under this proposed rule, the new term ''government guarantee'' would be defined as a guarantee provided by the U.S. Government, FDIC, NCUA or other U.S. Government agencies, or a public sector entity.

The Board recognizes that government guarantees provide enhanced credit protection, particularly to loans, and revised the risk weights for the portion of loans with a government guarantee to a lower risk weight.

Government-sponsored enterprise (GSE). Under this proposed rule, the new term ''government-sponsored enterprise'' would be defined as an entity established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress, but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

Guarantee. Under this proposed rule, the new term ''guarantee'' would be defined as a financial guarantee, letter of credit, insurance, or similar financial instrument that allows one party to transfer the credit risk of one or more specific exposures to another party. The Board is proposing to add this definition to provide clarity.

Identified losses. Under the Original Proposal, the term ''identified losses'' would have been defined as 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. That proposed definition also would have provided 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.

[116] See NCUA Regulatory Alert, 14–RA–01, Ability-to-Repay and Qualified Mortgage Requirements from the Consumer Financial Protection Bureau (CFPB), January 2014 for additional information.

The Board received no comments on the proposed definition of ''identified losses.'' Nevertheless, the Board is now proposing to amend the definition of ''identified losses'' from the Original Proposal to ensure that identified losses would be measured in accordance with GAAP. Accordingly, under this proposal, the term ''identified losses'' would be defined 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. The definition would provide further that 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.

Industrial development bond. Under this proposed rule, the new term ''industrial development bond'' would be defined as a security issued under the auspices of a state or other political subdivision for the benefit of a private party or enterprise where that party or enterprise, rather than the government entity, is obligated to pay the principal and interest on the obligation.

This definition would be added to ensure the ultimate obligor's risk weight is used for risk-based capital calculations.

Intangible assets. Under the Original Proposal, the term ''intangible assets'' would have been defined as those assets that are required to be reported as intangible assets on a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

The Board received no comments on the definition of ''Intangible assets'', but is proposing to revise the definition for clarity. Accordingly, under this proposal, the term ''intangible assets'' would be defined as assets, maintained in accordance with GAAP, other than financial assets, that lack physical substance. This proposed change would not affect the substance of the definition, but will make the definition clearer. Additionally, the Board is proposing to add a definition for ''other intangibles'', which are a subset of ''intangible assets,'' and discussed in more detail below.

Investment fund. Under this proposed rule, the new term ''investment fund'' would be defined as an investment with a pool of underlying investment assets. The proposed definition would provide further that the term investment fund includes an investment company that is registered under § 8 of the Investment Company Act of 1940, as amended, and collective investment funds or common trust investments that are unregistered investment products that pool fiduciary client assets to invest in a diversified pool of investments.

The Board is proposing to define the term ''investment fund'' broadly to capture more than SEC-registered investment companies and funds offered by banks. This broader definition is intended to allow for the use of the look-through approaches used in the Other Banking Agencies' capital regulations,[117] which are discussed in more detail below, to separate account insurance or other pooled investments.

Junior-lien residential real estate loan. Under this proposed rule, the new term ''junior-lien residential real estate loan'' would be defined as a loan or line of credit secured by a subordinate lien on a one-to-four family residential property.

Due to the observed higher delinquency and losses of junior lien residential real estate loans, and consistent with the risk weights assigned by the Other Banking Agencies,[118] the Board proposes assigning higher risk weights for junior-lien residential real estate loans than for first-lien residential real estate loans. This definition would generally include all residential real estate loans that do not meet the definition of a first-lien residential real estate loans since the credit union is secured by a second or subsequent lien on the residential property loan.

Loan to a CUSO. Under the Original Proposal, the term ''loans to CUSO'' would have been defined 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 Board received no comments on the definition of ''Loans to CUSOs'' and has decided to retain the term in this proposal with the following changes to the term and the definition. Under this proposed rule the term ''loan to a CUSO'' would be defined as the outstanding balance of any loan from a credit union to a CUSO as recorded on the statement of financial condition in accordance with GAAP.

The Board originally proposed to add this definition to capture the importance of recording loans to a CUSO in accordance with GAAP and to clarify how the assignment of risk weights would be determined. By following GAAP:

- For an unconsolidated CUSO, a credit union must assign the risk weight to the outstanding balance of the loans to the CUSO as presented on the statement of financial condition;
- For a consolidated CUSO, the loan to a CUSO is normally zero since the consolidation entries eliminate the intercompany transaction.

Loan secured by real estate. Under this proposed rule, the new term ''loan secured by real estate'' would be defined as a loan that, at origination, is secured wholly or substantially by a lien(s) on real property for which the lien(s) is central to the extension of the credit. The definition would provide further that a lien is ''central'' to the extension of credit if the borrowers would not have been extended credit in the same amount or on terms as favorable without the lien(s) on real property. The definition would also provide that, for a loan to be ''secured wholly or substantially by a lien(s) on real property,'' the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) must be greater than 50 percent of the principal amount of the loan at origination.

The Board proposes using this term to ensure consistency in the assignment of risk weights for real estate loans. The definition would clarify that the terms of the loan are predicated on the existence of the lien on real property and that the real estate value at origination of the loans must be at least 50 percent of the principal amount of the loan to meet the definition. The Board does not intend for this to mean that a real estate loan with a 50 percent loan-to-value ratio is an appropriate credit risk but rather such a loan only meets the definition of secured by real estate.

Loans transferred with limited recourse. Under the Original Proposal, the term ''loans transferred with limited recourse'' would have been defined 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 have clarified that the term does not include transfers that qualify for true sale accounting treatment but contain only routine

[117] *See, e.g.,* 12 CFR 324.53.

[118] *See, e.g.,* 12 CFR 324.32(g)(2).

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.

Commenters suggested that the proposed definition be amended to represent the true risk associated with that product. Commenters stated that the proposed definition mirrors the Call Report field and includes the ''total principal balance outstanding of loans transferred . . . for which the transferor credit union retained some limited recourse.'' Although commenters stated they appreciated NCUA's efforts to align defined terms with existing Call Report fields, they countered that contingent liabilities should be taken into account only to the extent the credit union retains contractual and legal liability on the exposure. On partial recourse loans, commenters suggested that the credit union only retains a small fraction of the liability and is not exposed on the total principal balance. However, commenters stated that, under the Original Proposal, a credit union would be treated as holding the full balance as a contingent liability. Commenters suggested that this was a significant misrepresentation of the risk and created a disincentive for credit unions to utilize limited recourse loan sale relationships, which provide credit unions with a valuable option in managing liquidity risk and IRR, while still incentivizing the credit union to make high-quality loans. Commenters stated that the proposal would penalize credit unions that have utilized these programs prudently and effectively as part of a safe and sound asset management program. To remedy this problem, commenters suggested the definition of the term ''loans transferred with limited recourse'' and the corresponding Call Report field should be amended to reflect the true recourse exposure of the credit union.

In response to these comments, the Board is now proposing to amend the calculation for determining the risk-based capital requirement for loans transferred with limited recourse to more accurately align the capital requirement with the true recourse exposure. Whereas the Original Proposal would have required the credit union to multiply the face amount, or notional value, of the loans transferred with limited recourse by the appropriate credit conversion factor and then apply the appropriate risk weight, this proposed rule would amend the calculation to require a credit union to multiply the off-balance sheet exposure by the appropriate credit conversion factor and then apply the appropriate risk weight. A new definition for off-balance sheet exposure is included in this proposal and is discussed in more detail below. In addition, the definition of ''loans transferred with limited recourse'' is revised by amending all references to ''warranty paragraphs'' to read ''warranty clauses'' to clarify that it is the content of the document and not its length that is important.

Accordingly, under this proposed rule, the term ''Loans transferred with limited recourse'' would be defined 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 definition would provide further that the term loans transferred with limited recourse excludes transfers that qualify for true sale accounting treatment but contain only routine representation and warranty clauses 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-backed security (MBS). Under this proposed rule, the new term ''mortgage-backed security'' would be defined as a security backed by first- or junior-lien mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure. This definition would be similar to the definition of MBS in part 704 of NCUA's regulations. The only difference is that the phrase ''first- or junior-lien mortgages'' in the proposed part 702 definition replaces the phrase ''first or second mortgage'' in the definition in part 704. This makes the proposed part 702 definition more consistent with the terminology used throughout the proposal.

Mortgage partnership finance program. Under this proposed rule, the new term ''mortgage partnership finance program'' would be defined as any Federal Home Loan Bank program through which loans are originated by a depository institution that are purchased or funded by the Federal Home Loan Banks, where the depository institutions receive fees for managing the credit risk of the loans and servicing them. The definition would provide further that the credit risk must be shared between the depository institutions and the Federal Home Loan Banks.

Adding this definition is necessary because this proposal would apply a separate risk weight to the off-balance sheet exposure resulting from loans transferred under the defined program. Additionally, the method that would be used to calculate the risk-based capital requirement for loans in the defined program would be different from other loans transferred with limited recourse. A separate definition and risk weight for loans sold under this program would result in a risk-based capital requirement consistent with the credit loss history of this program.

Mortgage servicing assets. Under the Original Proposal, the term ''mortgage servicing asset'' would have been defined 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 servicer for performing the servicing.

The Board received no comments on the definition of ''mortgage servicing asset'' and has decided to retain the proposed definition in this proposal with the following changes for clarity. Credit unions are expected to follow GAAP when reporting assets, which is intended to clarify that credit unions must report mortgage servicing assets net of any related valuation allowance because it is required by GAAP. Accordingly, under this proposed rule, the term ''mortgage servicing assets'' would be defined 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.

NCUSIF. Under the Original Proposal, the term ''NCUSIF'' means the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783. The Board received no comments on the definition of ''NCUSIF'' and has decided to retain the term in this proposal without modification.

Net worth. Generally consistent with the current rule, under this proposed rule the term ''net worth'' would be defined as:

- The retained earnings balance of the credit union at quarter-end as determined under GAAP, subject to bullet 3 of this definition.
- 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.

• 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 GAAP. A mutual combination, including a supervisory 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.

• The term ''net worth'' also includes loans to and accounts in an insured credit union, established pursuant to § 208 of the FCUA, provided such loans and accounts:

○ Have a remaining maturity of more than five years;

○ Are subordinate to all other claims including those of shareholders, creditors, and the NCUSIF;

○ Are not pledged as security on a loan to, or other obligation of, any party;

○ Are not insured by the NCUSIF;

○ Have non-cumulative dividends;

○ Are transferable; and

○ Are available to cover operating losses realized by the insured credit union that exceed its available retained earnings.''

The Original Proposal did not revise the definition of the term ''net worth,'' and NCUA did not receive any comments on the definition. This proposal, however, would delete from the current definition of net worth the sentence ''Retained earnings consists of undivided earnings, regular reserve, and any other appropriations designed by management or regulatory authorities,'' which is included in paragraph (f)(1) of the current definition. That sentence lists items that are included in retained earnings and is not necessary. No substantive change is intended by this amendment.

Paragraph (f)(3) of the current definition would also be revised to clarify that the term ''mutual combination'' includes a ''supervisory combination'' because this proposal introduces the new term supervisory merger to part 702, which is a specific type of mutual combination.

Net worth ratio. Under the Original Proposal, the term ''net worth ratio'' means the ratio of the net worth of the credit union to the total assets of the credit union truncated to two decimal places. The Board received no comments on the definition of ''net worth ratio'' and has decided to retain the term in this proposal without modification.

New credit union. To provide clarity and reduce the number of redundant rule sections, under this proposed rule, the term ''new credit union'' would be defined as having the same meaning as in § 702.201. No substantive changes to the current definition of ''new credit union'' are intended.

Nonperpetual capital. Under this proposed rule, the new term ''nonperpetual capital'' would be defined as having the same meaning as in 12 CFR 704.2 for consistency.

Off-balance sheet items. Under the Original Proposal, the term ''off-balance sheet items'' would have been defined 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 Board received no comments on the definition of ''off-balance sheet items,'' but is proposing to change the words ''balance sheet' in the definition to ''statement of financial condition.'' Accordingly, under this proposed rule, the term ''off-balance sheet items'' would be defined 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 statement of financial condition, but are normally reported in the financial statement footnotes.

The Board is proposing to make this change in a number of places throughout the rule to make the rule more accurate and to clarify the definition for the reader.

Off-balance sheet exposure. Under this proposed rule, the new term ''off-balance sheet exposure'' would be defined as follows, depending on the type of exposure: (1) For loans sold under the Federal Home Loan Bank mortgage partnership finance (MPF) program, the outstanding loan balance as of the reporting date, net of any related valuation allowance; (2) 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; (3) for unfunded commitments, the remaining unfunded portion of the contractual agreement.

The Board added the definition of off-balance sheet exposure to clarify the amount of the off-balance sheet item that will be used to calculate a credit union's risk-based capital ratio.

On-balance sheet. Under this proposal, the term ''on-balance sheet'' would be defined as a credit union's assets, liabilities, and equity, as disclosed on the statement of financial condition at a specific point in time.

Other intangible assets. Under this proposed rule, the new term ''other intangible assets'' would be defined as intangible assets, other than servicing assets and goodwill, maintained in accordance with GAAP. The definition would provide further that other intangible assets does not include excluded other intangible assets.

Under the Original Proposal, the term ''intangible assets'' would have been defined as those assets that are required to be reported as intangible assets on a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

The Board received no comments on the proposed definition of ''intangible assets,'' but has taken the opportunity in this proposed rule to clarify the definition. The term intangible asset is typically defined by GAAP and includes goodwill. However, in the context of deductions from the numerator of the risk-based capital ratio, goodwill is already a deduction. Further, servicing assets are also typically considered an intangible asset. However, because servicing assets can typically be readily sold in the marketplace, the Board believes that intangible assets excluded from the risk-based capital ratio numerator should not include servicing assets. To simplify this issue, the Board has defined the term ''other intangible assets'' to be those assets defined under GAAP as intangible assets, except goodwill and servicing assets. The Board notes that this is not a substantive change between the two proposals, but merely a clarification to make the rule easier to read and understand.

Over-the-counter (OTC) interest rate derivative contract. Under this proposed rule, the new term ''over-the-counter (OTC) interest rate derivative contract'' would be defined as a derivative contract that is not cleared on an exchange. The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

Perpetual contributed capital. Under this proposed rule, the new term ''perpetual contributed capital'' would be defined as having the same meaning as in § 704.2 of this chapter.

Public sector entity (PSE). Under this proposed rule, the new term ''public sector entity'' would be defined as a state, local authority, or other governmental subdivision of the United States below the sovereign level.

Qualifying master netting agreement. Under this proposed rule, the term ''qualifying master netting agreement'' would be defined as a written, legally enforceable agreement, provided that:

- 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;
- 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;
- 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
- 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:
  - The agreement meets the requirements of paragraph (2) of this definition; 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.

The Board has retained this definition from the Original Proposal with only minor clarifying amendments.

Recourse. Under this proposed rule, the new term ''recourse'' would be defined as a credit union's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred that exceeds a pro-rata share of that credit union's claim on the asset and disclosed in accordance with GAAP. The definition would provide further that if a credit union has no claim on an asset it has transferred, then the retention of any credit risk is recourse. The definition would also provide that a recourse obligation typically arises when a credit union transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Finally, the definition would provide that recourse may also exist implicitly if the credit union provides credit enhancement beyond any contractual obligation to support assets it has transferred.

Residential mortgage-backed security. Under this proposed rule, the new term ''residential mortgage-backed security'' would be defined as a mortgage-backed security backed by loans secured by a first-lien on residential property.

The Board proposes to define ''residential mortgage-backed security'' similarly to the conventional usage of that term. This definition was added to allow for non-subordinated mortgage-backed securities backed by first-lien real estate loans to receive the same risk weight as first-lien residential real estate loans.

Residential property. Under this proposed rule, the new term ''residential property'' would be defined as a house, condominium unit, cooperative unit, manufactured home, or the construction thereof, and unimproved land zoned for one-to-four family residential use. The definition would provide further that the term residential property excludes boats and motor homes, even if used as a primary residence, and timeshare property.

The purpose of this new term is to broadly define the types of property that will be considered residential property. The definition is intended to allow for the inclusion of single family residential construction loans. The definition is intended to exclude larger scale speculative residential land transactions, which would be considered commercial loans for assigning risk weights.

Restructured. Under this proposed rule, the new term ''restructured'' would be defined, with respect to any loan, as a restructuring of the loan in which a credit union, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. According to the definition of ''current'' loan in this proposal, as restructured loan would not be considered a ''current'' loan. The definition would provide further that the term restructured excludes loans modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program.

The restructuring of a loan may include, but is not necessarily limited to: (1) The transfer from the borrower to the lending credit union of real estate, receivables from third parties, other assets, or an equity interest in the borrower, in full or partial satisfaction of a loan; (2) a modification of the loan terms, such as a reduction of the stated interest rate, principal, or accrued interest or an extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk; or (3) a combination of the above.[119] A loan extended or renewed at a stated interest rate equal to the current market interest rate for new debt with similar risk is not a restructured loan.

The Board proposes to add the definition of ''restructured'' because a loan that is restructured contains elements, as addressed above, which increase the credit risk of the loan and therefore is assigned a higher risk weight associated with non-current loans. This definition also enables the definition of current loan to better align with the Other Banking Agencies [120] while addressing the same exception for loans modified or restructured pursuant to the U.S. Treasury's Home Affordable Mortgage Program.

Revenue obligation. Under this proposed rule, the new term ''revenue obligation'' would be defined as a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from the specific project financed rather than general tax funds.

Revenue obligation bonds or debt are generally paid with revenues from the specific project financed rather than the general credit and taxing power of the issuing jurisdiction.

Risk-based capital ratio. Under the Original Proposal, the term ''risk-based

[119] FASB ASC 310–40, ''Troubled Debt Restructuring by Creditors.''

[120] *See* 12 U.S.C. 324.32(g).

capital ratio'' would have been defined as the percentage, rounded to two decimal places, of the risk-based capital ratio numerator to total risk weighted assets, as calculated in accordance with § 702.104(a).

A number of commenters raised concerns with the proposed changes that would have been made to the terminology in the current rule, including adding the new term ''risk-based capital ratio'' to the rule. Several commenters suggested that the Board would be redefining a statutorily defined term by using the proposed term ''risk-based capital ratio'' in the rule instead of the statutory term ''risk-based net worth ratio'' in the proposed rule.

The Board disagrees with this comment for reasons that are discussed in more detail in the portion of the preamble relating to § 702.102 below. Other than the comment above, the Board received no comments on the substance of the definition of ''risk-based capital ratio'' and has decided to retain the definition in this proposal with only non-substantive changes. Accordingly, under this proposed rule the term ''risk-based capital ratio'' would be defined as the percentage, rounded to two decimal places, of the risk-based capital ratio numerator to risk weighted assets, as calculated in accordance with § 702.104(a).

Risk-weighted assets. Under the Original Proposal, the term ''risk-weighted assets'' would have been defined as the total risk-weighted assets as calculated in accordance with § 702.104(c).

The Board received no comments on the definition of ''risk-weighted assets'' and has decided to retain the definition unchanged in this proposal.

Secured consumer loan. Under this proposed rule, the new term ''secured consumer loan'' would be defined as a consumer loan associated with collateral or other item of value to protect against loss where the creditor has a perfected security interest in the collateral or other item of value.

The Board recognizes that a secured consumer loan has lower credit risk than an unsecured consumer loan and, therefore, the Board assigns secured consumer loans to a lower risk weight than unsecured consumer loans. Secured consumer loans generally have lower delinquency rates and lower charge-off rates than unsecured consumer loans. Secured consumer loans generally include those collateralized by new and used vehicles, all-terrain vehicles, recreational vehicles, boats, motorcycles, and other items with a title and could also include a perfected security interest in furniture, fixtures, equipment, antiques, investments and collectables.

Senior executive officer. Under the Original Proposal, the term ''senior executive officer'' would have been defined as a senior executive officer as defined by § 701.14(b)(2).

The Board received no comments on the definition of ''senior executive officer'' and has decided to retain the definition unchanged in this proposal.

Separate account insurance. Under this proposed rule, the new term ''separate account insurance'' would be defined as an account into which a policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier.

The Board added the definition of separate account insurance. The credit risk associated with separate account insurance may be higher than for general account permanent insurance because the separate account insurance is a segregated accounting and reporting account held separately from the insurer's general assets. The investments in the separate account would typically not be permissible for federal credit unions; therefore the separate account insurance is treated as if it were a non-part 703 compliant investment fund.

Shares. Under the Original Proposal, the term ''shares'' means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law. The Board did not receive any comments on this term and, therefore, has retained it in this proposal, without modification.

Share-secured loan. Under this proposed rule, the new term ''share-secured loan'' would be defined as a loan fully secured by shares on deposit at the credit union making the loan, and does not included the imposition of a statutory lien under 12 CFR 701.39.

The Board recognizes that share-secured loans have a low credit risk. It added this new definition to clarify which loans can be classified as share secured and, therefore, assigned a 20 percent risk weight. A credit union should have proper internal controls to ensure that pledged shares are not withdrawn prior to the full payment of the loan they secure. This definition specifically excludes a loan upon which a credit union has impressed a statutory lien pursuant to § 701.39 of NCUA's regulations, where the subject loan was not originated as share-secured.

STRIPS. Under this proposed rule, the new term ''STRIPS'' would be defined as separate traded registered interest and principal security.

The Board proposes to define ''STRIPS'' similarly to its conventional usage. This definition is meant to define investments that are created by separating a coupon paying security into distinct interest-only and principal-only securities.

Structured product. Under this proposed rule, the new term ''structured product'' would be defined as an investment that is linked, via return or loss allocation, to another investment or reference pool.

The Board proposes to define ''structured product'' to include investments that are created to behave like other investments. This definition is meant to ensure bonds that are indexed to equities are treated as equities for risk weight purposes. This definition is also meant to ensure that debentures that have losses that are allocated similarly to subordinated securities are treated as subordinated securities.

Subordinated. Under this proposed rule, the new term ''subordinated'' would mean, with respect to an investment, that the investment has a junior claim on the underlying collateral or assets to other investments in the same issuance. The definition would provide further that the term subordinated does not apply to securities that are junior only to money market fund eligible securities in the same issuance.

The Board recognizes that subordinated investments can contain substantial and complicated credit risk elements. The definition of subordinated is designed to encompass all investments that take losses before a more senior claim takes losses. This definition would not include an investment that was once subordinate to a senior investment, but then became non-subordinate because the previously senior investment paid off.

Supervisory merger or combination. Under this proposed rule, the new term ''supervisory merger or combination'' would be defined as a transaction that involved the following:

- An assisted merger or purchase and assumption where funds from the NCUSIF are provided to the continuing credit union;
- A merger or purchase and assumption classified by NCUA as an ''emergency merger'' where the acquired credit union is either insolvent or ''in danger of insolvency'' as defined under appendix B to part 701 of this chapter; or
- A merger or purchase and assumption that included NCUA's or the appropriate state official's

identification and selection of the continuing credit union.

The Board has added this definition to clarify which merger or combination transactions would be subject to an extended time period for absorbing the directly related goodwill and other intangible assets that are part of the transaction.

Swap dealer. Under this proposed rule, the new term ''swap dealer'' would be defined as having the same meaning as defined by the Commodity Futures Trading Commission in 17 CFT 1.3(ggg). The Board is proposing to add this new term to coincide with other changes it is proposing to make in the derivatives section of this proposal.

Total assets. The Original Proposal would have retained the definition of ''total assets'' in current § 702.2, but would have restructured the definition and provided 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 requirement). Proposed paragraph (2) under the definition of total assets would have provided 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.

The Board received no comments on the definition of ''total assets'' and has decided to retain the definition in this proposal with only minor conforming changes.

Tranche. Under this proposed rule, the new term ''tranche'' would be defined as one of a number of related securities offered as part of the same transaction. The definition would provide further that the term tranche includes a structured product if it has a loss allocation based off of an investment or reference pool.

The Board proposes to define ''tranche'' similarly to its conventional usage for securitizations. Structured products are included in this definition if they are allocated losses based on a reference investment or reference pool.

Unsecured consumer loan. Under this proposed rule, the new term ''unsecured consumer loan'' would be defined as a consumer loan not secured by collateral.

The Board recognizes that unsecured consumer loans generally have a higher credit risk than secured consumer loans. Unsecured consumer loans have higher delinquency rates and higher charge-off rates than secured consumer loans. Unsecured consumer loans generally include credit card loans, signature loans, and co-maker and cosigner loans. Accordingly, the Board assigns unsecured consumer loans to a higher risk weight category than secured consumer loans.

U.S. Government agency. Under the Original Proposal, the term ''U.S. Government agency'' would have been defined 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.

The Board received no comments on the definition of ''U.S. Government agency'' and has decided to retain the proposed definition unchanged in this proposal.

Weighted-average life of investments. Under this proposed rule, the definition of ''weighted-average life of investments'' and the entirety of current § 702.105 of NCUA's regulation would be removed. The use of weighted-average life (WAL) of investments for the assignment of risk weights is in the current risk-based capital measure and would have been modified with lower capital requirements for shorter average life investments in the Original Proposal. Many commenters objected to the use of WAL for the assignment of risk weights for investments because the risk weights are based primarily on interest rate and liquidity risks, not credit risk.

In response to the comments, the Board now proposes to assign investment risk weights primarily based on credit risk with risk weights more comparable to the risk weights assigned by the Other Banking Agencies.[121] This adjustment would require additional granularity in the reporting of investments on the Call Report.

The Board requests comments on the definitions included in this proposal.

A. Subpart A—Prompt Corrective Action

The Original Proposal would have established new subpart A titled ''Prompt Corrective Action.'' New subpart A would have contained 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 § 216(b)(2) of the FCUA.[122] The Board received no comments on these changes and has decided to retain the changes in this proposal.

Section 702.101 Capital Measures, Capital Adequacy, Effective Date of Classification, and Notice to NCUA

Under the Original Proposal, the requirements of proposed § 702.101 would have remained largely unchanged from current § 702.101. The title of proposed § 702.101, however, would have been changed to ''Capital measures, effective date of classification, and notice to NCUA'' to better reflect the three major topics that would have been covered in the section. In addition, the Original Proposal would have replaced the terms ''net worth measures'' with ''capital measures,'' ''net worth classification'' with ''capital classification,'' and ''net worth category'' with ''capital category'' to reflect the terminology changes being made throughout the proposal, which were discussed above and are discussed in further detail below.

A number of commenters raised concerns with the proposed changes that would have been made to the terminology in the current rule. The Board disagrees with these commenters for reasons that are discussed in more detail in the portion of the preamble relating to § 702.102. Other than the comments discussed in more detail below, the Board received no other comments on proposed changes to § 702.101 and has decided to retain the changes in this proposal.

Capital helps to ensure that individual credit unions can continue to serve as credit intermediaries even during times of stress, thereby promoting the safety and soundness of the overall U.S. financial system. As a prudential matter, the NCUA has a long-established policy that federally insured credit unions should 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.

The Board notes that Other Banking Agencies' capital standards are the ''minimum capital requirements and

[121] *See, e.g.,* 12 CFR 324.32.

[122] Section 1790d(b)(2).

overall capital adequacy standards for FDIC-supervised institutions . . . include[ing] methodologies for calculating minimum capital requirements . . . .'' [123]

The FDIC may require an FDIC-supervised institution to hold an amount of regulatory capital greater than otherwise required under this part if the FDIC determines that the institution's capital requirements under this part are not commensurate with the institution's credit, market, operational, or other risks.[124]

Further, the September 10, 2013 preamble to art 324 of FDIC's regulations state that:

> The FDIC's general risk-based capital rules indicate that the capital requirements are minimum standards generally based on broad credit-risk considerations. The risk-based capital ratios under these rules do not explicitly take account of the quality of individual asset portfolios or the range of other types of risk to which FDIC-supervised institutions may be exposed, such as interest-rate risk, liquidity, market, or operational risks . . . In light of these considerations, as a prudent matter, an FDIC-supervised institution is generally expected to operate with capital positions well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the risks to which it is exposed, which may entail holding capital significantly above the minimum requirements.[125]

As indicated above, FDIC's approach to risk weights is calibrated to be the minimum regulatory capital standard. This NCUA proposal would also be calibrated to be the minimum regulatory capital standard, similar to the FDIC's rule, as suggested by commenters on the Original Proposal. Therefore, the Board believes it is necessary to incorporate a broader regulatory provision requiring complex credit unions to maintain capital commensurate with the level and nature of all risks to which they are exposed, and to maintain a written strategy for assessing capital adequacy and maintaining an appropriate level of capital. Proposed new § 702.101(b) is based on a similar provision in the Other Banking Agencies' rules and within the Board's authority under the FCUA.[126] The Board notes that it has broad legal authority to take action to ensure the safety and soundness of credit unions and the NCUSIF and to carry out the powers granted to the Board.[127] Requiring credit unions to maintain capital adequacy is part of ensuring safety and soundness, and is not a new concept.[128] Rather, as discussed in more detail below, NCUA long-standing practice is to monitor and enforce capital adequacy through the supervisory process. Therefore, proposed § 702.10(b) is a proper use of NCUA's broad legal authority to ensure safety and soundness and to carry out its administrative powers, is consistent with its long-standing supervisory practices, and furthers comparability with the Other Banking Agencies' risk based capital rules.

As the Other Banking Agencies' approach to risk assigning risk weights is calibrated to be the minimum regulatory capital standard, and this proposal is calibrated predominantly based on the Other Banking Agencies' rules as suggested by commenters on the Original Proposal, the Board has concluded it is necessary to require complex credit unions to maintain capital commensurate with the level and nature of all risks to which they are exposed, and a written strategy for assessing capital adequacy and maintaining an appropriate level of capital. This provision would complement NCUA's existing regulatory framework by working in tandem with other regulatory requirements, such as those related to liquidity, interest rate, and credit risk.

Accordingly, proposed § 702.101 would amend current § 702.101 to include a new capital adequacy provision based on a similar provision in FDIC's rule.[129] The new capital adequacy provision would be added as proposed § 702.101(b) and paragraphs (b) and (c) of current § 702.101 would be renumbered as paragraphs (d) and (e) of proposed § 702.101. The new capital adequacy provision would not affect credit unions' PCA capital category. However, the Board believes it would support the assessment of capital adequacy in the supervisory process (assigning CAMEL and risk ratings).

A complex credit union is generally 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.[130] 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,[131] the supervisory assessment of capital adequacy will take account of 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; including, for example, the level and severity of problem assets and its exposure to operational risk, IRR and significant asset concentrations. 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 IRR 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 would develop and publish supervisory guidance for examiners on how to apply this provision.

Some commenters stated that they manage their capital so that they operate with a buffer over the regulatory minimum and that examiners expect such a buffer. These commenters expressed concern that examiners will expect even higher capital levels. The Board notes that the credit union system is generally very well capitalized, and

[123] *See, e.g.,* 12 CFR 324.1(a).

[124] *See, e.g.,* 12 CFR 324.1(d).

[125] 78 FR 55362, Tuesday, September 10, 2013.

[126] *See, e.g.,* 12 CFR 324.10(d)(1) and (2).

[127] 12 U.S.C. 1786 and 1789.

[128] See, *e.g.* 78 FR 55340, 55362(September 10, 2013).

[129] 12 CFR 324.10 Minimum capital requirements.

[130] The Basel framework incorporates similar requirements under Pillar 2 of Basel II.

[131] NCUA Letter to Credit Unions No. 07–CU–12, December 2007, CAMEL Rating System and NCUA Letter to Credit Unions No. 09–CU–03, November 2009, Reviewing Adequacy of Earnings.

this provision merely reflects existing supervisory standards for individual complex credit unions. However, NCUA plans to incorporate in its National Supervision Policy Manual procedural controls on the discretion examiners employ in relation to a complex credit union being deemed out of compliance with this provision.

101(b) Capital Adequacy

For the reasons discussed above, this proposal would add new capital adequacy provisions to current § 702.101(b). The proposed new capital adequacy provisions would be added as § 702.101(b), and the proposal would redesignate paragraphs (b) and (c) of current § 702.101 as paragraphs (d) and (e) of proposed § 702.101. Proposed § 702.101(b) would provide that:

- Notwithstanding the minimum requirements in this part, a credit union defined as complex must maintain capital commensurate with the level and nature of all risks to which the institution is exposed.
- A credit union defined as complex must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive written strategy for maintaining an appropriate level of capital.

Section 702.102 Capital Classifications

Under the Original Proposal, the title of § 702.102 would have been changed from ''statutory net worth categories'' to ''capital classifications.'' The section would also have continued to list the five statutory capital categories that are provided in § 216(c) of the FCUA.[132]

A number of commenters expressed concerns with the changes in terminology that were made in this and other sections of the regulation. Commenters suggested that by using the terms ''risk-based capital,'' ''capital categories,'' ''capital classifications,'' and other terms not specifically included in the FCUA, the Board was redefining the statutorily defined terms ''net worth'' and ''net worth ratio'' with terms that do not encompass the same things.

The Board disagrees. As the Board explained in the Original Proposal, although § 216(c) of the FCUA uses the general term ''net worth categories,'' the Board believes the term ''capital categories'' is less confusing for industry practitioners and better describes the two measurements, ''net worth ratio'' and ''risk-based net worth,'' that make up the categories listed in the statute. It is clear, from the distinct uses of the terms ''net worth'' and ''risk-based net worth'' in the FCUA that Congress intended those terms to have different meanings.[133] Moreover, the new terms were defined in the Original Proposal in a manner consistent with both the statutory terms and the FCUA's requirements. The Board has considered the use of these new terms, as well as the comments received, and believes that the new terminology would not alter or otherwise be inconsistent with the requirements of the FCUA. Rather, the Board continues to believe that the use of these new terms will help to clarify the requirements of the regulation for credit unions and other interested parties. Therefore, the Board has decided to retain the changes and new terminology in this proposal.

102(a) Capital Categories

Under the Original Proposal, proposed § 702.102(a) would have replaced current § 702.102(a) and would have set forth new minimum capital measures for complex credit unions. Consistent with sections 216(c)(1)(A) through (E) of the FCUA, the net worth ratio measures listed in proposed §§ 702.102(a)(1) through (5) would have continued to match those listed in the statute for each capital category, and would have used both the net worth ratio and the proposed risk-based capital ratio as elements of the capital categories for ''well capitalized,'' ''adequately capitalized,'' and ''undercapitalized'' credit unions. The risk-based capital ratio would have included components that required higher capital levels to reflect increased risk due to IRR, concentration risk, credit risk, market risk, and liquidity risk.

The Original Proposal also would have introduced a new, scaled risk-based capital ratio measurement approach for assigning capital classifications for well capitalized, adequately capitalized, and undercapitalized credit unions. This scaled approach would have recognized the relationship between higher risk-based capital ratios and the creditworthiness of credit unions.

The Board received numerous general comments concerning the capital categories, nearly all advocating a reduction in all of the risk-based capital ratios for complex credit unions. Some commenters suggested the following risk-based ratios for complex credit unions: Eight percent or greater for well capitalized, 5.5 percent to 7.99 percent for adequately capitalized, and 5.5 percent or lower for undercapitalized. Other commenters suggested that, in light of the historical performance of credit unions through the recent financial crisis, the risk-based capital ratio ratios should be: 8.5 percent or greater to be well capitalized, six percent to 8.49 percent to be adequately capitalized, and six percent or less to be undercapitalized. Still other commenters suggested a reduction in the risk-based capital ratios for each capital category by a minimum of 50 basis points to avoid harming the credit union industry by limiting credit unions' ability to make loans, decreasing their earnings, and hampering current business strategies.

After carefully considering the comments, the Board is now proposing to reduce the risk-based capital ratio threshold for well capitalized from 10.5 percent to 10 percent. All of the other risk-based capital ratio thresholds from the Original Proposal would remain unchanged. As discussed below, the Board believes this structure is within its legal authority to implement, and that this well capitalized ratio threshold both achieves parity with Other Banking Agencies' regulations[134] and simplifies NCUA's proposed risk-based capital ratio measure by not including the capital conservation buffer that is part of the Other Banking Agencies' risk-based capital regulations.

102(a)(1) Well Capitalized

Under the Original Proposal, proposed § 702.102(a)(1) would have required a credit union to maintain a net worth ratio of seven percent or greater and, if it were a complex credit union, a risk-based capital ratio of 10.5 percent or greater to be classified as well capitalized. The higher proposed risk-based capital requirement for the well capitalized classification was designed to boost the resiliency of complex credit unions throughout financial cycles and align them with the standards used by the Other Banking Agencies.[135] The proposed 10.5 percent risk-based capital ratio target was comparable to the Other Banking Agencies' eight percent total risk-based capital ratio to be adequately capitalized plus the 2.5 percent capital conservation buffer that banks will be required to meet when the capital conservation buffer is fully

[132] Section 1790d(c).

[133] *Compare* section 1790d(c)(1)(A) (providing that a credit union is ''well capitalized'' if it meets both the seven percent net worth ratio requirement and any applicable risk-based net worth requirement), *and* section 1790d(d) (requiring the Board to design a risk-based net worth requirement), *with* section 1790d(o) (defining the term ''net worth,'' but not defining the term risk-based net worth ratio).

[134] *See, e.g.,* 12 CFR 324.403.

[135] *See, e.g.,* 12 CFR 324.10, 324.11, and 324.403.

implemented in 2019.[136] To be well capitalized, the Other Banking Agencies require a total risk-based capital ratio of 10 percent. Therefore, a bank can be well capitalized with a total risk-based capital ratio of 10 percent, but its inadequate capital conservation buffer would still limit its ability to make capital distributions and discretionary bonus payments. The Original Proposal included a 10.5 percent risk-based capital ratio requirement, rather than the Other Banking Agencies' 10 percent,[137] to avoid the complexity of a capital conservation buffer.

The Board received a substantial number of comments regarding the proposed risk-based capital ratio for a credit union to be classified as well capitalized. As a threshold matter, a number of commenters questioned the Board's authority to impose any risk-based net worth requirement on well capitalized credit unions. Specifically, commenters suggested that § 1790d(d) of the FCUA, which they argued provides the entirety of the language in the FCUA dealing with the risk-based component of PCA, directs NCUA to connect the risk-based net worth requirement to the sufficiency of a credit union's net worth only for the adequately capitalized classification. Commenters further maintained that requiring a *higher* risk-based capital ratio level for well capitalized credit unions than the level required for adequately capitalized credit unions contravened both Congressional intent and the Board's statutory authority. They argued that, not only does the FCUA itself prohibit the Board from imposing a higher risk-based capital ratio for the well capitalized threshold, but that sound public policy also supports applying the risk-based net worth requirement only to the adequately capitalized threshold. They cited the seven percent net worth ratio for well capitalized credit unions as support for this argument, stating that this net worth ratio renders a separate, higher risk-based capital ratio level unnecessary for well capitalized credit unions.

Similarly, another commenter recommended that the Board impose the same risk-based capital ratio on both well capitalized and adequately capitalized credit unions, and the commenter encouraged the Board not to increase that risk-based capital ratio above eight percent. As support, the commenter noted that, in the preamble to the Original Proposal, the Board stated that the proposed risk-based capital ratio of eight percent would have been reasonable for an adequately capitalized credit union. The commenter further suggested that because adequately capitalized and well capitalized credit unions have higher net worth ratio requirements than similarly situated banks, an eight percent risk-based capital ratio would be sufficient and that it would be unreasonable to require adequately capitalized credit unions to maintain a 10.5 percent risk-based capital ratio.

Other commenters suggested that the proposed 10.5 percent risk-based capital ratio for a credit union to be classified as well capitalized is not appropriate because it unfairly incorporates the capital conservation buffer into the PCA framework for credit unions. These commenters noted that a bank can be classified as well capitalized with an eight percent total risk-based capital ratio, even if the bank fails to hold the 2.5 percent capital conservation buffer required under the Other Banking Agencies' capital regulations, although the commenters acknowledged that any such failure to meet the capital conservation buffer would limit that bank's ability to make capital distributions and discretionary bonus payments. These commenters maintained that by directly incorporating the capital conservation buffer into NCUA's PCA framework, the Board would disadvantage credit unions by making them more vulnerable to downgrades in their PCA capital classification level, a course of action which the Other Banking Agencies specifically declined to adopt. Commenters further stated that because the capital conservation buffer was designed to absorb losses in stressful periods, the Other Banking Agencies believed that it was appropriate for a depository institution to be able to use some of its capital conservation buffer without being considered less than well capitalized for PCA purposes. Commenters suggested that the Board should, at a minimum, provide credit unions the same flexibility. Other commenters suggested that the Other Banking Agencies adopted the capital conservation buffer as a means to restrict banks from paying dividends to shareholders and ''substantial discretionary bonuses'' to management, which occurred even as banks' financial conditions weakened during the last financial crisis. These commenters noted that even failed credit unions were not engaging in this practice and, therefore, the concern is not relevant to the credit union industry. Accordingly, the commenters argued that including the capital conservation buffer in the risk-based capital proposal and setting the risk-based capital ratio at 10.5 percent was arbitrary.

Another commenter suggested that the capital conservation buffer for banks applies only in periods of significant credit growth, while NCUA's proposed risk-based capital ratio of 10.5 percent would apply at all times in a financial cycle. Other commenters suggested that the Original Proposal would have applied the capital conservation buffer only to the well capitalized classification, thereby subjecting adequately capitalized credit unions only to the eight percent total risk-based capital ratio used by the Other Banking Agencies. Commenters maintained that, for the sake of consistency and comparability among banks and credit unions, the Board should remove the 2.5 percent capital conservation buffer from the well capitalized category and adjust the other levels accordingly. Alternatively, they argued that the Board should, at a minimum, allow credit unions an equivalent five-year implementation period to build capital reserves without sacrificing member services or dramatically increasing fees.

One commenter supported the proposed 10.5 percent risk-based capital ratio level as the appropriate level to be considered well capitalized.[138] This commenter maintained, however, that there should not be an associated increase in this risk-based capital requirement if NCUA determines to include the NCUSIF deposit in the risk-based capital ratio numerator.

Other commenters questioned why well capitalized credit unions would be subject to a risk-based capital ratio of 10.5 percent when banks only need a risk-based capital ratio of 10 percent.

Finally, still other commenters suggested that credit unions receiving an overall capital classification of well capitalized be granted blanket waivers, fixed asset exemptions, longer exam cycles, and other incentives under any final risk-based capital rule.

As noted in the legal authority section of this preamble, the Board has carefully considered these comments and generally disagrees with commenters' reading and interpretation of the FCUA. For the reasons stated in that discussion, it is within NCUA's legal authority to promulgate this proposal and to impose a separate, higher risk-based capital ratio requirement on well capitalized credit unions than the one imposed on adequately capitalized

[136] 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).

[137] *See, e.g.,* 12 CFR 324.403.

[138]

credit unions. NCUA's interpretation of its legal authority to require credit unions to meet different risk-based capital ratio levels to be classified as either well capitalized or adequately capitalized is further supported by the Other Banking Agencies' PCA statute and regulations, which require different risk-based capital ratio levels for banks to be classified as well capitalized, adequately capitalized, undercapitalized, or significantly undercapitalized.[139] Section 38(c)(1)(A) of the FDI Act requires that the Other Banking Agencies' relevant capital measures ''include (i) a leverage limit; and (ii) a risk-based capital *requirement.*'' [140] Therefore, by setting different risk-based capital ratio levels for credit unions to be adequately and well capitalized, NCUA's risk-based capital requirement is more ''comparable'' to the Other Banking Agencies' risk-based capital requirement.

The Board also notes 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, 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.[141] Moreover, credit unions classified as well capitalized are generally considered financially sound, afforded greater latitude under some other regulatory provisions,[142] and are not subject to most 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 earlier reflection in a credit union's net worth category. Under the current rule, a change in the credit union's risk profile, capital levels, or both that results in a decline in the 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 requires mandatory or discretionary supervisory actions.

The Board believes a more effective policy is to adopt 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 FCUA, and the Other Banking Agencies, in their risk-based capital regulations, designed the graduated PCA capital categories.

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 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 ($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. The Board notes the risk weights in this proposal are based predominantly on those used by the Other Banking Agencies, as suggested by commenters on the Original Proposal. For the total capital-to-risk assets ratio, the Other Banking Agencies establish a threshold of 10 percent to be well capitalized.[143]

For NCUA's risk-based capital requirement to be comparable, it should also be equivalent in rigor to the Other Banking Agencies' risk-based capital requirement.[144] 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. Thus, 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 and adequately capitalized were maintained and set at only 8 percent, as some commenters suggested, there would be a decline in the overall rigor of the risk-based capital ratio. Alternatively, the risk weights for various assets could be increased by 20 percent to offset this effect. The Board believes adjusting the risk weights in this manner would create more difficulty in comparing asset types and risk weights across financial institutions, and no doubt lead to misunderstanding and controversy.

Conversely, a uniform threshold 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, and therefore be subject to mandatory and discretionary supervisory actions. The Board does not believe this would be optimal, as the supervisory consequences for credit unions with risk-based capital ratios between eight percent and ten percent would be worse than for institutions operating under the Other Banking Agencies' rules.

Maintaining the rigor of the risk-based net worth requirement is also important for another key policy objective of the Board: Ensuring 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.[145] 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, and 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, as some commenters suggested, the risk-based net worth requirement would govern very few, if any, credit unions. If the highest risk-based capital ratio threshold were set at eight percent, NCUA estimates at most seven credit unions would have the proposed risk-based ratio be the governing requirement, with only one credit union currently holding insufficient capital to meet the requirement. Further, only credit unions with risk assets greater

[139] *See* 12 U.S.C. 1831o, *and* 12 CFR 324.403(b).

[140] 12 U.S.C. 1831o(c)(1)(A) (emphasis added).

[141] Per the FCUA, ''undercapitalized'' is the lowest PCA category in which a failure to meet the risk-based net worth requirement can result.

[142] *See* 12 CFR 745.9–2 and 12 CFR 723.7.

[143] The Other Banking Agencies' Total Risk-Based Capital ratio is the most analogous standard for credit unions given the proposed broadening of the definition of capital to include accounts that would not be included in the definition of Tier 1 capital, such as the allowance for loan and lease losses and secondary capital for low-income designated credit unions.

[144] *See* S. Rep. No. 193, 105th Cong., 2d Sess. (1998).

[145] The benefits of a capital system better correlated to risk are discussed in the Summary section of this preamble.

than 90 percent of total assets would be bound by the risk-based 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, the more likely that credit unions will build capital sufficient to prevent precipitous declines in their PCA 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 incent 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 recent financial crisis, credit unions experienced large losses in a compressed timeframe, resulting in a rapid deterioration of net worth. Some credit unions that historically had been classified as well capitalized were quickly downgraded to undercapitalized. As noted in the summary section, credit unions that failed at a loss to the NCUSIF on average were very well capitalized, based on their net worth ratios, 24 months prior to failure (average net worth ratio of 12 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 their failure. Unlike the net worth ratio, which is indifferent to the composition of assets, a well-designed risk-based net worth requirement would reflect material shifts in the risk profile of assets.

The Board believes that 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. Thus, the Board remains committed to implementing the risk-based requirement under a graduated (multi-tiered) capital category framework.

As noted earlier in this preamble, the Board supports lowering the well capitalized risk-based capital ratio threshold from 10.5 percent to 10 percent. The Board agrees with the commenters who suggested that a 10 percent risk-based capital ratio would simplify the comparison with the Other Banking Agencies' rules by removing the effect of the capital conservation buffer. The 10 percent threshold for well capitalized credit unions, along with the eight percent threshold for adequately capitalized credit unions, would also be consistent with the total risk-based capital ratio requirements contained in the Other Banking Agencies' capital rules.

Capital ratio thresholds are largely a function of risk weights. As discussed in other parts of this proposal, the Board is now proposing to more closely align NCUA's risk weights with those assigned by the Other Banking Agencies. Therefore, the Board believes that NCUA's risk-based capital ratio threshold levels should also align with those of the Other Banking Agencies as closely as possible.

102(a)(2) Adequately Capitalized

Under the Original Proposal, proposed § 702.102(a)(2) would have required a credit union to maintain a net worth ratio of six percent or greater and, if it were a complex credit union, a risk-based capital ratio of eight percent or greater to be classified as adequately capitalized. This risk-based capital ratio level is comparable to the eight percent total risk-based capital ratio level required by the Other Banking Agencies for a bank to be adequately capitalized.

Other than the comments discussed above and in other parts of this preamble, the Board received no comments on the Original Proposal's adequately capitalized risk-based capital ratio level. Therefore, the Board has decided to retain the changes, with only minor adjustments for clarity.

This proposal would also add proposed § 702.102(a)(2)(iii), which would clarify that a credit union is adequately capitalized only if it meets the net worth and risk-based capital criteria in proposed paragraphs (a)(2)(i) and (ii), and does not meet the definition of a well capitalized credit union.

102(a)(3) Undercapitalized

Under the Original Proposal, proposed § 702.102(a)(3) would have classified a credit union as undercapitalized if the credit union maintained a net worth ratio of four percent or greater but less than six percent and, if it were a complex credit union, a risk-based capital ratio of less than eight percent.

Other than the comments discussed above and other parts of this preamble, the Board received no comments on the Original Proposal's undercapitalized risk-based capital ratio requirement. However, to provide additional clarity the Board is proposing to make additional minor adjustments to the paragraph in this proposal.

Under this proposal, § 702.102(a)(3) would provide that a credit union is undercapitalized if: (1) The credit union has a net worth ratio of four percent or more but less than six percent; or (2) the credit union, if complex, has a risk-based capital ratio of less than eight percent.

102(a)(4) Significantly Undercapitalized

Under the Original Proposal, proposed § 702.102(a)(4) would have classified a credit union as significantly undercapitalized if: (1) It had a net worth ratio of less than five percent and had received notice that its net worth restoration plan had not been approved; [146] (2) the credit union had a net worth ratio of two percent or more but less than four percent; or (3) the credit union had a net worth ratio of four percent or more but less than five percent, and the credit union either failed to submit an acceptable net worth restoration plan within the time prescribed in § 702.110, or materially failed to implement a net worth restoration plan approved by NCUA. The Original Proposal would have made some clarifying changes to the language in current § 702.102(a)(4), but would not have changed the criteria for being classified as significantly undercapitalized under part 702.

The Board received no comments on the proposed changes to this paragraph and has decided to retain the changes in this proposal with several adjustments for clarity.

[146] To qualify for a higher net worth classification, a significantly undercapitalized credit union must have a net worth restoration plan approved by NCUA.

Under this proposal, § 702.102(a)(4) would provide that a credit union is significantly undercapitalized if:

- The credit union has a net worth ratio of two percent or more but less than four percent; or
- The credit union has a net worth ratio of four percent or more but less than five percent, and either—
  - Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111;
  - Materially fails to implement a net worth restoration plan approved by the Board; or
  - Receives notice that a submitted net worth restoration plan has not been approved.

102(a)(5) Critically Undercapitalized

Under the Original Proposal, proposed § 702.102(a)(5) would have classified a credit union as critically undercapitalized if it had a net worth ratio of less than two percent. The Original Proposal would have made some minor technical amendments to the language in current 702.102(a)(5), but would not have changed the criteria for being classified as critically undercapitalized under part 702.

The Board received no comments on the proposed changes to this paragraph and, therefore, it has decided to retain the changes in this proposal.

102(b) Reclassification Based on Supervisory Criteria Other Than Net Worth

The Original Proposal would have retained current § 702.102(b), with only a few amendments to update terminology and make minor edits for clarity. No substantive changes were intended.

The Board received no comments or suggested changes to this paragraph and has decided to retain the changes in this proposal.

102(c) Non-Delegation

Proposed § 702.102(c) would have been unchanged from current § 702.102(c).

The Board received no comments or suggested changes to this paragraph and has decided to make no changes in this proposal.

102(d) Consultation With State Officials

Proposed § 702.102(d) would have retained current § 702.102(d) with only a few small amendments for consistency with other sections of NCUA's regulations. No substantive changes were intended.

The Board received no comments or suggested changes to this paragraph and has decided to retain the changes in this proposal.

Section 702.103 Applicability of the Risk-Based Capital Ratio Measure

Under the Original Proposal, proposed § 702.103 would have changed 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 have provided 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.

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 over $50 million *and* they have a risk based net worth requirement exceeding six percent. The Original Proposal would have eliminated current § 702.103(b) and defined all credit unions with over $50 million in assets as ''complex.''

The Board received a significant number of comments on the proposed definition of complex credit unions. Many commenters pointed out that NCUA already has a complexity index based on deposit account types, member services, loan and investment types, and portfolio composition, and given the availability of such a measure, which takes into account ''the portfolio of assets and liabilities'' of credit unions. Commenters stated that it seemed odd that the Board would define complex based solely on credit unions' asset size given the fact that the NCUA already has a complexity index.

Commenters suggested that section 1790d(d)(1) of the FCUA directs the Board to establish a risk-based net worth system for ''complex'' credit unions, but does not give the Board complete discretion on how the system must be structured and applied to credit unions. Commenters argued that defining ''complex'' using only an asset size threshold fails to comply with the requirement in section 1790d(d)(1) that the Board take into account the ''portfolios of assets and liabilities of credit unions'' when defining complex credit unions.

Commenters also suggested that a single-dimension definition of ''complex'' credit union does not account for actual operational complexity. Other commenters suggested that the proposed definition of ''complex'' was arbitrary and is too simplistic a measure because it did not take into account a credit union's comprehensive book of assets, including all loans, investments, and liabilities, as well as whether a credit union's operations are sufficiently diverse to warrant a ''complex'' designation.

Other commenters stated that determining whether a credit union is complex should be influenced by whether they do real estate lending, member business lending, have risky investments, and many other factors contributing to the composition of a credit union's balance sheet and overall operation. Commenters claimed that many larger credit unions have limited service offerings or narrow portfolio composition and are not complex institutions. Commenters suggested that NCUA's own complexity index shows that using asset size alone does not result in an accurate measure of complexity for credit unions.

One commenter suggested that all federally insured credit unions with assets above $250 million and that have an NCUA complexity index value of 17 or higher be required to meet risk-based capital requirements. Another commenter suggested that, consistent with NCUA's final liquidity rule, credit unions with over $250 million in assets have a great degree of interconnectedness with other market entities, and when they experience unexpected or severe liquidity constraints they are more likely to adversely affect the credit union system, public perception, and the NCUSIF. The commenter suggested that setting the size threshold at $250 million will encourage mid-size credit union growth.

Other commenters believed the Board has defined complex in NCUA's derivatives regulation and for examinations as $250 million in assets.

Other commenters suggested the Board raise that threshold to $500 million given the burden they believe would be imposed by the rule and the potential for unintended consequences. The commenters further suggested it would be wise to phase-in the application of the rule slowly by starting with credit unions with assets of $500 million or more to ensure smooth implementation of the rule without threatening the viability of smaller institutions.

Other commenters questioned whether the Board cares about the safety and soundness of credit unions with $50 million in assets or less. Several of those commenters suggested the risk-based capital requirements should apply to all credit unions regardless of size because if they are not subject to the capital regulation they will be unprepared when they reach $50 million size threshold.

Some commenters suggested that the situation is further compounded by the number of credit unions that have

received a low-income designation. They envisioned a difficult transition for low-income credit unions going from no caps on commercial lending and commercial loan participations, to tiered risk weights that could become problematic in terms of regulatory compliance.

A small number of commenters suggested the Board should adjust for inflation any asset-size threshold used in the definition of complex.

Another commenter suggested that any credit union that is identified as ''complex'' by NCUA should be able to present evidence to the agency as to why it is not complex and should not be subject to risk-based capital requirements. The commenter suggested the process for contesting an agency designation of ''complex'' should also be detailed in the rule.

Other commenters suggested the rule should acknowledge the differences between credit unions of different asset sizes and assign different risk weights for credit unions of different asset sizes.

The Board has carefully considered the comments received and generally agrees that a higher asset size threshold is appropriate. Based on comments received on the Original Proposal, the Board is now proposing to use $100 million in assets as a proxy for determining whether a credit union is complex. Under this proposal, the title of current § 702.103 would continue to be changed from ''Applicability of risk-based net worth requirement'' to ''Applicability of risk-based capital ratio measure.''

However, after diligently considering the comments on the Original Proposal and further analyzing the ''portfolios of assets and liabilities of credit unions,'' the Board now believes that $100 million in assets would be a more appropriate threshold level for defining ''complex'' credit unions. Accordingly, consistent with requirements of § 216(d)(1) of the FCUA, this proposed § 702.103 would now 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 $100 million, as reflected in its most recent Call Report. The Board would periodically evaluate this threshold as part of NCUA's annual review of one-third of its regulations.

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 over $50 million *and* they have a risk-based net worth ratio over six percent. In effect, this means that all credit unions with over $50 million in assets are subject to the current risk-based net worth requirement unless their level of risk assets is relatively low.

Consistent with requirements of section 216(d)(1) of the FCUA, the Board is proposing to eliminate the additional complexity measure in current § 702.103(b) and declines to propose a complexity measure in addition to the $100 million asset sized threshold for defining ''complex'' credit unions. Accordingly, this proposal would eliminate current § 702.103(b) and define all credit unions with over $100 million in assets as ''complex.'' For reasons described more fully below, the Board believes that defining the term ''complex'' credit union using a single asset size threshold of $100 million as a proxy for a credit union's complexity would be accurate and reduce the complexity of the rule, would provide regulatory relief for smaller institutions, and would eliminate the complexity and potential unintended consequences of having a checklist of activities that would determine whether or not a credit union is subject to the risk-based capital requirement.

Under this proposal, the term ''complex'' is defined only for purposes of the risk-based capital ratio measure. The Board believes there are a number of products and services, which under GAAP are reflected as the credit unions portfolio of assets and liabilities, in which credit unions are engaged [147] that are inherently complex based on the nature of their risk and the expertise and operational demands necessary to manage and administer such activities effectively. The Board believes that credit unions offering such products and services have complex portfolios of assets and liabilities for purposes of NCUA's risk-based net worth requirement. In particular, the Board believes that the following products and services engaged in by credit unions are good indicators of complexity:

- 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/real estate mortgage investment conduits,
- Commercial mortgage-related securities,
- Borrowings,
- Repurchase transactions,
- Derivatives, or
- Internet banking.

Based on a review of Call Report data as of June 30, 2014, all credit unions with more than $100 million in assets were engaged in the products and services listed above, with 99 percent having more than one complex activity, and 87 percent having four or more. On the other hand, less than two-thirds of credit unions below $100 million in assets are involved in even a single complex activity, and only 15 percent have four or more. Moreover, credit unions with total assets less than $100 million are a small share (approximately 10 percent) of the overall assets in the credit union system—which limits the exposure of the Share Insurance Fund to these institutions. Accordingly, the Board believes $100 million in assets is a clear demarcation above which complex activities are always present, and where credit unions are almost always engaged in one or more complex activities, in contrast to credit unions $100 million or less in assets.

As discussed earlier, and consistent with section 216(d)(1) of the FCUA, the Board believes $100 million in assets is an accurate proxy for complexity based on credit unions' portfolios of assets and liabilities. It is logical, clear, and easy to administer. This proposed approach would also benefit credit union boards of directors, which consist primarily of volunteers. Based on December 31, 2013 Call Report data, this proposed approach would exempt almost 80 percent of credit unions from the regulatory burden associated with complying with the risk-based net worth requirement, while still covering 90 percent of the assets in the credit union system. It is also consistent with the fact that the majority of losses (68 percent as measured as a proportion of the total dollar cost [148]) to the NCUSIF over the last 10 years have come from credit unions with assets greater than $100 million.[149] Accordingly, this proposal

[147] 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 the assets and liabilities according to GAAP.

[148] Based on NCUA's loss and failure data.

[149] NCUA performed back testing analysis of Call Report and failure data to determine whether this proposed regulation would have resulted in earlier

would eliminate current § 702.103(b) and amend current § 702.103 to define all credit unions with over $100 million in assets as ''complex.''

In addition, the Board is requesting comment on an alternative measurement for the definition of ''complex.'' This alternative approach would define ''complex'' as engaging in a threshold number of products and services, such as those listed above, which the Board believes make up a complex portfolio of assets and liabilities. For example, this alternative approach could define a credit union as complex if it engaged in one or more of the products and services listed above. In addition to general comments on this approach, the Board is requesting comments on the following aspects of this alternative measurement for the definition of ''complex'':

1. What specific products and services should the Board 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?

Section 702.104 Risk-Based Capital Ratio

Under the Original Proposal, the Board proposed changing the title of current § 702.104 from ''Risk portfolio defined'' to ''Risk-based capital ratio measures.'' In addition, the Board originally proposed entirely replacing the requirements for calculating the risk-based net worth requirement for ''complex'' credit unions under current § 702.104 with a new risk-based capital ratio measure.[150] The proposed section would have required all ''complex'' credit unions to calculate their risk-based capital ratio as directed in the section. The proposed risk-based capital ratio was 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.

NCUA received a number of general comments on the proposed § 702.104. Commenters argued that the proposed risk-based capital calculation did not match the real risk in the system. Other commenters suggested the proposed risk-based capital calculation was an oversimplification of risk.

Some commenters stated that they generally supported the proposed calculation for the risk-based capital ratio. Other commenters stated that the proposed changes would make the risk-based capital ratio calculations more reflective of comparable calculations required by FDIC, provide clarity and understandability to a complex calculation, and make the resulting analysis more valuable and useable.

Other commenters suggested that the funding source of the credit union's assets should also be factored into the risk-based capital ratio measure, and that credit unions that fund assets solely with member deposits should be given a credit compared to credit unions that fund assets with borrowing and/or broker deposits. These commenters stated that the proposal would regulate only one side of the balance sheet—the assets—while not allowing credit unions the flexibility to deal with this new capital requirement through supplementary capital or the matching of term liabilities to specific assets. Similarly, other commenters suggested that the proposal did not effectively consider a credit union's liabilities as a source of funds matched against its assets. The commenters suggested that the cost at which some credit unions can borrow funds to then loan out or invest is very low and carry a healthy spread, but they believed the proposal would have penalized credit unions on the asset side of the balance sheets irrespective of their management of matching sources and uses of funds. Other commenters suggested that applying higher risk weights on long-term assets to deal with IRR is misleading without considering liabilities.

Commenters stated that NCUA assigns a CAMEL rating based on a number of factors, including management effectiveness, and that an institution with a more effective management team can adequately manage an increased level of risk. Commenters suggested that by not taking risk management techniques and qualities into account in the proposed rule when determining the required risk-based capital ratios, credit unions with strong management effectiveness would be essentially limited in how well they could utilize the skills that reside on their team.

One commenter suggested that credit unions should be given a credit for checking and savings non-maturity deposits. Another commenter suggested that the Original Proposal appeared to concentrate on risks faced by credit unions in a low interest rate environment, but that the rule should be amended to be flexible enough to also work in high interest rate environments that may occur in the future.

As discussed in more detail below, the Board believes most of the comments outlined above would be addressed by removing the IRR components from the risk weights in this proposal. Accordingly, consistent with the Original Proposal, the Board is now proposing to change the title of current § 702.104 from ''Risk portfolio defined'' to ''Risk-based capital ratio.'' In addition, the Board is now proposing, with some minor changes from the Original Proposal, to entirely replace the requirements for calculating the risk-based net worth ratio for ''complex'' credit unions under current § 702.104 with a new risk-based capital ratio measure.[151]

Proposed § 702.104 would continue to require all ''complex'' credit unions to calculate the risk-based capital ratio as directed in the section. The Board believes the proposed risk-based capital ratio would enhance sound capital management and help ensure that credit unions maintain adequate levels of loss-absorbing capital going forward, strengthen the stability of the credit union system, provide a more leading indicator of deteriorating strength than the net worth ratio, and ensure credit unions serve as a source of credit in times of stress.

104(a) Calculation of Capital for the Risk-Based Capital Ratio

Under the Original Proposal, proposed § 702.104(a) would have provided 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 ratio numerator as described in § 702.104(b) to its total risk-weighted assets denominator as described in § 702.104(c). The proposed method of calculating risk-based capital would have been generally consistent with the methods used in other sectors of the financial services industry. As with the current risk-based net worth requirement, the proposed risk-based capital ratio calculation would have been calculated primarily using information credit unions already report on the Call Report form required under § 741.6(a)(2) of NCUA's regulations.

The Board received a number of comments regarding the Original

identification of emerging risks and possibly reduced losses to the NCUSIF. We evaluated the impact of this proposal on more recent failures of credit unions with total assets over $100 million. This 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 NCUSIF.

[150] 12 U.S.C. 1790d(d).

[151] 12 U.S.C. 1790d(d).

Proposal's reliance primarily on information credit unions already report on the Call Report form. A number of commenters stated that the Call Report is sufficient and should not be amended or expanded. Commenters generally appreciated the Board's awareness of the regulatory burdens on credit unions relating to reporting requirements.

Other commenters suggested the Call Report information currently collected should be modified to properly capture risks associated with assets and liabilities in more detail. One commenter suggested that by supporting and ensuring strong risk-based capital calculations through enhanced Call Report data, the Board could help to improve communications between credit unions and examiners during the examination process, which could result in more efficient examinations and would help alleviate regulatory burdens on credit unions.

Other commenters suggested that adopting investment risk weights consistent with the Other Banking Agencies' regulations would require additional reporting in the Call Reports, but stated additional reporting would be a small issue for some credit unions and a non-event for others.

One commenter suggested that the Board's goal should be to produce the best risk-based capital proposal regardless of the current reporting structure and the proposal should be rewritten and the effort begun anew without the instructions to minimize changes to the current call report form. Another commenter suggested that the call report should be amended to include a separate line item labeled, ''deposits in Federal Reserve Banks,'' and that such a change would not be burdensome, either for credit unions or NCUA.

Several commenters stated that the revised Call Report would make the reporting process more costly and complicated for credit unions due to the amount of new information that credit unions would be required to provide under the Original Proposal because gathering new data would require changes by data processors, additional staff time and staff training, all of which costs money.

Conversely, one commenter suggested that the vast majority of credit unions that would be affected by the Original Proposal either use systems developed by, or outsourced their investment accounting and reporting to, firms who already provide the required information to banks, and it would require little relative effort to modify the reports provided to credit unions to be able to report this information in the Call Reports. Another commenter stated that the Board should overhaul the current call reporting platform to better align credit union Call Report data with the Call Report data collected by the other U.S. regulated depository institutions to build a consistent framework for both the assignment of appropriate risk weights, as well as the comparability of capital adequacy across institutions. Still another credit union commenter stated that it captures credit scores and current loan-to-value (LTV) ratios and would gladly report additional loan information to NCUA in its Call Report rather than be subject to the proposed risk-based capital standards.

The Board has decided to retain the original changes to § 702.104(a) in this proposal with only minor, non-substantive edits. However, the Board is aware that changes to the Call Report could create a reporting burden on credit unions. The Board agrees with commenters who encouraged Call Report data enhancement which would improve the assignment of appropriate risk weights using more granular data. While this approach would require more call report data, it would also result in improved precision of capital requirements, and more granular data that would also enhance NCUA's offsite supervision capabilities. As NCUA has done in the past (most recently in October 2012), the agency will provide credit unions with prior notification of significant reporting changes to the Call Report,[152] and credit unions will have an opportunity to comment via the related Paperwork Reduction Act filing through the U.S. Office of Management and Budget (OMB). The assignment and discussion of specific risk weights for assets that would be identified within the Call Report is contained in § 702.104(c).

104(b) Risk-Based Capital Ratio Numerator

Under the Original Proposal, proposed § 702.104(b) would have provided that the risk-based capital ratio numerator is the sum of certain specific 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 have continued 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 complicated, the Original Proposal would have added some additional equity and loss allowance items and other specified balance sheet items would be subtracted. The goal of the proposed risk-based capital ratio numerator was to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses.

A number of commenters suggested that the Board should focus more on the numerator of the risk-based capital ratio in the rule by allowing credit unions to hedge IRR by obtaining ''credits'' for low-risk assets such as certificates of deposit. Other commenters made similar statements suggesting that credit unions should be given a credit when they build their own insurance through certificates of deposit or long-term borrowing because such investments are considered additional insurance that are being used to hedge IRR.

The Board determined these comments are related to the IRR components of the risk weights in the Original Proposal and, as previously stated, this proposal would not include IRR components in the risk weights assigned to investments. The Board also determined quantifying ''credits'' for specific types of shares and liabilities would be extraordinarily complicated and require a large amount of additional data, and be inconsistent with how the Other Banking Agencies approach risk-based capital requirements.

The Original Proposal maintained the structure of the computation of the risk-based capital ratio numerator with some revisions, which are addressed under the discussion on each of the individual elements below. Accordingly, the Board is now proposing to retain § 702.104(b) of the Original Proposal without change.

104(b)(1) Capital Elements of the Risk-Based Capital Ratio Numerator

Section 702.104(b)(1) of the Original Proposal would have listed the capital elements of the risk-based capital ratio numerator as follows: undivided earnings (including any regular reserve); appropriation for non-conforming investments; other reserves; equity acquired in merger; net income; ALLL, limited to 1.25 percent of risk assets; secondary capital accounts included in net worth (as defined in § 702.2); and § 208 assistance included in net worth (as defined in § 702.2). Consistent with the Original Proposal, § 702.104(b)(1) of this proposal would list the elements of the risk-based capital ratio numerator.

The Board received a significant number of comments suggesting various changes or additions to the list of capital elements included in the Original

[152] NCUA Letter to Credit Unions No. 12–CU–12, October 2012, Changes Planned for Upcoming Call Reports.

Proposal, which are discussed in more detail below.

The Board generally disagrees with the comments received and has, with the exception of the ALLL, decided to retain the language from the Original Proposal without change. As explained above, the FCUA gives NCUA broad discretion in designing the risk-based net worth requirement. Thus, this proposal incorporates a broadened definition of capital for purposes of calculating the proposed new risk-based capital ratio that would serve as the risk-based net worth requirement. The Board proposes to do this to provide for a more comparable measure of capital across all financial institutions and better account for related elements of the financial statement that are available (or not) to cover losses and protect the NCUSIF. This broader definition of capital would contribute over 50 basis points, on average, to affected credit unions' risk-based capital ratio.

Undivided Earnings

The Original Proposal would have included undivided earnings (including any regular reserve) in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal with a minor change. The reference to regular reserve would be removed, as the regular reserve account is a part of undivided earnings and this proposal seeks to eliminate the provisions of the rule relating to maintenance of the regular reserve account.

Appropriation for Nonconforming Investments

The Original Proposal would have included the appropriation for nonconforming investments in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal without change.

Other Reserves

The Original Proposal would have included other reserves in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal without change.

Equity Acquired in Merger

Under the Original Proposal, the proposed risk-based capital ratio numerator would have included the equity acquired in merger component of the balance sheet. This equity item would have been used in place of the total adjusted retained earnings acquired through business combinations amount that 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 earnings acquired through business combinations, which is not a GAAP accounting item. The use of equity acquired in a merger, as measured using GAAP, would have more accurately reflected the overall value of the business combination transaction.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal without change.

Net Income

The Original Proposal would have included net income in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal without change.

ALLL

The Original Proposal would have included the ALLL in the risk-based capital ratio numerator. The Board noted in the Original Proposal that the ALLL would have been included in the risk-based capital ratio numerator because it is available to cover expected levels of loan losses at a credit union. The Original Proposal, however, would have limited the amount of the ALLL that a credit union could include in the risk-based capital ratio numerator to 1.25 percent of total risk-weighted assets. In the preamble to the Original Proposal, the Board stated that this approach would have been consistent with the Basel III framework and the Other Banking Agencies' capital regulations,[153] and it also would have induced credit unions to grant quality loans and record loan losses in a timely manner.

The Board received a number of comments regarding the proposed inclusion of the ALLL in the risk-based capital ratio numerator. A substantial number of commenters stated that the ALLL is a dedicated item on the balance sheet and should not be limited or restricted in any way. Commenters suggested that GAAP will not allow the ALLL to be an excessive amount, so the reasoning for limiting the ALLL in the Original Proposal was unclear, even if the Other Banking Agencies' rules treat it that way. Commenters suggested that, rather than implementing a 1.25 percent cap to capture risks in credit unions that are holding excess ALLL, the Board should address the risks that the cap was intended to address one-on-one with ''overly conservative'' credit unions. Commenters suggested that risk reserved for within the ALLL for credit risk should not be duplicated under the risk-based capital ratio measure. Other commenters stated that limiting the ALLL would have minimal practical effect on the way credit unions underwrite loans or record losses, but it could create a disincentive for credit unions to hold higher reserves.

Some commenters suggested that for banks, the 1.25 percent limitation prevents the use of the ALLL as a means to control taxable revenue by maintaining excessive reserves, but that credit unions have no incentive to manipulate the reserve in such a manner so the Board should include the full ALLL balance in the risk-based capital ratio numerator.

Other comments stated that the allocation of 1.5 percent of loans in the current rule more appropriately captures the insulating contribution that the ALLL provides to capital, particularly during times of economic stress.

Still other commenters stated that credit unions with portfolios of agricultural and business loans, which are allowed by GAAP to reserve for each loan individually in the ALLL rather than just using historical data, would be adversely affected by the original proposal because credit unions would have a lot less incentive to include economic downturns as part of their calculations under the rule.

A small number of commenters suggested that the ALLL in excess of 1.25 percent of risk assets should be recognized as a reduction of risk-based loans at 100 percent consistent with the treatment by the Other Banking Agencies.

Conversely, some other commenters stated that both the inclusion of the ALLL in the risk-based capital ratio numerator and the 1.25 percent limit were appropriate based on the current environment.

[153] *See, e.g.,* 12 CFR 324.20(d).

However, another commenter suggested that by excluding the amount of the ALLL above 1.25 percent, the Original Proposal would have implicitly encouraged credit unions to cap their ALLL at 1.25 percent, ignoring the responsibility to develop the ALLL based on portfolio risk.

In response to the comments received, the Board is now proposing to remove the 1.25 percent of risk asset limit on the amount of the ALLL that can be included in the risk-based capital ratio numerator. Under this proposal, all of the ALLL, maintained in accordance with GAAP, would be included in the risk-based capital ratio numerator. The proposed removal of the limit on the ALLL would result in this reserve fully counting as capital. The Board believes this is appropriate given that credit unions will have already expensed through the income statement the expected credit losses on the loan portfolio. 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 would allow a properly funded ALLL to somewhat offset the impact of the financial stressors on the risk-based capital ratio.

The Board also believes that this proposed change 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.

Further, the Board agrees with commenters that NCUA's supervision process could address any concerns with uncapping inclusion of the ALLL, such as artificially slow charge-offs to manipulate capital requirements. Removal of the limitation in the amount of the ALLL included in risk-based capital ratio would also address the treatment of excess ALLL that was excluded from the calculation.

A significant number of commenters also stated that if the Financial Accounting Standards Board (FASB) changes the accounting standards that cause more than inconsequential increases to the normal levels of ALLL, the Board should increase the limit of ALLL to be included in the risk-based capital ratio numerator comparable to the additional levels of normal ALLL. Other commenters suggested that the Board eliminate the ALLL cap of 1.25 percent of risk-weighted assets given the high risk weight associated with non-current loans. Further, commenters suggested elimination of the ALLL cap based on the FASB's proposed accounting for credit losses, which, if finalized, could result in an increase of credit unions' ALLL by more than 50 percent. Another commenter suggested that language be added to the rule that states that the ALLL credit will be increased if FASB proposal is implemented. Other commenters suggested that reducing the ALLL allocation would be inconsistent with the expected accounting conventions for future allowance methodologies.

The Board notes that eliminating the cap on ALLL inclusion in the risk-based capital ratio numerator would address concerns with FASB's proposed related changes to GAAP.[154] However, FASB has implied its intent in the upcoming Current Expected Credit Loss Model to change current GAAP and require entities to establish a day one credit loss allowance on Purchased Credit Impaired (PCI) assets.

As the entire credit loss allowance would be included in a credit union's risk-based capital ratio numerator under the proposed rule, the Board is requesting specific comment on how a final rule should mitigate strategies by credit unions to ''purchase'' a credit loss allowance by acquiring PCI assets in an acquisition or merger, and thus, artificially increase their risk-based capital ratio numerator.

Secondary Capital Accounts

The Original Proposal would have included secondary capital accounts included in net worth (as defined in § 702.2) in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal in this proposal without change.

Section 208 Assistance

The Original Proposal would have included § 208 assistance included in net worth (as defined in § 702.2) in the risk-based capital ratio numerator.

The Board received no comments on the inclusion of this capital element in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Original Proposal in this proposal without change.

Call Report Equity Items Not Included in the Risk-Based Capital Ratio Numerator

Under the Original Proposal, the proposed risk-based capital ratio numerator would not have included the following Call Report equity items: accumulated unrealized gains (losses) on available for sale securities; accumulated unrealized losses for other than temporary impairment (OTTI) on debt securities; accumulated unrealized net gains (losses) on cash flow hedges; and other comprehensive income. In designing the proposed rule, the Board recognized that the items listed above reflected a credit union's actual loss absorption capacity at a specific point in time, but included gains or losses that may or may not be realized. The Board also recognized that including these items 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.[155] Accordingly, the Board chose to exclude these items from the risk-based capital ratio numerator in the Original Proposal.

The Board received a number of comments on the exclusion of accumulated unrealized gains and losses from the risk-based capital ratio numerator in the proposed rule. Commenters suggested that to offset the effect of unrealized gains or losses, credit unions should be allowed to net the gain or loss against the investment that created it, which would mean valuing the investment at book. Commenters stated that this would make adjustments to the unrealized gains or losses have no net effect on the calculation. Commenters stated further that under the Original Proposal an unrealized gain would increase the value of the investment in the denominator and an unrealized loss would decrease the value of the investment in the denominator, creating volatility. Commenters also suggested that with an unrealized loss there is no deduction from net worth and the asset is still decreased in the risked-based asset calculation; thus, a large unrealized loss could hide a risk that the net worth would have to be reduced if the credit union was liquidated. Other commenters agreed that including unrealized gains and losses could lead to volatility in the risk-based capital measure, difficulty in capital planning and asset-management, and other unintended consequences as the unrealized gain or loss expands and contracts.

Still other commenters suggested that while the Original Proposal would have

[154] FASB Financial Instruments-Credit Losses Subtopic 825–15 (exposure drafted dated December 20, 2012).

[155] The Other 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).

appropriately left unrealized gains and losses on available-for-sale securities out of the risk-based capital ratio numerator, and explains NCUA's sound reasoning behind that position, the proposed high risk weights applied to investments would almost completely offset this for many credit unions. These commenters suggested the high risk weights applied to investments would reduce some credit unions' risk-based capital ratios as if they had already sold their entire portfolio at the loss in market values they would expect in an unrealized, instantaneous, ''up 300 basis points'' rate-shock scenario.

As noted earlier, this proposal removes the IRR components contained in the risk weights, so related concerns raised by commenters on the investment risk weights should now be moot.

Due to the changes this proposal would make to the assignment of risk weights for investments, and in response to the comments in agreement with the concerns about volatility in the risk-based capital ratio that can occur with investments, the Board has decided to retain this aspect of the Original Proposal without change. The proposed application of excluding 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 also would eliminate the added complication of an opt-in or opt-out approach.

Other Supplemental Forms of Capital

Under the Original Proposal, forms of supplemental capital, other than secondary capital accounts included in net worth (as defined in § 702.2), would not have been included in the risk-based capital ratio numerator. For natural-person credit unions, the only form of supplemental capital the FCUA includes in the definition of ''net worth'' is secondary capital that it authorizes for low-income credit unions.[156] The Board did not propose including other supplemental forms of capital in the risk-based capital ratio numerator.

As a result, the Board received a substantial number of comments expressing concern about the omission of supplemental capital from the risk-based capital ratio numerator.

A number of commenters suggested that the Original Proposal would have regulated only the asset side of the balance sheet, representing the risk-based capital ratio denominator, while depriving credit unions of the flexibility to use supplemental capital to address the newly introduced capital requirement through the risk-based capital ratio numerator. Other commenters stated that, in order for any credit unions but low-income credit unions to use supplemental capital to meet the risk-based net worth requirement, Congress would have to amend the FCUA to give NCUA the authority to permit that use of supplemental capital. In that regard, commenters contended that the Board should have raised the supplemental capital issue with Congress before issuing the proposed rule.

Without being able to include supplemental capital in the risk-based capital ratio numerator, some commenters stated that credit unions would be forced to address capital concerns by increasing profitability (through higher fees and loan rates, etc.), shrinking assets, or both; none of which they suggested would be in a credit union's best interest.

A small number of commenters suggested that credit unions would not need supplemental capital to be effective if the Board were to devise a risk-based capital regulation that enabled credit unions to grow in a manner consistent with safety and soundness.

Other commenters protested that since the Board had altered the definition of capital in the Original Proposal, it therefore should also extend the risk-based capital ratio numerator to include supplemental capital. In making the same argument, others noted that the risk-based capital ratio numerator as proposed already included items that are not part of ''net worth'' as defined by the FCUA.

Commenters 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 FCUA, but they maintain that, in contrast, nothing in the Act *prohibits* the Board from including supplemental capital in the risk-based capital ratio numerator. More expansively, some commenters interpreted the absence of an express prohibition in the Act barring the use of supplemental capital by any credit union for any purpose as implicit *support* for allowing it to be used for risk-based purposes only. Under either interpretation, commenters urged the Board to make supplemental capital a component of the risk-based capital ratio numerator consistent with the proposed definition of capital as ''equity, as measured by GAAP, available to a credit union to cover losses.'' [157]

In contrast to the lack of authority for federally chartered credit unions, other than low-income credit unions, to currently accept secondary capital, several commenters suggested that the laws of some states authorize their federally insured state chartered credit unions to raise other supplemental forms of capital. Therefore, the commenters suggested the rule should permit those federally insured state chartered credit unions that are authorized to raise other forms of capital under state law to also count that capital in the risk-based capital ratio numerator.

Commenters suggested that the FCUA already authorizes federally chartered credit unions to issue certificates of indebtedness, which function as loans from the holder to the credit union with interest paid to the holder, as well as to offer subordinated debt instruments to members and non-members. They urged the Board to allow FCUs to count those certificates of indebtedness, and those instruments that meet GAAP capital requirements, in the risk-based capital ratio numerator.

Having considered the comments on supplemental capital, the Board declines to permit credit unions (other than low-income credit unions) to include other supplemental forms of capital in the risk-based capital ratio numerator as part of this proposal, pending potential Congressional action and more specific comments as described below.[158]

Members of Congress have introduced legislation in the past that would authorize all federally insured credit unions to accept supplemental capital.[159] Individual Board members have publicly supported such legislation in the past. At this time the Board prefers to await the outcome of previously proposed legislation that, if passed by Congress, would expressly authorize supplemental capital as a component of net worth,[160] and permit

[156] 12 U.S.C. 1757(6), 1790d(o)(2)(C) (defining ''net worth''), *and* proposed § 702.2 (defining ''net worth'').

[157] *See* 79 FR 11183, 11211 (Feb. 27, 2014) (Proposing to define ''capital'' as ''the equity, as measured by GAAP, available to a credit union to cover losses.'').

[158] 702.104(b)(2)

[159] See, *e.g.,* HR 719, 113th Cong. (2013) (HR 719 would have amended the FCUA to allow the Board to authorize certain forms of supplemental capital that could be counted toward a credit union's ''net worth,'' as that term is defined in section 1790d(o)(2)).

[160] The Capital Access for Small Businesses and Jobs Act, HR 719, was introduced in the House of Representatives and referred to the House Financial Services Committee during the 113th Congress.

the Board to decide whether or how to include such capital in the net worth ratio and the risk-based net worth requirement. Individual Board members have publicly supported such legislation in the past.

Such authority would also raise a host of other complicated issues that would need to be addressed through additional changes to NCUA's regulations, including providing consumer protections, amending NCUSIF payout priorities, and imposing prudent limitations on the ability of non-low-income credit union to offer and include supplemental capital.

Although the FCUA does authorize federally chartered credit unions to issue certificates of indebtedness and subordinated debt instruments to members and non-members, the ability to include them in the risk-based capital ratio numerator depends on whether such supplemental forms of capital are structured to satisfy prudential capital and consumer protection requirements—issues not addressed in this rulemaking.

The Board does, however, specifically request comment on the following questions regarding additional supplemental forms of capital.

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, to be included in the risk-based capital ratio numerator, 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 supplemental 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 commenters 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?

104(b)(2) Risk-based Capital Ratio Numerator Deductions

Under the Original Proposal, proposed § 702.104(b)(2) would have provided that the elements deducted from the sum of the capital elements of the risk-based capital ratio numerator are: (1) The NCUSIF Capitalization Deposit; (2) goodwill; (3) other intangible assets; and (4) identified losses not reflected in the risk-based capital ratio numerator.

The Board received a significant number of comments, which are outlined in detail below, regarding the capital elements that would have been deducted from the risk-based capital ratio numerator. However, for the reasons explained in more detail below, the Board has decided to retain most of these aspects of the Original Proposal with a few changes that are discussed in more detail below.

NCUSIF capitalization deposit. The Original Proposal would have addressed concerns about the NCUSIF capitalization deposit being reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. Under the Original Proposal, the NCUSIF capitalization deposit would have been subtracted from both the numerator and denominator of the risk-based capital ratio.[161] This treatment of the risk-based capital ratio would not have altered the NCUSIF capitalization deposit's accounting treatment for credit unions.

The Board received a number of comments expressing concerns about the Original Proposal's treatment of the NCUSIF capitalization deposit. A majority of commenters disagreed with or questioned the treatment of the NCUSIF deposit. Commenters suggested that the NCUSIF deposit should not be deducted from the risk-based capital ratio numerator or denominator.

Commenters stated that if the risk-based capital ratio numerator is intended to reflect ''equity available to cover losses in the event of liquidation,'' then the NCUSIF deposit should be included because it is one of the most reliable assets available to credit unions to cover losses. Commenters suggested that the only condition under which it would not be available is during a system-wide catastrophe, in which case most other credit union assets, other than cash, would similarly be subject to substantial losses. Those commenters argued there is no reason to believe the NCUSIF capitalization deposit would not be available to cover losses or that it should be excluded from the numerator of the risk-based capital ratio.

Other commenters suggested that NCUA has control of these funds so credit unions should be able to count the deposit toward their capital requirement (*i.e.,* the deposit should be included in the risk-based capital ratio numerator and be counted only as a zero-risk item in the risk-based capital ratio denominator).

Other commenters stated that although banks expense their deposit insurance, credit unions treat the deposit as an asset. Commenters stated that while it is true that the bank's deposit insurance premiums have reduced the bank's capital, a credit union's capital has been reduced in real terms by the lost income the credit union would have earned had it placed the funds in an earning asset rather than in a non-interest-bearing deposit to NCUSIF.

Another commenter stated that it appeared that the Board was attempting to make the risk-based capital ratio numerator comparable to banks, which expense their insurance premiums paid by eliminating the NCUSIF capitalization, but that banks pay and expense their premiums for each period due and cannot get those funds back. The commenter stated further that federally insured credit unions, on the other hand, not only pay an upfront deposit of one percent of insured shares and record that as an asset, but also pay for and immediately expense periodic assessments from NCUA needed to bolster the NCUSIF. In addition, the commenter stated that federally insured credit unions can have their deposits returned if, for example, they convert to a bank, elect private insurance (in the nine states where private insurance is permitted), or complete a voluntary liquidation, and the NCUSIF capitalization deposit is an asset as recognized by GAAP, is tangible, and easily measured.

Some commenters suggested that this accounting difference is already captured as part of the higher leverage ratio for credit unions as compared to banks. They believe Congress established a capital level for credit unions two percentage points higher than the capital level for banks because one percent of a credit union's capital is dedicated to the NCUSIF and another one percent of the typical credit union's capital is dedicated to its corporate credit union. Those commenters stated that if the Board excludes the NCUSIF deposit it will create an uneven playing field between banks and credit unions

[161] *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.*

that will disadvantage credit unions by adjusting for the deposit twice.

Commenters generally suggested that this new approach could bring the accounting treatment of the NCUSIF deposit into question; that if the deposit is not available to cover a credit union's risks during liquidation then that leads to the question of whether or not the deposit is an asset. Going further, other commenters suggested the Board reconsider this aspect of the Original Proposal, as it implies that the deposit is worthless and should be expensed versus the current method of capitalizing the deposit.

Conversely, another commenter stated that after experiencing the corporate credit union meltdown, it has become evident that NCUA has the superior claim on the deposit and that the credit union really cannot claim to own it. Still another commenter stated that perhaps the NCUSIF deposit should have been expensed all along, but writing it down now comes at a time when generating earnings is already a big challenge.

One commenter suggested that the NCUSIF deposit should be treated as an investment like Federal Home Loan Bank stock, which would mean assigning a risk weight to account for the possibility of the NCUSIF having to use the credit union's funds beyond normal premiums and losing some of the credit union's equity in the NCUSIF. The commenter suggested that leaving the NCUSIF deposit on the balance sheet, assigning it a risk weight, and removing the deduction from net worth is the best option for accurately measuring the ability of each credit union to weather losses. Other commenters suggested that the deposit should be assigned a risk weight of 100 percent or lower.

It was suggested that the NCUSIF deposit should not be excluded from the calculation of risk-based capital ratios at all, but that excluding it from the denominator penalizes more than excluding it from the risk-based capital ratio numerator.

Yet other commenters disagreed, suggesting that the NCUSIF deposit be excluded from the calculation of risk-based capital altogether.

One commenter suggested that the deposit be treated like any other illiquid asset instead of contra-equity.

The Board has carefully considered the comments received and continues to believe exclusion of the NCUSIF deposit from both the risk-based capital ratio numerator and denominator is the appropriate way to handle its risk-based capital treatment. Accordingly, for all the reasons discussed below, the Board has decided to retain this aspect of the Original Proposal without change.

The 1997 U.S. Treasury Report on Credit Unions supports NCUA's current position of excluding the NCUSIF deposit from the risk-based capital ratio calculation. The Treasury report concluded that the NCUSIF deposit is double counted because it is an asset on credit union balance sheets and equity in the NCUSIF.[162] The Treasury noted that, in lieu of expensing the NCUSIF deposit, holding additional capital is necessary to offset risk of loss from required credit union replenishment. According to comments within the 1997 Treasury Report, Congress established a higher statutory leverage ratio for credit unions in part to offset the risk of loss from required credit union replenishment.[163]

The Board believes the NCUSIF deposit deduction needs to be addressed 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.

The NCUSIF deposit is not available for a credit union to cover losses from risk exposures on its own individual balance sheet in the event of insolvency.[164] The purpose of the NCUSIF deposit is to cover losses in the credit union system. The Board is required to assess premiums necessary to restore and maintain the NCUSIF equity ratio at 1.2 percent. Premiums were necessary from 2009 through 2011 as a result of losses. A series of NCUA Letters to Credit Unions issued during 2009 discuss the necessary write-down of the one percent NCUSIF deposit and required NCUSIF premium expenses needed to restore the NCUSIF equity ratio.[165]

The NCUSIF deposit is refundable in the event of voluntary credit union charter cancellation or conversion. However, this aspect does not change the unavailability of the NCUSIF deposit to cover individual losses while the credit union is an active going concern, or its at risk stature in the event of major losses to the NCUSIF. NCUA refunds the NCUSIF deposit only in the event a solvent credit union voluntarily liquidates, or converts to a bank charter or private insurance.

Consistent with its exclusion from the risk-based capital ratio numerator, the NCUSIF deposit would also be deducted from the denominator under proposed § 702.104(c)(1), which would properly adjust the risk-based capital ratio calculation and reduce the impact of the adjustment.

Neither the Original Proposal nor this second proposal would adjust for the NCUSIF deposit twice or put credit unions at a disadvantage in relation to banks because banks have expensed premiums to build the Deposit Insurance Fund.

The Board does not agree with commenters who suggested that the NCUSIF deposit should be treated as an investment similar to FHLB stock. The NCUSIF deposit and FHLB stock have several fundamental differences. The deposit in the NCUSIF results in double counting of capital within the credit union system. Investments in FHLB stock do not. A financial institution does not need to change its charter for a FHLB stock redemption as a credit union must do for a NCUSIF deposit refund. Further, unlike FHLB stock, the NCUSIF deposit is not an income-producing asset. The NCUSIF deposit has not paid a dividend since 2006. The NCUSIF cannot pay another dividend while the Corporate Stabilization Fund loan from the Treasury is still outstanding.

The Board is not requiring credit unions to expense the NCUSIF deposit, and does not believe the risk-based capital treatment will lead to a change in how this asset is accounted for under GAAP. The Board agrees with the U.S. Treasury position as stated in its 1997 Report on Credit Unions. Treasury stated expensing the NCUSIF deposit would not strengthen the NCUSIF. The financial structure of the NCUSIF is reasonable and works well for credit unions.

The assignment of a risk weight for the NCUSIF has the potential to create additional criticisms, as a low risk weight may not capture the true nature of the account and a high risk weight could produce unnecessary concern about risk of the NCUSIF. The NCUSIF is treated similarly to other intangible assets, (*e.g.* goodwill and core deposits intangible assets), as they are not available assets upon liquidation.

[162] Department of U.S. Treasury Report titled; *Credit Unions,* 1997, Page 58: ''The one 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—as we will explain—better ways of protecting the Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.''

[163] *Id.* at page 4–5 and 55–59

[164] 12 U.S.C. 1782(c)(1)(B)(iii).

[165] NCUA Letter 09–CU–20, Premium Assessments; NCUA Letter 09CU–14, Corporate Stabilization Fund Implementation; NCUA Letter 09–CU–02, Letter Corporate Credit Union System Strategy.

Goodwill and Other Intangible Assets

Under the Original Proposal, goodwill and other intangible assets would have been deducted from both the risk-based capital ratio numerator and denominator in order to achieve a risk-based capital ratio numerator reflecting equity available to cover losses in the event of liquidation.

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 Board received a number of comments regarding the treatment of goodwill under the proposal. Commenters suggested that credit unions should not be required to subtract goodwill even though doing so is consistent with Basel III and the Other Banking Agencies' capital regulations. One commenter suggested that the proposed rule and the treatment of goodwill should follow GAAP. Another commenter suggested that goodwill is an asset and should be counted as such.

Other commenters suggested that goodwill should be excluded from the risk-based capital calculation because goodwill is not immediately available to absorb losses in accordance with the intended purpose of regulatory capital, but that the Board should also consider what impact such a change could have on merger incentives in the industry. Another commenter suggested that goodwill not be immediately deducted from the numerator of the risk-based capital ratio, but instead be phased out over a 10-year period, or longer on a case-by-case basis.

Commenters generally suggested that the exclusion of goodwill disincentives merger activity, which would prevent healthy industry consolidation and the combining of unhealthy credit unions with stronger ones in the future.

Other commenters suggested that not including intangibles resulting from a merger in the risk-based capital ratio numerator causes a reduction in the risk-based capital ratio for non-goodwill intangibles, which are not included in the numerator and are deducted from the numerator when amortized.

Other commenters stated they agree with the proposed treatment of goodwill, but that the Board should only deduct those items initially included, and only to the extent of current (net) assets.

The Board also received a few comments on the treatment of other intangible assets under the proposed rule. Commenters suggested the Board should rethink the treatment of the core deposit intangible and let GAAP determine how core deposit intangible is to be written off in fairness to the surviving credit union and to encourage future mergers of both healthy and distressed institutions whether credit unions or banks.

The Board has considered the comments and, as explained above, has decided to retain the definition of goodwill and to clarify the definition of other intangibles. However, the Board recognizes that requiring the exclusion of goodwill and other intangibles associated with supervisory mergers and combinations that occurred prior to this proposal would directly reduce the credit union's risk-based capital ratio. The Board is now proposing to amend the Original Proposal in a manner that would allow credit unions to include certain goodwill and other intangibles in the risk-based capital ratio numerator. In particular, this second proposed rule would exclude from the definition of goodwill which must be deducted from the risk-based capital ratio numerator, any goodwill acquired by a credit union in a supervisory merger or consolidation that occurred before the publication of this rule in final form.

The Board notes, however, that this proposed change would not change financial reporting requirements for credit unions to use GAAP to determine how certain intangibles are valued over time.

Under this proposal, credit unions would still need to account for goodwill in accordance with GAAP and the amount of excluded goodwill and other intangibles is based on the outstanding balance of the goodwill directly related to supervisory mergers.

The Board is proposing to allow the excluded goodwill until December 31, 2024. The Board believes this date would allow most, if not all, credit unions to adjust to this change as they continue to value goodwill and other intangibles in accordance with GAAP. Also, the Board notes that this provision would only apply to goodwill and other intangibles acquired through supervisory mergers or consolidations, as that term is defined above, and is not available for goodwill and other intangibles acquired from mergers or consolidations that do not meet this definition. This change would allow affected credit unions time to revise business practices to ensure goodwill and other intangibles directly related to supervisory mergers do not adversely impact their risk-based capital calculation.

In response to commenters who sought to include goodwill and other intangibles in the risk-based capital ratio numerator, the Board reiterates that there is a high level of uncertainty regarding the ability of credit unions to realize the value of these items, particularly in times of adverse conditions. In addition, the Board notes that its proposed approach to other intangibles generally mirrors the treatment by the Other Banking Agencies.[166] However, the longer implementation period included in this proposal would serve to mitigate some of the commenters' concerns regarding existing goodwill and other intangibles because it would provide affected credit unions with approximately a 10-year period to write down the goodwill or otherwise adjust their balance sheet.

While the Board is proposing to include a provision to address goodwill and other intangibles acquired through supervisory mergers and consolidations completed prior to this rule, the Board is now proposing to retain the requirement that all other goodwill and other intangibles be excluded from the risk-based capital ratio numerator as they are not available to cover losses. Credit unions will need to consider the impact future combinations will have on both the net worth and risk-based capital ratios. For mergers involving financial assistance from the NCUSIF, 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 components of a merger proposal, which may result in higher costs to the NCUSIF. However, stronger capital and a risk-based capital measure that is less lagging should reduce the number and cost of failures, resulting in a net positive benefit to the NCUSIF and the industry.

Finally, in order to improve clarity about which particular intangible assets are deducted from the risk-based capital ratio numerator, the Board is proposing to revise the definition of other intangible assets. Specifically, the Board is proposing to exclude servicing assets from the amount of intangible assets deducted from the risk-based capital ratio numerator since they have the potential for value in the event of liquidation.

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

The Original Proposal would have included a provision to allow for identified losses, not reflected as

[166] *See, e.g.,* 12 CFR 324.22.

adjustments in the risk-based capital ratio numerator, to be deducted. The inclusion of identified losses would have allowed for the calculation of an accurate risk-based capital ratio.

The Board received no comments on this aspect of the proposal. Accordingly, the Board has decided to retain this aspect of the Original Proposal without change. However, the definition for identified losses was modified, for reasons articulated above, to make it clear any such items would be measured in accordance with GAAP.

104(c) Risk-weighted Assets

In developing the proposed risk weights included in the Original Proposal, the Board reviewed the Basel accords and the U.S. and various international banking systems' existing risk weights.[167] The Board considered the comments contained in MLRs prepared by the NCUA's OIG and comments by GAO in their respective reviews of the financial services industry's implementation of PCA.[168] As previously mentioned, the FCUA requires the risk-based measure to include all material risks. Accordingly, in assigning the originally proposed risk weights, the Board considered credit risk, concentration risk, market risk, IRR, operational risk, and liquidity risk.

The Board received a number of comments expressing general concerns about the proposed risk weights. A significant number of commenters suggested that the Original Proposal did not contain sufficient statistical analysis of credit union losses or failures, quantified and summarized data on historical NCUSIF loss experiences, and comparisons of the loss or failure rates at banks to rationalize the proposed asset risk weights. One commenter suggested that the risk weights reflect ''socio-economic reasons'' instead of ''reasoned judgment about actual risks.''

A number of commenters argued that the absence of rigorous quantitative analysis accompanying the proposal's risk weights raises many questions and makes it exceedingly difficult to respond fully to the agency's proposal. Other commenters contended that the proposal provides no explanation of how the risk-based ratings were derived and how they would directly correlate to risks the proposal attempts to mitigate. Commenters suggested that the Board's proposed increases to various risk weights were excessively blunt given the small number of failures and the MLR narratives cited in the proposed rule. Other commenters suggested that some of the risk weights appear to be excessive, arbitrary, and/or appear to cover all types of risk by adopting excessive risk weight amounts.

A number of commenters suggested that the proposed risk weights would encourage credit unions to increase levels of poorer credit quality consumer loans at the expense of higher levels of even the strongest, most secure MBLs, real estate loans, and longer-term investments. A significant number of commenters expressed concerns that the Original Proposal would have been inconsistent in the treatment of the real risks associated with some on-balance sheet assets when the risk weights of various assets were compared to one another; *e.g.,* the risk weights for delinquent first mortgage loans, buildings, prepaid expenses, foreclosed properties, investments in CUSOs, and any investment with a weighted-average life of more than 5 years.

Other commenters suggested that the Board reconsider the limitations of any single metric at assessing risk and match the consequences of a low risk-based capital ratio to the limitations and potential inaccuracy of that metric.

One commenter suggested that, based on the proposal, the implied balance sheet structure of most credit unions would be as follows: (1) Commercial lending would be limited to roughly 15 percent of assets, because of the heavier risk weight at higher thresholds; (2) real estate lending would be limited to approximately 35 percent of assets regardless of the repricing structure of the loans; (3) home equity loans/second lien mortgage loans would be limited to 10 percent of assets; and (4) the remainder of a credit union's balance sheet would be limited to consumer loans and very short-term investments because of the risk weights.

A number of commenters suggested that asset quality (*e.g.,* number of delinquencies, classified loans, and charge-offs) should also be taken into account in setting the risk weights to avoid penalizing credit unions that are doing their jobs well. Other commenters suggested that the calculation should provide relief to well-run credit unions that manage their risk appropriately.

A number of commenters suggested that the Original Proposal was biased toward lending and against investments, but that many credit unions have no other option but to purchase investments to improve their interest income to boost their overall earnings. Other commenters stated that the proposal created a bias in favor of consumer loans and short-term assets, which, along with the investment portfolio risk weights, would have forced credit unions down the yield curve to short-duration assets and impeded their ability to build capital. A number of commenters suggested that the risk weight categories and asset categories were over generalized.

A small number of commenters suggested that the rule would be better balanced if credit to the risk weights could be established with a rolling average to reward credit unions effectively managing their loan risks.

The Board generally agrees with comments related to the need for more consistency of risk weights across asset classes, and that IRR and credit risk should not be commingled in the risk weights. Therefore, the Board has decided to make corresponding changes to the risk weights in this proposal. In this second proposal, the Board would address credit risk and concentration risk to be comparable to the Other Banking Agencies.[169] The Board believes the other types of risks that would have been addressed in the Original Proposal are either currently addressed through supervision or will be addressed through alternative approaches in the future. In response to the comments received, particularly those related to investments and residential real estate loans, the Board believes deviating from the current rule's and Original Proposal's method for assigning risk weights would be more consistent with the associated credit risk and the risk weights assigned by the Other Banking Agencies.

This proposal would substantially change how the risk weights for investments would be assigned. Instead of assigning the investment risk weights based on weighted average life, the investment risk weights would be assigned based primarily on the credit quality of the underlying collateral or repayment ability of the issuer. This adjustment addresses the inconsistencies between the risk weights for loans and investments.

For example, under this proposal most first-lien residential real estate

[167] 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.*

[168] Section 988 of the Dodd-Frank Wall Street Reform and Consumer Protection Act obligates NCUA's OIG to conduct MLRs of credit unions that incurred a loss of $25 million or more to the NCUSIF. In addition, section 988 requires NCUA's OIG 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).

[169] *See, e.g.,* 12 CFR 324.32.

loans receive a 50 percent risk weight and an investment backed by similar assets would receive a 50 percent risk weight. Under this proposal, a credit union managing assets well by avoiding concentrations, non-current loans and risky investments would realize lower total risk-assets and thus a higher risk-based capital ratio. Further details on the changes to individual assets are addressed in the discussion on proposed § 702.104(c)(2) below.

Regarding support for the risk weights themselves, the Board notes that given the requirement in section 216(b)(1)(A)(ii) to maintain comparability with the Other Banking Agencies' PCA requirements, NCUA generally relied on risk weights assigned to various asset classes within the Basel Accords and established by the Other Banking Agencies' risk-based capital regulations to develop this proposal. Based on the comments received, the Board believes it has more precisely defined the risk weights. NCUA has tailored risk weights in this proposal for assets unique to credit unions, or where a demonstrable and compelling case existed based on contemporary and sustained performance differences as shown in Call Report data to differentiate for certain asset classes between banks and credit unions, or where a provision of the FCUA necessitated doing so. Thus, when compared to the Original Proposal, this second proposal would adjust asset classes and recalibrate risk weights, and is more comparable to the risk weights in the Other Banking Agencies' capital regulations.[170]

104(c)(1) General

Under the Original Proposal, proposed § 702.104(c)(1) would have provided 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 derivative contracts in § 702.104(c)(4), minus the risk-based capital ratio numerator deductions in § 702.104(b)(2). The proposal would have required a complex credit union to calculate its risk-weighted asset amount for its on- and off-balance sheet exposures. In the proposal, risk-weighted asset amounts would have generally been 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 have been calculated using a two-step process: (1) Multiplying the notational principal or face value of the off-balance sheet item by a credit conversion factor (CCF) to determine a credit equivalent amount, and (2) assigning the credit equivalent amount to the 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.

The Board received no comments on the language in this paragraph and has decided to retain this aspect of the Original Proposal with the following two changes.

First, the Board proposes to add the following language to this subsection to address the assignment of a risk weight should a particular on- or off-balance sheet item meet more than one defined risk weight category: ''If a particular asset, derivative contract, or off-balance sheet item has features or characteristics that suggest it could potentially fit into more than one risk weight category, then a credit union shall assign the asset, derivative contract, or off-balance sheet item to the risk weight category that most accurately and appropriately reflects its associated credit risk.'' A thorough evaluation of the true credit risk associated with such an item would be the determining factor for the appropriate risk weight.

Second, the Board proposes to make minor conforming amendments to the language to further clarify the requirements.

Accordingly, under this proposal § 702.104(c)(1) would provide that risk-weighted assets includes risk-weighted on-balance sheet assets as described in §§ 702.104(c)(2) and (c)(3), plus the risk-weighted off-balance sheet assets in § 702.104(c)(4), plus the risk-weighted derivatives in § 702.104(c)(5), less the risk-based capital ratio numerator deductions in § 702.104(b)(2). In addition, the section would provide further that if a particular asset, derivative contract, or off balance sheet item has features or characteristics that suggest it could potentially fit into more than one risk weight category, then a credit union shall assign the asset, derivative contract, or off-balance sheet item to the risk weight category that most accurately and appropriately reflects its associated credit risk. The Board is proposing to add this language to account for the evolution of financial products that could lead to such products meeting the definition of more than one risk asset category. If necessary, NCUA would publish guidance to address these products, if and when developed.

104(c)(2) Risk Weights for On-Balance Sheet Assets

Under the Original Proposal, proposed § 702.104(c)(2) would have defined 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 10 categories and risk weights.

The Board received a significant number of comments on the proposed risk-weight categories and the risk weights assigned to particular assets and has decided to make a number of changes to this subsection, which are discussed in more detail below.

Material Risks

In accordance with section 216(d)(2) of the FCUA, which requires NCUA's risk-based capital requirement ''to take account of 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,'' [171] the risk weights under the Original Proposal would have included elements to address credit, concentration, market risk, interest rate, and liquidity risk. In doing so, proposed § 702.104(c) of the Original Proposal would have addressed concentration risk by assigning higher risk weights to larger percentages of assets in MBLs and real estate loans in § 702.104(c). The concentration threshold amounts were generally based on the average percentage of assets held in the asset types.

The Board has addressed comments received on the Original Proposal related to specific assets in the preamble parts corresponding to the various types of assets covered by this proposal below. However, the Board received a number of general comments on total risk-weighted assets.

A number of commenters stated that NCUA did not adequately support the proposed risk weights nor show a significant correlation between losses and the current risk-based capital structure. Some commenters argued that the proposed risk weights were arbitrary and unsupported. Other commenters noted that the proposed risk weights did not take into account the quality of assets, the ability of credit unions to manage capital, liabilities on credit unions' balance sheets, or the actual loss experience of credit unions. A few commenters believed the proposal would create a bias against long-term lending and investments in favor of short-term assets. One commenter stated

[170] *See, e.g.,* 12 CFR 324.32.

[171] 12 U.S.C. 1790d(d)(2).

that all risk weights should be capped at 100 percent. One commenter stated that the proposal would essentially structure the balance sheet for most credit unions so that commercial lending would be limited to 15 percent of assets, real estate lending would be limited to 35 percent of assets, HELOCs and second-lien mortgages would be limited to 10 percent of assets, and the remainder of the balance sheet would be limited to short-term investments and consumer loans.

After diligently considering all of the comments, and as discussed in more detail in the applicable sections, the Board is now proposing to make significant revisions to the current rule and the Original Proposal, which are discussed in more detail below, to address many of the concerns raised by commenters.

Cash and investment risk weights. In general, the Original Proposal would have retained the approach used in the current rule for measuring risk weights for most cash items and investments. Consistent with the current rule, the risk weights for specific investments generally would have been based upon the weighted-average life of investments (WAL). The WAL is generally calculated based on the average time until a dollar of principal is repaid.[172] Under the current rule, a higher risk weight is generally assigned to an investment with a longer WAL.

Under the Original Proposal, the proposed risk weights for cash and investments would have been assigned as follows:

ORIGINAL PROPOSAL—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
Corporate credit union perpetual capital	200

The Original Proposal would have also lowered 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 percent risk weight, and maintained the current zero percent risk weight for NCUA-guaranteed assets. Finally, the Original Proposal would have removed nonperpetual and perpetual capital in corporate credit unions from the >1–3 year WAL category under the current rule and assigned those assets their own specific risk weights based on factors other than the WAL.

The Board received a large number of comments on the risk weights for investments. Generally, commenters disagreed with the proposed risk weights. Specifically, many commenters felt that the risk weights were not the appropriate place to address IRR and that many of the risk weights could act to limit credit unions' investments in a way that would be detrimental to the individual credit unions and the credit union industry. In addition, many commenters cited inconsistencies between the risk weights for certain investments and the risk weights for the underlying assets, arguing that this may have the unintended consequence of encouraging credit unions to obtain riskier assets with lower risk weights rather than relatively safe investments that have much higher risk weights.

Commenters who sought lower risk weights for investment varied in exactly how to lower risk weights. Some commenters argued that no investment should have a risk weight over 100 percent. Other commenters requested a reduced number of risk weight tiers, stating that it is more appropriate to have a 20 percent risk weight on investments with WALs up to five years and a risk weight of 100 percent for investments that have a WAL greater than 5 years. Commenters suggested that overall the proposed risk weight structure penalizes credit unions for investing and unfairly discriminates against longer-term investments. Several commenters also sought an ''other'' category for investments that would allow credit unions to demonstrate why certain investments do not warrant the risk weight associated with their WAL. Still other commenters asked that the Board adopt the weights for investments that are included in FDIC's interim final rule.

In addition to requesting lower overall risk weights, many of the commenters addressing this topic also requested all agency and GSE securities receive a lower risk weight. Most commenters felt that securities offered by a federal agency or GSE and overnight Fed Fund deposits should have the same zero percent risk weight that is applied to NCUA- and FDIC-issued guaranteed notes and direct, unconditional U.S. Government obligations. These commenters argued that securities offered by agencies other than NCUA and FDIC and overnight Fed Fund deposits pose little to no risk to the investing credit unions and have an implicit or, in some cases, explicit guarantee of the U.S. Government. Further, commenters contend that without a lower risk weight on agency securities and overnight Fed Fund deposits, credit unions are actually incentivized to avoid these low-risk investments in favor of investments that carry greater credit risk, but offer the potential for a higher return as both types of investments carry the same risk weight. Commenters provided the

[172] There are a few exceptions, most notably calculating WAL until the next adjustment date for variable-rate obligations.

following example to illustrate this point: A credit union can invest in a private-label, asset-backed security with a 5.5-year WAL, or a security backed by the guarantee of a GSE with the same WAL, and both investments would have carried a 150 percent risk weight.

Some commenters also asked for clarification on the risk weight for long-term CDs purchased from FDIC-insured institutions and investments in Federal Home Loan Banks.

Further, a majority of the commenters addressing this section of the proposed rule argued that risk-based capital is not the appropriate medium to address IRR. Commenters stated that NCUA's attempt to regulate IRR through the risk-based capital requirement appeared arbitrary and was inconsistent with treatment provided to banks by the Other Banking Agencies. One commenter stated that, if NCUA uses the risk-based capital requirement to regulate IRR, it should note that shocks of 300 basis points are rare and have not been seen since the early 1980's. Further, commenters stated that basing risk weights on the WAL does not take into account credit risk, the funding source for the investments, whether the investment is fixed- or variable-rate, actual maturity of the investment, optionality, or the benefit of longer-term investments—all of which, commenters argue, provide a better evaluation of the risk associated with an investment than the WAL.

Some commenters also noted that the proposed risk weights for investments would lead to inconsistent treatments among various assets. Specifically, commenters argued that the risk weights on some long-term investments that pose a low degree of risk are weighted higher than other, riskier assets. To support these arguments, commenters cited examples that included: A member business loan with a seven-year balloon would carry a lower risk weight than a seven-year bullet agency security; a current credit card loan would have a lower risk weight than a 5.5-year security guaranteed by a GSE; and an indirect auto loan with a 130 percent loan-to-value would have a lower risk weight than a 5.5-year GSE guaranteed security. Other commenters questioned why the risk weight for a mortgage-backed security is higher than the underlying 30-year mortgage that backs the security.

Several commenters questioned how the proposal affects the authority in § 701.19, which allows a federal credit union to purchase investments to fund employee benefit plans without being subject to NCUA's investment rules. Generally, commenters requested lower risk weights for investments held to fund employee benefit plans and life insurance contracts held by the credit union on its executive-level employees. Commenters contend that credit unions may be less likely to offer and fund employee benefit plans because of the risk weights. Further, one commenter stated that the proposal does not take into account the purpose of the investments and their applicability to benefit plan funding, potentially creating risks from both a fiduciary standpoint and the loyalty of executives and employees. Several commenters also requested that the Board include specific risk weights for annuities and mutual funds used to fund employee benefit programs based on the underlying accounts and investment strategies. One commenter suggested that mutual funds be weighted based on the underlying investment strategy. This commenter suggested the following breakdown: State and federal government funds—20 percent; Municipal bond strategies—50 percent; Asset-backed, mortgage-backed, and bank loan funds—100 percent; Other funds—150 percent; Bonds—WAL; Equity securities—200 percent. Another commenter stated that life insurance contracts owned by the credit union should be rated at 20 percent for AAA- and AA-rated insurers.

The Board generally agrees with commenters' concerns regarding the differences between the current risk-based requirements, the Original Proposal's investment risk weights, and the risk weights assigned by the Other Banking Agencies. As discussed in the summary part of the preamble above, the Board believes that measures of IRR should be based on a credit union's entire balance sheet to take into account the offsetting risk effects of assets and liabilities (including any benefits from derivative transactions). The Board also generally agrees with commenters that the use of asset-duration risk weights in the risk-based capital scheme is overly simplistic and does not fully take into account potential risk mitigation benefits, such as liabilities and derivatives.

The Board agrees that the approach taken in the Original Proposal should be revised. Accordingly, the Board is now proposing to change the risk weights in the investment area to more closely align them with the risk weights in the Other Banking Agencies' regulations,[173] and to handle IRR outliers through alternative approaches and possibly a separate subsequent rulemaking.

In particular, the Board is now proposing to eliminate the process of assigning risk weights for investments based on WAL of investments in favor of a credit-risk centered approach for investments. As discussed earlier in the document, the credit risk approach to assigning risk weights under this proposal is based on applying lower risk weights to safer investment types and higher risk weights to riskier investment types.[174] The proposed investment risk weights would be similar to the risk weights assigned to investments under the Other Banking Agencies' regulations,[175] which are based on the credit-risk elements of the issuer and the position of the particular type of investment. The proposed changes to the risk weights assigned to investments are outlined in the following table:

THIS PROPOSAL—RISK WEIGHTS FOR CASH AND INVESTMENTS

Item	Proposed risk weight (percent)
• The balance of cash, currency and coin, including vault, automatic teller machine, and teller cash	0
• The exposure amount 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 principal and interest only mortgage-backed STRIPS.	
○ Federal Reserve Bank stock and Central Liquidity Facility stock.	
• Insured balances due from FDIC-insured depositories or federally insured credit unions	

[173] *See, e.g.,* 12 CFR 324.32.

[174] When the Board evaluates the risk of an investment type, it is based on criteria such as volatility, historical performance of the investments, and standard market conventions.

[175] *See, e.g.,* 12 CFR 324.32.

THIS PROPOSAL—RISK WEIGHTS FOR CASH AND INVESTMENTS—Continued

Item	Proposed risk weight (percent)
• The uninsured balances due from FDIC-insured depositories, federally insured credit unions, and all balances due from privately-insured credit unions	20
• The exposure amount of:	
○ A non-subordinated obligation of the U.S. Government, its central bank, or a U.S. Government agency that is conditionally guaranteed, excluding principal and interest only mortgage-backed STRIPS.	
○ A non-subordinated obligation of a GSE other than an equity exposure or preferred stock, excluding principal and interest only GSE obligation STRIPS.	
○ Securities issued by PSEs in the United States that represent general obligation securities.	
○ Investment funds whose portfolios are permitted to hold only part 703 permissible investments that qualify for the zero or 20 percent risk categories.	
○ Federal Home Loan stock.	
• Balances due from Federal Home Loan Banks.	
• The exposure amount of:	50
○ Securities issued by PSEs in the U.S. that represent non-subordinated revenue obligation securities.	
○ Other non-subordinated, non-U.S. Government agency or non-GSE guaranteed, residential mortgage-backed securities, excluding principal and interest only STRIPS.	
• The exposure amount of:	100
○ Industrial development bonds.	
○ All stripped mortgage-backed securities (interest only and principal only STRIPS).	
○ Part 703 compliant investment funds, with the option to use the look-through approaches.	
○ Corporate debentures and commercial paper.	
○ Nonperpetual capital at corporate credit unions.	
○ General account permanent insurance.	
○ GSE equity exposure and preferred stock.	
• All other assets listed on the statement of financial condition not specifically assigned a different risk weight.	
• The exposure amount of perpetual contributed capital at corporate credit unions	150
• The exposure amount of:	300
○ Publicly traded equity investment, other than a CUSO investment.	
○ Investment funds that are not in compliance with part 703 of this Chapter, with the option to use the look-through approaches.	
○ Separate account insurance, with the option to use the look-through approaches.	
• The exposure amount of non-publicly traded equity investments, other than equity investments in CUSOs	400
• The exposure amount of any subordinated tranche of any investment, with the option to use the gross-up approach	1,250

The Board disagrees with commenters who suggested that all investments should be assigned a risk weight of 100 percent or less. Assigning a maximum of 100 percent risk weight to all investments would not sufficiently capture the risk of equity or leveraged investments, and would unjustifiably differ from the risk weights used by the Other Banking Agencies. Based on the extensive analyses performed by the Basel Committee [176] and the Other Banking Agencies in the development of their regulations, the Board believes the Other Banking Agencies' risk weights sufficiently reflect the credit risk in their respective categories. As the same type of investment will perform on a credit risk basis identically for credit unions and banks, in general, variations in this proposal from the approach taken by the Other Banking Agencies' regulations [177] are due to differences in credit union investments, the investment authorities of credit unions, or are intended to offer credit unions a simplified but equivalent approach for applying risk weights.

Another area where commenters expressed concern was with the risk weights assigned to U.S. Government agency and GSE securities under the Original Proposal. The Board believes it has addressed these concerns in this second proposed rule by removing the IRR component from the risk weights for investments. The Board also believes this concern would be addressed for these and other investment types by assigning risk weights on long-term assets only based on the credit risk, and not IRR. For example, an 11-year WAL non-subordinated mortgage-backed security issued by a GSE would have been assigned a 200 percent risk weight under the Original Proposal, while a 2-year WAL of the same security type would have been assigned a 50 percent risk weight. Conversely, under this second proposed rule, both securities would be assigned a 20 percent risk weight, which is based only on the credit risk of the investment type.

The Board has also assigned risk weights to types of investments, such as corporate bonds, asset-backed securities and corporate equities, which are generally not available to federal credit unions. These risk weights were assigned to account for the fact that federally insured state chartered credit unions sometimes have investment authorities that allow then to invest in assets not available to FCUs. In addition, § 701.19 permits federal credit unions to purchase investments to fund employee benefits that are not otherwise available to federal credit unions under NCUA's investment regulations. For these types of assets, the Board has assigned risk weights that it believes reflect the risk of the assets that could be used to fund employee benefit plans.

The Board disagrees with commenters who suggested lower risk ratings should be applied to such assets because they were purchased for employee benefit plans. However, the Board does seek comment on whether lower risk weights should be applied to investments that fund employee benefit plans in which all of the risk of loss is held by the

[176] Basel Committee on Banking Supervision, ''International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version'' 214 (June 2006) *available at http://www.bis.org/publ/bcbs128.pdf* (*Basel II*) and Basel Committee on Banking Supervision, ''An Explanatory Note on the Basel II IRB Risk Weight Functions'' (July 2005).

[177] *See, e.g.,* 12 CFR 324.32.

beneficiary. For example, how should NCUA assign a risk weight to an equity investment on a credit union's statement of financial condition that represents a holding in a credit union executive's 457(b) plan?

The Board chose not to assign risk weights based on credit ratings, as at least one commenter requested. Consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which required agencies to remove all references to credit ratings, NCUA does not use credit ratings to determine risk weights for part 702.[178]

Loans generally. NCUA received a substantial number of comments regarding the risk weights assigned to loans in general. A number of commenters stated that the proposed risk weights for various types of loans were overly broad, arbitrary, punitive, and did not take into account the individual underwriting terms, pricing and risk management of individual credit unions. Other commenters suggested that the proposed risk weights for loans failed to consider loan-to-value ratios, fixed- versus variable-rate loans, repricing opportunities, maturity length, and other risk mitigation strategies. Still other commenters stated that the quality of the loan portfolio is the most determinant of risk to capital. A number of commenters stated that all loans are not the same like the rule is treating them. Other commenters objected to laddering quantitative risk-based metrics for loans because doing so ignores credit union's strategic and business plans, taking growth management away from the board of directors.

However, the Board cannot uniformly use these criteria to measure minimum capital requirements for credit unions because of the indeterminate reporting that would be necessary and the myriad of variables available to establish a sound lending program. This second proposed rule is consistent with the regulatory capital models under the Basel framework, which are portfolio invariant.[179] Being ''portfolio invariant'' means that the capital charge for a particular loan category is consistent among all credit union portfolios based on the loan characteristics, rather than the individual credit union's portfolio performance or characteristics. Taking into account each credit union's individual characteristics would be too complicated for both credit unions and NCUA for minimum regulatory capital requirements.

A number of commenters stated that assigning risk weights to loans based on the risk of the underlying loans makes more sense than on the size of the portfolio. Other commenters suggested that if IRR is included in investment risk weights, it should also be included in loan risk weights.

As noted in the summary section, the Board believes the revised loan concentration risk thresholds and corresponding risk weights under this proposal would address only credit risk exposures, and to a limited extent concentration risk exposures. While certain loans contain a substantial amount of IRR, the Board does plan to consider alternative approaches to address IRR separately from this rulemaking.

Several commenters suggested that the Board remove the higher-risk components for delinquent loans because the ALLL balance is already factored into the formula. Conversely, other commenters stated that they appreciated that the Original Proposal assigned delinquent and non-delinquent loans different risk weights.

At least one commenter suggested that troubled debt restructuring loans be risk-weighted at 50 percent.

This proposal would maintain a separate, higher risk weight for loans that are not current, but would also, as discussed in detail above, eliminate the 1.25 percent cap on the ALLL in the risk-based capital ratio numerator. The Board believes the proposed higher risk weight that would be assigned to non-current loans is warranted because such loans have a higher probability of default when compared to current loans. Non-current loans are more likely to default because repayment is already impaired making them one step closer to default compared to current loans. Additionally, a higher risk weight for non-current loans is consistent with the risk weights assigned by the Other Banking Agencies.[180]

A small number of commenters suggested that share-secured loans should have a risk weight between zero and 25 percent since they are fully secured. Also, some commenters noted that secured consumer loans generally pose less risk than unsecured consumer loans. The Board generally agrees that share-secured loans pose less risk to credit unions than other types of secured loans. Accordingly, under this second proposal share-secured loans would be assigned a 20 percent risk weight. The board does not believe a risk weight of zero percent is warranted because of the small amount of operational and transaction risk present in share-secured loans. A risk weight of 20 percent for share-secured loans is proposed because it recognizes the low amount of risk and is consistent with the 20 percent risk weight for contractual compensating balances on commercial loans that are also secured by shares on deposit.

The Board also agrees unsecured consumer loans generally pose more risk than secured consumer loans, and is therefore proposing to assign a lower risk weight of 75 percent to secured consumer loans and a higher risk weight of 100 percent to unsecured consumer loans. The 100 percent risk weight for unsecured consumer loans would be comparable to the Other Banking Agencies' risk weight for consumer loans.[181] Because secured consumer loans pose less risk to a credit union than unsecured consumer loans, the Board is proposing to assign secured consumer loans a lower risk weight of 75 percent compared to the 100 percent risk weight for unsecured consumer loans.

A small number of commenters suggested that loans held for sale should have a 25 percent risk weight. Other commenters suggested that loans held for sale should have a 50 percent risk weight.

After considering the comments received, the Board continues to believe that loans held for sale carry identical risks to the originating credit union as other loans held in the credit union's portfolio until transfer to the purchaser is final. Until the originating credit union transfers the loan to the purchaser, the originating credit union bears the risk of the loan defaulting. If the loan defaults prior to the finalization of the transfer, the originating credit union must account for any loss from the defaulting loan, similar to other loans held on the credit union's books. Because they carry the same risks, loans held for sale would be assigned a risk weight based on the loan's type.

Commercial Loans. The Original Proposal would have increased the risk weights for member business loans (MBLs) from the current rule to address the historical correlation between high concentrations of MBLs and higher risk to the credit union. As noted in the

[178] Public Law 111–203, Title IX, Subtitle C, section 939A, 124 Stat. 1376, 1887 (July 21, 2010).

[179] Basel Committee on Banking and Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions,* July 2005, *available at http://www.bis.org/bcbs/irbriskweight.htm.* ''The model should be portfolio invariant, *i.e.* the capital required for any given loan should only depend on the risk of that loan and must not depend on the portfolio it is added to. This characteristic has been deemed vital in order to make the new IRB framework applicable to a wider range of countries and institutions.''

[180] *See, e.g.,* 12 CFR 324.32(k).

[181] *See, e.g.,* 12 CFR 324.32(l)(5).

Original Proposal, many of the largest losses the NCUSIF has experienced over its history have occurred in credit unions with high concentrations of MBLs.[182] In addition, the failures of many small banks between 2008 and 2011 were largely driven by high concentrations of commercial loans.[183]

For purposes of the Original Proposal, ''member business loans outstanding'' would have consisted of loans outstanding that qualified as MBLs under NCUA's definition,[184] or under a state's NCUA-approved definition.[185] If a loan qualified as a MBL when it is originated, it would have remained so until it had been repaid in full, sold, or otherwise disposed of.

Consistent with the current rule, the Original Proposal would have applied risk weights to MBLs as a percentage of total assets. As a credit union's concentration in particular asset classes increased, incrementally higher levels of capital would have been required.[186] The following table shows a comparison of the current rule and the Original Proposal:

COMPARISON—MBL COMPONENTS OF THE CURRENT RULE AND ORIGINAL PROPOSAL

Total MBLs	Current rule MBL risk weights[187]— (converted for 8% adequately capitalized level)	Original proposal MBL risk weights
0 to 15% of Assets	75%	100%[188]
>15 to 25% of Assets	100%	150%
Amount over 25%	175%	200%

Under the Original Proposal, MBLs that were at least 75 percent guaranteed by the federal government, typically by the Small Business Administration (SBA) or U.S. Department of Agriculture, would have received a risk weight of 20 percent regardless of the percent of the credit union assets they represented.[189]

A substantial number of commenters addressed MBLs and generally disagreed with the proposed risk weights in the Original Proposal, noting that the risk weight assigned to commercial loans under the Other Banking Agencies' capital regulations would have been lower for such loans when held in higher concentrations.

There were, however, a few commenters that agreed that higher risk weights should be applied to MBLs held in higher concentrations.

Many commenters objected to the Board's methodology for assigning risk weights to MBLs based on concentration. Other commenters disagreed with NCUA's methodology of assigning risk weights based on concentrations of MBLs compared to total assets. These commenters argued that risk weights based on concentration levels do not take into account all pertinent information to accurately determine risk. Some commenters believed that risk weights should be assigned based on the type of loan, specifically separating loans by business purpose (commercial, agricultural, or construction and development). Some of these commenters suggested the Board should address concentration risk through supervision rather than through a rulemaking.

Some commenters questioned the interplay between exemptions from the statutory cap on MBLs and higher risk weights for credit unions that exceed the cap. These commenters pointed out that many credit unions have been given an exemption from the statutory MBL concentration limit. Some of these commenters stated that the proposed risk weights would nullify the exemptions included in the Federal Credit Union Act and may lead some credit unions to discontinue business lending, particularly in the area of agriculture. To that end, commenters requested a variety of solutions. Some commenters believed credit unions exempt from the statutory MBL cap should be given more time to comply with the MBL risk weights, while other commenters argued there should be a separate set of risk weights for exempt credit unions. Finally, some commenters requested that the Board allow credit unions exempt from the statutory MBL cap to continue following the risk weights in the current rule.

Higher capital requirements for concentrations of MBLs exist in the current rule and the Board believes 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.

NCUA does currently review credit concentrations during examinations as commenters recommended. However, as discussed in the summary section, the

[182] GAO found in its 2012 report that credit unions who failed had more MBLs as a percentage of total assets than peers and the industry average. *See.* U.S. Govt. 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.*

[183] U.S. Government 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.*

[184] *See* 12 CFR 723.1.

[185] *See* 12 CFR 723.20.

[186] Under the current rule, the Original Proposal and this second proposal, concentration risk is accounted for in commercial and real estate loans because historically this is where credit unions have experienced concentration risk problems.

[187] The current MBL risk weights were converted to a comparable risk weight by dividing the current risk weight by eight percent, with eight 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 six percent risk weight, which is equivalent to a 75 percent risk weight under this proposal (six percent divided by eight percent). The next threshold in the current regulation for total MBLs from 15 percent to 25 percent of assets received an eight percent risk weight, which is equivalent to a 100 percent risk weight under this proposal (eight percent divided by eight percent) and the highest concentrations of MBLs received a 14 percent risk weight, which is equivalent to a 175 percent risk weight under the proposal (14 percent divided by eight percent).

[188] This is consistent with the Other Banking 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 weigh for loans defined as high-volatility commercial real estate (HVCRE). *See, e.g.,* 78 FR 55339 (Sept. 10, 2013).

[189] Under the current rule the entire balance of MBLs outstanding, including any amount partially guaranteed by a U.S. Government agency, is included in the risk weight for MBLs (*i.e.,* the equivalent risk-weight under the current rule for an MBL that is 75 percent government guaranteed is the same as the risk weight for any other MBL. Thus, this proposed rule would be more favorable because it would assign a low risk weight of 20% to the portion of the commercial loan with a U.S. Government guarantee. This is in addition to the lower risk weight that would be assigned to non-owner occupied one-to-four-family residential real estate loans that would not be risk-weighted as commercial loans under this proposal.

FCUA requires that NCUA's risk-based net worth requirement account for material risks that the six percent net worth ratio may not provide adequate protection, which would include credit concentration risks.[190]

Basel II states, ''risk concentrations are arguably the single most important cause of major problems in banks.'' [191] In addition, GAO specifically recommended that the Board continue to address concentration risk in the risk-based capital requirement. GAO found in its 2012 report that credit unions that failed had more MBLs as a percentage of total assets than peers and the industry average.[192] GAO advised the Board to revise NCUA's PCA requirements to take into account credit unions with a high percentage of MBLs to total assets. In addition, NCUA's OIG recommended in MLRs that the Board increase the risk weights assigned to MBLs, citing numerous and excessive NCUSIF losses related to MBLs, including a number of large credit unions with high concentrations of MBLs.[193]

However, after consideration of the comments, the Board is proposing to modify the approach to MBLs taken in the Original Proposal assigning risk weights to ''commercial loans'' rather than ''MBLs.'' Under this second proposal the risk weights assigned to commercial loans would generally be consistent with those assigned by Other Banking Agencies and with the objectives of the Basel Committee on Banking Supervision.[194] This proposal reduces the number of commercial loan concentration thresholds from two to one, with a single concentration threshold at 50 percent of total assets. Applicable commercial loans less than the 50 percent threshold would be assigned a 100 percent risk weight, and commercial loans over the threshold would be assigned a 150 percent risk weight. Commercial loans that are not current would be assigned a 150 percent risk weight. This change to a single, higher concentration risk threshold would simplify the risk weight framework and calibrate it to only pick up outliers. The concentration threshold for commercial loans is well over two standard deviations from the mean. Based on December 2013 Call Report data, all but 12 credit unions with total assets of $100 million or greater operate at a level in which the risk weights assigned to commercial loans would be similar to the risk weight assigned by the Other Banking Agencies.[195]

Further, 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 rule, for high concentrations of commercial loans. This creates parity to the Other Banking Agencies' rules[196] for virtually all credit unions, and allows credit unions exempt from the MBL cap (with very high concentration levels) to continue to operate under effectively the same capital requirements of the current rule. Further, none of the credit unions that would be subject to the concentration threshold have material variations in the type of their MBLs. So such an approach would add significant complexity to the rule with no benefit.

	Commercial loan concentration (percent of total assets)				
	15%	20%	50%	75%	100%
Effective Capital Rate:[197]					
Current Rule	6.0%	6.5%	10.4%	11.6%	12.2%
This Proposal	10.0%	10.0%	10.0%	11.7%	12.5%

The Board also disagrees that concentration thresholds for commercial loans should vary based on the business purpose or underlying collateral. Utilizing specific commercial loan type or collateral loss history is not a reliable or consistent method for assigning risk weights in a regulatory model. Nor is it consistent with the Basel framework or the Other Banking Agencies' capital models. All commercial asset classes experience performance fluctuations with variations in business cycles. Some sectors that have experienced minimal losses are now pre-disposed to heightened credit risk. Both NCUA and FDIC have recently addressed these types of exposures in respective Letters to Credit Unions and Financial Institution Letters.[198]

A large number of commenters addressing MBLs argued that the risk weights for credit unions should be lower than the risk weights employed by FDIC for banks. Commenters noted that the proposed risk weight of 100 percent for total MBLs of zero to 15 percent of total assets was the same as the risk weight for commercial loans under FDIC's interim final regulation. Commenters argued, however, that credit unions have historically had a lower loss rate on MBLs than community banks had for commercial loans. These commenters argued that since credit unions have a lower historical loss rate than banks, the risk weights assigned to MBLs should also be lower. Other commenters noted that NCUA's MBL regulation is more conservative than commercial lending regulations for banks, and, therefore, at a minimum the Board should adopt a 100 percent risk weight, regardless of concentration, to mirror the commercial loan risk weights for banks.

The Board does not believe the contemporary variances between bank and credit union losses on commercial loans are substantial enough to warrant assigning lower risk weights to

[190] *See* 12 U.S.C. 1790d(d)(2).

[191] International Convergence of Capital Measurement and Capital Standards—June 2006. Basel Committee on Banking Supervision.

[192] *See* U.S. Govt. Accountability Office, GAO–12–247, *Earlier Actions Are Needed to Better Address Troubled Credit Unions* (Jan. 2012) *available at http://www.gao.gov/products/GAO–12–247.*

[193] *OIG Capping Report on Material Loss Reviews,* Report # OIG–10–20, November 23, 2010. Also see *Material Loss Review of Telesis Community Credit Union,* Report # OIG–13–05, March 15, 2013.

[194] This is comparable 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). Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards,* June 2006, ''In 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, 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.*

[195] *See, e.g.,* 12 CFR 324.32(f).

[196] *Id.*

[197] The effective capital rate represents the blended percentage of capital necessary for a given level of commercial loan concentration. For this proposal's figures, the calculation uses 10% as the level of risk-based capital to be well capitalized under this proposal.

[198] NCUA Letter to Credit Unions, 14–CU–06, *Taxi Medallion Lending,* April 2014. Financial Institution Letter, *Prudent Management of Agricultural Credits Through Economic Cycles,* FIL–39–2014, July 16, 2014.

commercial loans held by credit unions. Credit unions' commercial loan loss experience is comparable to community banks after adjusting for asset size. The recent loss experience for credit unions and banks is very similar.

	3 Year average loss history	
	Credit unions >$100M in assets	Banks $100M to $10B in assets
Commercial & Industrial	0.75	0.78

Further, credit unions' long-term historical MBL losses are somewhat understated because the NCUA's Call Report did not collect separate MBL data until 1992. Thus, significant MBL losses experienced in the late 1980s and early 1990s are not included in the long-term historical credit union MBL loss data.[199]

Some commenters also questioned the disparity between NCUA's treatment of unfunded commitments and the treatment in Basel III. For this second proposal, the Board has adjusted the treatment for unfunded MBL commitments to be more comparable to the Other Banking Agencies' rules.[200]

Under this proposal, the definition of ''commercial loans,'' as discussed in the definition section of this preamble, would: (1) include all commercial purpose loans regardless of dollar amount; (2) exclude one-to-four-family non-owner occupied first-lien real estate loans, which would be considered residential real estate loans for the purpose of assigning risk weights in this proposal; (3) exclude any loans secured by a vehicle generally manufactured for personal use; (4) assign to the portion of a commercial loan that is insured or guaranteed by the U.S. Government, U.S. Government agency, or a public sector entity a lower risk weight of 20 percent and not count such loans toward the 50 percent of assets concentration threshold; and (5) assign to any amount of a contractual compensating balance associated with a commercial loan and on deposit in the credit union a 20 percent risk weight and not count such amounts toward the 50 percent of assets concentration threshold. The revised definition of commercial loan would better capture the loans made for a commercial purpose that have similar risk characteristics. The portion of a commercial loan that is insured or guaranteed by the U.S. Government, U.S. Government agency, or a public sector entity would be assigned a lower risk weight of 20 percent and would not count toward the 50 percent of asset threshold. This provision is comparable to the Other Banking Agencies.[201] 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 since the credit union has the ability to apply the compensating balance against the amount owed, lowering the potential loss exposure. This provision would be unique to credit unions but appropriately reduces the risk weight due to the existence of the compensating balances. The Board believes these changes would encourage the use of government guarantees and compensating balances and provide credit unions with additional methods to serve commercial borrowers while reducing their minimum capital requirement without increasing risk to the NCUSIF for commercial loan losses.

Residential real estate loans. The current standard approach to assigning risk weights in part 702 of NCUA's regulations establishes higher capital requirements for only ''long term'' real estate loans, and excludes 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, as a result, the current rule does not adequately account for credit unions that have high real estate loan concentrations.

Additionally, junior-lien real estate loans, which have a significantly higher loss history, are assigned the same risk weight as first-lien mortgage real estate loans under the current rule. As a result, the current real estate loan risk weights incentivize credit unions to structure their mortgage products to minimize their capital requirements, which can impact the marketability of such loans. As discussed in more detail below, the Original Proposal would have made a number of changes to the current rule to address these concerns.

Consistent with the current rule, the Original Proposal would have continued to exclude from the real estate risk weights those real estate loans reported as MBLs. The Original Proposal would have recognized 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.[202] To account for concentration risk, the proposal would have raised the risk weight for first-lien real estate 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 have been assigned a 100 percent risk weight. The threshold of 25 percent was based on the average percentage of first-lien real estate loans to total assets, which, as of June 30, 2013, was 24.9 percent for complex credit unions, as defined under the current rule.

Under the Original Proposal, if a credit union held the first- and junior-liens on a property, and no other party held an intervening lien, the credit union could have treated the combined exposure as a single loan secured by a first lien for the purpose of assigning the risk weight. First-lien real estate loans assigned to the 50 percent risk weight category could not have been restructured or modified loans. First-lien real estate loans modified or restructured on a permanent or trial basis solely under the U.S. Treasury's Home Affordability Mortgage Program (HAMP) would not have been considered restructured or modified.

First-lien real estate loans guaranteed by the federal government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) generally would have been risk-weighted at 20 percent. While a U.S. Government guarantee against default mitigates credit risk, normally the loans

[199] NCUSIF losses from MBLs 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 NCUSIF over $100 million. Department of the Treasury, *Credit Union Member Business Lending* (Washington DC January 2001).

[200] *See, e.g.,* 12 CFR 324.33.

[201] *See,* 12 U.S.C. 324.32(a).

[202] This is comparable with the Other Banking 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).

are not fully guaranteed and routinely subject the credit union to meeting loan underwriting and servicing requirements.

Under the Original Proposal, real estate-secured loans that did not meet the definition of a ''first mortgage real estate loan'' would have been defined 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 have been included in the category of other real estate loans for the purpose of assigning the risk weight. Other real estate loans would have been 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, and other real estate loans over 20 percent of assets would have been risk-weighted at 150 percent.

The threshold of 10 percent was based on the average percentage of other real estate loans to total assets, which, as of June 30, 2013, was 6.85 percent for complex credit unions.

Under the Original Proposal, the aggregate minimum capital requirement for first- and junior-lien real estate loans would have been slightly less than the current minimum requirement.[203] The originally proposed risk weights for real estate loans, however, would have resulted in a higher variance in the minimum capital requirement for individual affected credit unions because the risk weights better differentiated between the risks associated with lien position and concentration.

NCUA received a significant number of comments on the proposed risk weights for real estate loans. Most commenters generally disagreed with the proposed risk weights, stating that they were too high. Commenters suggested that, given lower historical loss rates on residential mortgage loans at credit unions compared to community banks and the fact that credit unions with higher concentrations of these loans tend to experience lower loss rates than their peers, the risk weights and concentration thresholds for real estate loans should be far lower than the Original Proposal indicated and lower than what banks must meet. Commenters generally acknowledged that the proposed 50 percent risk weight (*i.e.,* excluding the higher weights for concentration risk) for first mortgage loans was equal to the bank risk weight, but argued that credit union losses on these loans historically have been lower than community bank loss totals. One commenter claimed that credit unions' losses on first mortgage loans were in fact equal to 60 percent of community bank loss totals over the long term, since the start of the Great Recession, and at peak value losses. Based on this historical performance, the commenter suggested that if the appropriate bank risk weights for residential first mortgages is indeed 50 percent, the history-based risk weights for credit unions ought to be closer to 30 percent (*i.e.,* 60 percent of 50 percent).

The Board does not believe the contemporary variances between bank and credit union losses on real estate loans are substantial enough to warrant assigning lower risk weights. Based on the credit union Call Reports and FDIC Quarterly Banking reports for the years ended December 31, 2011, 2012, and 2013, credit union real estate loan loss experience is comparable to community banks. Credit unions with over $100 million in assets have an average overall real estate loan loss ratio of 0.58 percent over the past three years. Banks with assets up to $10 billion have an average real estate loan loss ratio of 0.65 percent over the same time period. Credit union first mortgage loan losses average 0.34 percent over the last three years compared to 0.49 percent for banks. Credit union home equity loan losses average 0.96 percent over the last three years compared to 0.73 percent for banks.

Another commenter suggested that NCUA's tiered risk weight approach for real estate-secured loans for both the current risk-based net worth ratio framework and the proposed risk-based capital ratio framework is arbitrary and unsupported by the administrative record, and that NCUA has not offered specific analyses or other evidence to support either framework's implied assumption that there is a correlative relationship between the size of a credit union's portfolio of real estate secured loans and the risk that portfolio presents to the NCUSIF.

Other commenters believed the proposed risk weights would discriminate against homeownership because home loans bring a positive reputation value that the rule cannot factor, and that any additional capital requirement for providing home loans to the common family is destructive. Commenters also suggested that the proposed risk weights would limit credit unions' ability to help low-income members and members with troubled real estate and impact credit unions' ability to provide members with a low cost source of funds for financing their primary residence by discouraging credit unions from making real estate loans over 25 percent or 35 percent of their total assets.

A small number of commenters suggested that the rule allow some type of waiver when it is apparent that a credit union can make sound real estate loans. Another commenter suggested that the rule exclude some parts of a credit union's first-lien mortgage portfolio.

Some commenters suggested that although significant losses did occur during the recent economic downturn, first-lien residential mortgage loans have historically been a low credit risk and an important part of credit unions' presence and mission in their communities. One commenter stated that major progress has been made in underwriting first mortgage loans following the recent recession, that high-risk mortgage products are no longer common, and the CFPB and Dodd-Frank Act regulations have eliminated the likelihood of a repeat of the circumstances that caused extensive losses for first-lien residential mortgage loans during the recession. Therefore, the commenters suggested the Board should eliminate the higher risk weights for a concentration of first-lien residential mortgage loans.

A small number of commenters acknowledged that there is a great deal of differentiation across mortgage products that make it difficult to determine the best framework to identify those higher-risk mortgages without imposing an untenable reporting requirement. Given the delicate balance between regulatory burden and meaningful reporting, many commenters suggested the Board should maintain the proposed definition for non-delinquent first mortgage real estate loans and risk weight them all at 50 percent, regardless of concentration level. Commenters argued that such a change would provide parity with the banking system and obviate the need for more onerous reporting. Commenters argued the Board should adopt a similar approach for other real estate-secured loans by eliminating the concentration thresholds and, consistent with the Other Banking Agencies' rules, risk-weight them all at 100 percent.

[203] Credit unions predominantly offering first lien real estate loans would have had lower capital requirements than the current rule. Credit unions predominantly offering junior-lien real estate loans would have had higher capital requirements than the current rule. Analysis of December 31, 2013, Call Report data indicates that the originally proposed risk weights produce an aggregate minimum capital requirement, at the well capitalized level, of 97 percent of the current minimum risk-based net worth ratio required for real estate loans when applied to affected credit unions.

A number of other commenters suggested various specific risk weight schemes for real estate loans, but did not explain why their suggested risk weights would more accurately account for risk than those originally proposed by the Board.

Higher capital requirements for concentrations of real estate loans exists in the current rule, and the Board believes 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 because a significant portion of their assets are focused in one industry.

NCUA does currently review credit concentrations during examinations as commenters recommended. However, as discussed in the summary section, the FCUA requires that NCUA's risk-based capital requirement account for material risks that the 6 percent net worth ratio may not provide adequate protection, including credit and concentration risks.[204]

Credit concentration risk can be a material risk under certain circumstances. The Board generally agrees that CFPB's new ability-to-repay regulations should improve credit quality. However, the extent to which this will alter loss experience rates remains to be seen.

NCUA has also been advised by its OIG and GAO to address real estate credit concentration risk. NCUA's OIG completed several MLRs where failed credit unions had large real estate loan concentrations. The NCUSIF 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, home equity lines of credit, or both.[205] In addition, in 2012 GAO recommended that NCUA address the credit concentration risk concerns the NCUA OIG raised.[206] 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 indicated that the Board should revise PCA so that minimum net worth levels emphasize credit concentration risk. Accordingly, the Board believes eliminating the concentration dimension for risk weights entirely would be inconsistent with the concerns raised on concentration risk by GAO and the MLRs conducted by NCUA's OIG.

However, after consideration of the comments, the Board proposes to modify the real estate loan risk weights presented in the Original Proposal. Under this second proposal the risk weights assigned to residential real estate loans would generally be consistent with those assigned by Other Banking Agencies.[207] This proposal would reduce the number of first- and junior-lien residential real estate loan concentration thresholds from two to one, with single concentration thresholds at 35 percent and 20 percent of total assets respectively.

RESIDENTIAL REAL ESTATE LOANS CONCENTRATION THRESHOLDS

	50%	75%	100%	150%
First-Lien	Current <35% of Assets	Current ≥35% of Assets.		
Junior-Lien			Current <20% of Assets	Current ≥20% of Assets

First- and junior-lien residential real estate loans that are not current would be assigned 100 percent and 150 percent risk weights respectively. This change to a single, higher concentration risk threshold would simplify the risk weight framework and calibrate it to only pick up outliers. The concentration thresholds are roughly two standard deviations from the mean for both first and junior-liens. This means that roughly 90 percent of credit unions with more than $100 million in assets operate at levels below the concentration thresholds proposed for residential real estate loans, and only two credit unions operate above both thresholds (based on December 2013 Call Report data). Thus, most credit unions would operate at a level in which the risk weights assigned to residential real estate loans would be the same as the risk weights of the Other Banking Agencies.[208]

The Board believes the single higher concentration threshold would simplify the risk weight framework and better calibrate it to apply only to credit unions with outlying levels of concentration risk. The revised approach taken in this second proposal would be more comparable with the approaches taken by the Other Banking Agencies' rules [209] and Basel III, while also maintaining higher minimum capital requirements for large concentrations of real estate loans as recommended by GAO and OIG. The Board believes the proposed risk weights would also be consistent with credit union loss history and recent NCUSIF losses reviewed by OIG.

The Board does not agree that the proposed risk weights would slow residential real estate loan origination, stifle homeownership, or limit credit unions' ability to assist low-income members because the revised risk weights provide credit unions with continued flexibility to assist members in a sustainable manner while maintaining sufficient minimum capital.

Commenters stated that credit unions should not be penalized for having high-quality, performing first mortgage loan portfolios, suggesting that risk weights should be lowered on first mortgage real estate portfolios that demonstrate strong performance through lower charge-off ratios. Numerous commenters suggested that the risk weights should take underwriting into account that offsets the risk of these loans (*e.g.,* a portfolio made up of borrowers with high credit scores is less risky than one that is made of low-credit-score borrowers).

A small number of commenters suggested the mortgage risk weights could be better balanced by providing credit unions with some type of earned credit based on managed risk performance.

Another commenter suggested that low-income credit unions that are Community Development Financial Institutions have loan portfolios that are primarily made up of non-prime and sub-prime loans, which have a greater propensity for delinquency. The commenter suggested that such institutions should not be penalized for

[204] *See* 12 U.S.C. 1790d(d)(2).

[205] See OIG–10–03, Material Loss Review of Cal State 9 Credit Union (April 14, 2010), OIG–11–07, Material Loss Review OF Beehive Credit Union (July 7, 2011), OIG–10–15, Material Loss Review OF Ensign Federal Credit Union, (September 23, 2010), *available at http://www.ncua.gov/about/Leadership/CO/OIG/Pages/MaterialLossReviews.aspx*

[206] See U.S. Govt. Accountability Office, GAO–12–247, Earlier Actions are Needed to Better Address Troubled Credit Unions (2012), *available at http://www.gao.gov/products/GAO–12–247.*

[207] *See, e.g.,* 12 CFR 324.32(g).

[208] *See, e.g.,* 12 CFR 324.32(g).

[209] *Id.*

serving historically disenfranchised and marginalized populations.

The Board agrees with commenters that credit scores, loan underwriting, portfolio seasoning, and portfolio performance are good measures to evaluate a residential real estate lending program. However, broadly applicable regulatory capital models are portfolio invariant. This means the capital charge for a particular loan category is consistent among all credit union portfolios based on the loan characteristics, rather than the individual credit union's portfolio performance or characteristics. Taking into account each credit union's individual characteristics would be too complicated for many credit unions and NCUA for minimum capital requirements.[210] Further, such an approach would not be comparable to the risk weight framework used by the other banking agencies.

NCUA will continue to take into account loan underwriting practices, portfolio performance and loan seasoning as part of the examination and supervision process. This method of review is consistent with the Basel three-pillar framework: minimum capital requirements, supervisory review, and market discipline.[211] Credit unions should use criteria from their own internal risk models and loan underwriting in developing their internal risk management systems.

The Board also agrees LTV ratios are an informative measure to assess risk. However, it is not a practical measure to assess minimum capital requirements because of volatility in values and the corresponding reporting burden for credit unions tracking LTVs and keeping them current. There also is no historical data across institutions upon which to base varying risk weights according to LTVs and other underwriting criteria (like credit scores). Examiners take LTVs into consideration during the examination process. Supervisory experience has demonstrated LTV verification requires on-site review and application of credit analytics to validate the most current information. On-site review also minimizes reporting requirements on credit unions.

Commenters questioned why real estate loans were risk-weighted differently than GSE and other mortgage-backed securities. Under the Original Proposal, a 30-year first mortgage loan would have been assigned a 50 percent risk weight while a federal agency mortgage-backed security that has an average life of six years would have been assigned a 150 percent risk weight. Numerous commenters remarked that the differences between these two risk weights seemed inappropriate because the two assets have similar interest-rate risk, and that the security has less credit risk and is more marketable. Commenters stated that one way credit unions can lower the risk of holding first mortgage loans on their balance sheets is to securitize them, making them more readily available to serve as collateral to borrow against or to sell as a security. Commenters also suggested that the higher risk weight that would apply to securitized mortgages would discourage credit unions from using this strategy.

The Board agrees with the commenters' concerns regarding consistency of risk weights across assets classes. As noted above, by removing consideration of IRR from the risk weights for purposes of this second proposal, analogous risk across loans and investments would be more consistently risk-weighted.

Commenters suggested that the rule should distinguish between variable-rate first mortgage loans and fixed-rate first mortgage loans, with lower risk weights associated with the variable-rate loans and shorter-term fixed-rate loans in order to capture the lower IRR associated with such loans as compared to 30-year fixed-rate first mortgage loans. Other commenters suggested that the capital requirement for adjustable-rate mortgages and shorter-maturity fixed-rate mortgage loans should be lowered to take into consideration the reduced risk associated with these adjustable and shorter-term mortgage loan products. Commenters also suggested that the IRR may in fact be lower for junior-lien loans because many are home equity lines of credit with variable rates. The Board notes, as discussed above, removal of consideration of IRR from the risk weights for purposes of this second proposal resolves these commenters' concerns.

Commenters questioned the risk weight for junior-lien mortgage loans, suggesting such loans represent no more risk than first mortgage loans if underwritten at appropriate loan-to-value ratios. Some of these commenters stated that many credit unions have established loan-to-value and combined loan-to-value limits for junior-lien real estate loans of 75–80 percent (or less) as a means of managing risk. Commenters suggested that consideration should also be given to the equity position and not just the lien position when setting risk weights.

A small number of commenters stated that no clear explanation or rationale was offered for why junior-lien mortgage loans have higher risk weights than first mortgage loans.

Conversely, other commenters stated that while they have many concerns about the risk weights, they agree that the proposed risk weights for home equity/second mortgages seem appropriate based on losses at comparable banks and credit unions.

The Board continues to believe junior-lien residential real estate loans warrant a higher risk weight based on loss history. Call Report data indicates credit unions over $100 million in asset size reported three times the rate of loan losses (0.96 percent) on other real estate loans[212] when compared to first mortgage real estate loans (0.34 percent) during the past three years. In addition, the base risk weight for junior-lien residential real estate loans in this proposal is comparable to the Other Banking Agencies.[213]

After carefully considering the comments, the Board is now proposing to modify the definitions and risk weights for loans secured by residential real estate. Three substantive changes are discussed in more detail below.

First, one-to-four family non-owner-occupied residential real estate loans would now be included in the definition of either first- or junior-lien residential real estate loan.[214] The Board believes this change is consistent with the credit risk inherent in these loans and corresponding risk weights assigned by the Other Banking Agencies.[215]

Second, for a loan to be included in the definition of a first-lien residential

[210] Basel Committee on Banking and Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions,* July 2005, *available at http://www.bis.org/bcbs/irbriskweight.htm:* ''The model should be portfolio invariant, *i.e.* the capital required for any given loan should only depend on the risk of that loan and must not depend on the portfolio it is added to. This characteristic has been deemed vital in order to make the new IRB framework applicable to a wider range of countries and institutions.''

[211] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards,* June 2006, *available at http://www.bis.org/publ/bcbs128.htm.* ''The Committee notes that, in their comments on the proposals, banks and other interested parties have welcomed the concept and rationale of the three pillars (minimum capital requirements, supervisory review, and market discipline) approach on which the revised Framework is based.''

[212] Junior-lien real estate loans are currently reported on the Call Report as part of ''other real estate loans.''

[213] *See, e.g.,* 12 CFR 324.32(g)(2).

[214] Under the Original Proposal, one-to-four-family non-owner occupied residential real estate loans greater than $50,000 would have been defined as member business loans.

[215] *See, e.g.,* 12 CFR 324.32(g).

real estate loan, a reasonable and good faith determination must have been made to determine that the borrower had the ability to repay the loan according to its terms. The Board believes this change is consistent with existing legal requirements for residential real estate secured loans and prudential underwriting expectations in the Other Banking Agencies' risk weight definitions, and would provide some standard of quality to justify residential real estate loans receiving a lower risk weight. Under this second proposal a credit union would not be required to underwrite ''qualified mortgages'' to receive a lower risk weight. However, a first-lien residential real estate loan would receive the proposed 50 percent risk weight only if the credit union underwrites them in accordance with CFPB's ability-to-repay requirements under § 1026.43 of this title.[216]

Finally, this second proposal would provide a risk weight of 20 percent for the portion of real estate loans with a government guarantee and exclude this amount from the calculation of the concentration threshold. The Board believes this change would better reflect the risk and encourage credit unions to take advantage of available programs designed to reduce their risk of loss.

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.[217] For most current consumer loans, the Original Proposal would have assigned a risk weight of 75 percent.[218] Non-federally guaranteed student loans, which contain higher risks (*e.g.,* default risk and extension risk), would have been risk-weighted at 100 percent under the Original Proposal. Federally guaranteed student loans would have received a zero percent risk weight.[219]

The Board received a number of comments regarding the risk weights for consumer loans. A number of commenters recommended the Board lower the risk weights for performing collateralized consumer loans, and that data on such loans is reflected on the Call Report and could easily be incorporated into the risk weights.

Several commenters asked why a secured auto loan was assigned the same risk weight as an unsecured credit card loan under the Original Proposal when credit card loans have a delinquency rate more than four times that of auto loans.

Other commenters stated the rule should take into account the type of consumer loan (unsecured versus secured, loss history, and term of the loan) and generation source (direct versus indirect) because different loan types and generation sources have different performance experiences historically and should be evaluated as part of the rulemaking.

Another commenter stated that the proposal would have made no distinction between indirect loans and loans originated in-house, which would have encouraged ''buy rate'' indirect lending (*i.e.,* markups by dealer), which is bad for consumers.

Other commenters suggested different risk weights should be applied to consumer loans based on credit score ranges.

A small number of commenters suggested that consumer loans have significantly less IRR than first-mortgage loans, but are assigned a 75 percent risk weight while first-mortgage loans are assigned a 50 percent risk weight, suggesting that only credit risk was considered in setting the risk weight for consumer loans.

A small number of commenters suggested that consumer loans should be assigned a 20 percent risk weight because credit loss risk is covered in the ALLL.

A number of other commenters suggested that the proposed risk weights for consumer loans seemed appropriate based on losses at comparable banks and credit unions.

The Board generally agrees with commenters who suggested that secured and unsecured consumer loans have different levels of risk exposure. To address the different risks between these two loan types, this second proposal would assign separate risk weights for secured and unsecured consumer loans. To differentiate between these two loan types, this proposed rule would include new definitions for secured consumer loans and unsecured consumer loans. Loans meeting the definition of a current secured consumer loan would receive a risk weight of 75 percent, and those meeting the definition of a current unsecured consumer loan would be assigned a 100 percent risk weight. This would account for the higher risk associated with unsecured loans given their lack of collateral.

The Board also generally agrees that credit scores, staff qualifications, loan underwriting, portfolio seasoning, and portfolio performance are good measures to evaluate a lending program. However, the Board cannot uniformly use these criteria to measure minimum capital requirements for all credit unions because of the indeterminate reporting requirements that would be necessary and the myriad variables used to establish sound lending programs.

The Board disagrees that credit loss risk would be entirely covered in the ALLL. The ALLL is intended to cover expected losses as of the balance sheet date. The ALLL is not intended to cover unexpected losses. While a credit union's funding of the ALLL through provision expenses decreases retained earnings, the proposed new risk-based capital ratio calculation would add back in the balance of the ALLL without limit.

Non-current consumer loans. The current risk-based capital measure does not contain a higher risk weight for non-current consumer loans. Increasing levels of non-current loans are an indicator of increased risk. To reflect the impaired credit quality of past-due loans, the Original Proposal would have required credit unions to assign a 150 percent risk weight to loans (other than real estate loans) 60 days or more past due or in nonaccrual status. The 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 were intended to capture the risk associated with the impaired credit quality of these exposures, and were consistent with the risk weights used by Basel III and the Other Banking Agencies.[220]

A small number of commenters questioned why delinquent consumer loans were assigned a 150 percent risk weight under the Original Proposal

[216] The Ability-to-Repay requirements include eight loan underwriting factors a credit union will need to consider and verify. These include the following: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. *See, e.g.,* 78 FR 6407 at 6585 (Jan. 30, 2013).

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

[218] The Other Banking Agencies' capital rules maintained the 100 percent risk weight for current consumer loans. *See, e.g.,* 12 CFR 324.32 *and* 78 FR 55339 (Sept. 10, 2013).

[219] 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.

[220] *See, e.g.,* 12 CFR 324.32(k).

when such loans are assigned only a 100 percent risk weight under the Other Banking Agencies' capital rules. However, in fact, a 150 percent risk weight is consistent with the risk weight for past-due consumer loans under the Other Banking Agencies' regulations [221] and would result in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio. Thus, this proposal would retain the 150 percent risk weight for consumer loans that are not current.

Loans to CUSOs and CUSO Investments.

Under the Original Proposal, investments in CUSOs were assigned a risk weight of 250 percent and loans to CUSOs were assigned a risk weight of 100 percent. A majority of the commenters addressed these risk weights and, nearly unanimously, opposed them. There were, however, a few commenters who generally agreed with the proposed risk weights.

In brief, commenters generally maintained that the originally proposed risk weight for investments in CUSOs was too high. Some commenters argued that the Original Proposal was arbitrary and unsupported by analytical data. Others stated that the risk weights did not take into account the requirements of the CUSO regulation or the nature and business of individual CUSOs. Finally, some commenters believed the Original Proposal would have a chilling effect on CUSOs and could lead credit unions to seek out more expensive third-party vendors.

Some commenters questioned why the Original Proposal included different risk weights for investments and loans. Other commenters argued that there should be only one risk weight and that it should not exceed 100 percent. Several commenters suggested risk weights below 100 percent, stating that higher risk weights would diminish the cooperative nature of credit unions. A few commenters advocated eliminating risk weights for CUSOs altogether, claiming that assigning risk weights to these assets would be detrimental to credit unions forming and utilizing CUSOs.

Other commenters stated that NCUA should address risk in CUSOs through supervision of the credit union investors, rather than assigning risk weights to investments and loans.

One commenter expressed concern about investments in CUSOs being included in the risk-based capital ratio calculation on an unconsolidated basis, combined with including a CUSO's mortgage servicing assets (MSAs) on a consolidated basis. This commenter stated that if mortgage servicing assets represent a significant portion of the equity of a CUSO on an unconsolidated basis, then the credit union's MSAs would effectively be weighted at 500 percent.

Several commenters argued that the risk weights for CUSO loans and investments should be lower because the actual degree of risk from CUSOs is relatively low. A few commenters noted that credit unions have less than 0.2 percent of total assets invested in CUSOs, which, they argued, is an immaterial risk to the credit union industry.

Other commenters stated that the requirements in the recently finalized CUSO rule effectively reduce risk from CUSOs, thereby eliminating the need for higher risk weights.

Several commenters expressed concern that the 250 percent risk weight on investments in CUSOs would restrict or reduce the benefits from using CUSOs. Some of these commenters argued that credit unions would be forced to contract with higher-priced third-party vendors for services because third-party vendors do not carry a capital risk weight.

Several commenters also questioned the mechanics of the two risk weights that would have applied to CUSOs. One commenter stated that the risk weight for loans did not take into account collateral for the loan or the quality of any such collateral.

Another commenter stated that there was no reason for a risk weight if the amount of an investment in a CUSO was fully offset by net income or cost savings generated by the CUSO. Other commenters suggested that NCUA not apply a risk weight to both the cash investment made in the CUSO and the CUSO's appreciated value.

Several commenters stated that the Original Proposal would have double counted exposure for majority-owned CUSOs. They reasoned that because risk-based capital is based on a credit union's consolidated balance sheet, adding a schedule that shows unconsolidated results is essentially double counting.

Several commenters addressed a comparison made in the Original Proposal between CUSOs and an unsecured equity investment by a bank in a non-publicly traded entity. These commenters argued that this comparison is not analogous and NCUA should abandon this approach. These commenters stated further that the regulations applying to credit union investments in CUSOs and the collaborative platform between CUSOs and credit unions makes this relationship sufficiently different, such that it should not be treated the same as a bank's unsecured equity investment in a non-publicly traded entity.

Finally, several commenters requested that risk weights for CUSOs take into account certain aspects of the specific CUSO. Many of these commenters stated that they supported risk weights that were based on the CUSO's business function. Others stated that risk weights should take into account the CUSO's historical profitability, if it is generating income for its investors, the complexity of the CUSO's operations, or how long it has been in operation. Several commenters argued that a ''one-sized-fits-all'' approach is not sufficient to accurately risk weight investments in CUSOs.

After diligent consideration of the comments discussed above, the Board has decided to rely on GAAP accounting standards to determine the reporting basis upon which any CUSO equity investments and loans are assigned risk weights. For CUSOs subject to consolidation under GAAP, the amount of CUSO equity investments and loans are eliminated from the consolidated financial statements because the loans and investments are intercompany transactions. The related CUSO assets that are not eliminated are added to the consolidated financial statement and receive risk-based capital treatment as part of the credit union's statement of financial condition. For CUSOs not subject to consolidation, the recorded value of the credit union's equity investment would be assigned a 150 percent risk weight, and the balance of any outstanding loan would be assigned a 100 percent risk weight.

NCUA recognizes the uniqueness of CUSOs and the support they provide. However, an equity investment in a CUSO is an unsecured, at-risk equity investment (first loss position), which is analogous to an investment in a non-publicly traded entity. There is no price transparency and extremely limited marketability associated with CUSO equity exposures. In addition, unlike the Other Banking Agencies, NCUA has no enforcement authority over third-party vendors, including CUSOs.

The Board recognizes there are statutory limits on how much a federal credit union can loan to and invest in CUSOs. However, 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 (that is, the position can grow in proportion to assets over time). In setting capital standards (*e.g.,* Basel and FDIC), the risk of loss is central to

[221] *See, e.g.,* 12 CFR 324.32(k).

determining the risk weight—not the size of the exposure.

In addition, while a CUSO must predominantly serve credit unions or their members (more than 50 percent) to be a CUSO, it can be owned and controlled primarily by persons and organizations other than credit unions. Therefore, it may not only serve non-credit unions, it can be majority-controlled by a party or parties with interests not necessarily aligned with the credit union's interests.[222]

Also, given the equity investment in a CUSO is in a first loss position, is an unsecured equity investment in a non-publicly traded entity, the significant history of losses to the NCUSIF related to CUSOs, and the fact NCUA lacks vendor authority, the risk weight should be higher than 100 percent.

Loans to CUSOs, on the other hand, have a higher payout priority in the event of bankruptcy of a CUSO and therefore warrant a lower risk weight of 100 percent, which corresponds to the base risk weight for commercial loans.

The Board notes it may be possible to make more meaningful risk distinctions between the risk various types of CUSOs pose once the CUSO registry is in place and sufficient trend information has been collected.

Under the Original Proposal, the risk weights were derived from a review of FDIC's capital treatment of bank service organizations. FDIC's rule looks across all equity exposures.[223] If the total is ''non-significant'' (less than 10 percent of the institution's total capital), the entire amount receives a risk weight of 100 percent. Otherwise, all the exposures are matched against a complicated risk weight framework that runs from a minimum of 250 percent to 600 percent risk weight, with some subsidiary equity having to be deducted from capital. The equity investment in a CUSO would be treated the same as an equity investment in a non-publicly traded entity (limited marketability and valuation transparency), which would receive a 400 percent risk weight unless the cumulative level of all equity exposures held by the institution were ''non-significant.''

The Board recognizes the complexity of FDIC's approach and continues to believe that a simplified risk weight approach is more appropriate given the limited amount of credit union assets in CUSOs and the value CUSOs provide to credit unions in achieving economies of scale.

Mortgage Servicing Assets (MSAs).

The Original Proposal would have assigned a 250 percent risk weight to MSAs to address the complexity and volatility of these assets. In the preamble to the Original Proposal, the Board noted that MSAs typically lose value when interest rates fall and borrowers refinance or prepay their mortgage loans, leading to earnings volatility and erosion of capital.

A large number of commenters addressed this provision and generally disagreed with the 250 percent risk weight. Most commenters addressing this topic maintained that the risk weight was too high and would have been punitive to credit unions. Further, some of these commenters noted that MSAs are an important hedge for credit unions and that MSAs are very liquid assets with an active secondary market.

A few commenters provided suggestions on how to amend this provision of the rule. Most suggested lowering the risk weight to 100 percent. Others, however, suggested a phase-in approach of the 250 percent risk weight or assigning a risk weight above 100 percent when a credit union reaches a certain concentration level of MSAs.

One commenter suggested that assigning the same risk weight to all MSAs, as if they are all equivalent, is not an accurate representation of the actual risk involved. One other commenter stated that the rule should include a mechanism for differentiating between loans sold with and without recourse.

Another commenter stated, ''For many credit unions, maintaining the personal member relationship throughout the life of a transaction is of strategic importance. If the practical effect of a regulation is to force the sale of a mortgage or the servicing rights, the supervisory necessity of such a regulation must be unquestionably clear.''

Finally, a few commenters predicted that a 250 percent risk weight on MSAs could discourage loan participations and limit the options available to manage balance sheet risk. One commenter further suggested that risk weights for loan participations should be lowered not to exceed the weight of the underlying loan participated.

After considering these comments, the Board continues to believe that the 250 percent risk weight is appropriate in light of the relatively greater risks inherent in these assets, and to maintain comparability with the risk weight assigned to these assets by the Other Banking Agencies.[224] Specifically, MSA valuations are highly sensitive to unexpected shifts in interest rates and prepayment speeds. MSAs 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, and support assigning a 250 percent risk weight to MSAs.

While the Board acknowledges that MSAs may provide some hedge against falling rates under certain circumstances, it further believes that MSAs' effectiveness as a hedge, relative to particular credit unions' balance sheets, is subject to too many variables to conclude that MSAs warrant a lower risk weight. More importantly, since IRR has been removed from the risk weights of this proposal, this argument is no longer directly applicable.

Furthermore, NCUA does not agree with commenters who suggested that the proposed 250 percent risk weight assigned to this relatively small asset class would significantly disincentivize credit unions from granting loans, engaging in loan participations, and retaining servicing of their member loans. NCUA notes that banks have been subject to at least as stringent (if not more so) of a risk weight for MSAs for some time and continue to sell loans and retain MSAs.

The Board believes the proposed January 1, 2019 effective date for this rule would provide credit unions sufficient time to adjust to this second proposal and would provide credit unions with a phase-in period comparable to that given to banks following a similar change to the Other Banking Agencies' capital regulations.[225]

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 Original Proposal, these same assets would have received a 100 percent risk weight.[226]

[222] Further, not all CUSOs are closely held. They can have wider ownership distributed among many credit unions, none of which may have significant control. If a particular credit union has significant control, it will likely have to consolidate under GAAP and then there will be no risk weight associated with the loan or investment for the controlling credit union since it will be netted out on a consolidated basis.

[223] *See, e.g.,* 12 CFR 324.52.

[224] *See, e.g.,* 12 CFR 324.32(l)(4)(i).

[225] *See, e.g.,* 12 CFR 324.1(f).

[226] This is comparable to the Other Banking 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).

ORIGINAL PROPOSAL—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

The Board received a number of comments regarding the proposed risk weights for other on-balance sheet assets.

A small number of commenters suggested that under Basel III loans held for sale are risk-weighted at zero as long as they are sold within 120 days because such assets are more of a receivable than a loan.

Commenters suggested that a 100 percent risk weight for land and building was excessive and that speculative land should be risk weighted at 50 percent and a financial institution building should be risk-weighted at 25 percent, less depreciation. Other commenters stated that all credit unions must invest in fixed assets (such as buildings, furniture and equipment) and that the current 5 percent cap on fixed assets helps to manage risk and credit unions seeking to exceed the 5 percent cap must obtain prior NCUA approval. Commenters suggested that consideration should be given to assigning a lower risk weight to investments in fixed assets when the 5 percent cap is maintained. Other commenters suggested that assigning a 100 percent risk weight on land, building and fixed assets would discourage investments in growing branch networks or modernizing equipment.

A small number of commenters suggested that accounts receivable, prepaid income items, accrued interest, and other small items that have no credit risk or IRR should be assigned a zero percent risk weight. These commenters suggested that a 100 percent risk weight assigned to accrued interest on loans and accrued interest on investments is excessive.

As with the Original Proposal, in this second proposal, where the rule does not assign a specific risk weight to an asset or exposure type, the applicable risk weight would be 100 percent. For example, premises, fixed assets, and other real estate owned would receive a risk weight of 100 percent.

The Board determined the 100 percent risk weight would be appropriate for this class of assets since 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. Differentiating between the risks of types of assets not otherwise identified is not currently possible due to lack of data, would add complexity to the rule, and require even more Call Report data.

The 100 percent risk weight would also be 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.

Further, the proposed risk weights match the risk weights in the Other Banking Agencies' capital regulations.[227]

This proposal would include loans held for sale within the pool of loans subject to assignment of risk weights by loan type to avoid the added complexity of determining the age of the loans held for sale.

104(c)(2)(i) Category 1—Zero Percent Risk Weight

Proposed § 702.104(c)(2)(i) would provide that a credit union must assign a zero percent risk weight to the following on-balance sheet assets:

- The balance of cash, currency and coin, including vault, automatic teller machine, and teller cash.
- The exposure amount 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 principal and interest only mortgage-backed STRIPS.
  - Federal Reserve Bank stock and Central Liquidity Facility stock.
- Insured balances due from FDIC-insured depositories or federally insured credit unions.

Consistent with the Original Proposal, this second proposal would continue to assign a zero percent risk weight for cash, which includes the balance of cash, currency and coin, including vault, automatic teller machine, and other teller cash.

This proposal would change the assignment of risk weights for cash on deposit, assigning a zero percent risk weight to insured cash on deposit and a 20 percent risk weight for all uninsured [228] cash on deposit as outlined in the proposed changes to the revised risk weights. Cash items in process of collection (currently included in cash on deposit) would not be specifically measured or assigned a risk weight. This change would be comparable with the risk weights applicable to banks.[229] The Board believes having two risk weights for cash on deposit is appropriate because of the different risk profiles between insured and uninsured deposits.

This proposal would apply 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 principal and interest only mortgage-backed STRIPS. This zero percent risk weight would also exclude indirect ownership and securities collateralized with zero percent risk weight assets.

This proposal would apply a risk weight of zero percent to these types of exposures because they have no or very limited credit risk.

However, exposures that are through a trust, or similar vehicle, would not receive a zero percent risk weight. In addition, conditional guarantees that can be revoked if a condition(s) is not met would not receive a zero percent risk weight.

For example, the following types of investment exposures would be assigned a zero percent risk weight: [230]

- U.S. Treasury Securities
- GNMA securities (not including principal and interest only STRIPS)
- SBA pools (not including principal and interest only STRIPS)
- SBA loan participations
- FDIC-guaranteed securities
- NCUA-guaranteed securities

This proposal would also apply a zero percent risk weight to Federal Reserve Bank stock and Central Liquidity Facility stock. Under the applicable statutes, these two types of ''stocks'' do not carry a risk of loss of principal [231]

[227] *See, e.g.,* 12 CFR 324.32(l).

[228] Privately insured balances are included with uninsured deposits and assigned a risk weight of 20 percent as outlined in the proposed rule language.

[229] *See* 12 CFR 324.32(a)(1)(i)(B) and (d)(1).

[230] The list provided is not meant to be comprehensive. Any exposure in a principal- or interest-only mortgage-backed strip would not be assigned a zero percent risk weight.

[231] *See* 12 U.S.C. 287 and 12 U.S.C. 1795f(a).

and, therefore, the Board believes they warrant a zero percent risk weight.

This proposed rule would materially increase the amount of zero risk-weighted investments compared to the current rule. The proposed zero percent risk weight category is consistent with risk weights applicable to banks.[232] The Board believes it is appropriate to assign a zero percent risk weight to additional investments under this proposal because IRR would no longer be included in the proposed risk weights.

The Board requests comments on whether any items currently listed in this category should be assigned a higher risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a zero percent risk weight and why.

104(c)(2)(ii) Category 2—20 Percent Risk Weight

Proposed § 702.104(c)(2)(ii) would provide that a credit union must assign a 20 percent risk weight to the following on-balance sheet assets:

- The uninsured balances due from FDIC-insured depositories, federally insured credit unions, and all balances due from privately insured credit unions.
- The exposure amount of:
  - A non-subordinated obligation of the U.S. Government, its central bank, or a U.S. Government agency that is conditionally guaranteed, excluding principal and interest only mortgage-backed STRIPS.
  - A non-subordinated obligation of a GSE other than an equity exposure or preferred stock, excluding principal and interest only GSE obligation STRIPS.
  - Securities issued by public sector entities in the United States that represent general obligation securities.
  - Investment funds whose portfolios are permitted to hold only part 703 permissible investments that qualify for the zero or 20 percent risk categories.
  - Federal Home Loan Bank stock.
- The balances due from Federal Home Loan Banks.
- The balance of share-secured loans.
- The portions of outstanding loans with a government guarantee.
- The portions of commercial loans secured with contractual compensating balances.

This proposal would apply a 20 percent risk weight to uninsured balances due from FDIC-insured depositories and federally insured credit unions, and all balances due from privately insured credit unions. The proposed 20 percent risk weight is consistent with the risk weights applicable to banks.[233] The Board believes it is an appropriate risk weight due to the low risk of loss with these types of exposures.

This proposal would also apply 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 principal- and 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 would be applied to non-subordinated exposures of a GSE, other than an equity exposure or preferred stock, excluding principal- and interest-only GSE obligation STRIPS.

The following are exposures that would be 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
- United States Postal Service

The above list is not meant to be comprehensive and includes mortgage-backed securities issued and guaranteed by U.S. Government agencies and GSEs, excluding principal- and interest-only mortgage-backed STRIPS that are assigned a 100 percent risk weight. The above risk weights are generally consistent with the risk weights applicable to banks,[234] as several commenters requested. Many commenters also requested that U.S. Government agency and GSE exposures be measured based on their risk, and not WAL, which is addressed by the risk weights above. The Board believes it is appropriate to assign these investments a 20 percent risk weight due to the fact that GSEs generally do not have the full faith and credit of the U.S. Government guaranteeing payment of their obligations. It is common, however, for GSEs to have an assigned federal regulator and an ability to borrow from the U.S. Treasury.

This proposal would also apply 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 low risk weight. This risk weight is consistent with risk weights applicable to banks.[235] The Board believes it is an appropriate risk weight due to the low risk and full faith and credit of the public sector entities.

Indirect unconditionally guaranteed exposures to the U.S. Government, its Central Bank, or a U.S. Government agency would 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 since 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.[236]

Another example of an indirect unconditional guarantee would be a U.S. Treasury security in an investment fund. The obligation is to the investment fund, and not the owner of the fund. This is why an investment fund, or individual asset in an investment fund, cannot have a risk weight of less than 20 percent. This proposal would apply 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 (*e.g.* prospectus), and must be binding (*e.g.* intent alone is not sufficient).

Based on June 2014 Call Report data, approximately 93 percent of investments held by complex credit unions would receive a risk weight of 20 percent or less, with the majority of investments receiving a 20 percent risk weight.[237]

As discussed earlier, the Board agrees with commenters who suggested that share-secured loans present a lower risk than other loan types and has added a new category in this proposal for share-secured loans under the 20 percent risk weight, as well as for portions of compensating balances on commercial loans.

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments

[232] *See, e.g.,* 12 CFR 324(a)(i).

[233] *See, e.g.,* 12 CFR 324.32(d)(1).

[234] *See, e.g.,* 12 CFR 324.32(a)(1)(ii) and (c).

[235] *See, e.g.,* 12 CFR 324.32(e).

[236] *See, e.g.,* 12 CFR 324.53.

[237] This analysis assumes immaterial exposures to subordinated tranches and interest-only and principal-only STRIPS.

on whether additional items should be assigned a 20 percent risk weight and why.

104(c)(2)(iii) Category 3—50 Percent Risk Weight

Proposed § 702.104(c)(2)(iii) would provide that a credit union must assign a 50 percent risk weight to the following on-balance sheet assets:

- The outstanding balance (net of government guarantees), including loans held for sale, of current first-lien residential real estate loans less than or equal to 35 percent of assets.
- The exposure amount of:
  - Securities issued by PSEs in the U.S. that represent non-subordinated revenue obligation securities.
  - Other non-subordinated, non-U.S. Government agency or non-GSE guaranteed, residential mortgage-backed security, excluding principal- and interest-only STRIPS.

As discussed earlier, this proposal would include the use of a single concentration threshold for current first-lien residential real estate loans. All current first-lien residential real estate loans less than or equal to 35 percent of assets would receive a 50 percent risk weight.

The proposal would also apply a risk weight of 50 percent to the exposure amount of securities issued by PSE in the U.S. that represent non-subordinated revenue obligation securities (revenue bonds). These securities are backed by the revenue assigned when the security is issued. An example is a revenue security backed by tolls on the toll road for which the funding was used. This risk weight is comparable to the Other Banking Agencies' capital regulations,[238] which some commenters recommended. This risk weight also reflects the greater risk that non-subordinated revenue obligations have compared to securities issued by a PSE that represent general obligation securities.

The proposal would also apply a risk weight of 50 percent to other non-subordinated, non-agency and non-GSE guaranteed, residential mortgage-backed securities (RMBS), excluding principal- and interest-only STRIPS. The underlying loans in the security must be first-lien residential real estate loans, in order to qualify. 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 would be consistent with the 50 percent risk weight that would be assigned to first-lien residential real estate loans under this proposal and FDIC's capital regulation.[239] Many commenters wanted risk weights more aligned with the collateral risk weight, which this risk weight does. Furthermore, this risk weight would be comparable with the FDIC's approach for calculating the risk weight for RMBSs [240] as some other commenters requested.

The Board requests comments on whether certain items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 50 percent risk weight and why.

104(c)(2)(iv) Category 4—75 Percent Risk Weight

Proposed § 702.104(c)(2)(iv) would provide that a credit union must assign a 75 percent risk weight to the outstanding balance (net of government guarantees), including loans held for sale, of the following on-balance sheet assets:

- Current first-lien residential real estate loans greater than 35 percent of assets.
- Current secured consumer loans.

This proposal would apply to the amount of first-lien residential real estate loans above the single concentration threshold of 35 percent of assets, which is a reduction in the amount of capital required due to exceeding the concentration thresholds when compared to the Original Proposal.

This proposed rule would apply separate risk weights for current consumer loans based on whether they are secured or unsecured. Current secured consumer loans would receive a 75 percent risk weight because they generally have a lower credit risk than unsecured consumer loans due to the collateral available for secured loans.

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 75 percent risk weight and why.

104(c)(2)(v) Category 5—100 Percent Risk Weight

Proposed § 702.104(c)(2)(v) would provide that a credit union must assign a 100 percent risk weight to the following on-balance sheet assets:

- The outstanding balance (net of government guarantees), including loans held for sale, of:
  - First-lien residential real estate loans that are not current.
  - Current junior-lien residential real estate loans less than or equal to 20 percent of assets.
  - Current unsecured consumer loans.
  - Current commercial loans, less contractual compensating balances that comprise less than 50 percent of assets.
  - Loans to CUSOs.
- The exposure amount of:
  - Industrial development bonds.
  - All stripped mortgage-backed securities (interest only and principal only STRIPS).
  - Part 703 compliant investment funds, with the option to use the look-through approaches in § 702.104(c)(3)(ii) of this section.
  - Corporate debentures and commercial paper.
  - Nonperpetual capital at corporate credit unions.
  - General account permanent insurance.
  - GSE equity exposure or preferred stock.
- All other assets listed on the statement of financial condition not specifically assigned a different risk weight under this subpart.

Unless otherwise noted below, the investment risk weights are also consistent with the risk weights applicable to banks,[241] which some commenters requested. The Board believes the 100 percent risk weight for these investments would be appropriate due to their risk of loss.

Industrial development bonds (IDB) 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 IDB 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.

Stripped mortgage-backed securities (interest-only and principal-only STRIPS) represent either the payments of principal or interest from an underlying pool of mortgages. The Board believes the increased risk associated with these two structures warrants a higher risk weight compared to non-principal-only and non-interest-only STRIPS with similar collateral. The Board chose to include principal-only STRIPS in the 100 percent risk weight category due to the explicit prohibition of this structure in part 703. The Board

[238] *See, e.g.,* 12 CFR 324.32(e)(1)(ii).

[239] *See, e.g.,* 12 CFR 324.32(g)(1).

[240] 12 CFR 324.43(e).

[241] *See, e.g.,* 12 CFR 324.32 and 324.42.

requests comments on whether risk weights for principal-only STRIPS should be more comparable to the Other Banking Agencies and assign a risk weight for STRIPS based on the underlying guarantor or collateral.

The proposal would assign a risk weight of 100 percent to part 703 compliant investment funds, with the option to use the look-through approaches in the proposal. 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 credit union also has the ability to choose an alternate approach for investment funds. The risk weight for investment funds deviates slightly from the approach applicable to banks. The Board has added a standard risk weight of 100 percent for part 703 compliant funds, in addition to adopting the approach applicable to banks,[242] as an additional option for credit unions. However, the Board believes the approach for investment funds is consistent with recommendations received from commenters who suggested the risk weights be based on the underlying accounts and investment strategies.

The proposal would assign a risk weight of 100 percent to the balance of nonperpetual capital at corporate credit unions. Nonperpetual capital is subordinate to deposits in a corporate credit union, which warrants a higher risk weight than deposits.

The proposal would apply the 100 percent risk weight to general account permanent insurance. This type of insurance is typically associated with the funding of employee benefits. General account permanent insurance with returns indexed to equity returns should have the same risk weight as publically traded equity investments, unless it has a positive return floor. The 100 percent risk weight is reflective of the moderate risk associated with this asset.

Some commenters argued for lower risk weights for investments funding employee benefits. However, the Board disagrees with those commenters and, consistent with the general approach taken in assigning risk weights under this proposal, believes that the risk weight assigned to investments funding employee benefits should be based on the credit risk and not the purpose of the asset. The Board notes this is comparable to the approach taken by the Other Banking Agencies.[243]

Under this proposal, first-lien residential real estate loans that are not current would be assigned a 100 percent risk weight reflecting the increased credit risk and consistent with the risk weights for similar loans held by banks under the Other Banking Agencies' regulations.[244] The Board believes the proposed higher risk weight that would be assigned to non-current loans is warranted because such loans have a higher probability of default when compared to current loans. Non-current loans are more likely to default because repayment is already impaired making them one step closer to default compared to current loans. Additionally, a higher risk weight for non-current loans is consistent with the risk weights assigned by the Other Banking Agencies.

Under this proposal, current junior-lien residential real estate loans under the single concentration threshold would be assigned a 100 percent risk weight, which would be consistent with the risk weight for similar residential real estate loans assigned by the Other Banking Agencies.[245]

The 125 percent risk category that was included in the Original Proposal would be eliminated. The 125 percent risk category applied to the portion of other real estate loans that made up between 10 to 20 percent of a credit union's total assets. The reduction in the number of concentration thresholds applicable to junior-lien real estate loans resulted in the elimination of the 125 percent risk weight.

Under this proposal, secured and unsecured consumer loans would be separated into different risk-weight categories, with current unsecured consumer loans assigned a 100 percent risk weight. The higher risk weight for current unsecured consumer loans would reflect the elevated risk from this loan type compared to current secured consumer loans. Generally, unsecured loans reflect higher levels of delinquency and charge-offs, as reported on the quarterly Call Report, and, therefore, expose the credit union to higher risk than secured loans.

The Board notes that under this proposal, student loans would be incorporated into the definition of consumer loans and risk-weighted accordingly.

The approach for assigning the risk weight for commercial loans would be comparable to the Other Banking Agencies' rules.[246] As discussed previously, the changes to the definition of commercial loans would align the risk weights with actual credit risk exposure instead of assigning risk weights based on the $50,000 exemption as it relates to the statutory MBL cap[247] (which commenters pointed out). The change would result in improved and more easily reconcilable call reporting, and enhance NCUA's ability to account for all loans that support commercial ventures.[248]

Consistent with the Original Proposal, this proposed rule would assign a 100 percent risk weight to the outstanding balance of unconsolidated loans to CUSOs.

This proposal would assign a 100 percent risk weight to all other balance sheet assets not specifically assigned a different risk weight under this subpart, but reported on the statement of financial condition. This 100 percent risk weight is consistent with the risk weight applicable to banks[249] and the Board believes this risk weight is appropriate for assets not specifically assigned a risk weight.

104(c)(2)(vi) Category 6—150 Percent Risk Weight

Proposed § 702.104(c)(2)(vi) would provide that a credit union must assign a 150 percent risk weight to the following on-balance sheet assets:

- The outstanding balance, net of government guarantees and including loans held for sale, of:
  - Current junior-lien residential real estate loans that comprise more than 20 percent of assets.
  - Junior-lien residential real estate loans that are not current.
  - Consumer loans that are not current.
  - Current commercial loans (net of contractual compensating balances), which comprise more than 50 percent of assets.
  - Commercial loans (net of contractual compensating balances), which are not current.
- The exposure amount of:
  - Perpetual contributed capital at corporate credit unions.
  - Equity investments in CUSOs.

Under the Original Proposal, the risk weight for perpetual contributed capital at corporate credit unions would have

[242] *See, e.g.,* 12 CFR 324.53.

[243] *See, e.g.,* 12 CFR 324.32.

[244] *See, e.g.,* 12 CFR 324.32(g)(2).

[245] *See, e.g.,* 12 CFR 324.32(g)(2).

[246] *See, e.g.,* 12 CFR 324.32(f) (standard commercial loans) and 324.32(j) (high volatility commercial real estate loans).

[247] *See.* 12 CFR 723.1(b).

[248] Other than auto secured loans, business purpose loans below $50,000 would still receive a 100 percent risk weight as an unsecured consumer loan or fall into the ''all other assets'' category.

[249] *See, e.g.,* 12 CFR 324.32(l)(5).

been 200 percent. This proposal would lower the risk weight for perpetual contributed capital at corporate credit unions to 150 percent. Perpetual contributed capital at corporate credit unions would receive a higher risk weight than nonperpetual capital at corporate credit unions because perpetual contributed capital is available to absorb losses before nonperpetual capital. The Board believes the 150 percent risk weight is appropriate due to heightened risk of loss compared to the 100 percent risk-weighted nonperpetual capital.

Under this proposal, current junior-lien residential real estate loans that exceed 20 percent of assets would be assigned a 150 percent risk weight. Additionally, any junior-lien residential real estate loans that are not current, as defined in the proposal, would receive the 150 percent risk weight reflecting the higher credit risk of such loan than current junior-lien real estate loans up to 20 percent of assets, which would receive a 100 percent risk weight.

The Board also proposes that consumer loans that are non-current be assigned a 150 percent risk weight, as in the Original Proposal. The Board believes the proposed higher risk weight that would be assigned to non-current loans is warranted because such loans have a higher probability of default when compared to current loans. Non-current loans are more likely to default because repayment is already impaired making them one step closer to default compared to current loans. This rule would more clearly define those loans that are assigned a 150 percent risk weight through new definitions for consumer loan and current loan. The 150 percent risk weight for non-current consumer loans is also consistent with the risk weight for non-current consumer loans assigned by the Other Banking Agencies.[250]

This proposal would maintain higher risk weights for high concentrations of commercial loans as GAO and OIG recommend. A high concentration is defined as commercial loans over 50 percent of assets, which would receive the 150 percent risk weight. The amount of commercial loans subject to the 150 percent concentration risk weight would be determined as follows:

Total Commercial Loans

- Compensating Balances on Commercial Loans

- The Guaranteed Portion of Commercial Loans

- Non-Current Commercial Loans

= The Amount of Commercial Loans Subject to the Concentration Threshold

- Commercial Loans Subject to the Concentration Threshold that are less than 50% of Assets

= Commercial Loans Subject to a 150% risk weight

As discussed earlier, due to the higher credit risk of non-current commercial loans, they would receive a 150 percent risk weight.

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 150 percent risk weight and why.

104(c)(2)(vii) Category 7—250 Percent Risk Weight

Proposed § 702.104(c)(2)(vii) would provide that a credit union must assign a 250 percent risk weight to the carrying value of mortgage servicing assets (MSAs) held on-balance sheet.

As discussed above, MSA valuations are highly sensitive to unexpected shifts in interest rates and prepayment speeds. As noted above, MSAs 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 such assets, especially under adverse financial conditions, and support this proposed rule's treatment for MSAs. Given there is no differentiation between the risk as it relates to MSAs for credit unions versus banks, the Board believes this treatment would generally maintain comparability with the Other Banking Agencies' capital regulations.[251]

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 250 percent risk weight and why.

104(c)(2)(viii) Category 8—300 Percent Risk Weight

Proposed § 702.104(c)(2)(viii) would provide that a credit union must assign a 300 percent risk weight to the exposure amount of the following on-balance sheet assets:

- Publicly traded equity investments, other than a CUSO investment.
- Investment funds that are not in compliance with 12 CFR part 703, with the option to use the look-through approaches in § 702.104(c)(3)(ii) of this section.
- Separate account insurance, with the option to use the look-through approaches in § 702.104(c)(3)(ii).

The 300 percent risk weight category would be a new category relative to current rule and the Original Proposal. This second proposal would apply a 300 percent risk weight to the exposure amount of publicly traded equity

[250] *See, e.g.,* 12 CFR 324.32(k)(1).

[251] *See, e.g.,* 12 CFR 324.32(l)(4)(i).

investments, other than a CUSO investment. This proposal would also apply a 300 percent risk weight to investment funds that do not comply with part 703, and to separate account insurance, with the option to use the look-through approaches for both. The 300 percent risk weight 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, publically traded equities have a greater risk of loss since they are in a first loss position versus the debt of a company. Non-part 703 compliant investment funds 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 would have the option of applying one of the look-through approaches discussed in more detail below for investment funds and separate account insurance risk weights to lower risk weights for investment funds and separate account insurance, if a credit union chooses to use one of the alternative approaches.

This proposal would allow the 300 percent risk weight to apply to all publicly traded equity exposures, both directly and indirectly. The 300 percent risk weight for publicly traded equities is generally consistent with the risk weight applicable to banks [252] and the Board believes this risk weight is appropriate due the elevated risk of loss with publicly traded equities. This would include direct exposure via purchasing an equity investment or having exposure to publicly traded equities through some other structure. An example of public equity exposure through other structures would be general account permanent insurance where the returns are indexed off of the Standard and Poor's 500 Index. A minimum positive return floor is sufficient to exclude general account permanent insurance from the 300 percent risk weight. Structured products can also be structured to have returns based off the return of an index or one or more publicly traded equities.

The risk weights for investment funds and separate account insurance deviate slightly from the Other Banking Agencies' capital regulations.[253] This proposal adds a standard risk weight of 300 percent for non-part 703 compliant funds, in addition to the approach applicable to banks,[254] as an additional option for credit unions. The approach for investment funds and separate account insurance is consistent with several commenters who requested risk weights be based on the underlying accounts and investment strategies.

The Board believes the 300 percent risk weight that would be assigned to non-part 703 compliant investment funds and separate account insurance is appropriate due to the potential risk the underlying assets may have. The risk weight of 300 percent for these exposures is due to the wide availability of equity-based investment funds and equity-based separate account insurance in the market. The Board notes that credit unions may get a lower risk weight if they use a look-through approach for investment funds and separate account insurance.

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 300 percent risk weight and why.

104(c)(2)(ix) Category 9—400 Percent Risk Weight

Proposed § 702.104(c)(2)(ix) would provide that a credit union must assign a 400 percent risk weight to the exposure amount of 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 [255] and the Board believes this risk weight is appropriate due to the increased risk of non-publicly traded equities versus publicly traded equities.

The 400 percent risk weight category is a new category when compared to the current rule and the Original Proposal. This risk weight is unlikely to have an effect on most credit unions due to federal and state restrictions on credit union purchases of these types of investments. The Board, however, believes it is a necessary category to have in the unlikely event a credit union would own a non-publically traded non-CUSO investment. The proposed addition of this category would also be comparable to the Other Banking Agencies' capital regulations.[256]

The Board requests comments on whether any items currently listed in this category should be assigned a higher or lower risk weight and why. In addition, the Board requests comments on whether additional items should be assigned a 400 percent risk weight and why.

104(c)(2)(x) Category 10—1,250 Percent Risk Weight

Under the Original Proposal, proposed § 702.104(c)(2)(x) would have required a credit union to assign a 1,250 percent risk weight 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.[257]

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 Original Proposal would have provided for assigning a risk weight of 1,250 percent to that investment.

The Board received a significant number of comments on the assignment of the 1,250 percent risk weight to certain investments and the proposed due diligence requirements in § 702.104(d). Commenters generally agreed that credit unions should have a

[252] *See, e.g.,* 12 CFR 324.52(b)(5).

[253] *See, e.g.,* 12 CFR 324.53.

[254] *See, e.g.,* 12 CFR 324.53.

[255] *See, e.g.,* 12 CFR 324.52(b)(6).

[256] *Id.*

[257] The eight percent adequately capitalized level times 1,250 percent = 100 percent.

comprehensive understanding of any investments they purchase. Several commenters objected to assigning a 1,250 percent risk weight to investments credit unions do not understand.

One commenter stated that the proposal gave the Board broad discretion to require dollar-for-dollar capital on asset-backed investments that NCUA determines the credit union is unable to demonstrate a comprehensive understanding. The commenter stated that while such an investment may represent a significant safety and soundness concern, an elevated capital requirement is not an appropriate means of addressing that risk. The commenter suggested that if a credit union does not understand an investment on its books, the regulator should rectify the situation through the supervisory process. The commenter stated further that, although this provision was adopted in the bank rule, use of these types of products is more limited in the credit union industry and risks can and should be addressed through examinations.

Other commenters suggested that the Board minimize the regulatory burdens of this provision by limiting the proposed reporting requirements to investments identified during the supervisory process as a potential concern.

A number of commenters expressed concern that NCUA would not apply the requirements in a fair and consistent manner across credit unions. A small number of commenters suggested that the Board should be required to perform an on-site evaluation and reach a joint determination with the state regulator before recommending a 1,250 percent risk weight on a state-chartered institution.

Commenters suggested that the rule should clarify the administrative level within NCUA at which this determination will be made because such a finding could have a dramatic impact on a credit union's PCA classification and major implications for that credit union's balance sheet and management structure. Other commenters suggested that the rule should specify that a 1,250 percent risk weight constitutes a material supervisory determination that is subject to appeal.

A number of commenters stated that the term ''asset-backed investment'' is not defined, which they stated could lead to wide interpretation both of the 1,250 percent risk weight as well as potential examiner expectations of the initial and ongoing depth of the review, analysis, and documentation of asset-backed investments. Commenters suggested that such depth of review is appropriate for some types of investments, but not others. For example, commenters contended that a government agency-guaranteed mortgage-backed security does not warrant the type of analysis and documentation outlined in the Original Proposal because the lack of inherent credit risk in the government agency security should reduce the concern of a large credit loss on the investment and therefore should reduce the depth of review and analysis.

Other commenters suggested if the Board determines it can provide a clear definition of ''asset-backed investments,'' it should do so in a new proposed rule that also outlines reasonable expectations and provides a method for fair and consistent application of the due diligence requirements.

One commenter agreed that complex asset backed investments (private label) with inherent credit risk exposure should have additional due diligence requirements, but argued a 250 percent risk weight would be more appropriate. Another commenter suggested that the rule should make it clear that the due diligence requirement does not apply to any asset backed investments guaranteed by the U.S. Government or any U.S. Government agency.

Based on a diligent review of these comments the Board has significantly revised this section and now proposes to require a 1,250 percent risk weight only for subordinated tranches of any investments. Specifically, the Board is proposing to change application of a 1,250 percent risk weight from ''asset-backed investments,'' to ''subordinated tranche'' investments.

Commenters requested clarity on the interpretation on what investments would be considered asset-backed investments. The Board believes subordinated tranche is a clearer term, has provided a corresponding definition, and thus will eliminate the ambiguity cited by commenters.

The Board also believes this proposed change will more accurately apply risk weights based on risk while providing clarity and consistency.

However, NCUA still expects credit unions to perform appropriate credit analysis on non-subordinated tranches of mortgage- and asset-backed securities. NCUA will address deficiencies in the credit analysis of non-subordinated tranches through the supervision process.

The Board is also proposing changes to address concerns raised by commenters with respect to securities issued by the U.S. Government and NCUA's ability to use its discretion to apply a 1,250 percent risk weight.

First, the Board is proposing to specifically exclude senior tranches and most securities issued by the U.S. Government, any U.S. Government agency, or GSEs. The Board believes this change would address a major concern expressed by commenters.

The Board is also proposing to remove the discretion for NCUA to impose a 1,250 percent risk weight by allowing credit unions to choose the standard 1,250 percent risk weight or allowing credit unions the option to use the gross-up approach, which is explained in more detail below. The Board believes that removing NCUA discretion to impose a 1,250 risk weight also addresses a major concern by commenters. As previously noted, deficiencies in credit analysis will be addressed in supervision.

The Board believes a 1,250 percent risk weight is appropriate for subordinated tranches based on the leveraged nature of the credit risk in these investments. In addition, this approach is consistent with the approach applicable to banks,[258] which some commenters requested.

The Board intends for the 1,250 percent risk weight to apply to subordinated tranches of MBS, asset-backed securities, revenue bonds, and areas where there is subordinated credit risk in a structured product. Subordinated MBS and asset-backed securities are the most common form of subordinated tranches, and include any MBS or asset-backed securities that take credit losses before a more senior class. Senior mezzanine tranches [259] would be considered subordinated unless the more senior tranches have paid off. A subordinated tranche 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.

[258] *See, e.g.,* 12 CFR 324.43(e) and 324.44; Note, the 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.

[259] Senior mezzanine tranches are subordinated to more senior tranches at issuance.

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, the Board is ensuring that the risk of highly leveraged subordinated tranches would be captured.

The Board is also proposing to provide 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.

Accordingly, under this proposal, § 702.104(c)(2)(x) would provide that a credit union must assign a 1,250 percent risk weight to the exposure amount of any subordinated tranche of any investment held on balance sheet, with the option to use the gross-up approach in § 702.104(c)(3)(i).[260]

The Board is not retaining the due diligence requirement that would have been contained in § 702.104(d) of the Original Proposal. Proposed § 702.104(d) would have contained a list of due diligence requirements credit unions would have been required to implement to demonstrate a comprehensive understanding of the features of an asset-backed investment and a requirement that if a credit union is unable to demonstrate 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 Original Proposal would have also required 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. As noted above, the Board is deleting this section from this proposal in conjunction with the changes it is making to the requirements to apply a 1,250 percent risk weight.

While it remains a best practice for credit unions to understand the features that would affect the performance of all investments, not just asset-based investments, any weakness with investment purchase analysis and documentation can be addressed through the supervision process.

The Board requests comments on this provision of the proposal.

104(c)(3) Alternative Risk Weights for Certain On-Balance Sheet Assets

Proposed § 702.104(c)(3) would provide that instead of using the risk weights assigned in § 702.104(c)(2), a credit union may determine the risk weight of investment funds and subordinated tranches of any investment using the approaches which are discussed in more detail below. The Board believes these alternative approaches would provide a credit union with the ability to risk weight based on the underlying exposure of the subordinated tranche or investment fund without exposing the NCUSIF to additional risk. This approach may also allow for lower risk weights compared to the standard risk weights proposed.

104(c)(3)(i) Gross-up Approach

Proposed § 702.104(c)(3)(i) would provide that a credit union may use the gross-up approach under 12 CFR 324.43(e) to determine the risk weight of the carrying value of any subordinated tranche of any investment. As noted above, the Board is allowing for the use of the gross-up approach, included in the Other Banking Agencies' capital rules, when applying risk weights to subordinated tranches of any investment. The Board believes this approach is appropriate in applying risk weights, if the credit union chooses to use it, since it captures the total exposure the subordinate tranche is supporting.

However, the credit union can only use one methodology to calculate the risk weight for subordinate tranches, either the gross-up approach or a 1,250 percent risk weight.

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 tranche the credit union owns the subordinated tranche; and
- The weighted average risk weight applicable to the assets underlying the securitization.

The following is an example of the application of the gross-up approach: [261]

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.

		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

[260] Based on June 30, 2014, Call Report data, NCUA estimates that 93.3 percent of all investments for credit unions with more than $100 million in assets would receive a risk weight of 20 percent or less; and, 96.1 percent of all investments would receive a risk weight of 100 percent or less.

[261] More simple terminology than the FDIC rule language is used to make this example easier to follow.

		Calculation	Result
C	Pro-rata 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 1st 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 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 (1250 percent times $4 million). The Board believes this example shows the benefit to credit unions of the proposed inclusion of the gross-up approach.

In the case of master trust [262] type structures and structured products,[263] credits unions should calculate the pro-rata share of the more senior positions using the prospectus and current servicing/reference pool reports.

104(c)(3)(i) Look-Through Approaches

Proposed § 702.104(c)(3)(ii) would provide that a credit union may use one of the look-through approaches under 12 CFR 324.53 to determine the risk weight of the fair value of mutual funds that are not in compliance with part 703 of this chapter, the recorded value of separate account insurance; or part 703 compliant mutual funds. The Board is proposing this approach to allow credit unions to use the look-through approach in the Other Banking Agencies' regulations for investment funds. This proposed provision responds to commenters who requested this authority.

Specifically, for purposes of applying risk weights to investment funds, the Board is proposing to give credit unions the option of using the three look-through approaches that FDIC allows its regulated institutions to use under 12 CFR 324.53 of its regulations, instead of using the standard risk weights of 20, 100 and 300 percent that would be assigned under proposed § 702.104(c)(2). The Board believes that including these alternative approaches makes NCUA's risk-based capital requirement more comparable to the Other Banking Agencies' regulations and grants credit unions additional flexibility.

The first of the three full look-through approaches under 12 CFR 324.53 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 under 12 CFR 324.53 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 Board notes that regardless of the look-through approach selected, the credit union must include any derivative contract that is part of the investment fund, unless the derivative contract is used for hedging rather than speculative purposes and does not constitute a material portion of the fund's exposure.[264]

The following examples outline each of the three look-through approaches:

Full look-through approach. The full look-through approach would 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 would 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 is as follow:

CREDIT UNION INVESTMENT—$10,000,000

Fund investment:	Fund holding (% of fund):	Credit union exposure [265]:	Risk weight:	Dollar risk weight:
U.S. Treasury Notes:	50	$5,000,000	20% [266]	$1,000,000.
FNMA PACs:	30	3,000,000	20%	$600,000.
PSE Revenue Bonds:	17.5	1,750,000	50%	$875,000.
Subordinated MBS [267]	2.5	250,000	1,250%	$3,125,000.

[262] 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.

[263] 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 tranched security.

[264] At this time FCUs are not permitted to engage in derivative contract activity for the purpose of speculation. However, federally insured, state-chartered credit unions may be permitted to use derivative contracts for speculative purposes under applicable state law, and thus the Board is including this statement to address those scenarios.

[265] Fund holdings (percent of fund) multiplied by the credit union investment.

[266] Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

[267] Use 1,250 percent risk weight or gross-up calculation.

[268] 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).

CREDIT UNION INVESTMENT—$10,000,000—Continued

Fund investment:	Fund holding (% of fund):	Credit union exposure [265]:	Risk weight:	Dollar risk weight:
Totals		10,000,000	56% [268] (weighted average risk weight)	$5,600,000 (amount of risk assets).

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.

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 is as follow:

CREDIT UNION INVESTMENT—$10,000,000

Permissible investments:	Fund limits (% of fund):	Risk weight (percent):
U.S. Treasury Notes:	100	[269] 20
Agency MBS (non IO or PO):	50	20
PSE GEO Bonds:	20	20
PSE Revenue Bonds:	20	50
Non-Government/Subordinated/IO/PO MBS	30	50
Subordinated MBS	10	[270] 1,250

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 MBS. 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.

Alternative modified look-through approach. The alternative modified look-through approach would 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 is as follows:

CREDIT UNION INVESTMENT—$10,000,000

Permissible investments:	Fund limits (% of fund):	Risk weight:	CU Exposure:	Dollar risk weight:
U.S. Treasury Notes:	100	20% [271]	$0	
Agency MBS (non IO or PO):	50	20%	2,000,000	400,000.
PSE GEO Bonds:	20	20%	2,000,000	400,000.
PSE Revenue Bonds:	20	50%	2,000,000	1,000,000.
Non-Government/ Subordinated/IO/PO MBS	30	50%	3,000,000	1,500,000.
Subordinated MBS	10	1,250% [272]	1,000,000	12,500,000.
Total		158% [273] (weighted average risk weight).	$10,000,000	15,800,000 (Amount of Risk Assets).

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.

104(c)(4) Risk Weights for Off-Balance Sheet Activities

Under the Original Proposal, proposed § 702.104(b)(3), which has been re-numbered as § 702.104(b)(4) under this proposal, would have

[269] Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

[270] Use 1,250 percent risk weight unless the prospectus limits gross-up risk weight.

[271] Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

[272] Use 1,250 percent risk weight unless the prospectus limits gross-up risk weights.

[273] 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).

provided 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.

Under the Original Proposal, a credit union would have calculated the exposure amount of an off-balance sheet component, which is typically the contractual amount multiplied by the applicable credit conversion factor (CCF). This treatment would have applied to specific off-balance sheet items, including loans transferred with limited recourse, unfunded commitments for business loans, and other unfunded commitments. The Original Proposal would have improved risk sensitivity and implemented capital requirements for certain exposures through a simple methodology.

The Board received a number of comments on the proposed risk weights for off-balance sheet activities. Commenters suggested that the off-balance sheet computations seemed excessive and added unnecessary risk assets.

One commenter disagreed with the 75 percent conversion factor with a 100 percent risk weight for unfunded commitments for MBLs, if that meant that a $10,000 line of credit that is funded to $6,000 would require a risk-based capital funding of $10,000 times 0.75, which would equal $7,500 for a $4,000 unfunded commitment.

A number of commenters suggested that under the proposed rule, credit unions would have been penalized for having unfunded commitments on non-business loans and business loans. Other commenters suggested that unfunded commitments on non-business loans and business loans should be assigned lower risk weights because the proposed risk weights would encourage credit unions to terminate or decrease lines of credit to consumers or small business owners to improve their risk-based capital classification. Another commenter agreed with including off-balance sheet activities in the assets denominator.

Others stated the 75 percent conversion factor for unfunded business loans did not give appropriate consideration to the liability side of off-balance sheet items to offset some of this risk or other risks needs to be considered for lowering the assets denominator. Another commenter appreciated the proposed approach to capture off-balance sheet items.

Still others stated that the reporting of off-balance sheet loans sold with limited recourse creates a negative impact on a credit union's balance sheet. One other commenter suggested that the rule should include a mechanism for differentiating between loans sold with and without recourse.

A number of commenters stated that some credit unions that sell conforming first mortgages through the Federal Home Loan Banks' (FHLB) mortgage partnership finance (MPF) program retain a limited contractual portion of the credit risk. Those commenters suggested that the proposed risk weight is much too high for these loans because credit unions must generate their net earnings on such transactions at origination. Those commenters stated further that to generate sufficient income under the proposed risk weights, credit unions would have to charge rates on the MPF loans that would be very high and would not be competitive with bank rates for the same types of mortgages. Other commenters suggested that MPF loans sold to FHLBs should be assigned a conversion factor of 50 percent or less (along with the proposed 50 percent risk weight) because of their low risk exposure and to allow credit unions to compete in the mortgage market. Those commenters observed that the MPF program is a unique secondary market outlet for conforming fixed rate residential mortgages, in which participating FHLB members provide a credit enhancement (CE) based on the characteristics of mortgages being originated and sold under the Program. Those commenters stated further that the CE is a fixed dollar exposure for a specific pool of loans or Master Commitment, and one piece of the credit support that absorbs losses in a specific loan pool which exceed homeowners' equity, primary mortgage insurance and an FHLB-provided first loss account (FLA). Those commenters explained that in exchange for providing the CE, members receive ongoing credit enhancement fee income over the life of the loans. Those commenters stated that this approach rewards FHLB-member credit unions for quality underwriting and provides a superior execution because it removes inefficiencies associated with charging guarantee fees based on the possible future performance of loans because, instead of assessing charges to cover projected losses, actual losses are covered by private capital provided by the FHLB and its members, resulting in strong historic performance of the MPF loans. In addition, those commenters suggested that due to the FLA covering the majority of the credit risk on MPF loans, participating member credit unions do not retain any interest rate or concentration risk on the sold loans. Those commenters recommended that, based on the historic performance of MPF loans and the very small amount of sustained credit losses, the capital charge under the Original Proposal was too high and a lower conversion factor should be used that recognizes the FLA and the strong historic performance of MPF loans.

After considering the comments, the Board continues to believe that the risks associated with recourse loans and unfunded commitments are analogous to those associated with similar on-balance sheet loans. For this reason, these items will continue to be included in the risk-based capital ratio calculation. The Board generally agrees, however, that some specific changes should be made to more accurately measure the risks this subsection of the proposal is intended to account.

In particular, the Board generally agrees that a credit union's risk-based capital ratio calculation relating to off-balance sheet items should be limited to the amount of the credit union's contractual exposure. Accordingly, the Board has amended this proposal to require that 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, which is newly defined in this rule, by the appropriate credit conversion factor.

This proposal would retain the 10 percent credit conversion factor for non-commercial unused lines of credit. Commenters suggested that to improve their risk-based capital ratio credit unions would have looked to either terminate or decrease their lines of credit to consumers. Open lines of

credit to consumers, even those that are unconditionally cancellable, 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. Credit unions need to monitor the amount and type of outstanding unused lines of credit. The Board believes the proposed 10 percent credit conversion factor for unused consumer lines of credit would encourage credit unions to manage open consumer lines of credit through active monitoring and review of trends and exposures, and is consistent with the calculation of off-balance sheet exposure measures contained in Basel III.[274]

The Board generally agrees with commenters' who stated that the credit conversion factor for unfunded commercial loans, in the Original Proposal, was too high and could have created a competitive disadvantage for credit unions in relation to banks. Accordingly, the Board is proposing to reduce the credit conversion factor for commercial loans from 75 percent to 50 percent. This change would be consistent with the credit conversion factor applied to longer-term commitments not unconditionally cancelable under the Other Banking Agencies' regulations.[275]

The Board also generally agrees with commenters that, based on the structure of the CE provided through the FHLBs' MPF or similar programs, loans sold under these programs should be categorized and risk-weighted separately from other types of loans transferred with limited recourse. In an effort to better match the minimum capital requirements for loans sold as part of the MPF or similar programs, the proposed credit conversion factor, which converts the off-balance sheet exposure to a credit equivalent amount, would be set at 20 percent and applied a 50 percent risk weight (the same risk weight applied to first-lien residential real estate loans), resulting in an effective minimum capital requirement of one percent of the outstanding balance.[276] Applying the CCF against the outstanding loan balance would reduce the risk-based capital requirement as loans in the MPF pool pay down. The Board believes this proposed methodology and CCF would result in a risk-based capital requirement consistent with historic credit losses in this program. The Board believes such treatment is appropriate because a credit union incurring higher than normal levels of losses from loans in the MPF or similar programs would have to record a reserve for losses that would reduce the credit union's retained earnings.

In addition, under this proposed rule, credit unions would be able to deduct any associated established valuation allowance when determining the off-balance sheet exposure amount that is multiplied by the CCF to obtain the credit equivalent amount.

The Board recognizes commenters' concerns that the conversion factors and risk weights applicable to loans transferred with limited recourse could result in a competitive disadvantage. Therefore, the Board has changed its approach with respect to loans transferred with limited recourse to amend the conversion factors to better match those used by the Other Banking Agencies. Under this proposed rule, the Board has further clarified that the conversion factors and risk weights only apply to the maximum amount of the loan exposure, rather than the whole loan[277] as in the Original Proposal. The maximum amount of exposure is the portion of the loan that a credit union could be required to take back under the recourse provision of a loan sales contract.

As shown in the charts and proposed rule text below, the Board has amended many of the conversion factors and applicable risk weights in an effort to lower the burden on credit unions while still retaining the necessary safety and soundness components of this section of the rule.

First, the Board has lowered the conversion factor for unfunded commitments for commercial loans to achieve parity with the Other Banking Agencies' approach.[278] Further, the conversion factors for loans transferred with limited recourse would be consistent with the conversion factors assigned for banks under the Other Banking Agencies' rules.

However, under this proposal the conversion factor is applied only to the credit union's off-balance sheet exposure. The Board is also proposing to apply a lower credit conversion factor to loans sold under the FHLBs' MPF to more accurately account for historical losses in this program and to reduce the risk-based capital requirement as each loan pays down.

The following tables summarize the risk weights and conversion factors included in this proposal:

Loans Sold With Recourse

ORIGINAL PROPOSAL

	Conversion factor (applied to the outstanding loan balance) (percent)	Risk weight (percent)
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.

[274] Basel III was published in December 2010 and revised in June 2011. The text is available at *http://www.bis.org/publ/bcbs189.htm.*

[275] *See, e.g.,* 12 CFR 324.33.

[276] This proposed approach is based on historical loss information regarding the MPF program that was provided to NCUA by the Federal Home Loan Banks.

[277] As noted earlier, FHLBs' MPF loans are handled separately.

[278] *See, e.g.,* 12 CFR 324.33.

THIS PROPOSAL

Loan type transferred with limited recourse	Conversion factor (applied to the off-balance sheet exposure) (percent)	Risk weight (percent)
Outstanding balance of loans sold under the FHLB's mortgage partnership finance or similar program	20	50
Commercial loans	100	100
First-lien residential real estate loans	100	50
Junior-lien residential real estate loans	100	100
Secured consumer loans	100	75
Unsecured consumer loans	100	100

Unfunded Commitments

ORIGINAL PROPOSAL

	Conversion factor (percent)	Risk weight (percent)
Total unfunded commitments for non-business loans	10	75
Unused MBL commitments	75	100

THIS PROPOSAL

Loan Type of Unfunded Commitment	Conversion factor (percent)	Risk weight (percent)
Commercial loans	50	100
First-lien residential real estate loans	10	50
Junior-lien residential real estate loans	10	100
Secured consumer loans	10	75
Unsecured consumer loans	10	100

For the reasons discussed above, the Board has revised this section of the proposed rule and lowered many of the conversion factors and applicable risk weights. Accordingly, proposed § 702.104(b)(4) would provide that the risk-weighted amounts for all off-balance sheet items are 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 MPF program, a 20 percent CCF and a 50 percent risk weight.
- For other loans transferred with limited recourse, a 100 percent CCF applied to the off-balance sheet exposure and:
  - For commercial loans, a 100 percent risk weight.
  - 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 CCF with a 100 percent risk weight.
  - For first-lien residential real estate loans, a 10 percent CCF with a 50 percent risk weight.
  - For junior-lien residential real estate loans, a 10 percent CCF with a 100 percent risk weight.
  - For all secured consumer loans, a 10 percent CCF with a 75 percent risk weight.
  - For all unsecured consumer loans, a 10 percent CCF with a 100 percent risk weight.

The Board requests comments on this provision of the proposal.

104(c)(5) Derivatives

This section of the Original Proposal addressed the risk weights for derivative contracts. Based on NCUA's recently finalized derivatives rule, the Board is proposing to make minor changes and additions to the treatment of derivative contracts. Further, the Board is proposing to move derivative contracts to its own section of the rule for clarity and ease of reading. The full discussion of derivative contracts is included below in § 702.105.

Current § 702.105 Weighted-Average Life of Investments

As discussed above, proposed new § 702.105 below would replace current § 702.105 regarding weighted-average life of investments. The definition of weighted-average life of investments and the term ''weighted-average life of investments'' would be removed from this proposed rule altogether.

Section 702.105 Derivatives

This proposal separates derivatives into its own 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 § 702.105. This new proposed section includes all of the language from § 702.104(c)(4) of the Original Proposal, with only a few minor amendments. In addition, this proposed section 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 under NCUA's rules.

Derivatives rule. The Board finalized NCUA's derivatives rule at its January

2014 open meeting. In brief, that final rule allows FCUs to use specific types of derivatives for the purpose of mitigating IRR. The final rule also addressed ''clearing,'' which was not addressed in the proposed derivatives rule. Specifically, the final derivatives rule permits FCUs to clear derivatives transactions, provided the FCU follows applicable Commodity and Futures Trading Commission (CFTC) regulations. The Board notes, however, that NCUA's derivatives rule only applied to FCUs. As discussed in the preamble to the final rule, federally insured, state-chartered credit unions engaging in derivatives are required to follow applicable state regulations.

Proposed risk based capital treatment of derivatives. Based on its recently finalized derivatives rule, the Board is now proposing to adopt an approach to assign risk weights to derivatives that is generally consistent with the approach adopted by FDIC in its recently issued interim final rule regarding regulatory capital.[279] Under FDIC's interim rule, derivatives transactions covered under clearing arrangements are treated differently than non-cleared transactions. The Board addresses clearing separately below.

The Board is proposing to focus only on interest rate related derivatives in the proposed rule and to refer credit unions to FDIC's rules for all non-interest-rate-related derivatives. The Board is making 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 September 30th, 2014, NCUA is not aware of any non-interest rate derivative contracts being used by federally insured, state-chartered credit unions (as per the Call Report data) for derivative contracts.

OTC derivatives transaction risk weight. The Original Proposal only assigned risk weights to OTC derivatives transactions. While the Board received few comments on the general language in this section, the Board is now proposing to make two amendments. First, the Board is proposing to state that the current credit exposure is the greater of the fair value or zero rather than the mark to fair value or zero. This change is non-substantive and only intended as a clarifying correction.

Second, the Board is proposing to delete two subsections from the Original Proposal's section on potential future credit exposure, §§ 702.104(d)(4)(B)(2) and (3) of the Original Proposal. Section 702.104(d)(4)(B)(2) stated that 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. Section 702.104(d)(4)(B)(3) stated that for an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005. In place of these two sections, the Board is now proposing to add the following:

> A credit union must use an OTC interest rate derivative contract's effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the OTC interest rate derivative contract) rather than the apparent or stated notional principal amount in calculating potential future exposure (PFE).

The Board is making these changes to improve how credit unions will calculate the PFE given the high probability of only having interest rate-related contracts. The Board believes these proposed changes make the rule clearer and more closely align this section with other changes it is proposing throughout this rule.

Including the changes discussed above, the following is a description of the process a credit union would undertake under this proposal to determine the risk weight for OTC derivative contracts. The Board is proposing to require that to determine the risk-weighted asset amount for a derivatives contract; under this proposal, a credit union would first determine its exposure amount for the contract. It would then recognize the credit mitigation of financial collateral, if qualified, and then apply to that amount a risk weight based on the counterparty or recognized collateral or exchange (Derivatives Clearing Organization or DCO). For a single interest rate derivatives contract that is not subject to a qualifying master netting agreement, 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 fair value or zero, and (2) PFE, which is calculated by multiplying the notional principal amount of the derivatives contract by the appropriate conversion factor, in accordance with the table below. Non-interest rate derivative contract conversion factors can be referenced in 12 CFR 324.34 of the FDIC rule.

PROPOSED CONVERSION FACTOR MATRIX FOR INTEREST RATE DERIVATIVES CONTRACTS

Remaining maturity	IRR hedge derivatives
One year or less	0.00
Greater than one year and less than or equal to five years	0.005
Greater than five years	0.015

For multiple interest rate 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 proposed § 702.105(a)(2)(ii)(B).

Under this proposal, 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 net the counterparty exposure if the transactions fall under the same 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 §§ 702.105(a)(i) or (ii). Next, to recognize the credit risk mitigation benefits of the financial collateral, the credit union would use the approach for collateralized transactions as described in § 702.105(c) of the proposed rule, which is discussed in more detail below.

Cleared derivatives risk weight. As discussed above, under the Original Proposal, the Board did not include a discussion of cleared derivatives contracts, but generally tried to mirror the Other Banking Agencies' approach to derivatives, which treats derivatives transactions covered under clearing arrangements differently than non-cleared transactions. NCUA's Original Proposal, however, proposed a single regulatory capital approach regardless of the credit union's derivatives transaction clearing status, because most credit unions would qualify for an exemption or exception from clearing

[279] *See* 78 FR 55339 (Sept. 10, 2013).

under CFTC's regulations. The exemption and exception applicable to credit unions is discussed below.

As noted above, the Board received only a few comments on the proposed derivatives section of the Original Proposal. However, the majority of the comments the Board did receive requested that NCUA's rules align with the rules for banks. Specifically, commenters pointed out that the derivatives industry is migrating toward clearing and that clearing provides a valuable risk- reducing component to a derivatives transaction.

Other commenters requested examples of calculations and clarification on the process by which a credit union can recognize the risk mitigation benefits of collateral and how derivatives in federally insured, state-chartered credit unions would be treated under the Original Proposal.

After carefully considering the comments and its recent final derivatives rule, the Board agrees that NCUA's risk-based capital regulations should more closely align with the Other Banking Agencies' capital regulations. To that end, the Board is now proposing to include provisions to address clearing, a more robust collateral process, and the treatment of derivatives outside of NCUA's rule. The Board notes that this is consistent with its statement in the Original Proposal that it would amend any final rule regarding NCUA's risk-based capital requirements to take into account changes made in the final derivatives rule.

As noted above, the Board is now proposing to include a separate risk weight for cleared derivatives transactions. The approach in this section mirrors the approach taken by the Other Banking Agencies and will allow credit unions to account for the lower degree of risk for cleared transactions.

In NCUA's final derivatives rule, the Board discussed recent CFTC final rules [280] on cleared derivatives and included a section allowing FCUs to elect to clear under CFTC rules. The Board noted that CFTC's final rules provide credit unions with an exception and an exemption from clearing. The CTFC exception and exemption are the End-User Exception, which applies to financial institutions with total assets of $10 billion or less and the Cooperative Exemption, which applies to entities with assets greater than $10 billion where the entity is a cooperative.[281] CFTC's definition scope includes credit unions. Therefore, all credit unions have the right, as cooperatives, to elect to either clear swaps or engage in a traditional bilateral agreement. The Board notes that the clearing structure only applies to swaps.

For cleared derivatives transactions, each party to the swap submits the transaction to a DCO [282] for clearing. This reduces counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the intermediary DCO as their counterparty. In addition, DCOs exist for the primary purpose of managing credit exposure from the swaps being cleared and therefore DCOs 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 (*i.e.,* 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 (*i.e.,* 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.

Proposed § 702.105 would adopt an approach to assign risk weights to derivatives that is generally consistent with the approach adopted by the Other Banking Agencies.[283] Under this proposed rule, a credit union would be required to calculate a trade exposure amount, determine the risk mitigation of any financial collateral, and multiply that amount by the applicable risk weight. The Board notes that this approach allows credit unions to take into account the lower degree of risk associated with cleared derivatives transactions and the benefit of collateral associated with these transactions. In addition, this approach also accounts for the risk of loss associated with collateral posted by a credit union.

Trade exposure amount. The trade exposure amount, in this proposal, would equal the amount of the derivative, calculated as if it were an OTC transaction under subsection (b) of this section, added to the fair value of the collateral posted by the credit union and held by a DCO, clearing member or custodian. This calculation would take into account the exposure amount of the derivatives transaction and the exposure associated with any collateral posted by the credit union. The Board notes that this is the same approach employed by the Other Banking Agencies.[284]

Cleared transaction risk weights. Under this proposal, after a credit union determines its trade exposure amount, it would be required to apply a risk weight that is based on agreements preventing risk of loss of the collateral posted by the counterparty to the transaction. The proposed rule would require credit unions to apply a two percent risk weight if the collateral posted by a counterparty is subject to an agreement that prevents any losses caused by the default, insolvency, liquidation, or receivership of the clearing member or any of its clients. To qualify for this risk weight, a credit union would also have conducted a sufficient legal review and determined that the agreement to prevent risk of loss is legal, valid, binding, and enforceable. If a credit union does not meet either or both of these requirements, the credit union would have to apply a four percent risk weight to the transaction.

The differing risk weights for cleared transactions take into account the risk that collateral will not be there because of a default or other event, which further exposes the credit union to loss. However, cleared transactions pose very low probability that collateral will not be available in the event of a default, which is reflected in the low overall risk weights. Again, the Board notes that this is the same approach employed by the Other Banking Agencies.[285]

Collateralized transactions. Under the Original Proposal, NCUA proposed to permit a credit union to recognize risk-mitigating effects of financial collateral in OTC transactions. The collateralized portion of the exposure would receive 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

[280] 78 FR 52285 (Aug. 22, 2013); *see also* 17 CFR 50.51.

[281] *Id.*

[282] DCO has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(d)

[283] *See* 78 FR 55339 (Sept. 10, 2013).

[284] *See, e.g.,* 12 CFR 324.35.

[285] *See, e.g.,* 12 CFR 324.35.

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 this 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 this 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. The Board is proposing to include a new subsection in this section to address recognizing the risk mitigation of collateral. In the Original Proposal, this section was included in the discussion on assigning risk weights to OTC derivatives transactions. The Board recognizes, however, that derivative contracts are collateralized for risk mitigation purposes whether OTC or cleared. Collateralizing derivatives transactions is now industry practice and widely accepted to reduce and mitigate the credit risk and default impact of a counterparty to a transaction not being able to meet its obligations of the contract. A collateral agreement between two counterparties or exchange will stipulate the type of collateral that may be used, otherwise known as ''eligible collateral.'' As such, this proposed subsection will be applicable to both types of transactions.

Under this proposal, 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.

Finally, 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 with terms requiring maintenance of collateral values at specified thresholds.

When collateral other than cash is used to satisfy a margin requirement, then a haircut is applied to incorporate the credit risk associated with collateral, such as securities. The Board is proposing to include this concept in the revised rule so that credit unions can accurately recognize the risk mitigation benefit of collateral. The Board notes that this is the same approach taken by the Other Banking Agencies.

The table below illustrates an example of the calculations for Risk Weighted Asset Amounts for both OTC and clearing derivatives agreements. For this example both the OTC and clearing are considered to be a multiple contracts under a Qualified Master Netting Agreement. Credit unions can use this as a guide in confirming the calculations involved to produce a risk-weighted asset for derivatives. (See the number references below for each line number of the table example.)

1. The Agreement Type indicates the transaction legal agreement between the credit union and the counterparty.

2. The examples provide, but are not limited to the basis calculations required for various collateral and agreement approaches.

3. Variation Margin (amount as basis for margin calls which are satisfied with collateral) collateral used for these examples.

4. The Risk Weight of Collateral is applied when utilizing the Simple Approach in the recognition of credit risk of collateralized derivative contracts.

5. To recognize the risk-mitigating effects of financial collateral, a credit union may use the ''Simple Approach'' or the ''Collateral Haircut Approach''.

6. The Collateral Haircut is determined by using Table 2 to § 702.105 in the rule text: ''Standard Supervisor Market Price Volatility Haircuts.''

7. Counterparty risk weights are determined in § 702.104 for OTC and § 702.105 for clearing.

8–16. Are calculations based on the approach and types of agreement, collateral, fair values and notional amounts of the credit union derivatives transactions.

Example of Derivatives Risk Weight Calculations

DataSet: 31-Oct-14 (All amounts in USD whole dollars)

				Exposure Amount Components		
Product	Notional	Maturity	Fair Value	CCE	PFE Factor	PFE Amt and aGross
Swap	10,000,000	10/31/2017	500,000		0.005	50,000
Swap	20,000,000	11/1/2021	(250,000)		0.015	300,000
Swap	25,000,000	11/2/2025	650,000		0.015	375,000
Totals	55,000,000		900,000	***900,000***		***725,000***

Calculations:

1.) Agreement Type	OTC Multiple*			Clearing**		
2.) Scenario	A	B	C	D	E	F
3.) Variation Margin Collateral	Cash	MBS(1)	MBS(1)	Cash	MBS(1)	MBS(1)
4.) Risk Weight of Collateral (for Risk weight substitution).	0%	20%		0%	20%	
5.) Collateral Mitigation Method (c)	Simple	Simple	Haircut	Simple	Simple	Haircut
6.) Collateral Haircut (Table #2 to §702.105)			6%(2)			6%(2)
7.) Counterparty Risk Weight See (3)	100%	100%	100%	2%	2%	2%
8.) Net Current Credit Exposure (NCCE) (a)(1)(A)	900,000	900,000	900,000	900,000	900,000	900,000
9.) Potential Future Credit Exposure (PFE, Anet) (a)(1)(B)	630,435	630,435	630,435	630,435	630,435	630,435
10.) Exposure Amount	1,530,435	1,530,435	1,530,435	1,530,435	1,530,435	1,530,435
11.) Collateral: (Market value of Variation Margin)(4)	750,000	750,000	750,000	750,000	750,000	750,000
12.) Net Exposure Amount	780,435	780,435	780,435	780,435	780,435	780,435
Add:						
13.) Collateral Risk Weight (only in Simple Approach)	0	150,000		0	150,000	
14.) Haircut (2) (only in Collateral Haircut approach)			45,000			45,000
15.) Risk Asset before counterparty weighting	780,435	930,435	825,435	780,435	930,435	825,435
16.) Risk Weighted Asset Amount (3)	***780,435***	***930,435***	***825,435***	***15,609***	***18,609***	***16,509***

* Multiple OTC calculations assume qualified master netting agreement

** Initial Margin is assumed to be Bankruptcy Remote for this example and not included for Clearing Risk Weighted Asset Amount

(1) MBS considered to be GSE MBS pass-thru securities greater than 5 years of Residual Maturity

(2) See Table 2 to §702.105 for Haircut amounts

(3) Risk weight assumed to be 100% for OTC and 2% for Clearing

(4) Clearing margin thresholds are set by the exchange and will only by uncollaterized for the daily margin requirement while OTC minimum thresholds are negotiated

Federally insured, state-chartered credit unions' derivative transactions. As noted above, the Original Proposal did not specifically address derivatives transactions entered into by federally insured, state-chartered credit unions under state law that are impermissible under NCUA's regulations for FCUs. In this proposal, the Board is proposing to include language that would require federally insured, state-chartered credit unions to calculate risk weights in accordance with FDIC's rules for derivatives transactions that are not permissible under NCUA's derivatives rule.

The Board has also considered the following two approaches to addressing derivatives held by FISCUs that are not permissible under NCUA's rules, and invites stakeholders to comment on each:

- *Additional risk weights.* The Board has considered including an additional risk weight that would address any derivative entered into by a federally insured, state-chartered credit union that would be impermissible for an FCU to enter into. The Board notes that this risk weight would have to account for the added risk of additional types of transactions that are not permitted under its rules.
- *Adopting FDIC's rules verbatim.* Finally, the Board has considered incorporating FDIC's risk weights and rules for derivatives verbatim and creating a separate appendix for derivatives transactions. Incorporating FDIC's rules verbatim would add a high degree of complexity to a final risk-based capital rule and would likely address transactions into which federally insured, state chartered credit unions, while permitted to engage in, would likely not enter into.

The Board is interested in the comments of stakeholders on the pros and cons of each of these approaches, as well as any other approaches that may adequately address derivatives transactions by federally insured, state-chartered credit unions.

Current Section 702.106 Standard Calculation of Risk-based Net Worth Requirement

Consistent with the Original Proposal, this 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 would be removed by this proposed rule.

Current Section 702.107 Alternative Component for Standard Calculation

Consistent with the Original Proposal, this proposed rule would eliminate current § 702.107 regarding the use of

alternative risk weight measures. The Board believes the current alternative risk weight measures add unnecessary complexity to the rule. The current alternative risk weights focus almost exclusively on IRR, 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 excessive concentrations of assets.

Current Section 702.108 Risk Mitigation Credit

The Original Proposal would have eliminated current § 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 risk or IRR. Credit unions have rarely taken advantage of risk mitigation credits; only one credit union has ever received a risk mitigation credit.

The Board did receive a few comments regarding the elimination of the provision for risk mitigation credit in the current rule. Commenters suggested that there should continue to be a risk mitigation credit and that the agency has well-developed procedures for credit unions under current § 701.108, as well as for examiners under its ''Guidelines for Evaluation of an Application for a PCA Risk Mitigation Credit.'' Commenters suggested that this authority could provide an important incentive for credit unions to manage certain risks more proactively—and receive an added benefit of seeing their risk-based capital requirements at least somewhat reduced as a result. Other commenters suggested that by not allowing for some method of recognizing credit unions' ability to manage risks, the Board runs the risk of de-incentivizing credit unions to invest in the resources necessary to manage and mitigate risks, which could encourage a dangerous mind-set among credit unions to hold additional capital in place of a well-managed risk mitigation program.

Consistent with the Original Proposal, this proposed rule would eliminate current § 702.108 regarding the 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. The Board appreciates the issues raised by commenters, but continues to believe that maintaining the risk mitigation credit option is unjustified given the burden it imposes on NCUA and credit unions, its limited use in the past, and its improbable use in the future.

Mandatory and Discretionary Supervisory Actions

Section 216(a)(2) of the FCUA directs the Board to take ''prompt corrective action to resolve the problems of insured credit unions.'' [286] 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.[287]

This proposal would generally maintain the existing mandatory and discretionary supervisory actions (PCA actions) currently contained in §§ 702.201 through 702.204,[288] with certain additions that are discussed in more detail below. The PCA actions assist the Board in accomplishing the statutory purpose of section 219 [289] of the FCUA and provide a transparent guide to the supervisory actions that a credit union can expect as capital measures decline.

Section 702.106 Prompt Corrective Action for Adequately Capitalized Credit Unions

Generally consistent with the Original Proposal, this 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

Generally consistent with the Original Proposal, this 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

Generally consistent with the Original Proposal, this 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.

Section 702.109 Prompt Corrective Action for Critically Undercapitalized Credit Unions

Generally consistent with the Original Proposal, this 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

Generally consistent with the Original Proposal, this proposed rule would renumber current § 702.205 as proposed § 702.110, and would make only minor conforming amendments to the text of the section.

[286] 12 U.S.C. 1790d(a)(2).

[287] Credit unions defined as ''new credit unions'' under section 1790(d)(2) of the FCUA are subject to an alternative PCA system.

[288] The requirements would be moved to proposed §§ 702.106 through 702.109.

[289] 12 U.S.C. 1790d(a).

Section 702.111 Net Worth Restoration Plans (NWRPs)

Generally consistent with the Original Proposal, this 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

Consistent with the Original Proposal, 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 consecutive calendar quarters. The italicized words above ''and risk-based capital ratio, if applicable'' would be added 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. This proposal would remove the sentence ''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 to be adequately capitalized.'' This statement would be removed as repetitive and unnecessary because proposed § 702.102(a)(2)(i) already states clearly that a complex credit union must also attain a net worth ratio of higher than six percent to be adequately capitalized. No substantive changes to the requirements of this paragraph are intended by these revisions.

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 by removing the requirement that credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

111(g)(4) Submission of Multiple Unapproved NWRPs

Consistent with the Original Proposal, 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.[290] 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

Consistent with the Original Proposal, 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

Generally consistent with the Original Proposal, this proposed rule would renumber current § 702.401 as proposed § 702.112. Consistent with the text of current § 702.401(a), this proposal also would require that 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 Board or appropriate state official.

Regular Reserve Account

As mentioned above, this proposed rule would eliminate current § 702.401(b) regarding the regular reserve account from the earnings retention process. 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, a federal credit union would close out the regular reserve balance into undivided earnings. A state-chartered, federally insured credit union may, however, still be required to maintain a regular reserve account by its respective state supervisory authority.

In the past, 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.'' [291] 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 same section of 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.[292] However, NCUA 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 considers the regular reserve account requirement to be obsolete and is proposing to eliminate it upon the effective date of a final rule. The proposed rule would also eliminate 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

Generally consistent with the Original Proposal, this proposed rule would renumber current § 702.402 as proposed § 702.113, and would make only minor conforming amendments to the text of

[290] 12 U.S.C. 1786 and 1790d.

[291] 12 U.S.C. 1790(e)(1).

[292] 12 U.S.C. 1762.

the section with the exception of the changes to proposed § 702.113(d) that are discussed in more detail below.

113(d) Charges for Loan and Lease Losses

Consistent with the proposed elimination of the regular reserve requirement which is discussed above, proposed § 702.113(d) would remove paragraph (d)(4) of the current rule, which provides 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 part 702.

In addition, the proposed rule would remove paragraph (d)(3) of the current rule, which provides that adjustments to the valuation ALLL will be recorded in the expense account ''Provision for Loan and Lease Losses.'' This is to clarify that the ALLL is to be maintained in accordance with GAAP, as discussed above.

The remaining provisions in paragraph (d) of the current rule would be amended as follows:

(d)(1)

Proposed § 702.113(d)(1) would amend current § 702.401(d)(1) to provide that charges for loan *and lease* losses shall be made *timely and* in accordance with GAAP. The proposal would add the italicized words ''and lease'' and ''timely and'' to the language in the current rule to clarify that the requirement also applies to lease losses and to require that credit unions make charges for loan and lease losses in a timely manner. As with the section above, this section was changed to clarify that charges for potential lease losses are to be recorded in accordance with GAAP through the same allowance account as loan losses. In addition, timely recording is critical to maintain full and fair disclosure as required under this section.

(d)(2)

Proposed § 702.113(d)(2) would amend current § 702.401(d)(2) to eliminate the detailed requirement and simply provide that the ALLL must be maintained in accordance with GAAP. This is necessary to provide full and fair disclosure to a credit union member, NCUA, or, at the discretion of a credit union's board of directors, to creditors to fairly inform them of the credit union's financial condition and operations.

(d)(3)

Proposed § 702.113(d)(3) would retain the language in current § 702.401(d)(5) with no changes.

Section 702.114 Payment of Dividends

Generally consistent with the Original Proposal, this proposed rule would renumber current § 702.402 as proposed § 702.114 and make a number of amendments to the text of paragraphs (a) and (b).

The Board received several comments to the Original Proposal regarding the proposed restrictions on the payments of dividends. Commenters generally stated that the rule should not prohibit states from authorizing FISCUs to declare dividends. Other commenters suggested that NCUA should not be able to restrict dividend payments.

The Board disagrees with commenters and continues to believe that reasonable restrictions on dividend payments for credit unions that are less than adequately capitalized are necessary to protect the NCUSIF. The restrictions in § 702.402 of the current rule are prudent restrictions that were brought forward into the Original Proposal and now into this proposal. The changes would simply clarify what funds are available for dividends under GAAP. Accordingly, the Board is proposing the following amendments to the current rule.

Since the implementation of PCA for credit unions, FASB has issued accounting standards that impact the accounting for credit union equity items. Most specifically in December 2007, the FASB issued Accounting Standards Codification (ASC) Topic 805, *Business Combinations.*[293] Under ASC 805, all business combinations were to be accounted for by applying the acquisition method starting in late 2008.

In June of 2010, *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions* was released and principally focused on bargain purchase gains and business combinations in general. The supervisory guidance addressed the special considerations to regulatory capital reporting for credit unions involved in combinations and specifically that acquired equity generated as a result of a business combination for credit unions is part of GAAP equity, but not part of net worth. Consistent with the statutory definition of net worth, a credit union includes an amount equal to the acquired credit unions retained earnings as measured in accordance with GAAP. This special consideration can result in a credit union reporting a negative balance in undivided earnings while reporting a much larger positive balance of acquired equity which produces a total positive GAAP equity position and different positive total net worth. The changes to this section seek to address this issue.

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. Under this proposal, § 702.114(a), however, only credit unions that have substantial net worth, but no undivided earnings, would be allowed to pay dividends without regulatory approval. Due to the removal of the regular reserve account, as discussed above, and to conform with GAAP, this proposal would amend the language to further clarify that dividends may be paid when there is sufficient net worth. Net worth may incorporate accounts in addition to undivided earnings. Accordingly, § 702.114(a) of this proposal would provide that dividends shall be available only from net worth, net of any special reserves established under § 702.112, if any.

114(b) Payment of Dividends and Interest Refunds

This proposed rule would eliminate the language in current § 702.403(b) and § 702.114(b) and (c) of the Original Proposal entirely and replace it with a new provision. Under this proposal, § 702.114(b) would provide that the board of directors must not pay a dividend or interest refund that will cause the credit union's capital classification to fall below adequately capitalized under subpart A of part 702 unless the appropriate regional director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise). Paragraph (b) would provide further that the request for written approval must include the plan for eliminating any negative retained earnings balance.

Historically, credit unions with a net worth ratio below adequately capitalized were restricted from making a dividend payment without regional director approval and, if state-chartered, approval of the appropriate state official. This proposed rule would not remove the existing regulatory requirement for credit unions to obtain prior approval from the regional director and, if state-chartered, the appropriate state official, to pay a dividend if the credit union's net worth classification is, or if the dividend payment will cause the credit union's net worth

[293] Pre-codification reference: Statement of Financial Accounting Standards No. 141(R), *Business Combinations.*

classification to fall below, adequately capitalized.

However, as addressed above, special circumstances can result in a credit union reporting a negative balance in retained earnings while reporting a much larger positive balance of acquired equity which produces a total positive GAAP equity position and a different amount of positive total net worth. The Board believes it is prudent for credit unions with negative retained earnings to develop a plan to eliminate that negative balance to ensure long-term viability and sustainability. As such, this proposal would require a credit union that must request written approval to pay dividends because the payment would cause its net worth classification to fall below adequately capitalized to also include a plan for eliminating the negative retained earnings balance as part of the written request. This will ensure credit unions that are classified below adequately capitalized and have negative retained earnings have in place a plan to increase retained earnings and thereby increase net worth.

B. Subpart B—Alternative Prompt Corrective Action for New Credit Unions

Consistent with the Original Proposal, this proposed rule would add new subpart B, which would contain most of the capital adequacy rules that apply to ''new'' credit unions. Section 216(b)(2) of the FCUA requires NCUA to prepare regulations that apply to new credit unions.[294]

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 under the proposed rule, except for minor conforming changes and the following substantive amendments:

(1) Clarification of the language in current § 702.301(b) regarding the ability of credit unions to become ''new'' again due to a decrease in asset size after having exceed the $10 million threshold.

(2) Elimination of the regular reserve account requirement in current § 702.401(b) and all cross references to the requirement;

(3) 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

(4) Amendment of the language of current § 702.402 regarding the full and fair disclosure of financial condition.

(5) Amendment of the requirements of current § 702.403 regarding the payment of dividends.

Section 702.201 Scope

Consistent with the Original Proposal, this proposed rule would renumber current § 702.301 as proposed § 702.201. The proposed rule would also clarify that a credit union may not regain a designation of ''new'' after reporting total assets in excess of $10 million.

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.[295] Section 216(b)(2)(B)(v) of the FCUA further requires that rules for new credit unions prevent evasion of the purpose of § 216, which provides new credit unions a period of time to accumulate net worth.[296] 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 as a ''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, consistent with the current rule, proposed § 702.201(b) would amend the definition of ''new'' credit union in current § 702.301(b) to provide that a ''new'' credit union for purposes of subpart B is a credit union that both has been in operation for less than 10 years and has total assets of not more than $10 million. In addition, consistent with section 216(b)(2) of the FCUA, proposed paragraph (b) would further provide that 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.

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 sophistication 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. Accordingly, the Board believes any burden associated with the proposed change to the requirements of part 702 would be minimal.

Section 702.202 Net Worth Categories for New Credit Unions

Consistent with the Original Proposal, this proposed rule would renumber current § 702.302 as proposed § 702.202, and would make only minor technical edits and conforming amendments to the text of the section.

Section 702.203 Prompt Corrective Action for Adequately Capitalized New Credit Unions

Consistent with the Original Proposal, this 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 also 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

Consistent with the Original Proposal, this 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

Consistent with the Original Proposal, this proposed rule would renumber current § 702.305 as proposed § 702.205,

[294] 12 U.S.C. 1790d(b)(2).

[295] 12 U.S.C. 1790d(b)(2)(B)(iii).

[296] 12 U.S.C. 1790d(b)(2)(B)(v).

and would make only minor conforming amendments to the text of the section.

Section 702.206 Revised Business Plans (RBP) for New Credit Unions

Consistent with the Original Proposal, this 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

Consistent with the Original Proposal, proposed § 702.206(g)(3) would provide that the submission of more than two RBPs that were 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.[297] 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 amendment is 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

Consistent with the Original Proposal, this 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

Consistent with the Original Proposal, this proposed rule would add new § 702.208 regarding reserves for new credit unions to the rule and, consistent with the text of the current reserve requirement in § 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 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, a federal credit union would close out the regular reserve balance into undivided earnings. A federally insured, state-chartered credit union would still be required to maintain a regular reserve account as per state law or its state supervisory authority.

Section 702.209 Full and Fair Disclosure of Financial Condition

Generally consistent with the Original Proposal, this proposed rule would renumber current § 702.402 as § 702.209 and would make only minor conforming amendments to the text of this section with the exception of the changes to paragraph (d) that are discussed in more detail below.

209(d) Charges for Loan and Lease Losses

Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.209(d) would remove paragraph (d)(4) of the current rule, which provides 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 part 702. In addition, this proposed rule would remove paragraph (d)(3) of the current rule, which provides that adjustments to the valuation ALLL will be recorded in the expense account ''Provision for Loan and Lease Losses.'' As discussed in § 702.113, the changes in the section emphasize the need to record the ALLL in accordance with GAAP.

The remaining provisions in paragraph (d) of the current rule would be amended as follows:

(d)(1)

Proposed § 702.209(d)(1) would amend current § 702.401(d)(1) to provide that charges for loan *and lease* losses shall be made *timely and* in accordance with GAAP. The proposal would add the italicized words ''and lease'' and ''timely and'' to the language in the current rule to clarify that the requirement also applies to lease losses and to require that credit unions make charges for loan and lease losses in a timely manner. As with the section above, this section was changed to clarify that charges for potential lease losses should be recorded in accordance with GAAP through the same allowance account as loan losses. In addition, timely recording is critical to maintain full and fair disclosure as required under this section.

(d)(2)

Proposed § 702.209(d)(2) would amend current § 702.401(d)(2) to eliminate the detailed requirement and simply provide that the ALLL must be maintained in accordance with GAAP.

This is necessary to provide full and fair disclosure to a credit union member, NCUA, or, at the discretion of a credit union's board of directors, to creditors to fairly inform them of the credit union's financial condition and operations.

(d)(3)

Proposed § 702.209(d)(3) would retain the language in current § 702.401(d)(5) with no changes.

Section 702.210 Payment of Dividends

Generally consistent with the Original Proposal, this 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 also would make a number of amendments to the text of paragraphs (a) and (b) of the current rule. Each of these changes is discussed in more detail below.

210(a) Restriction on Dividends

Current § 702.402(a) permits small 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 provide that, for small credit unions, dividends shall be available only from net worth, net of any special reserves established under § 702.208, if any.

210(b) Payment of dividends if retained earnings depleted

This proposed rule would eliminate the language in current § 702.403(b) and § 702.210(b) and (c) of the Original Proposal entirely and replace it with a new provision. Under this proposal, § 702.210 would provide that the board of directors must not pay a dividend or interest refund that will cause the credit union's capital classification to fall below adequately capitalized under

[297] 12 U.S.C. 1786 and 1790d.

subpart B of part 702 unless the appropriate regional director and, if state-chartered, the appropriate state official, have given prior written approval (in an RBP or otherwise). Paragraph (b) would provide further that the request for written approval must include the plan for eliminating any negative retained earnings balance.

As noted earlier in the section of this preamble associated with § 702.114(b), the changes in this section would retain the restrictions on payment of dividends included in the current rule. However, this proposal would require a credit union that must request written approval to pay dividends because the payment would cause its net worth classification to fall below adequately capitalized to also include a plan for eliminating the negative retained earnings balance as part of the written request. This will ensure credit unions that are classified below adequately capitalized and have negative retained earnings to have in place a plan to increase retained earnings and thereby increase net worth.

C. Other Conforming Changes to the Regulations

In addition to the amendments discussed above, and consistent with the Original Proposal, this 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.

V. Effective Date

How much time would credit unions have to implement these new requirements?

The Original Proposal included an effective date of 18 months from the date of publication of a final rule. An overwhelming majority of commenters addressed this provision and nearly all disagreed with an 18-month effective date. They argued that 18 months would be insufficient to allow credit unions to make adjustments to internal systems, balance sheets, and operations in advance of the effective date.

Some commenters cited the phased-in implementation period that the Other Banking Agencies' rules provided in their final rules on risk-based capital for banks, and requested that the Board consider the same. Other commenters suggested implementation time frames from three years to nine years, with some suggesting each credit union have its own implementation period based on the complexity of its operations. The majority position, however, was that the effective date be three years from the date of publication of a final rule.

The Board agrees with the comments that a longer implementation period is necessary. Therefore, the Board is proposing an implementation date of January 1, 2019 to provide both credit unions and NCUA sufficient time to make the necessary adjustments, such as systems, processes, and procedures, and to reduce the burden on affected credit unions in meeting the new requirements.

In response to commenters who asked the Board to phase in the implementation, the Board has concluded that phasing in the new capital rules for credit unions would add additional complexity with minimal benefit, and therefore has provided for an extended implementation period. The Board believes this increase would provide credit unions with sufficient time to make the necessary adjustments to systems and operations before the effective date of this final rule. In addition, as noted above, an extended effective date would generally coincide with the full phase-in of FDIC's.

VI. Impact of the Proposed Regulation

A substantial number of commenters on the Original Proposal suggested NCUA underestimated the adverse effect the proposal would have had on credit unions. A number of commenters stated that they believed that more credit unions than the Board indicated in the proposal would be impacted because their net worth would fall to just barely over well capitalized or adequately capitalized levels. The Board has considered the concerns that were raised by commenters and has made substantial modifications in this proposal, as summarized above, to refine the scope and improve the targeting of the proposed risk-based capital requirements. These changes would reduce the number of affected credit unions substantially.

This proposal would apply to credit unions with $100 million or greater in total assets. As of December 31, 2013, there were 1,455 credit unions (21.5 percent of all credit unions) with assets of $100 million or greater. This proposal would therefore exempt almost 80 percent of all credit unions.[298] The Board notes that the risk-based capital requirements in this proposed rule would apply *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.[299]

Based on December 2013 Call Report data, NCUA estimates over 98 percent of credit unions with over $100 million in assets already have sufficient capital to remain well capitalized under this proposal.[300] NCUA estimates this proposal (based on December 2013 data) would cause fewer than 20 credit unions (with total assets of $10.9 billion) to experience a decline in their capital classification from well capitalized to adequately capitalized.[301] NCUA estimates that these credit unions would need to retain an additional $53.6 million in eligible capital in total to be well capitalized, assuming no adjustments to asset distributions.[302]

Based on December 2013 Call Report data, NCUA estimates that if the risk-based capital requirements in the current proposal were applied today, the proposed risk weights would result in a ratio of total risk-weighted assets (in the aggregate) to total assets of 57.4 percent. Further, the aggregate average risk-based capital ratio would be 18.2 percent with an average risk-based capital ratio of 19.3 percent.[303] As

[298] The Original Proposal applied to credit unions with total assets of more than $50 million. At the time, 2,237 credit unions had total assets greater than $50 million. Thus, the original proposal would have exempted over two-thirds of all credit unions. For those credit unions that would have been subject to the Original Proposal, over 90 percent would have remained well capitalized.

[299] There are 1,975 FDIC-insured banks with assets less than $100 million as of June 2014.

[300] Of the 1,455 impacted credit unions, only 27, or 1.86%, would have less than the 10 percent risk-based capital requirement to be well capitalized. Of these, eight have net worth ratios less than seven percent and therefore are already categorized as less than well capitalized.

[301] One credit union declines to undercapitalized in the estimate. However, given the proposal's provision to phase in supervisory goodwill over a longer period, which the estimation methodology could not separate out from total goodwill, this credit union's capital category would not actually decline.

[302] NCUA estimated the original proposal (based on June 2013 data) 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. Assuming no other adjustments to the balance sheet structure, NCUA estimated that the 10 credit unions that would experience a decline to undercapitalized would have needed to retain an additional $63 million (total) in risk-based capital to become adequately capitalized; the 189 credit unions would have needed to add roughly $700 million in capital to be restored to well capitalized.

[303] Based on June 2013 Call Report data, NCUA estimated that if risk-based capital requirements in the original Proposal were applied at that time, 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. By way of

shown in the two tables below, almost all complex credit unions would operate well above the proposed 10 percent requirement for classification as well capitalized.

DISTRIBUTION OF PROPOSED RISK BASED CAPITAL RATIO

Proposed RBC Ratio	<10%	10–13%	13–16%	16–20%	20–30%	30–50%	>50%
# of CUs	27	169	365	408	382	86	18

DISTRIBUTION OF NET WORTH RATIO AND PROPOSED RISK BASED CAPITAL RATIO

# of CUs	Less than well capitalized	Well capitalized to well + 2%	Well capitalized + 2% to + 3.5%	Well capitalized + 3.5% to + 5%	Greater than well capitalized + 5%
Net Worth Ratio	16	339	430	332	338
Proposed RBC Ratio	27	99	118	181	1,030

Various commenters suggested that as many as 1,000 credit unions would have been required to raise anywhere from $2 billion to $7 billion in additional capital under the original proposal to retain the same ''buffers'' that exist today to be considered well capitalized. Commenters stated that credit unions cannot easily manage their capital to the exact dollar level that equates to NCUA's proposed standards, and that the management of credit unions typically strives to maintain sufficient space or buffers between their actual net worth ratios and the minimum required levels to be well capitalized because the consequences of missing the net worth standards would be very serious. Commenters stated that to regain their buffer, credit unions would only have three choices: (1) Rebalance their assets, recognizing an opportunity cost when they forego higher earnings which would diminish their ability to grow; (2) ration services, stifling asset and membership growth; or (3) ask members to pay more, resulting in fewer member benefits and increased competition from banks.

The Board believes sound capital levels are vital to the long-term health of all financial institutions. Further, provided it is not otherwise unsafe or unsound, it is a business decision on the part of a credit union to maintain capital levels above those required by regulation. Balancing proper capital accumulation with product offering and pricing strategies helps ensure credit unions are able to provide affordable member services over time. Credit unions are already expected to incorporate into their business models and strategic plans provisions for maintaining prudent levels of capital.

This proposal is intended to ensure minimum regulatory capital levels are better correlated to risk. Regulatory capital levels correlated to risk help reduce the incentive for credit unions to hold levels of capital significantly higher than required, unless it is the credit union's choice to do so to meet member service and strategic objectives. The Board does recognize that unduly high minimum regulatory capital requirements could lead to less than optimal outcomes.

Some commenters suggested that for some credit unions the Original Proposal would have increased the amount of capital required to be well-capitalized above the current level of seven percent of total assets depending on the ratio of risk assets to total assets. The commenter claimed that on net, across all potentially affected credit unions (those with more than $40 million in assets), the total amount of capital necessary to be well capitalized would increase by $7.6 billion, or in other words, that the proposal would have increased the net worth ratio required to be well capitalized, on average, from seven percent to 7.76 percent. It is not the Board's intent to systematically increase capital requirements for all credit unions. Rather, the Board's goals are to ensure capital is commensurate with risk, thereby aligning incentives for managing risk with required capital levels, and to increase regulatory tools for addressing outliers. The Board believes this proposal will be effective in achieving these goals.

As shown in the table below, this proposal is estimated to raise minimum required capital levels above the current net worth ratio requirement for only 59 complex credit unions (four percent of the credit unions subject to the proposal). The proposed 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.

DISTRIBUTION OF RISK-BASED LEVERAGE EQUIVALENT RATIO [304]

Proposed RBC ratio—leverage equivalent	< 6%	6–7.5%	7.5–8.5%	8.5–9.5%	9.5–11%	> 11%	Average
# of CUs	878	518	42	11	6	0	5.74%

comparison, the bank aggregate total risk-weighted assets to total assets is 67.8 percent, with an average total risk-based capital ratio of 18.4 percent.

[304] This computation calculates the amount of capital required by multiplying the proposed risk weighted assets by 10 percent (the level to be well capitalized), and then dividing this result by total assets. This provides a measure comparable to the net worth ratio. Since the risk-based capital provisions provide for a broader definition of capital included in the risk-based capital ratio numerator, which on average benefits credit unions by approximately 50 basis points, the appropriate comparison point for the leverage equivalent is 7.5 percent, not the 7 percent level for well capitalized for the net worth ratio.

Unlike the Original Proposal, which was more closely tied to existing Call Report data, there are greater limitations in estimating the impact of this second proposal. Some of the key differences between the Original Proposal and the current proposal include: Assigning a risk weight to loans secured by non-owner-occupied residential property (First-Lien, 1–4 Family) of 50 percent rather than 100 percent; assigning a risk weight to insured and Federal Reserve deposits of zero percent; and assigning a risk weight to all loans with government guarantees or portions of commercial loans with compensating balances on deposit of 20 percent. These differences, among others, would benefit credit unions, as the lower risk-weights would result in lower capital requirements than those measured under the Original Proposal. Thus, NCUA reasonably believes, based on its estimates using the Call Report data currently available, that this second proposal would have a lower impact than the Original Proposal. Further, these estimates are believed to be conservative, with the expected benefit to credit unions likely being larger than projected, potentially resulting in even fewer adversely impacted credit unions than estimated.

As noted earlier, concentration risk is a material risk that NCUA addresses in this proposed rule. Based on December 31, 2013 Call Report data, if this proposal were applied today, NCUA estimates that this additional capital requirement for concentration risk would have the following impact:

Concentration threshold	Number of credit unions with total assets greater than $100 million as of 12/31/2013	Percentage of 1,455 credit unions with total assets greater than $100 million
First Lien Residential Real Estate (≤ 35% of Total Assets)	149	10.2%
Junior Lien Residential Real Estate (≤ 20% of Total Assets)	67	4.6%
Commercial Loans (Used MBLs as a proxy)[305] > 50% of Total Assets)	12	0.8%

VII. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities. A regulatory flexibility analysis is not required, however, if the agency certifies 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 $50 million) and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

The proposed amendments to part 702 would primarily affect complex credit unions, which are those with $100 million or more in assets. As a result, small credit unions with assets less than $50 million are much less affected by the proposed rule. NCUA recognizes, however, that even small credit unions will be affected by the proposed amendments to some minor extent in that credit unions may need to collect additional data for the NCUA Call Report.

In particular, the proposed rule, if finalized as-is, would likely impose some one-time minimal costs on credit unions mostly related to training and updates to internal data systems. NCUA estimates that for any small credit union that does have to change its current practices to deal with the expanded reporting required, it would take, on average, less than an additional three hours per quarter per credit union. For many small credit unions, it would take even less time because they would not need to collect as much data because of the simplicity of their operations and products and services offered. The costs associated with this would also be minimal. The Call Report changes prompted by this proposed rule are the kind that would easily be handled as part of the normal and routine maintenance of a credit union's data reporting system. Accordingly, the costs and other effects of this proposal on small credit unions are minor, and NCUA certifies that this proposal 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.[306] For purposes of the PRA, a paperwork burden may take the form of a reporting, disclosure or recordkeeping requirement, each referred to as an information collection. The proposed changes to part 702 impose new information collection requirements.

NCUA has determined that the proposed changes to part 702 will have costs associated with updating internal policies, and updating data collection and reporting systems for preparing Call Reports. Based on December 2013 Call Report data, NCUA estimates that all 6,554 credit unions would have to amend their procedures and systems for preparing Call Reports. NCUA will address the costs and provide notice of these changes in other collections, such as the NCUA Call Report and Profile as part of its regular amendments separate from this proposed rule.

Finally, NCUA estimates that approximately 21.5 percent, or 1,455 credit unions, will be defined as ''complex'' under the proposed rule and would have additional data collection requirements related to the new risk-based capital requirements.

Title of Information Collection: Risk-Based Capital policy implications for complex credit unions
Affected Public: Complex Credit Unions
Estimated Number of Respondents: 1,455
Estimated Burden Per Respondent: One-time policy review and revision, 40 hours
Estimated Cost Per Respondent: $1,276
Title of Information Collection: Risk-Based Capital policy implications for non-complex credit unions
Affected Public: Non-Complex Credit Unions
Estimated Number of Respondents: 5,099
Estimated Burden Per Respondent: One-time policy review and revision, 20 hours
Estimated Cost Per Respondent: $638
Total Estimated One-Time:

One-time burden for policy review and revision, (20 hours times 5,099 credit unions (non-complex), or 40 hours times 1,455 credit unions (complex)). The total one-time cost for non-complex credit unions totals 101,980 hours or $3,252,142, an average

[305] Using MBL data as the current Call Report does not capture commercial loan data as defined in this proposal.

[306] 44 U.S.C. 3507(d); 5 CFR part 1320.

of $638 per credit union. The total one-time cost for complex credit unions totals 58,200 hours or $1,855,998, an average of $1,276 per credit union.

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.

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 principles of 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, to some degree, 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. The Board believes this impact is minor, and it 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. Comments and suggestions of those state regulators are reflected in this 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

Credit, Credit unions, Insurance, Reporting and recordkeeping requirements.

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.

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 15, 2015.

Gerard Poliquin,

Secretary of the Board.

For the reasons discussed above, the 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) introductory text 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]

■ 5. Amend § 701.34 as follows:

■ a. In paragraph (b)(12) 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]

■ 6. 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)''.

PART 702—CAPITAL ADEQUACY

■ 7. The authority citation for part 702 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1790d.

■ 8. Revise § 702.1 to read as follows:

§ 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, and mandatory and discretionary supervisory actions applicable according to a credit union's capital classification, designed primarily to restore and improve the capital adequacy of federally insured credit unions.

(c) *Scope.* Subparts A and B of this part implement 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. Subpart C applies capital planning and stress testing to credit unions with $10 billion or more in total assets. This part does not apply to corporate credit unions. Unless otherwise provided, 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.

■ 9. Revise § 702.2 to read as follows:

§ 702.2 Definitions.

Unless otherwise provided 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:

Allowances for loan and lease losses (ALLL) means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables or other extensions of credit as determined in accordance with GAAP.

Amortized cost means the purchase price of a security adjusted for amortizations of premium or accretion of discount if the security was purchased at other than par or face value.

Appropriate state official means the state commission, board or other supervisory authority having jurisdiction over the credit union.

Call Report means the Call Report required to be filed by all credit unions under § 741.6(a)(2) of this chapter.

Carrying value means, with respect to an asset, the value of the asset on the statement of financial condition of the credit union, determined in accordance with GAAP.

Central counterparty (CCP) means a counterparty (for example, a clearing house) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts.

Commercial loan means any loan, line of credit, or letter of credit (including any unfunded commitments) to individuals, sole proprietorships, partnerships, corporations, or other business enterprises for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. Commercial loan excludes loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans.

Commitment means any legally binding arrangement that obligates the credit union to extend credit, to purchase or sell assets, or enter into a financial transaction.

Consumer loan means a loan to one or more individuals for household, family, or other personal expenditures, including any loans secured by vehicles generally manufactured for personal, family, or household use regardless of the purpose of the loan. Consumer loan excludes commercial loans, loans to CUSOs, first- and junior-lien residential real estate loans, and loans for the purchase of fleet vehicles.

Contractual compensating balance means the funds a commercial loan borrower must maintain on deposit at the lender credit union as security for the loan in accordance with the loan agreement, subject to a proper account hold and on deposit as of the measurement date.

Credit conversion factor (CCF) means the percentage used to assign a credit exposure equivalent amount for selected off-balance sheet accounts.

Credit union means a federally insured, natural person credit union, whether federally- or state-chartered.

Current means, with respect to any loan, that the loan is less than 90 days past due, not placed on non-accrual status, and not restructured.

CUSO means a credit union service organization as defined in part 712 and 741 of this chapter.

Custodian means a financial institution that has legal custody of collateral as part of a qualifying master netting agreement, clearing agreement, or other financial agreement.

Depository institution means a financial institution that engages in the business of providing financial services; that is recognized as a bank or a credit union by the supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. Depository institution includes all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions and international banking facilities of domestic depository institutions, and all privately insured state chartered credit unions.

Derivatives Clearing Organization (DCO) means the same as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(d).

Derivative contract means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, and credit derivative contracts. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument.

Equity investment means investments in equity securities and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

Equity investment in CUSOs means the unimpaired value of the credit union's equity investments in a CUSO as recorded on the statement of financial condition in accordance with GAAP.

Exchange means a central financial clearing market where end users can trade derivatives.

Excluded goodwill means the outstanding balance, maintained in accordance with GAAP, of any goodwill originating from a supervisory merger or combination that was completed no more than 29 days after publication of this rule in final form in the **Federal Register**. This term and definition will expire on January 1, 2025.

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 no more than 29 days after publication of this rule in final form in the **Federal Register**. This term and definition will expire on January 1, 2025.

Exposure amount means:

(1) The amortized cost for investments classified as held-to-maturity and available-for-sale, and the fair value for trading securities.

(2) The outstanding balance for Federal Reserve Bank Stock, Central Liquidity Facility Stock, Federal Home Loan Bank Stock, nonperpetual capital and perpetual contributed capital at corporate credit unions, and equity investments in CUSOs.

(3) The carrying value for non-CUSO equity investments, and investment funds.

(4) The carrying value for the credit union's holdings of general account permanent insurance, and separate account insurance.

(5) The amount calculated under § 702.105 of this part for derivative contracts.

Fair value has the same meaning as provided in GAAP.

Financial collateral means collateral approved by both the credit union and the counterparty as part of the collateral agreement in recognition of credit risk mitigation for derivative contracts.

First-lien residential real estate loan means a loan or line of credit primarily secured by a first-lien on a one-to-four family residential property where:

(1) 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; and

(2) In transactions where the credit union holds the first-lien and junior lien(s), and no other party holds an intervening lien, for purposes of this part the combined balance will be treated as a single first-lien residential real estate loan.

GAAP means generally accepted accounting principles in the United States as set forth in the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC).

General account permanent insurance means an account into which all premiums, except those designated for separate accounts are deposited, including premiums for life insurance and fixed annuities and the fixed portfolio of variable annuities, whereby the general assets of the insurance company support the policy.

General obligation means a bond or similar obligation that is backed by the full faith and credit of a public sector entity.

Goodwill means an intangible asset, maintained in accordance with GAAP, 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. Goodwill does not include excluded goodwill.

Government guarantee means a guarantee provided by the U.S. Government, FDIC, NCUA or other U.S. Government agency, or a public sector entity.

Government-sponsored enterprise (GSE) means an entity established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress, but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

Guarantee means a financial guarantee, letter of credit, insurance, or similar financial instrument that allows one party to transfer the credit risk of one or more specific exposures to another party.

Identified losses means 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. 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.

Industrial development bond means a security issued under the auspices of a state or other political subdivision for the benefit of a private party or enterprise where that party or enterprise, rather than the government entity, is obligated to pay the principal and interest on the obligation.

Intangible assets mean assets, maintained in accordance with GAAP, other than financial assets, that lack physical substance.

Investment fund means an investment with a pool of underlying investment assets. Investment fund includes an investment company that is registered under section 8 of the Investment Company Act of 1940, and collective investment funds or common trust investments that are unregistered investment products that pool fiduciary client assets to invest in a diversified pool of investments.

Junior-lien residential real estate loan means a loan or line of credit secured by a subordinate lien on a one-to-four family residential property.

Loan to a CUSO means the outstanding balance of any loan from a credit union to a CUSO as recorded on the statement of financial condition in accordance with GAAP.

Loan secured by real estate means a loan that, at origination, is secured wholly or substantially by a lien(s) on real property for which the lien(s) is central to the extension of the credit. A lien is ''central'' to the extension of credit if the borrowers would not have been extended credit in the same amount or on terms as favorable without the liens on real property. For a loan to be ''secured wholly or substantially by a lien(s) on real property,'' the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) must be greater than 50 percent of the principal amount of the loan at origination.

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). Loans transferred with limited recourse excludes transfers that qualify for true sale accounting treatment but contain only routine representation and warranty clauses 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-backed security (MBS) means a security backed by first- or junior-lien mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure.

Mortgage partnership finance program means a Federal Home Loan Bank program through which loans are originated by a depository institution that are purchased or funded by the Federal Home Loan Banks, where the

depository institutions receive fees for managing the credit risk of the loans and servicing them. The credit risk must be shared between the depository institutions and the Federal Home Loan Banks.

Mortgage servicing assets mean 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.

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.

(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 GAAP. A mutual combination, including a supervisory 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 has the same meaning as in § 702.201.

Nonperpetual capital has the same meaning as in § 704.2 of this chapter.

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 statement of financial condition, but are normally reported in the financial statement footnotes.

Off-balance sheet exposure means:

(1) For loans transferred 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.

(2) 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.

(3) For unfunded commitments, the remaining unfunded portion of the contractual agreement.

On-balance sheet means a credit union's assets, liabilities, and equity, as disclosed on the statement of financial condition at a specific point in time.

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.

Over-the-counter (OTC) interest rate derivative contract means a derivative contract that is not cleared on an exchange.

Perpetual contributed capital has the same meaning as in § 704.2 of this chapter.

Public sector entity (PSE) means a state, local authority, or other governmental subdivision of the United States below the sovereign level.

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; 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.

Recourse means a credit union's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred that exceeds a *pro rata* share of that credit union's claim on the asset and disclosed in accordance with GAAP. If a credit union has no claim on an asset it has transferred, then the retention of any credit risk is recourse. A recourse obligation typically arises when a credit union transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if the credit union provides credit enhancement beyond any contractual obligation to support assets it has transferred.

Residential mortgage-backed security means a mortgage-backed security backed by loans secured by a first-lien on residential property.

Residential property means a house, condominium unit, cooperative unit, manufactured home, or the construction thereof, and unimproved land zoned for one-to-four family residential use. Residential property excludes boats or motor homes, even if used as a primary residence, or timeshare property.

Restructured means, with respect to any loan, a restructuring of the loan in which a credit union, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Restructured excludes loans modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program.

Revenue obligation means a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from the specific project financed rather than general tax funds.

Risk-based capital ratio means the percentage, rounded to two decimal places, of the risk-based capital ratio numerator to 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).

Secured consumer loan means a consumer loan associated with collateral or other item of value to protect against loss where the creditor has a perfected security interest in the collateral or other item of value.

Senior executive officer means a senior executive officer as defined by § 701.14(b)(2) of this chapter.

Separate account insurance means an account into which a policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier.

Shares means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

Share-secured loan means a loan fully secured by shares on deposit at the credit union making the loan, and does not include the imposition of a statutory lien under § 701.39 of this chapter.

STRIPS means a separately traded registered interest and principal security.

Structured product means an investment that is linked, via return or loss allocation, to another investment or reference pool.

Subordinated means, with respect to an investment, that the investment has a junior claim on the underlying collateral or assets to other investments in the same issuance. Subordinated does not apply to securities that are junior only to money market fund eligible securities in the same issuance.

Supervisory merger or combination means a transaction that involved the following:

(1) An assisted merger or purchase and assumption where funds from the NCUSIF were provided to the continuing credit union;

(2) A merger or purchase and assumption classified by NCUA as an ''emergency merger'' where the acquired credit union is either insolvent or ''in danger of insolvency'' as defined under appendix B to part 701 of this chapter; or

(3) A merger or purchase and assumption that included NCUA's or the appropriate state official's identification and selection of the continuing credit union.

Swap dealer has the meaning as defined by the Commodity Futures Trading Commission in 17 CFT 1.3(ggg).

Total assets means a credit union's total assets as measured [1] by either:

(1) *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;

(2) *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;

(3) *Average daily balance.* The credit union's total assets measured by the average daily balance over the applicable calendar quarter; or

(4) *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.

Tranche means one of a number of related securities offered as part of the same transaction. Tranche includes a structured product if it has a loss allocation based off of an investment or reference pool.

Unsecured consumer loan means a consumer loan not secured by collateral.

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.

[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 702.106 (risk-based capital requirement).

■ 10. Revise subpart A to read as follows:

Subpart A—Prompt Corrective Action

Subpart A—Prompt Corrective Action

§ 702.101 Capital measures, capital adequacy, effective date of classification, and notice to NCUA.

(a) *Capital measures.* 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) *Capital adequacy.* (1) Notwithstanding the minimum requirements in this part, a credit union defined as complex must maintain capital commensurate with the level and nature of all risks to which the institution is exposed.

(2) A credit union defined as complex must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive written strategy for maintaining an appropriate level of capital.

(c) *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;

(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).

(d) *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 classification.

(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 risk-based capital ratio of 10 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 risk-based capital ratio of 8.0 percent or greater; and

(iii) Does not meet the definition of a well capitalized credit union.

(3) *Undercapitalized* if:

(i) *Net worth ratio.* The credit union has a net worth ratio of 4.0 percent or more but less than 6.0 percent; or

(ii) *Risk-based capital ratio.* The credit union, if complex, has a risk-based capital ratio of less than 8.0 percent.

(4) *Significantly undercapitalized* if:

(i) The credit union has a net worth ratio of 2.0 percent or more but less than 4.0 percent; or

(ii) 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 § 702.110;

(B) Materially fails to implement a net worth restoration plan approved by the NCUA Board; or

(C) Receives notice that a submitted net worth restoration plan has not been approved.

(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 also applicable if complex*	*And subject to following condition(s) . . .*
Well Capitalized	7% or greater	And	10.0% or greater.	
Adequately Capitalized	6% or greater	And	8% or greater	And does not meet the criteria to be classified as well capitalized.
Undercapitalized	4% to 5.99%	Or	Less than 8%.	
Significantly Undercapitalized	2% to 3.99%		N/A	Or if ''undercapitalized at < 5% net worth and (a) fails to timely submit, (b) fails to materially implement, or (c) receives notice of the rejection of a net worth restoration plan.
Critically Undercapitalized	Less than 2%		N/A.	

(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 providing the credit union with 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 providing the credit union with 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 the risk-based capital ratio measure.

For purposes of § 702.102, a credit union is defined as ''complex'' and the risk-based capital ratio measure is applicable only if the credit union's quarter-end total assets exceed one hundred million dollars ($100,000,000), as reflected in its most recent Call Report.

§ 702.104 Risk-based capital ratio.

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 ratio 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;

(ii) Appropriation for non-conforming investments;

(iii) Other reserves;

(iv) Equity acquired in merger;

(v) Net income

(vi) ALLL, maintained in accordance with GAAP;

(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 ratio numerator deductions.* The elements deducted from the sum of the capital elements of the risk-based capital ratio numerator 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) *Risk-weighted assets.* (1) *General.* Risk-weighted assets includes risk-weighted on-balance sheet assets as described in paragraphs (c)(2) and (3) of this section, plus the risk-weighted off-balance sheet assets in paragraph (c)(4) of this section, plus the risk-weighted derivatives in paragraph (c)(5) of this section, less the risk-based capital ratio numerator deductions in paragraph (b)(2) of this section. If a particular asset, derivative contract, or off balance sheet item has features or characteristics that suggest it could potentially fit into more than one risk weight category, then a credit union shall assign the asset, derivative contract, or off balance sheet item to the risk weight category that most accurately and appropriately reflects its associated credit risk.

(2) *Risk weights for on-balance sheet assets.* The risk categories and weights for assets of a complex credit union are as follows:

(i) *Category 1—zero percent risk weight.* A credit union must assign a zero percent risk weight to:

(A) The balance of cash, currency and coin, including vault, automatic teller machine, and teller cash.

(B) The exposure amount of:

(*1*) 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 principal- and interest-only mortgage-backed STRIPS.

(*2*) Federal Reserve Bank stock and Central Liquidity Facility stock.

(C) Insured balances due from FDIC-insured depositories or federally insured credit unions.

(ii) *Category 2—20 percent risk weight.* A credit union must assign a 20 percent risk weight to:

(A) The uninsured balances due from FDIC-insured depositories, federally insured credit unions, and all balances due from privately-insured credit unions.

(B) The exposure amount of:

(*1*) A non-subordinated obligation of the U.S. Government, its central bank, or a U.S. Government agency that is conditionally guaranteed, excluding principal- and interest-only mortgage-backed STRIPS.

(*2*) A non-subordinated obligation of a GSE other than an equity exposure or preferred stock, excluding principal- and interest-only GSE obligation STRIPS.

(*3*) Securities issued by PSEs in the U.S. that represent general obligation securities.

(*4*) Investment funds whose portfolios are permitted to hold only part 703 permissible investments that qualify for the zero or 20 percent risk categories.

(*5*) Federal Home Loan Bank stock.

(C) The balances due from Federal Home Loan Banks.

(D) The balance of share-secured loans.

(E) The portions of outstanding loans with a government guarantee.

(F) The portions of commercial loans secured with contractual compensating balances.

(iii) *Category 3—50 percent risk weight.* A credit union must assign a 50 percent risk weight to:

(A) The outstanding balance (net of government guarantees), including loans held for sale, of current first-lien residential real estate loans less than or equal to 35 percent of assets.

(B) The exposure amount of:

(*1*) Securities issued by PSEs in the U.S. that represent non-subordinated revenue obligation securities.

(*2*) Other non-subordinated, non-U.S. Government agency or non-GSE guaranteed, residential mortgage-backed security, excluding principal- and interest-only STRIPS.

(iv) *Category 4—75 percent risk weight.* A credit union must assign a 75 percent risk weight to the outstanding balance (net of government guarantees), including loans held for sale, of:

(A) Current first-lien residential real estate loans greater than 35 percent of assets.

(B) Current secured consumer loans.

(v) *Category 5—100 percent risk weight.* A credit union must assign a 100 percent risk weight to:

(A) The outstanding balance (net of government guarantees), including loans held for sale, of:

(*1*) First-lien residential real estate loans that are not current.

(*2*) Current junior-lien residential real estate loans less than or equal to 20 percent of assets.

(*3*) Current unsecured consumer loans.

(*4*) Current commercial loans, less contractual compensating balances that comprise less than 50 percent of assets.

(*5*) Loans to CUSOs.

(B) The exposure amount of:

(*1*) Industrial development bonds.

(*2*) All stripped mortgage-backed securities (principal- and interest-only STRIPS).

(*3*) Part 703 compliant investment funds, with the option to use the look-through approaches in paragraph (c)(3)(ii) of this section.

(*4*) Corporate debentures and commercial paper.

(*5*) Nonperpetual capital at corporate credit unions.

(*6*) General account permanent insurance.

(*7*) GSE equity exposure or preferred stock.

(C) All other assets listed on the statement of financial condition not specifically assigned a different risk weight under this subpart.

(vi) *Category 6—150 percent risk weight.* A credit union must assign a 150 percent risk weight to:

(A) The outstanding balance, net of government guarantees and including loans held for sale, of:

(*1*) Current junior-lien residential real estate loans that comprise more than 20 percent of assets.

(*2*) Junior-lien residential real estate loans that are not current.

(*3*) Consumer loans that are not current.

(*4*) Current commercial loans (net of contractual compensating balances), which comprise more than 50 percent of assets.

(*5*) Commercial loans (net of contractual compensating balances), which are not current.

(B) The exposure amount of:

(*1*) Perpetual contributed capital at corporate credit unions.

(*2*) Equity investments in CUSOs.

(vii) *Category 7—250 percent risk weight.* A credit union must assign a 250 percent risk weight to the carrying value of mortgage servicing assets.

(viii) *Category 8—300 percent risk weight.* A credit union must assign a 300 percent risk weight to the exposure amount of:

(A) Publicly traded equity investment, other than a CUSO investment.

(B) Investment funds that are not in compliance with part 703 of this Chapter, with the option to use the look-

through approaches in paragraph (c)(3)(ii) of this section.

(C) Separate account insurance, with the option to use the look-through approaches in paragraph (c)(3)(ii) of this section.

(ix) *Category 9—400 percent risk weight.* A credit union must assign a 400 percent risk weight to the exposure amount of non-publicly traded equity investments, other than equity investments in CUSOs.

(x) *Category 10—1,250 percent risk weight.* A credit union must assign a 1,250 percent risk weight to the exposure amount of any subordinated tranche of any investment, with the option to use the gross-up approach in paragraph (c)(3)(i) of this section.

(3) *Alternative risk weights for certain on-balance sheet assets.* Instead of using the risk weights assigned in paragraph (c)(2) of this section, a credit union may determine the risk weight of investment funds and subordinated tranches of any investment as follows:

(i) *Gross-up approach.* A credit union may use the gross-up approach under § 324.43(e) of this title to determine the risk weight of the carrying value of any subordinated tranche of any investment.

(ii) *Look-through approaches.* A credit union may use one of the look-through approaches under § 324.53 of this title to determine the risk weight of the exposure amount of investment funds that are not in compliance with part 703 of this chapter, the holdings of separate account insurance; or part 703 compliant investment funds.

(4) *Risk weights for off-balance sheet activities.* The risk weighted amounts for all off-balance sheet items are determined by multiplying the off-balance sheet exposure amount by the appropriate CCF and the assigned risk weight as follows:

(i) For the outstanding balance of loans transferred to a Federal Home Loan Bank under the mortgage partnership finance program, a 20 percent CCF and a 50 percent risk weight.

(ii) For other loans transferred with limited recourse, a 100 percent CCF applied to the off-balance sheet exposure and:

(A) For commercial loans, a 100 percent risk weight.

(B) For first-lien residential real estate loans, a 50 percent risk weight.

(C) For junior-lien residential real estate loans, a 100 percent risk weight.

(D) For all secured consumer loans, a 75 percent risk weight.

(E) For all unsecured consumer loans, a 100 percent risk weight.

(iii) For unfunded commitments:

(A) For commercial loans, a 50 percent CCF with a 100 percent risk weight.

(B) For first-lien residential real estate loans, a 10 percent CCF with a 50 percent risk weight.

(C) For junior-lien residential real estate loans, a 10 percent CCF with a 100 percent risk weight.

(D) For all secured consumer loans, a 10 percent CCF with a 75 percent risk weight.

(E) For all unsecured consumer loans, a 10 percent CCF with a 100 percent risk weight.

(5) *Derivative contracts.* A complex credit union must assign a risk-weighted amount to any derivative contracts as determined under § 702.105 of this part.

§ 702.105 Derivative contracts.

(a) *OTC interest rate derivative contracts.*

(1) *Exposure amount*—(i) *Single OTC interest rate derivative contract.* Except as modified by paragraph (a)(2) of this section, the exposure amount for a single OTC interest rate derivative 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 OTC interest rate derivative contract.

(A) *Current credit exposure.* The current credit exposure for a single OTC interest rate derivative contract is the greater of the fair value of the OTC interest rate derivative contract or zero.

(B) *PFE.* (*1*) The PFE for a single OTC interest rate derivative contract, including an OTC interest rate derivative contract with a negative fair value, is calculated by multiplying the notional principal amount of the OTC interest rate derivative contract by the appropriate conversion factor in Table 1 of this section.

(*2*) A credit union must use an OTC interest rate derivative contract's effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the OTC interest rate derivative contract) rather than the apparent or stated notional principal amount in calculating PFE.

TABLE 1 TO § 702.105—CONVERSION FACTOR MATRIX FOR INTEREST RATE DERIVATIVE CONTRACTS [2]

Remaining maturity	Conversion factor
One year or less	0.00
Greater than one year and less than or equal to five years	0.005
Greater than five years	0.015

[2] Non-interest rate derivative contracts are addressed in paragraph (d) of this section.

(ii) *Multiple OTC interest rate derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (a)(2) of this section, the exposure amount for multiple OTC interest rate derivative 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 OTC interest rate derivative 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 fair value of the individual OTC interest rate derivative contracts subject to the qualifying master netting agreement or zero.

(B) *Adjusted sum of the PFE amounts (Anet).* The adjusted sum of the PFE amounts is calculated as Anet = $(0.4 \times \text{Agross}) + (0.6 \times \text{NGR} \times \text{Agross})$, where:

(*1*) Agross equals the gross PFE (that is, the sum of the PFE amounts as determined under paragraph (a)(1)(i)(B) of this section for each individual derivative 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 (a)(1)(i) of this section) of all individual derivative contracts subject to the qualifying master netting agreement.

(3) *Recognition of credit risk mitigation of collateralized OTC derivative contracts.* A credit union may recognize credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivative contracts subject to a qualifying master netting agreement (netting set) by following the requirements of paragraph (c) of this section.

(b) *Cleared transactions for interest rate derivatives*—(1) *General requirements.* A credit union must use

the methodologies described in paragraph (b) of this section to calculate risk-weighted assets for a cleared transaction.

(2) *Risk-weighted assets for cleared transactions.* (i) To determine the risk weighted asset amount for a cleared transaction, a credit union must multiply the trade exposure amount for the cleared transaction, calculated in accordance with paragraph (b)(3) of this section, by the risk weight appropriate for the cleared transaction, determined in accordance with paragraph (b)(4) of this section.

(ii) A credit union's total risk-weighted assets for cleared transactions is the sum of the risk-weighted asset amounts for all its cleared transactions.

(3) *Trade exposure amount.* For a cleared transaction the trade exposure amount equals:

(i) The exposure amount for the derivative contract or netting set of derivative contracts, calculated using the methodology used to calculate exposure amount for OTC interest rate derivative contracts under paragraph (a) of this section; plus

(ii) The fair value of the collateral posted by the credit union and held by the, clearing member, or custodian.

(4) *Cleared transaction risk weights.* A credit union must apply a risk weight of:

(i) Two percent if the collateral posted by the credit union to the DCO or clearing member is subject to an arrangement that prevents any losses to the credit union due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member; and the clearing member credit union has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from an event of default or from liquidation, insolvency, or receivership proceedings) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdictions; or

(ii) Four percent if the requirements of paragraph (b)(4)(i) are not met.

(5) *Recognition of credit risk mitigation of collateralized OTC derivative contracts.* A credit union may recognize the credit risk mitigation benefits of financial collateral that secures a cleared derivative contract by following the requirements of paragraph (c) of this section.

(c) *Recognition of credit risk mitigation of collateralized interest rate derivative contracts.* (1) A credit union may recognize the credit risk mitigation benefits of financial collateral that secures an OTC interest rate derivative contract or multiple interest rate derivative contracts subject to a qualifying master netting agreement (netting set) or clearing arrangement by using the simple approach in paragraph (c)(3) of this section.

(2) 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 (a) or (b) of this section using the collateral approach in paragraph (c)(3) of this section. The credit union must substitute the exposure amount calculated under paragraphs (b) or (c) of this section in the equation in paragraph (c)(3) of this section.

(3) *Collateralized transactions.* (i) *General.* A credit union may use the approach in paragraph (c)(3)(ii) of this section to recognize the risk-mitigating effects of financial collateral.

(ii) *Simple collateralized derivatives approach.* To qualify for the simple approach, the financial collateral must meet the following requirements:

(A) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(B) The collateral must be revalued at least every six months; and

(C) The collateral and the exposure must be denominated in the same currency.

(iii) *Risk weight substitution.* (A) 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).

(B) 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.

(iv) *Exceptions to the 20 percent risk weight floor and other requirements.* Notwithstanding the simple collateralized derivatives approach in paragraph (c)(3)(ii) of this section:

(A) 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.

(B) 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)(i).

(v) A credit union may assign a zero percent risk weight to the collateralized portion of an exposure where:

(A) The financial collateral is cash on deposit; or

(B) The financial collateral is an exposure that qualifies for a zero percent risk weight under § 702.104(c)(2)(i), and the credit union has discounted the fair value of the collateral by 20 percent.

(4) *Collateral haircut approach.* (i) A credit union may recognize the credit risk mitigation benefits of financial collateral that secures a collateralized derivative contract by using the standard supervisory haircuts in paragraph (c)(3) of this section.

(ii) The collateral haircut approach applies to both OTC and cleared interest rate derivatives contracts discussed in this section.

(iii) A credit union must determine the exposure amount for a collateralized derivative contracts by setting the exposure amount equal to the max{0,[(exposure amount—value of collateral)+(sum of current fair value of collateral instruments * market price volatility haircut of the collateral instruments)]}, where:

(A) The value of the exposure equals the exposure amount for OTC interest rate derivative contracts (or netting set) calculated under paragraphs (a)(1)(i) and (ii) of this section.

(B) The value of the exposure equals the exposure amount for cleared interest rate derivative contracts (or netting set) calculated under paragraph (b)(3) of this section.

(C) The value of the collateral is the sum of cash and all instruments under the transaction (or netting set).

(D) The sum of current fair value of collateral instruments as of the measurement date.

(E) A credit union must use the standard supervisory haircuts for market price volatility in Table 2 to § 702.105 of this section.

TABLE 2 TO § 702.105—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS

[based on a 10 business-day holding period]

Residual maturity	Haircut (in percent) assigned based on:	
	Collateral risk weight (in percent)	
	Zero	20 or 50
Less than or equal to 1 year	0.5	1.0
Greater than 1 year and less than or equal to 5 years	2.0	3.0
Greater than 5 years	4.0	6.0
Cash collateral held	Zero	
Other exposure types	25.0	

(d) *All other derivative contracts and transactions.* Credit unions must follow the requirements of the applicable provisions of Part 324, Title 12, Chapter 3, when assigning risk weights to exposure amounts for derivatives contracts not addressed in paragraphs (a) or (b) of this section.

§ 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 FISCU.* 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)(i);

(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 a 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 maintain a risk-based capital ratio equal to or greater than 8 percent 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;

(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 and lease losses.* Full and fair disclosure demands that a credit union properly address charges for loan losses as follows:

(1) Charges for loan and lease losses shall be made timely and in accordance with GAAP;

(2) The ALLL must be maintained in accordance with GAAP; and

(3) 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, net of any special reserves established under § 702.112, if any.

(b) *Payment of dividends and interest refunds.* The board of directors must not pay a dividend or interest refund that will cause the credit union's capital classification to fall below adequately capitalized under this subpart unless the appropriate Regional Director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise). The request for written approval must include the plan for eliminating any negative retained earnings balance.

■ 11. Revise subpart B to read as follows:

Subpart B—Alternative Prompt Corrective Action for New Credit Unions

Sec.

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(c); and written notice 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—

(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%).

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 uncapitalized 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 uncapitalized new credit union that remains uncapitalized one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as uncapitalized; 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 uncapitalized, 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 uncapitalized federal credit union.* In lieu of paragraph (c) of this section, an uncapitalized 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 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 (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;

(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 and lease losses.* Full and fair disclosure demands that a new credit union properly address charges for loan losses as follows:

(1) Charges for loan and lease losses shall be made timely in accordance with generally accepted accounting principles (GAAP);

(2) The ALLL must be maintained in accordance with GAAP; and

(3) At a minimum, adjustments to the ALLL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.210 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from net worth, net of any special reserves established under § 702.208, if any.

(b) *Payment of dividends and interest refunds.* The board of directors may not pay a dividend or interest refund that will cause the credit union's capital classification to fall below adequately capitalized under subpart A of this Part unless the appropriate regional director and, if state-chartered, the appropriate state official, have given prior written approval (in an RBP or otherwise). The request for written approval must include the plan for eliminating any negative retained earnings balance.

Subpart C—[Removed]

■ 12. Remove subpart C.

Subpart E [Redesignated as Subpart C]

■ 13. Redesignate subpart E as subpart C and redesignate §§ 702.501 through 702.506 as §§ 702.301 through 702.306 respectively.

§ 702.304 Capital planning.

■ 14. Amend the newly redesignated § 702.304(b)(4) by replacing the citation ''§ 702.506(c)'' with ''§ 702.306(c)''.

§ 702.305 NCUA action on capital plans.

■ 15. Amend the newly redesignated § 702.305(b)(4) by replacing the citation ''§ 702.504'' with ''§ 702.304''.

§ 702.306 Annual supervisory stress testing.

■ 16. Amend the newly redesignated § 702.306(c) by replacing the citation ''§ 702.504'' with ''§ 702.304''.

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 17. 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]

■ 18. 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

■ 19. 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).

■ 20. 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,''.

The revision reads as follows:

§ 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

■ 21. 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]

■ 22. In § 723.7 amend paragraph (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—ADMINSTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS

■ 23. 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]

■ 24. In § 747.2001, amend paragraph (a) by removing the citation ''702.302(d)'' and adding in its place the citation ''702.202(d)''.

§ 747.2002 [Amended]

■ 25. In § 747.2002, amend paragraph (a)(1) 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]

■ 26. In § 747.2003, amend paragraph (a) by removing the citation ''702.302(d)'' and adding in its place the citation ''702.202(d)''.

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