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12 CFR Parts 700, 701, 702, 703, et al.
Risk-Based Capital; Final 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:** Final rule.

SUMMARY: The NCUA Board (Board) is amending NCUA's current regulations regarding prompt corrective action (PCA) to require that credit unions taking certain risks hold capital commensurate with those risks. The risk-based capital provisions of this final rule apply only to federally insured, natural-person credit unions with assets over \$100 million.

The overarching intent is to reduce the likelihood of a relatively small number of high-risk outliers exhausting their capital and causing systemic losses—which, by law, all federally insured credit unions would have to pay through the National Credit Union Share Insurance Fund (NCUSIF).

This final rule restructures NCUA's PCA regulations and makes various revisions, including amending the agency's current risk-based net worth requirement by replacing it with a new risk-based capital ratio for federally insured, natural-person credit unions (credit unions).

The risk-based capital requirement set forth in this final rule is more consistent with NCUA's risk-based capital measure for corporate credit unions and, as the law requires, more comparable to the regulatory risk-based capital measures used by the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System, and Office of the Comptroller of Currency (Other Banking Agencies). The effective date is intended to coincide with the full phase-in of FDIC's risk-based capital measures in 2019.

The final rule also eliminates several provisions in NCUA's current PCA regulations, including provisions relating to the regular reserve account, risk-mitigation credits, and alternative risk weights.

DATES: This final rule is effective on January 1, 2019.

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SUPPLEMENTARY INFORMATION:

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- II. Summary of the Final Rule
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I. Background

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. NCUA performs this function by examining and supervising federally chartered 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 all federally insured credit unions.¹ In its role as the administrator of the NCUSIF, NCUA insures and regulates approximately 6,270 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 proposed amendments were intended to implement the statutory requirements of the Federal Credit Union Act (FCUA) and follow recommendations made by the Government Accountability Office (GAO) and NCUA's Inspector General. The proposal was also intended to amend NCUA's risk-based capital

regulations to be more consistent with NCUA's risk-based capital measure for corporate credit unions and comparable to the new regulatory risk-based capital regulations finalized by the Other Banking Agencies in 2013.³ In response to the Original Proposal, the Board received over 2,000 comments with many suggestions on how to improve the proposed regulation. The comments received addressed a wide range of issues. In general, however, the commenters nearly all agreed that, because the proposal assigned higher risk weights to some credit union asset classes, it would have placed credit unions at a competitive disadvantage to banks. The change most frequently recommended by commenters to address this concern was to adopt the same risk weights as the Other Banking Agencies. The Board generally agreed and, after reviewing all of the comments received, determined that it was appropriate to issue a second proposed rule.

So, at its January 2015 meeting, the Board issued a second proposed rule (the Second Proposal)⁴ to amend NCUA's PCA regulations, part 702. The Second Proposal, which was based largely on the comments NCUA received on the Original Proposal, addressed the competitive disadvantage concerns raised by commenters and made the proposal more comparable to the Other Banking Agencies' risk-based capital requirements. Particular changes from the Original Proposal included: (1) Amending the definition of "complex" credit union, resulting in an increase in 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 member business loans); (3) assigning the same risk weights to one-to-four family non-owner-occupied residential real estate loans and other types of residential real estate loans; (4) eliminating provisions intended to address interest rate risk (IRR); (5) eliminating the proposed individual minimum capital requirement; and (6) extending the effective date to January 1, 2019. These changes would have, among other things, substantially reduced the number of credit unions subject to the rule, and would have provided credit unions significantly

¹ Within the nine states that allow privately insured credit unions, approximately 129 state-chartered credit unions are privately insured and are not subject to NCUA regulation or oversight.

² 79 FR 11183 (Feb. 27, 2014).

³ The Office of the Comptroller of Currency, and the Board of Governors of the Federal Reserve System: 78 FR 62017 (Oct. 11, 2013); and the Federal Deposit Insurance Corporation: 78 FR 55339 (Sept. 10, 2013).

⁴ 80 FR 4339 (Jan. 27, 2015).

more time to prepare to implement the rule's requirements.

Summary of Public Comments on the Second Proposal

In response to the Second Proposal, the Board received over 2,100 comments. While the total number of comment letters received was higher than the number received in response to the Original Proposal, the comment letters responding to the Second Proposal were significantly shorter and raised fewer distinct concerns regarding the rule's provisions. In addition, significantly fewer credit unions sent in comment letters in response to the Second Proposal. In response to the Original Proposal, NCUA received comment letters from more than 1,100 different credit unions, while only 514 different credit unions sent in comment letters in response to the Second Proposal. In addition, more than 900 of the comment letters received in response to the Second Proposal provided no substantive input on the rule. Nearly all of these non-substantive letters simply stated that the commenter believed Congress should "approve" the rule, or that the commenter wanted to "vote no" on the rule.

A majority of significant comment letters received stated that the commenter opposed the proposal in its entirety and suggested that the Second Proposal be withdrawn. Most of these commenters stated they opposed the rule for one or more of the following reasons: A substantial number of commenters suggested that the strong performance of credit unions and the NCUSIF during and after the 2007–2009 financial crisis demonstrated there was no need for the proposal, and that the Board provided no evidence that the proposal would have reduced material losses to the NCUSIF if it had been in place before the financial crisis. Other commenters maintained that the proposal was unnecessary given how extremely well capitalized the industry is today. Commenters contended further that, given NCUA's own estimates that fewer than 30 credit unions would be less than well capitalized under the proposed risk-based capital ratio if it went into effect immediately, NCUA's current risk-based capital regulations and other supervisory tools seem to be doing an adequate job. Several commenters claimed that most credit union failures, including the corporate credit unions (Corporates), and significant losses to the NCUSIF were the result of high concentration levels in risky loans and investments, or were otherwise related to a lack of internal controls that should have been

identified through the examination process. Commenters suggested that, instead of updating NCUA's risk-based capital regulations, the Board should focus on enhanced training to improve examiner skills. A substantial number of commenters also claimed that the proposal would regulate credit unions in the same general manner as banks. They argued credit unions should be regulated differently than banks because they are structured and operate differently. Other commenters argued the proposed rule would place credit unions at a competitive disadvantage to banks, because in these commenters' opinion, the proposed rule would require credit unions to hold incrementally more capital than banks given similar levels of asset concentration. At least one commenter suggested that the proposal would drive the largest credit unions to convert to bank charters. Other commenters argued that risk-based capital requirements, to which banks have been subject for approximately 25 years, have not worked well. In addition, they argued that bank regulators are now moving away from risk-based capital structures after they failed to help banks during the 2007–2009 recession. In support of this argument, many commenters cited a statement in which one FDIC Board Member, the FDIC's Vice Chairman, stated publicly that he believed the risk-based capital approach to regulation was a bad idea. A substantial number of commenters expressed concern that the proposal would stifle growth, innovation, diversification, and member services within credit unions by restricting credit unions' use of capital, and would impose excessive costs on credit unions and their members. At least one commenter suggested that the proposal would likely cause more risk, not less risk, to the system as a whole because the lower risk weightings assigned in some asset classes compared to others would force credit unions to take on excessive concentrations of lower risk-weighted assets. This, the commenter argued, would increase concentration risk compared to a diverse balance sheet.

Other commenters expressed concern that the proposal would be detrimental to the interests of many credit union members because credit unions would have to charge their members higher interest rates and fees and pay lower interest on deposits to raise the additional capital required under the proposal. A significant number of commenters maintained that the benefits of the proposal did not

outweigh its costs to the credit union industry.

A significant number of commenters opposing the rule also argued that the Board failed to adequately justify the proposed changes to NCUA's current risk-based net worth requirement. At least one commenter suggested that the Board should not base its justification for the risk-based capital regulation on global financial trends. Other commenters claimed that the historical loss data and other information provided by NCUA in the proposed rule did not support establishing a higher capital standard for credit unions than banks. Some commenters disagreed with the Board's statutory justification for NCUA to maintain comparability with the capital rules of FDIC, and argued that the Board overemphasized the need for the regulation to be comparable to the other banking agency regulations. Commenters acknowledged that comparability is commendable where there are truly comparable institutions. Commenters suggested, however, that the fundamental structure of credit unions as not-for profit financial cooperatives is not comparable with the for-profit banking system. Commenters suggested further that member-owned credit unions generally have a different risk model than the profit-oriented banks, so if anything credit unions should have lower risk-based capital requirements than banks. Those commenters argued that the narrative accompanying the Second Proposal did not indicate sufficient research and analysis into the differences between banks and credit unions had been done or, if it had, that it was not presented in a transparent manner that adequately justified the structure of the proposal.

A substantial number of commenters pointed out that, of the 1,400 credit unions with more than \$100 million in assets, only 27 would have a risk-based capital ratio below the 10 percent level proposed for a credit union to be well capitalized. Commenters contended that, based on these numbers, the current rule and other supervisory tools already at NCUA's disposal were already doing an adequate job. Other commenters argued that only 112 credit unions failed during the 2007–2009 recession, costing the insurance fund less than \$1 billion, which they suggested was remarkable considering the dollars and number of commercial banks that failed. Of the natural-person credit unions that did fail during the crisis, the commenters acknowledged that most were under the \$100 million asset size threshold proposed. Commenters contended that, from 1998

to 2012, the NCUSIF fund losses were only \$989 million; \$513 million came from 7 credit unions in the \$200 million to \$500 million asset range, and \$343 million came from credit unions under \$100 million that would not have been covered under the Second Proposal. At least one commenter claimed that its analysis of the 26 credit unions with more than \$80 million in assets just before the crisis (as of December 2007) that subsequently failed revealed that only seven would have had a lower capital classification under Second Proposal. The commenter suggested that six of the 21 well-capitalized credit unions under current rules would have been downgraded—four to adequately capitalized and two to undercapitalized—and that one adequately capitalized credit union under the current rules would have been classified as undercapitalized under the proposal. In other words, the commenter maintained, of the 26 failures, a total of three credit unions would have been demoted to undercapitalized if the Second Proposal had been in effect before the crisis. And the amount of capital they would have been required to obtain to become adequately capitalized was only \$7 million, as compared to the insurance loss of over \$700 million. The commenter claimed that the amount of capital that would have been necessary for all seven downgraded credit unions to regain their previous capital classifications (six to well-capitalized, one to adequately-capitalized) would have totaled \$43 million.

While most commenters did oppose finalizing the proposal, a substantial number of the commenters who opposed the rule acknowledged that the Board, in response to comments received on the Original Proposal, had made significant improvements to Second Proposal. Specific improvements mentioned included: The removal of the IRR provisions; the new zero percent risk weight assigned to cash held at the Federal Reserve; the reduction of the concentration thresholds from three to two tiers for residential mortgages, junior liens, and commercial loans; the removal of the 1.25 percent cap on allowance for loan and lease losses (ALLL); the lower 10 percent risk-based capital ratio threshold level required for credit unions to be classified as well capitalized; the removal of the enumerated processes to require that individual credit unions hold higher levels of capital under certain circumstances; the increase in the asset size threshold for defining credit unions

as “complex”; the extended implementation period; the lower risk-weights assigned to many categories of assets; and the designation of one-to-four family non-owner occupied mortgage loans as residential loans.

A small number of commenters stated that they supported the Second Proposal. These commenters generally agreed that the credit union system should have risk-based capital requirements that protect the Share Insurance Fund and other well run credit unions by requiring that credit unions with more complex balance sheets hold modestly more capital. Several commenters supported the proposal because they felt that the Board had listened to commenters following the Original Proposal and had made substantial improvements to the Second Proposal. Several commenters supported the proposal for various other reasons: One financial services consulting firm suggested that, overall, the proposal presented a fair alternative to the risk-based capital requirements applicable to banks. At least one state supervisory authority suggested that, on the whole, the proposal was sound and substantially better than NCUA’s current risk-based capital rule. One credit union commenter stated that it supported the proposal because insured credit unions, which together hold assets of \$1.1 trillion, are backed by the full faith and credit of the United States. And if insured credit unions engaging in high-risk lending fail in significant enough numbers, then the taxpayer is left holding the bill. One individual stated that he supported the proposal because, in his opinion, it would lower the number of loans credit unions could make by imposing higher risk weights on loans made to higher-risk persons. Another individual supported the proposal because he believed it would lower rates for consumers who utilize credit unions. Yet another individual suggested that he supported the proposal because credit unions should be given the same scrutiny as other major lenders and not be given a free pass because they have good intentions as non-profits. The commenter suggested further that credit unions should be subject to tough and robust regulations such as the proposed risk-based capital rule.

In addition to the comments on the Second Proposal discussed above, NCUA received the following general comments: At least one commenter agreed that NCUA’s current risk-based net worth regulation is outdated and does not accurately reflect the level of risk in individual credit unions, but criticized that the statutory net worth

ratio level is fixed at 7 percent. The commenter suggested that if the 7 percent net worth ratio level is inadequate, the Board should convince Congress to arrive at an appropriate net worth level rather than address risks through revisions to NCUA’s risk-based capital regulations. Another commenter recommended that a risk-based capital requirement be developed to replace the statutory net worth ratio, instead of imposing a risk-based capital requirement in addition to the statutory net worth ratio requirement. The commenter argued that managing two different capital limits would place an unnecessary burden on credit unions and serve as an additional competitive disadvantage to the credit union charter. A significant number of commenters suggested that the proposed rule went too far in treating credit unions like banks, and that if credit unions are regulated and supervised as banks they will be forced to act more like banks, which would be to the detriment of their members. At least one state supervisory authority agreed with using a Basel III style capital model, but remained concerned that notable differences continued to exist between NCUA’s proposed model and the one employed by FDIC and other federal bank regulators. In particular, the commenter suggested that the differences between the risk weightings for a number of the proposed asset categories represented a missed opportunity to reduce public confusion, and might actually increase confusion. The commenter explained that public users of government-provided Call Report data could assume that NCUA’s risk-based capital ratio is the same as other institutions’ measurements of capital using the same terminology, but, under the Second Proposal, the ratios could be materially different for banks and credit unions. A bank trade association recommended the Board adopt the same Basel III model adopted by the Other Banking Agencies because without comparable capital requirements, credit unions will be undercapitalized relative to community banks, and such undercapitalization, along with credit unions’ limited access to alternative forms of capital when needed, could increase the bailout risk faced by the American taxpayer. The commenter suggested that because credit unions are not required to pay federal income taxes on earnings and can retain a larger percentage of their earnings than community banks, they should have little or no difficulty in maintaining very high levels of Tier 1 capital. The commenter also suggested

that the Board impose a capital surcharge of 5 percent on credit unions when they exceed total consolidated assets of \$10 billion because large credit unions, with their limited ability to react to depleted capital levels in times of economic uncertainty, should be subjected to increased scrutiny and additional capital reserves. Other commenters suggested that, before issuing a proposed rule, NCUA test regulatory approaches of the type included in the Second Proposal through the examination process and share the results with the industry. Some commenters suggested that the rule does not take into account that the vast majority of credit unions already have written policies to deal with balance sheet risk. At least one commenter suggested that the rule would not protect credit unions or NCUA in the event of another crisis that requires natural-person credit unions to pay out huge assessments. A few commenters recommended that the proposed risk-based capital ratio measure should be used as a modeling tool rather than a rigid rule, similar to interest rate risk monitoring tools. The commenters suggested that this would allow credit union risk to be calculated as a model by examiners using risk weights appropriate for each credit union's environment, and discuss with boards and management their views of risk for various asset classes. A model, the commenters suggested, would be far more flexible than a rule, and would allow for the pragmatic management of risk rather than through rule-based estimates of risk, which may or may not be accurate. Finally, one credit union supported making the risk-based capital framework as complicated as it needs to be to more accurately reflect the unique needs and structure of the credit union industry. The commenter suggested that the Board, for example, took a step in that direction in the Second Proposal when it created a risk-weight category for "commercial loans" as distinct from traditional member business loans for purposes of the risk-based capital ratio measure.

Discussion

Commenters calling for a withdrawal of the proposed rule altogether are ignoring NCUA's general statutory requirement to maintain a risk-based system comparable to the Other Banking Agencies' requirements.⁵ In 2013, the Other Banking Agencies issued final

⁵ See 12 U.S.C. 1790d(b)(1)(A)(ii), which requires that the NCUA's system of PCA be "comparable" to the PCA requirements in section 1831o of the Federal Deposit Insurance Act.

rules updating the risk-based capital regulations for insured banks.⁶ The changes to the Other Banking Agencies' risk-based capital regulations, the lessons learned from the 2007–2009 recession, and the fact that NCUA's current risk-based net worth requirement is ineffective and has not been materially updated since 2002, prompted the Board to propose revisions to NCUA's current risk-based net worth ratio requirement and other aspects of NCUA's current PCA regulations. The proposed changes were also prompted by specific recommendations to NCUA made by GAO in its January 2012 review of NCUA's system of PCA. In particular, GAO recommended that NCUA design a more forward-looking system to detect problems earlier.⁷

The Second Proposal addressed the important role and benefits of capital. The proposal discussed the impact of a financial crisis and the benefit a higher level of capital provided to insulate certain financial institutions from the effects of unexpected adverse developments in assets and liabilities. Higher levels of capital can reduce the probability of a systemic crisis, allow credit unions to continue to serve as credit providers during times of stress without government intervention, and produce benefits that outweigh the associated costs. The proposal also emphasized that credit unions' senior management and boards are accountable for ensuring that appropriate capital levels are in place based on the credit union's risk exposure.

Capital is the buffer that depository institutions, including credit unions, use to prevent institutional failure or dramatic deleveraging during times of stress. As evidenced by the 2007–2009 recession, during a financial crisis a buffer can mean the difference between the survival or failure of a financial institution. Financial crises are very costly, both to the economy in general and to individual depository institutions.⁸ While the onset of a

⁶ 78 FR 55339 (Sept. 10, 2013) (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 FDIC's IFR.).

⁷ 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>.

⁸ 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 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.⁹ 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.¹⁰ The cited figures are just 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>.

⁹ 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/bcbst173.pdf>. These losses do not explicitly account for government interventions that ameliorated the observed economic impact. This is the median loss estimate.

¹⁰ 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

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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 2007–2009 financial crisis is roughly \$10 trillion (2014 dollars).¹¹ 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.¹²

Research using bank data across several countries and time periods indicates that higher levels of capital insulate financial institutions from the effects of unexpected adverse developments in their asset portfolio or their deposit liabilities.¹³ 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.¹⁴ 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.¹⁵ 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).¹⁶

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.¹⁷ 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.¹⁸ 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 equity¹⁹ to risks assets ratio would be on the order of 0.1 percent.²⁰ Thus, it is clear that the relatively large potential long-term benefits of holding higher levels of capital outweigh the relatively small long-term costs.

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

intervention in the form of capital infusions.²¹

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

In addition, during that same period, 27 consumer credit unions with assets greater than \$50 million failed at a cost of \$728 million to the NCUSIF.²² NCUA performed back-testing of the 9 complex credit unions (those with over \$100 million in assets) that failed during this period to determine whether this final rule would have resulted in earlier identification of emerging risks and reduced losses to the NCUSIF. The back-testing revealed that maintaining a risk-based capital ratio in excess of 10 percent would have required 8 of the 9 complex credit unions that failed to hold additional capital.

The failure of the 27 consumer credit unions was due in large part to holding inadequate levels of capital relative to the levels of risk associated with their assets and operations. In many cases, the capital deficiencies relative to elevated risk levels were identified by examiners and communicated through the examination process to officials at these credit unions.²³ Although the credit union officials were provided with notice of the capital deficiencies, they ignored the supervisory concerns

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.

¹¹ 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>.

¹² Tyler Atkinson, David Luttrell & Harvey Rosenblum, Fed. Reserve Bank of Dallas, *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>.

¹³ 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.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ 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.

¹⁸ 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).

¹⁹ 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.

²⁰ 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.

²¹ For a readable overview of the 2007–2009 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>.

²² 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.

²³ 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).

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.

From 2008 to 2012, over a dozen very large consumer credit unions, and numerous smaller ones, also were in danger of failing and required extensive NCUA intervention, financial assistance, or both, along with increased reserve levels for the NCUSIF.²⁴ NCUA estimates these actions saved the NCUSIF over \$1 billion in losses.

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

Unlike banks that can issue other forms of capital like common stock, credit unions that need to raise additional capital when faced with a capital shortfall generally have no choice except to reduce member dividends or other interest payments, raise lending rates, or cut non-interest expenses in an attempt to direct more income to retained earnings.²⁵ 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 2007–2009 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

Net worth ratio in 2006Q4	Lowest net worth ratio between 2007Q1 and 2010Q4						Total	Number of credit unions
	<6%	6–7%	7–8%	8–10%	≥10%			
<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 2007–2009

recession. The table shows that the credit unions that survived the crisis and recession had higher net worth ratios going into the Great Recession. In particular, credit unions with more than \$100 million in assets before the crisis

began, but failed during the crisis, had a median 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.

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

	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.

²⁴ As most of these credit unions are still active institutions, or have merged into other active institutions, NCUA cannot provide additional details publicly.

²⁵ 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.

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

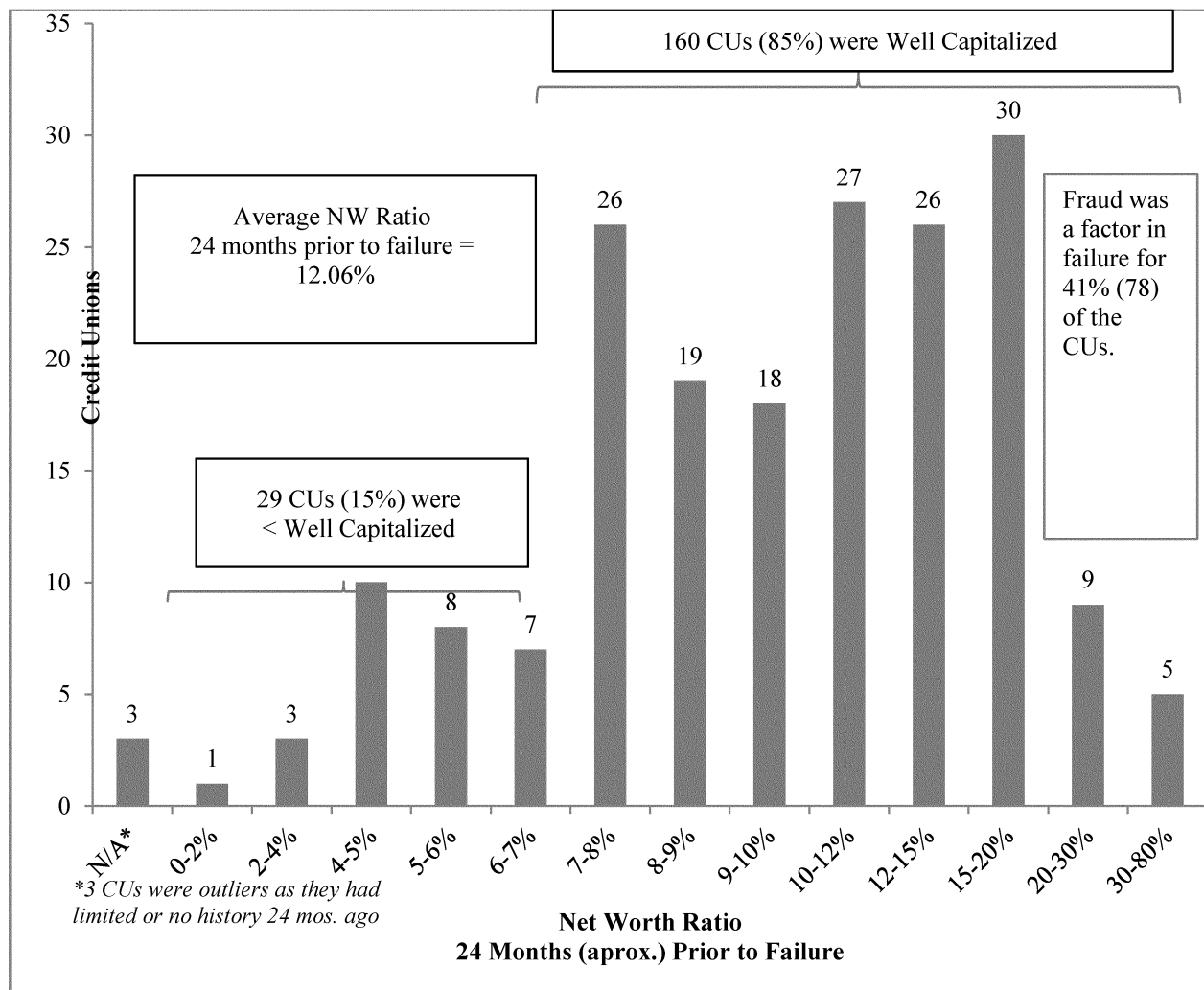
that factors in addition to capital levels play an important role in preventing failure. For example, all of the failures listed in the table above had net worth ratios in excess of the well capitalized level at the end of 2006. The severe weakness of NCUA's current risk-based net worth requirement is 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.²⁶ 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.

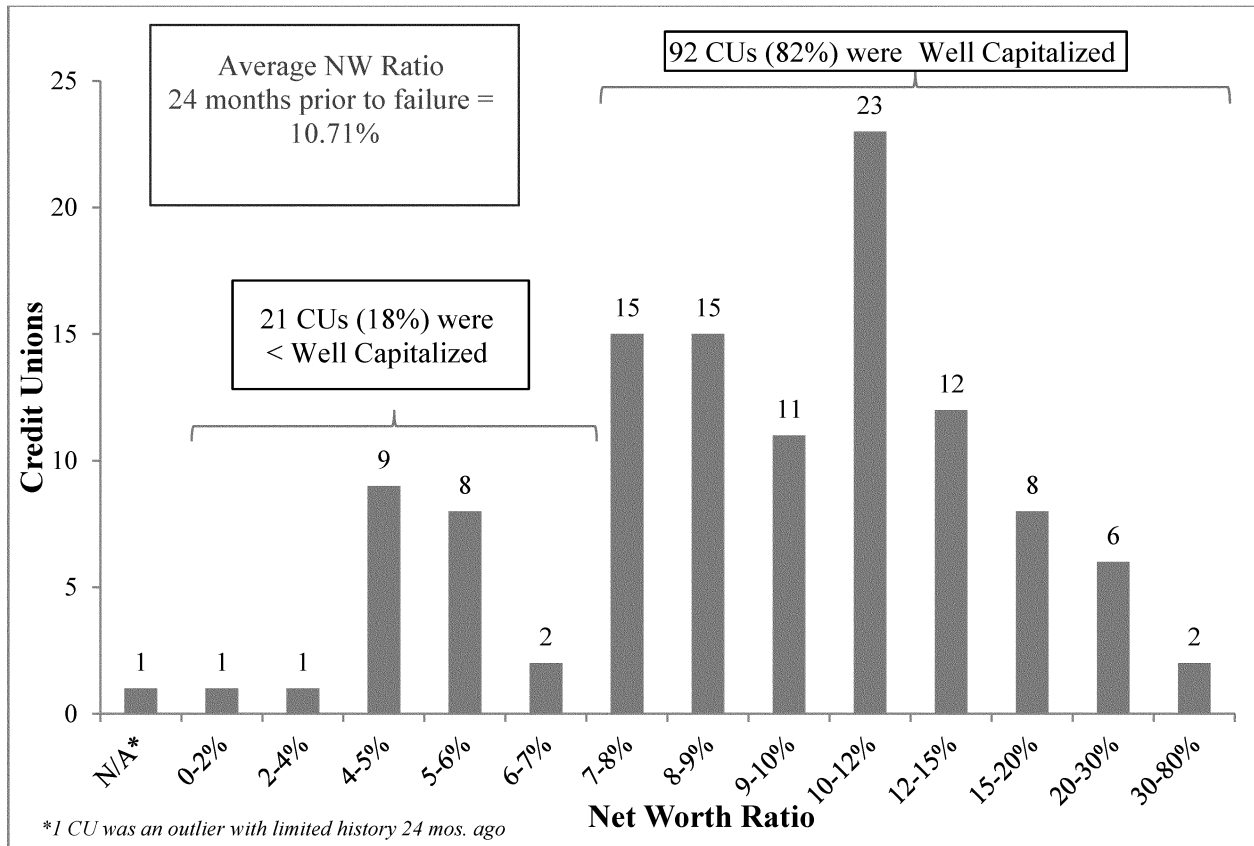
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Net Worth Ratio 24 Months Prior to Failure (All CU Failures in the Last 10 Years)



²⁶ See table above (referencing the 27 failures of credit unions over \$100 million in assets).

Net Worth Ratio 24 Months Prior to Failure of CUs – Non-Fraud (Last 10 Years)



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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.²⁷

²⁷ 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

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.

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>.

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.

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

The new risk-based capital ratio adopted in this final rule is designed to complement the statutory net worth ratio, which is often referred to as the leverage ratio. The net worth ratio is a measure of statutorily defined capital divided by total assets. The net worth ratio does not assign relative risk weights among asset classes, making it more difficult to manipulate and provides a simple picture of a financial institution's ability to absorb losses, regardless of the source of the loss. The new risk-based capital ratio, on the other hand, is a measure of loss absorption ability to assets weighted based on the associated risk, and is intended to be more forward looking and reactive to changes in the risk profile of a credit union. In general, a risk-based capital requirement increases capital requirements at those institutions with asset portfolios that are, on average, higher risk. Conversely, risk-based capital standards generally decrease capital requirements at institutions with lower risk profiles. In that way, risk-based capital standards generate the benefits of helping to insulate the economy from financial crises, while also preventing some of the potential costs that would occur from holding unnecessarily high levels of capital at low-risk institutions.

Many commenters suggested that the Board withdraw the Second Proposal and retain the existing risk-based capital requirement and the related risk-weights, which are based largely on interest rate risk and liquidity risk. Ironically, most of the commenters objected to the Original Proposal because it included IRR and liquidity risk in the proposed risk weights. As discussed in the Original Proposal, since its implementation, the current risk-based net worth requirement has required less than a handful of credit

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

The current risk-based net worth requirement also fails to allow for comparison of capital adequacy on a risk-weighted level across financial institutions. A creditor or uninsured depositor is able to obtain and understand the capital measures available for all banks. Creditors generally know that, for banks, a higher capital ratio is an indication of better financial strength and a reduction in their risk of loss. Creditors and uninsured shareholders in credit unions, however, generally do not understand the application of the risk-based net worth requirement where a lower ratio is an indicator of financial strength; nor are they generally aware that the risk-based net worth requirement is only available by reviewing a specific page of the Call Report. The current lack of a comparable risk-based capital measure for credit unions deprives creditors and uninsured shareholders of a useful measure in determining the financial strength of credit unions.

The Board also disagrees with commenters who called for a withdrawal of the Second Proposal because a limited number of credit unions may experience a decline in their capital classification, or because commenters claimed that back-testing the proposal would have resulted in only minor savings to the NCUSIF had the proposal's capital requirement been in place during the 2007–2009 recession. The Original Proposal would have imposed higher risk-weights for concentrations of MBLs, junior-lien real estate loans, and equity investments, which would have resulted in approximately 199 credit unions experiencing a decline in their capital classification and could have reduced losses to the NCUSIF to a greater degree had those requirements been in place prior to the 2007–2009 recession. Due to legitimate concerns raised by commenters regarding the impacts of the Original Proposal, however, the Board reduced the risk-weights for concentrations of MBLs and real estate loan concentrations in the Second Proposal. Thus, the potential impacts of the Second Proposal were lower, but still require that credit unions taking higher levels of risk hold higher levels

of capital. Based on the comments received on the Original Proposal and the Second Proposal, the risk weights in the Second Proposal are calibrated to appropriately balance the impact of the proposed changes on credit unions while also providing meaningful improvement to the risk-based capital standards to which credit unions will be held in the future.

The Board disagrees with commenters who suggested that the Board not finalize the proposal and instead focus on enhancing training to improve examiner skills to reduce the number of failures and losses to the NCUSIF. NCUA already continually seeks to enhance the training and skills of examiner staff within budget limitations. NCUA already performs analyses of all material losses to the NCUSIF, including material loss reviews prepared by NCUA's Inspector General on losses that exceed \$25 million. The loss reviews include analyses of NCUA's and the State Supervisory Authorities' supervision of credit unions and include recommendations to address any weaknesses in related supervision policies and approaches. Additionally, not issuing a final rule would result in retention of the current risk-based net worth measure, which is not a comparable measure across financial institutions and contains risk-weights that are less closely associated with credit risk.

Moreover, the Board disagrees with commenters who suggested that credit unions should have less stringent regulatory capital standards than banks. The combined statutory requirement for a minimum net worth ratio and the risk-based capital requirement, supported by the supervision process, is the backbone of protection for both the credit union and bank insurance funds. In addition, prudent capital standards serve to protect taxpayers who ultimately must fund any reliance by the insurance funds on the full faith and credit of the United States.

Commenters claimed that the Second Proposal would place credit unions at a competitive disadvantage to banks by requiring credit unions to hold incrementally more capital than banks given similar asset-concentration levels. The net worth ratio, which is defined by statute, requires credit unions to hold more capital than banks are required to hold using the comparable Tier 1 leverage ratio for banks.²⁸ Congress

²⁸ The net worth ratio and a bank's Tier 1 leverage ratio are both based on the total assets of the institution. Congress set the net worth ratio 200 basis points higher than the Tier 1 leverage ratio

required NCUA to develop PCA regulations that are comparable to those of banks, including the risk-based net worth requirement for complex credit unions. The Board ensured compliance with the law while issuing the Second Proposal, which would not place credit unions at a competitive disadvantage to banks. The vast majority of risk weights for credit unions would be comparable to the risk weights for banks, and some risk weights for credit unions would actually be lower than the risk weights for banks. Because the Second Proposal

generally used the same overall risk-based capital levels as banks, the differences in the individual elements of the calculation can be easily identified and understood. For example, the proposed risk weight for secured consumer loans, which represent about 20 percent of total assets for complex credit unions, is 25 basis points less than the corresponding risk weight for banks. The Second Proposal also would not cap credit unions' allowance for loan and lease losses at 1.25 percent of risk assets, while the Other Banking

Agencies impose such a cap in the risk-based capital ratio calculation for banks. In the few instances where the risk weights are higher for credit unions, they apply to a very low percentage of total assets and are directly tied to sources of higher losses to the NCUSIF, primarily concentrations of real estate and business assets.

The table below contains an estimate of how risk-weights generally compare between the risk-weights in this final rule to the risk-weights applied to FDIC insured institutions.

	Sub-category as % of total assets	Category as % of total assets
Lower Risk Weight Than FDIC		
Secured Consumer Loans .....	.....	21.09%
More Conservative Risk Weight Than FDIC		
First-Lien Real Estate Loans >35 percent of assets	1.19%	.....
Junior-Lien Real Estate Loans >20 percent of assets	0.11%	.....
Commercial Loans >50 percent of assets	0.13%	.....
Non-Current Junior-Lien Real Estate Loans	0.02%	.....
Unfunded Non-Commercial Loans	1.46%	2.91%
Not Directly Comparable to FDIC		
CUSO Investments and Corporate Capital .....	.....	0.34%
Comparable Risk Weight to FDIC		
All Other Assets .....	.....	75.66%

Commenters asserted that bank regulators are moving away from risk-based capital structures and referenced the FDIC Vice Chairman's related statements. The FDIC Vice Chairman, however, has favored higher generally accepted accounting principles (GAAP) equity ratios at banks of at least 10 percent of assets as an alternative to risk-based capital structures.²⁹ The NCUA Board lacks authority to impose higher GAAP equity-to-asset ratios because the FCUA specifically defines the net worth ratio for credit unions and sets forth the minimum ratio levels required. Moreover, the current statutory net worth ratio requirement, combined with a reasonable risk-based capital ratio requirement to address institutions taking higher levels of risk, provides a well targeted level of protection to the NCUSIF.

The Board disagrees with commenters who suggested that the proposal would stifle growth, innovation, diversification, and member services. The commenters' suggested revisions to the proposal revealed there is clear

disagreement among credit unions and other interested parties regarding how the proposal would have impacted factors such as growth, innovation, diversification, and member services at credit unions. This final rule better reflects each individual credit union's risk profile, provides for more active management of risk in relation to capital, further ensures individual credit unions can continue to serve as credit providers even during times of stress, and promotes the safety and soundness of the credit union system.

Commenters asserted that credit unions would need to charge higher interest rates, higher fees, and pay lower rates on deposits to raise capital because of the new risk-based capital measure. Credit unions, however, would have more than three years before the new risk-based capital requirement goes into effect. A credit union that determines it is in danger of having a risk-based capital ratio level below the required minimum level has the option of: Reducing the amount of risk-weighted assets it holds; raising additional

capital, primarily through earnings; or both.

NCUA's analysis of credit union Call Report data indicates that the overwhelming majority of complex credit unions already have sufficient capital to comply with the proposed risk-based capital regulation. In particular, NCUA estimates that over 98 percent of complex credit unions would be in compliance with the regulatory capital minimums under the final rule if it were in effect today. The final rule is designed to ensure that these credit unions maintain their capacity to absorb losses in the future. A few credit unions, however, will likely want to take advantage of the three-year implementation period provided in this final rule to accumulate retained earnings, reduce their level of risk-assets, or both. As noted above, the overwhelming majority of credit unions have sufficient capital to comply with the revised capital rules, and the resulting improvements to the stability and resilience of the credit union

level for banks due to the nature of the 1 percent NCUSIF deposit, the level of investment within the corporate credit union system, and credit unions' limited access to capital other than retained

earnings. U.S. Department of Treasury, *Credit Unions* (1997).

²⁹ Thomas M. Hoening, American Banker, *The Safe Way to Give Traditional Banks Regulatory*

Relief, (June 22, 2015), available at <https://www.fdic.gov/news/letters/reg-relief.html>.

system outweigh any costs associated with its implementation.

In this final rule, the Board complied with the statutory requirement to take into account the cooperative character of credit unions in that they are not-for-profit, do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers. To do this, the Board avoided undue complexity within the rule by, among other things, not implementing a complex conservation buffer requirement; establishing a simple and straightforward proxy for the definition of a complex credit union; reducing the number of asset concentration thresholds; and requiring only complex credit unions to have a written strategy for maintaining an appropriate level of capital.

Accordingly, and for the reasons discussed in more detail below, the Board is now adopting this final rule to revise NCUA's current regulations regarding PCA to require that complex credit unions taking certain risks hold capital commensurate with those risks.

II. Summary of the Final Rule

This final rule replaces the method currently used by complex credit unions to apply risk weights to their assets with a new risk-based capital ratio measure that is generally comparable to that applied to depository institutions worldwide. As discussed in more detail in the Legal Authority part of this preamble, the FCUA gives NCUA broad discretion in designing the risk-based net worth requirement applicable to complex credit unions. Accordingly, this final rule revises part 702 of NCUA's current regulations to establish a risk-based capital ratio measure that is the percentage of a credit union's capital available to cover losses, divided by the credit union's defined risk-weighted asset base.

This final rule adopts a broadened definition of capital to be used as the numerator in the new risk-based capital ratio measure. The Board is adopting 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 specifically available to cover losses and protect the NCUSIF. This broader definition of capital more accurately reflects the amount of capital that is actually available at a credit union to absorb losses.

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."³⁰ Section 216(d)(2) of the FCUA differs from the corresponding provision in section 38 of the FDI Act,³¹ 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, the Board is required to account for any material risks in the risk-based requirement unless the risk is deemed *immaterial* because of the existence of another 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, 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. Based on long-term balance sheet trends at credit unions, the comments received on the Second Proposal, and NCUA's experiences dealing with problem institutions, however, the Board concluded that NCUA can adequately address IRR through its other regulations and supervisory processes. Accordingly, the final rule generally excludes IRR from NCUA's risk-based capital ratio calculation. But the Board may consider adopting additional regulatory or supervisory approaches for addressing IRR at credit unions if the need arises in the future.

With the removal of the IRR component from the current rule, this final rule narrows the list of risks accounted for in the denominator of the new risk-based capital ratio measure. The methodology for assigning risk weights in this final rule primarily accounts for credit risk and concentration risk.

This final rule includes a tiered risk weight framework³² for high

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

³¹ 12 U.S.C. 1831o.

³² The tiered framework would provide for an incrementally higher capital requirement resulting in a blended rate for the corresponding portfolio. That is, the portion of the portfolio below the threshold would receive a lower risk weight, and the portion above the threshold would receive a higher risk weight. The higher risk weight would be consistent across asset categories as a 50 percent increase from the base rate. Some comments on the

concentrations of residential real estate loans and commercial loans³³ in NCUA's risk-based capital ratio measure. As a credit union's concentration in these asset classes increases, incrementally higher levels of capital are required. This approach addresses concentration risk as it relates to minimum required capital levels through a transparent, standardized, regulatory requirement. The concentration thresholds do not limit a credit union's lending activity; rather, the thresholds merely require the credit union to hold additional capital to account for the elevated concentration risk. The inclusion of concentration risk in the final rule does not put credit unions at a competitive disadvantage to banks because most real estate and member business loans (except for loans held in high concentrations) would still be assigned risk weights similar to those applicable to banks.

Consistent with many commenters and 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 relied primarily on the risk weights assigned to various asset classes under the Basel Accords and the Other Banking Agencies' risk-based capital regulations for this final rule.³⁴ So this final rule provides for greater comparability to the Other Banking Agencies' risk weights than NCUA's current risk-based net worth regulation. The Board, however, has tailored the risk weights in this final rule for certain assets that are unique to credit unions or where a demonstrable and compelling case exists, based on contemporary and sustained performance differences, to differentiate for certain asset classes (such as consumer loans) between banks and credit unions, or where a provision of the FCUA requires doing so.

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.

³³ The definition of commercial loans and the differences between commercial loans and MBLs are discussed in more detail in the section-by-section analysis.

³⁴ The Board has simplified certain aspects of this final 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).

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

SUMMARY OF THE RISK WEIGHTS

	0%	20%	50%	75%	100%	150%	250%	300%	400%	1250%
Cash/Currency/Coin	X									
<i>Investments:</i>										
Unconditional Claims—U.S. Government	X									
Balances Due from Federal Reserve Banks	X									
Federally Insured Deposits in Financial Institutions	X									
Debt Instruments issued by NCUA and FDIC	X									
Central Liquidity Facility Stock	X									
Uninsured deposits at U.S. Federally Insured Institutions		X								
Agency Obligations		X								
FNMA and FHLMC pass through Mortgage Backed Securities (MBS)		X								
General Obligation Bonds Issued by State or Political Subdivisions		X								
Federal Home Loan Bank Stock and Balances		X								
Senior Agency Residential MBS or Asset-Backed Securities (ABS) Structured		X								
Revenue Bonds Issued by State or Political Subdivisions			X							
Senior Non-Agency Residential MBS Structured			X							
Corporate Membership Capital					X ^c					
Industrial Development Bonds					X					
Agency Stripped MBS (Interest Only)					X					
Part 703 Compliant Investment Funds ^a					X					
Value of General Account Insurance (bank owned life insurance, and credit union owned life insurance) ^a					X					
Corporate Perpetual Capital					X ^c	X ^c				
Mortgage Servicing Assets							X			
Separate Account Life Insurance ^a								X		
Publicly Traded Equity Investment (non-CUSO)					X ^c			X ^c		
Mutual Funds Part 703 Non-Compliant ^a								X		
Non-Publicly Traded Equity Investments (non-CUSO)					X ^c				X ^c	
Subordinated Tranche of Any Investment ^b										X
<i>Consumer Loans:</i>										
Share-Secured (shares held at the credit union)	X									
Share-Secured (shares held at another depository institution)		X								
Current Secured				X						
Current Unsecured					X					
Non-Current						X				
<i>Real Estate Loans:</i>										
Share-Secured (shares held at the credit union)	X									
Share-Secured (shares held at another depository institution)		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				
<i>Commercial Loans:</i>										
Share-Secured (shares held at the credit union)	X									
Share-Secured (shares held at another depository institution)		X								
Portion of Commercial Loans with Compensating Balance		X								
Commercial Loans <50% of Assets					X					
Commercial Loans >50% of Assets						X				
Non-current						X				
<i>Miscellaneous:</i>										
Loans to CUSOs					X					
Equity Investment in CUSO					X ^c	X ^c				
Other Balance Sheet Items not Assigned					X					

^a With the option to use the look-through options.³⁵

^b With the option to use the gross-up approach.³⁶

^c If a credit union's total equity exposures are "non-significant"³⁷ under § 702.104(c)(3)(i), then the risk weight is 100 percent. This lowers the risk weight to 100 percent for CUSO equity exposures, corporate perpetual capital, and all other equity investments when they are part of a credit union's non-significant equity exposures.

³⁵ The "look-through" approaches are discussed in more detail in the part of this preamble discussing § 702.104(c)(3)(iii)(B).

³⁶ The "gross-up" approach is discussed in more detail in the part of this preamble discussing § 702.104(c)(3)(iii)(A).

³⁷ Under § 702.104(c)(3)(i) of this final rule, a credit union has non-significant equity exposures if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union's capital elements of the risk-based capital ratio numerator (as defined under paragraph § 702.104(b)(1)). To determine its aggregate amount of its equity exposures, the credit union must

include the total amounts (as recorded on the statement of financial condition in accordance with GAAP) of the following (1) equity investments in CUSOs, (2) perpetual contributed capital at corporate credit unions, (3) nonperpetual capital at corporate credit unions, and (3) equity investments subject to a risk weight in excess of 100 percent.

The following table provides an estimate of the risk weighting for aggregate assets held by complex credit union assets as of December 31, 2014.

Risk weight	Complex credit union assets (in millions) ³⁸	Percent of complex credit union assets	Cumulative percent of complex credit union assets
0%	\$18,713	1.82	1.82
20%	289,932	28.15	29.97
50%	224,618	21.81	51.78
75%	270,440	26.24	78.02
100%	217,159	21.08	99.01
150%	8,017	0.78	99.88
250% or greater	1,195	0.12	100.00

The following table compares on-balance sheet risk weights in this final rule to the applicable risk weights assigned by other federal banking agencies:

	NCUA Risk-weight	FDIC Risk-weight
Cash/Currency/Coin	0%	0%
<i>Investments:</i>		
Unconditional Claims—U.S. Government	0%	0%
Balances Due from Federal Reserve Banks	0%	0%
Federally Insured Deposits in Financial Institutions	0%	0%
Debt Instruments issued by NCUA and FDIC	0%	0%
Central Liquidity Facility Stock	0%	n/a
Uninsured deposits at U.S. Federally Insured Institutions	20%	20%
Agency Obligations	20%	20%
FNMA and FHLMC pass through Mortgage Backed Securities (MBS)	20%	20%
General Obligation Bonds Issued by State or Political Subdivisions	20%	20%
Federal Home Loan Bank Stock and Balances	20%	20%
Senior Agency Residential MBS or Asset-Backed Securities (ABS) Structured	20%	20%
Revenue Bonds Issued by State or Political Subdivisions	50%	50%
Senior Non-Agency Residential MBS Structured	50%	Gross-up or Simplified Supervisory Formula
Corporate Membership Capital	100%	n/a
Industrial Development Bonds	100%	100%
Agency Stripped MBS (Interest Only)	100%	100%
Part 703 Compliant Investment Funds	100% ^a	n/a
Value of General Account Insurance (bank owned life insurance, and credit union owned life insurance) ^a	100%	100%
Corporate Perpetual Capital	100%/150% ^c	n/a
Mortgage Servicing Assets	250%	250%
Separate Account Life Insurance	300% ^a	Look-through
Publicly Traded Equity Investment (non-CUSO)	100%/300% ^c	300%
Mutual Funds Part 703 Non-Compliant	300% ^a	n/a
Non-Publicly Traded Equity Investments (non-CUSO)	100%/400% ^c	400%
Subordinated Tranche of Any Investment	1,250% ^b	Gross-up or Simplified Supervisory Formula
<i>Consumer Loans:</i>		
Share-Secured (shares held at the credit union)	0%	0%
Share-Secured (shares held at another depository institution)	20%	20%
Current Secured	75%	100%
Current Unsecured	100%	100%
Non-Current Consumer	150%	150%
<i>Real Estate Loans:</i>		
Share-Secured (shares held at the credit union)	0%	0%
Share-Secured (shares held at another depository institution)	20%	20%
Current First Lien <35% of Assets	50%	50%
Current First Lien >35% of Assets	75%	50%
Not Current First Lien	100%	100%
Current Junior Lien <20% of Assets	100%	100%
Current Junior Lien >20% of Assets	150%	100%
Noncurrent Junior Lien	150%	100%
<i>Commercial Loans:</i>		

³⁸ Includes off-balance sheet items after application of the credit conversion factor.

	NCUA Risk-weight	FDIC Risk-weight
Share-Secured (shares held at the credit union)	0%	0%
Share-Secured (shares held at another depository institution)	20%	20%
Portion of Commercial Loans with Compensating Balance	20%	n/a
Commercial Loans <50% of Assets	100%	100%/150% ^d
Commercial Loans >50% of Assets	150%	100/150% ^d
Non-current Commercial	150%	150%
<i>Miscellaneous:</i>		
Loans to CUSOs	100%	100%
Equity Investment in CUSO	100%/150% ^c	100%–600%
Other Balance Sheet Items not Assigned	100%	100%

^a With the option to use the look-through options.

^b With the option to use the gross-up approach.

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

^d FDIC identifies certain commercial loans as High Volatility Commercial Real Estate (HVCRE) and assigns a 150% risk weight.

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" ³⁹ In other words, FDIC may require an FDIC-supervised institution to hold an amount of regulatory capital greater than otherwise required under its capital rules if 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.⁴⁰

As indicated above, FDIC's approach to risk weights is calibrated to be the minimum regulatory capital standard. Similarly, this final rule is calibrated to be the minimum regulatory capital standard. Accordingly, the final rule incorporates a broader regulatory provision reminding complex credit unions that, as a matter of safety and soundness, they are required to maintain capital commensurate with the level and nature of all risks to which they are exposed.⁴¹ In addition, the final rule adds a new provision requiring complex credit unions to maintain a written strategy for assessing capital adequacy and maintaining an appropriate level of capital.

Capital ratio thresholds are largely a function of risk weights; and this final rule more closely aligns NCUA's risk weights with those assigned by the Other Banking Agencies.⁴² Accordingly, the final rule adopts a 10 percent risk-based capital ratio level for well capitalized credit unions, and an 8 percent risk-based capital ratio level for adequately capitalized credit unions. To take into account the cooperative

character of credit unions, the Board set the risk-based capital ratio level for well capitalized credit unions at 10 percent, and omitted the capital conservation buffer imposed on banks.⁴³ The omission of the capital conservation buffer simplifies NCUA's risk-based capital requirement relative to the Other Banking Agencies' rules without appreciably lowering the protections provided by NCUA's risk-based capital regulations.⁴⁴

The final rule defines a credit union as "complex" if it has assets of more than \$100 million.⁴⁵ Credit unions meeting this threshold have a portfolio of assets and liabilities that is complex, based upon the products and services in which they are engaged. As discussed later in this document, the \$100 million asset threshold is a proxy measure based on detailed analysis, and a clear demarcation line above which all credit unions engage in complex activities and where almost all such credit unions (99 percent) are involved in multiple complex activities.

An asset size threshold is clear, logical, and easy to administer when compared with the more complicated formula used to determine whether a credit union is complex under the current rule.⁴⁶ Using a more straightforward proxy for determining complexity also helps account for the cooperative character of credit unions, particularly, the fact that credit unions have boards of directors that consist primarily of volunteers. The \$100 million asset size threshold exempts

⁴³ The "capital conservation buffer" is explained in more detail in the discussion on § 702.102(a) in the section-by-section analysis part of this preamble.

⁴⁴ See, e.g., 12 CFR 324.403.

⁴⁵ There is no exemption for banks from the risk-based capital requirements of the other banking agencies. There are 1,872 FDIC-insured banks with assets less than \$100 million as of December 2014.

⁴⁶ 12 CFR 702.106.

approximately 76 percent of credit unions⁴⁷ from many of the regulatory burdens associated with complying with this rule; yet it will cover almost 90 percent of the assets in the credit union system. The threshold is consistent with the fact that the majority 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 detailed discussion associated with section 702.103 in the Section-By-Section Analysis part of the preamble below.

In response to public comments received, the final rule also makes a number of changes to the Second Proposal. These changes include: Assigning a lower risk weight to non-significant equity exposures and certain share-secured loans; giving credit unions the option to assign a 100 percent risk weight to certain charitable donation accounts; permitting credit unions to use the gross-up approach for non-subordinated investment tranches; assigning principal-only mortgage-backed-security STRIPS a risk-weight based on the underlying collateral; extending the period during which credit unions can count supervisory goodwill and supervisory other intangible assets in the risk-based capital ratio numerator; and incorporating the text of the gross-up and look-through approaches into a new appendix A to the PCA regulation. As discussed in more detail below, for certain assets, these changes will lower the risk weights that would have been assigned under the Second Proposal, extend the period during which certain assets can be included in a credit union's risk-based capital ratio

⁴⁷ Based upon December 31, 2014 Call Report data.

³⁹ See, e.g., 12 CFR 324.1(a).

⁴⁰ See, e.g., 12 CFR 324.1(d).

⁴¹ See, e.g., 12 U.S.C. 1786.

⁴² See, e.g., 12 CFR 324.32; and 12 CFR 324.403.

numerator—effectively lowering certain credit unions' overall capital requirement for 10 years—and lower the impact of the rule for certain complex credit unions. The final rule also makes conforming and other minor changes to NCUA's regulations, which are also discussed in more detail below.

To provide 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, the revisions adopted in this final rule will not become effective until January 1, 2019. This effective date is intended to coincide with the full phase-in of FDIC's risk-based capital measures in 2019.

III. Legal Authority

In 1998, Congress enacted the Credit Union Membership Access Act (CUMAA).⁴⁸ Section 301 of CUMAA added new section 216 to the FCUA,⁴⁹ which requires the Board to maintain, by regulation, a system of PCA to restore the net worth of credit unions that become inadequately capitalized. Section 216(b)(1)(A) requires that NCUA's system of PCA for federally insured credit unions be “consistent with” section 216 of the FCUA, and “comparable to” section 38 of the Federal Deposit Insurance Act (FDI Act).⁵⁰ Section 216(b)(1)(B) requires that the Board, in designing the PCA system, take into account credit unions' cooperative character: That credit unions are not-for-profit cooperatives that do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers.⁵¹ In 2000, the Board first implemented the required system of PCA⁵² and, prior to this rulemaking, had made only minor adjustments to the rule's original requirements.⁵³

The stated 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].”⁵⁴ To carry out that purpose, Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) A statutory framework that requires certain mandatory classifications of credit unions and that NCUA take certain mandatory and discretionary actions against credit unions based on their classification; (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” that applies to credit unions that NCUA defines as “complex.” This final 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 final rule.

Among other things, section 216(c) of the FCUA requires that NCUA use a credit union's net worth ratio to determine its classification among the five “net worth categories” set forth in the FCUA.⁵⁵ Section 216(o) generally defines a credit union's “net worth” as its retained earnings balance,⁵⁶ and a credit union's “net worth ratio”⁵⁷ as the ratio of its net worth to its total assets.⁵⁸ 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.⁵⁹

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, “a risk-based net worth requirement”⁶⁰ for

by NCUA. 76 FR 16234 (Mar. 23, 2011). 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).

⁴⁸ 12 U.S.C. 1790d(a)(1).

⁴⁹ 12 U.S.C. 1790d(c).

⁵⁰ 12 U.S.C. 1790d(o)(2).

⁵¹ Throughout this document the terms “net worth ratio” and “leverage ratio” are used interchangeably.

⁵² 12 U.S.C. 1790d(o)(3).

⁵³ 12 U.S.C. 1790d(c)–(g); and 12 CFR 702.204(a) & (b).

⁵⁴ 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 unions. The term “risk-based capital ratio” is 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

insured credit unions that are complex, as defined by the Board”⁶¹ Unlike the terms “net worth” and “net worth ratio,” which are specifically defined in section 216(o), the term “risk-based net worth” is not defined in the FCUA.⁶² While Congress prescribed the net worth ratio requirement in detail in section 216, it elected not to define the term “risk-based net worth,” leaving the details of the risk-based net worth requirement to be filled in by the Board through the notice and comment rulemaking process. Section 216, when read as a whole, grants the Board broad authority to design reasonable PCA regulations, including a risk-based net worth requirement, so long as the regulations are comparable to the Other Banking Agencies' PCA requirements, are consistent with the requirements of section 216 of the FCUA, and take into account the cooperative character of credit unions.

Section 216(d)(1) of the FCUA directs NCUA, in determining which credit unions will be subject to the risk-based net worth requirement, to base its definition of complex “on the portfolios of assets and liabilities of credit unions.”⁶³ The statute does not require, as some commenters have argued, that the Board adopt a definition of “complex” that takes into account the portfolio of assets and liabilities of each credit union on an individualized basis. Rather, section 216(d)(1) authorizes the Board to develop a single definition of complex that takes into account the portfolios of assets and liabilities of all credit unions.

In addition, section 216(d)(2) specifies that the risk-based net worth requirement must “take account of any material risks against which the *net worth ratio* required for [a federally] insured credit union to be adequately capitalized [(six percent)] *may not provide adequate protection.*”⁶⁴ In the Senate Report on CUMAA, Congress expressed its intent with regard to the design of the risk-based net worth requirement and the meaning of section 216(d)(2) by providing:

The NCUA must design the risk-based net worth requirement to take into account any

Other Banking Agencies and the international banking community 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.

⁶¹ 12 U.S.C. 1790d(d)(1).

⁶² 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.”).

⁶³ 12 U.S.C. 1790d(d).

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

⁴⁸ Public Law 105–219, 112 Stat. 913 (1998).

⁴⁹ 12 U.S.C. 1790d.

⁵⁰ 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).

⁵¹ 12 U.S.C. 1790d(b)(1)(B).

⁵² See 65 FR 8584 (Feb. 18, 2000); and 65 FR 44950 (July 20, 2000) (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.)

⁵³ 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

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.⁶⁵

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

Section 216(c) of the FCUA provides that, if a credit union meets the definition of “complex” and it meets or exceeds the net worth ratio requirement to be classified as either adequately capitalized or well capitalized, the credit union must also satisfy the corresponding risk-based net worth requirement to be classified as either adequately capitalized or well capitalized.⁶⁶ Accordingly, under the separate risk-based net worth requirement, a complex credit union must, in addition to meeting the statutory net worth ratio requirement, also meet or exceed the corresponding minimum risk-based net worth requirement in order to receive a capital classification of adequately capitalized or well capitalized, as the case may be.⁶⁷ For example, a complex credit union must meet or exceed both the applicable net worth ratio requirement and the applicable risk-based net worth

requirement to be classified as well capitalized. If the credit union fails to meet either requirement, it is classified in the lowest category for which it meets both the net worth ratio requirement and the risk-based net worth requirement.

If a 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 minimum risk-based net worth requirement to be adequately capitalized, then the credit union’s capital classification is “undercapitalized” based on the risk-based net worth requirement. Similarly, if a complex credit union’s net worth ratio meets or exceeds the requirement that corresponds to the well capitalized category, but its risk-based net worth ratio meets only the requirement that corresponds with the adequately capitalized capital category, then that credit union’s capital classification is adequately capitalized. In either case, the credit union is subject to the mandatory supervisory and discretionary supervisory actions applicable to its capital classification category.⁶⁸

In response to the Second Proposal, a significant number of commenters questioned the Board’s legal authority to impose a risk-based net worth requirement on both well capitalized and adequately capitalized credit unions. As also discussed in the Section-by-Section part of the preamble below, the commenters’ selective reading of section 216 of the FCUA is a misinterpretation. NCUA is legally authorized to impose a risk-based net worth requirement on both well capitalized and adequately capitalized credit unions 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)(A)(ii) provides that a credit union must meet *any* applicable risk-based net worth requirement under section 216(d) of this section to be classified as well capitalized. The plain language of sections 216(c)(1)(A)(ii) and (c)(1)(B)(ii), read in conjunction with the language in section 216(d), indicates Congress’ intent to authorize the Board to impose risk-based net worth requirements on both well capitalized and adequately capitalized credit unions.

Section 216(d)(2) of the FCUA sets forth specific requirements for the

design of the risk-based net worth requirement mandated under section 216(d)(1).⁶⁹ 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.”⁷⁰ 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.⁷¹ The plain language of section 216(d)(2) supports NCUA’s interpretation that Congress intended for the Board to design a risk-based net worth requirement to take into account any material risks that may not be addressed adequately through the statutory 6 percent *net worth ratio* required for a credit union to be adequately capitalized.⁷²

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 should 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, that Congress’s use of the term “adequately capitalized” in section 216(d)(2) somehow limits the Board’s authority to require that complex credit unions maintain a higher risk-based capital ratio level to be classified as well capitalized. Rather than prohibiting the Board from imposing a higher risk-based capital ratio level for credit unions to be classified as well capitalized, section 216(d)(2) simply requires that the Board design the risk-based net worth requirement to take into account those risks that may not adequately be addressed by the statute’s six percent *net worth ratio* requirement. Thus, the plain language of section 216(d) does not support those commenters’ interpretation.

The Board’s legal authority to impose a risk-based net worth requirement on both well capitalized and adequately capitalized credit unions is further supported by the Other Banking

⁶⁹ 12 U.S.C. 1790d(d).

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

⁷¹ 12 U.S.C. 1790d(c)(1)(B).

⁷² 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.”).

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

⁶⁶ See 12 U.S.C. 1790d(c)(1)(A) & (c)(1)(B).

⁶⁷ 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) & (c)(1)(B)(ii).

⁶⁸ 12 U.S.C. 1790d(c)(1)(c)(ii).

Agencies' PCA statute and regulations.⁷³ Some commenters have argued that Congress's use of the singular noun "requirement" in Section 216(d) of the FCUA indicates its intent that there be only one risk-based net worth ratio level tied to the adequately capitalized level. Section 38(c)(1)(A) of the FDI Act, upon which section 216 of the FCUA was modeled,⁷⁴ however, requires that the Other Banking Agencies' "relevant capital measures" include "(i) a leverage limit; and (ii) a risk-based capital requirement."⁷⁵ 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. Moreover, the United States Code addresses the singular—plural question in its rules of statutory construction: "In determining the meaning of any Act of Congress, unless the context indicates otherwise . . . words importing the singular include and apply to several persons, parties, or things; words importing the plural include the singular . . ." ⁷⁶ Therefore, setting different risk-based capital ratio levels for credit unions to be adequately and well capitalized, is consistent with the requirements of section 216 of the FCUA and is "comparable" to the Other Banking Agencies' PCA regulations.

As explained in the Second Proposal, the FCUA requires NCUA to establish a risk-based capital system that is comparable to that in place for FDIC insured banks, *and* to take into account the cooperative character of credit unions. Some commenters criticized, however, that the Second Proposal took into account only the comparability requirement, and ignored the requirement to take into consideration the cooperative nature of credit unions. In support of their assertion, the commenters suggested that, because of their unique cooperative structure, strong member focus, and the absence of stock options for executives or pressure from stockholders, credit unions eschew excessive risk taking. The commenters

suggested further, that in the face of the 2007–2009 financial crisis, credit unions—unlike their counterparts in the for-profit banking sector—served as both a counter-cyclical force and a safe haven, with much stronger loan and deposit growth than banking institutions. Accordingly, many commenters suggested that the Board, to take into account the cooperative character of credit unions, must impose risk-based capital requirements that are equal to or lower than the standards applicable to banks.

The Board disagrees with the claim that NCUA failed to take into account the cooperative character of credit unions in designing the risk-based capital requirement. In the Original Proposal, which varied to a greater degree from the Other Banking Agencies' capital regulations than the Second Proposal, the Board proposed a significant number of alternative provisions, many of which were specifically intended to take into account the cooperative character of credit unions. The overwhelming response from credit unions in relation to that proposed approach, however, was to recommend that the Board revise the proposal to be more like the capital requirements adopted by the Other Banking Agencies to avoid putting credit unions at a competitive disadvantage to banks. As discussed in more detail below, the Board generally agreed with commenters' recommendations in that regard, and designed the Second Proposal to be more like the Other Banking Agencies' capital regulations. In the preamble to the Second Proposal, however, the Board specifically discussed ways in which the proposal continued to deviate from the Other Banking Agencies' capital requirements to take into account the cooperative character of credit unions. Furthermore, while it may generally be true that "credit unions eschew excessive risk taking," as suggested by some commenters, that fact alone does not support assigning lower risk weights to credit union assets, or requiring that credit unions meet lower risk-based capital ratio levels to be adequately or well capitalized. To the contrary, for reasons explained in more detail below, a credit union that eschews excessive risk taking should have no trouble maintaining a high risk-based capital ratio level under this final rule.

At least one commenter also suggested that credit unions' reliance primarily on retained earnings to build capital and operate make their operational structures both unique and challenging. Thus, the commenter

concluded that, by requiring a higher risk-based capital ratio level for well capitalized credit unions, the Second Proposal failed to take these factors into consideration, as required by section 216(b)(1)(B) of the FCUA. The Board disagrees. Credit unions' limited access to supplemental forms of capital and reliance primarily on retained earnings for building capital suggests, if anything, that requiring credit unions to maintain higher levels of capital is appropriate. In a financial downturn, the retained earnings of a financial institution are likely to decrease. Under such circumstances, an institution with limited access to other alternative forms of capital needs a higher level of capital on hand to ensure its survival. In the case of NCUA's capital requirements, that higher level of capital is already required under the statutory net worth ratio requirement, which requires credit unions maintain higher leverage (net worth) ratios than banks. Accordingly, consistent with the Second Proposal, the risk-based capital ratio levels adopted in this final rule for adequately and well capitalized credit unions are designed to be generally equivalent to the corresponding risk-based capital ratio levels required for banks.

IV. Section-by-Section Analysis

Part 702—Capital Adequacy Revised Structure of Part 702

Consistent with the Second Proposal, this final rule reorganizes part 702 by consolidating NCUA's PCA requirements, which are currently included under subsections A, B, C, and D, under new subparts A and B. New subpart A is titled "Prompt Corrective Action" and new subpart B is titled "Alternative Prompt Corrective Action for New Credit Unions." The reorganization is designed so that a credit union need only reference the subpart that applies to its institution, rather than having to flip back-and-forth between multiple subparts in part 702 to identify the applicable minimum capital standards and PCA regulations. Consolidating these sections reduces confusion and will save credit union staff from having to frequently flip back and forth through the four subparts of the current PCA rule.

In general, this final rule restructures part 702 by consolidating most of the sections relating to capital and PCA that are applicable to only credit unions that are not "new" under new subpart A. The specific sections that would be included in new subpart A and the changes to those sections are discussed in more detail below.

⁷³ See 12 U.S.C. 1831o, *and, e.g.*, 12 CFR 324.403(b).

⁷⁴ 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.").

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

⁷⁶ 1 U.S.C. 1.

Similarly, this final rule consolidates most of NCUA's rules relating to alternative capital and PCA requirements for "new" credit unions under new subpart B. The sections under new subpart B 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 are discussed in more detail below.

Finally, this final rule retains subpart E of part 702, Stress Testing, but re-designates and re-numbers the current subpart as subpart C. Other than re-designating and re-numbering the subpart, the language and requirements of current subpart E are unchanged by this final rule.

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

Consistent with the Proposal, § 702.1 of the final rule remains substantially similar to current § 702.1, but is amended to update terminology and internal cross references within the section, consistent with the changes that are being made in other sections of part 702. No substantive changes to the section are intended.

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.⁷⁷ 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."⁷⁸ As explained in more detail below, this final 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 final rule, this rule deviates from the PCA and risk-based capital requirements applicable to banks as required by section 216 of the FCUA,

and to take into account the cooperative character of credit unions. Accordingly, the revised risk-based net worth requirement and this final rule are consistent with section 216 of the FCUA.

Section 702.2—Definitions

The Second Proposal would have removed the paragraph numbers 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. Many of the definitions in current § 702.2 were retained, however, with no substantive changes. The reorganization of the section and the removal of the paragraph numbering made proposed § 702.2 more consistent with current §§ 700.2, 703.2 and 704.2 of NCUA's regulations.⁷⁹ In addition, proposed § 702.2 included a number of new definitions, and would have amended some of the definitions in current § 702.2.

Consistent with section 202 of the FCUA,⁸⁰ the Second Proposal also incorporated the phrase 'in accordance with GAAP' into many of the definitions to clarify that generally accepted accounting principles must be used to determine how an item is recorded on the statement of financial condition from which it would be incorporated into the risk-based capital calculation. This proposed change was intended to help clarify the meaning of terms used in the Second Proposal.

The Board received no comments on the proposed technical changes to § 702.2. The Board did, however, receive one general comment on the definitions section: At least one commenter stated that the revisions to the definitions, particularly those that now rely on GAAP definitions, seemed fair and reasonable. At least one commenter also suggested that the proposed changes to the definitions were all for the better and made the rule much clearer. The Board agrees with the commenters and has decided to retain the changes described above in this final rule.

The following definitions, consistent with the Second Proposal, are also added to, amended in, or removed from § 702.2 by this final rule:

Allowances for loan and lease losses (ALLL). The Second Proposal defined the term "allowances for loan and lease losses" 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.

The Board received no comments on the proposed definition and has decided to retain the definition in this final rule without change.

Amortized cost. The Second Proposal defined the term "amortized cost" 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.

The Board received no comments on the proposed definition and has decided to retain the definition in this final rule without change.

Appropriate regional director. The Second Proposal would have amended current § 702.2 to remove the definition of the term "appropriate regional director" from the current rule.

The Board received no comments on this proposed revision and has decided to retain the revision in this final rule without change.

Appropriate state official. Under the Second Proposal, the Board proposed revising the definition of the term "appropriate state official" by adding the italicized words ("state" and "the") to the current definition, and by removing the words "chartered by the state which chartered the affected credit union." The revised definition would have provided that the term "appropriate state official" means the state commission, board or other supervisory authority having jurisdiction over the credit union.

Public Comments on the Second Proposal

One commenter suggested that, although the proposed revision to the definition was meant to provide clarity, it might obfuscate the role of state supervisors in the PCA process because several states could have "jurisdiction" over a given credit union on a particular issue. In contemplating the possible effects of the proposed revision, the commenter asked a number of questions: Will NCUA consult with all state regulators where an affected credit union has a branch or member when taking discretionary supervisory action?⁸¹ Will a credit union have to obtain approval from all states that it operates in before issuing dividends when less than adequately capitalized?⁸² The commenter suggested further that while timely sharing of information across all

⁷⁷ 12 U.S.C. 1790d(b)(1).

⁷⁸ 12 U.S.C. 1790d(a)(1).

⁷⁹ 12 CFR 700.2; 12 CFR 703.2; and 12 CFR 704.2.

⁸⁰ 12 U.S.C. 1782(a)(6)(C)(i).

⁸¹ 12 CFR 702.110(c).

⁸² 12 CFR 702.114(b).

affected regulators was a laudable goal, crucial and time sensitive decisions regarding the reclassification or conservatorship of a credit union should be made by only the primary chartering authority of the institution in consultation with the deposit insurer. Accordingly, the commenter recommended that the Board should amend this definition to read “the state commission, board or other supervisory authority which chartered the affected credit union.”

Discussion

The Board generally agrees with the commenter and is adopting the proposed revisions to the definition of “appropriate state official” by making the following changes: At the end of the proposed definition, the final rule deletes the words “having jurisdiction over the” from the proposed definition, and adds in their place the words “that chartered the affected.” This change clarifies that NCUA must consult with only the state authority that chartered the credit union; not every state agency having some form of jurisdiction over the credit union.

Accordingly, the final rule defines “appropriate state official” as the state commission, board or other supervisory authority that chartered the affected credit union.

Call Report. The Second Proposal defined the term “Call Report” 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 and has decided to retain the proposed definition in this final rule without change.

Carrying value. The Second Proposal defined the term “carrying value,” 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.

The Board received no comments on the proposed definition, but is clarifying in this final rule that “carrying value” applies to both assets and liabilities. Accordingly, this final rule defines “carrying value” as the value of the asset or liability on the statement of financial condition of the credit union, determined in accordance with GAAP.

Central counterparty (CCP). The Second Proposal defined the term “central counterparty” 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 received no comments on the definition and has decided to retain

the proposed definition in this final rule without change.

Charitable donation account. The Second Proposal did not use or define the term “charitable donation account.” Under the proposal, such accounts, which federal credit unions are authorized to establish under § 721.3(b)(2) of NCUA’s regulations, would have been assigned a risk weight based on the risk-weight of each individual asset type in the account.

Public Comments on the Second Proposal

NCUA received several comments regarding the risk weights assigned to charitable donation accounts under the Second Proposal. Commenters suggested that the proposed risk weights assigned to charitable donation accounts would contravene the appeal for credit unions to put money into these investments to fund charitable activities. The commenters pointed out that the risk-based capital regulation from the Office of the Comptroller of the Currency (OCC) recognizes the importance of community development investments and assigns a risk weight of 100 percent to such assets. Commenters suggested that the NCUA Board should adopt a similar approach to encourage charitable donation accounts to support charitable goals and purposes.

Discussion

The Board generally agrees with the commenters and, as also discussed in the part of the preamble associated with § 702.104(c), has decided to assign a 100 percent risk weight to certain charitable donation accounts under this final rule, at the credit union’s option. Under the Second Proposal, the assets held in a charitable donation account were each assigned a risk weight based on each individual asset type in the account. After reviewing the comments received, however, the Board generally agrees with commenters who suggested that charitable donation account equity exposures, which are held at credit unions, have a role analogous to community development equity exposures, which are held at banks, and therefore warrant assigning such accounts an equivalent risk weight. Community development equity exposures are assigned a 100 percent risk weight under the Other Banking Agencies’ regulations. Thus, this final rule gives credit unions the option for risk weighting charitable donation accounts in a manner that is generally equivalent to the Other Banking Agencies’ 100 percent risk weight for community development investment equity exposures. Under this final rule,

a credit union has the option of applying risk weights to the individual assets within a charitable donation account, or just applying a 100 percent risk weight to the whole charitable donation account. A credit union cannot, however, use a combination of the two methods described to assign a risk weight to the same charitable donation account.

In defining “charitable donation account,” the Board chose to limit the types of accounts that would qualify for the 100 percent risk weight. In particular, the Board chose allow such treatment for accounts only if they met certain restrictions in 12 CFR 721.3(b)(2)(i), (b)(2)(ii), and (b)(2)(v). Thus, to qualify for the optional 100 percent risk weight under § 702.104(c)(3)(ii) of this final rule, an account must meet the following criteria:

- The book value of the credit union’s investments in all charitable donation accounts (CDAs), in the aggregate, as carried on its statement of financial condition prepared in accordance with generally accepted accounting principles, must be limited to 5 percent of the credit union’s net worth at all times for the duration of the accounts, as measured every quarterly Call Report cycle. This means that regardless of how many CDAs the credit union invests in, the combined book value of all such investments must not exceed 5 percent of its net worth. The credit union must bring its aggregate accounts into compliance with the maximum aggregate funding limit within 30 days of any breach of this limit.

- The assets of a charitable donation account must be held in a segregated custodial account or special purpose entity and must be specifically identified as a charitable donation account.

- The credit union is required to distribute to one or more qualified charities, no less frequently than every 5 years, and upon termination of a charitable donation account regardless of the length of its term, a minimum of 51 percent of the account’s total return on assets over the period of up to 5 years. Other than upon termination, the credit union may choose how frequently charitable donation account distributions to charity will be made during each period of up to 5 years. For example, the credit union may choose to make periodic distributions over a period of up to 5 years, or only a single distribution as required at the end of that period. The credit union may choose to donate in excess of the minimum distribution frequency and amount;

The three criteria above are included in the definition of charitable donation account to ensure that such accounts, if assigned a 100 percent risk weight, will be used primarily for charitable purposes and not present a material risk to a credit union regardless of the types of assets held in the accounts. The definition includes a 5 percent of net worth limit on charitable donation accounts to reflect an amount that allows a credit union to generate income for the charity while ensuring any risks associated with such accounts do not pose safety and soundness issues. In determining the 5 percent of net worth limit, the Board considered the investment types a credit union could purchase in a charitable donation account, which can include investments with significant credit risk. The Board determined that a 5 percent of net worth limit was reasonable given NCUA's charitable donation account regulations and necessary to ensure that the accounts were small enough to not pose a safety and soundness issue to the NCUSIF if assigned a 100 percent risk weight.

The definition also specifies that charitable donation accounts must be held in segregated custodial accounts or special purpose entities, and must be specifically identified as charitable donation accounts, to ensure holdings can be measured for exposure and monitored for performance and distribution. The Board determined the segregation of accounts is necessary to ensure a credit union and NCUA could measure compliance with the net worth and distribution criteria, consistent with safety and soundness and the account's purpose.

Finally, the definition specifies that distributions must be made in a particular manner to ensure such accounts are used primarily for charitable giving. By specifying the distribution manner, the definition of charitable donation account ensures that the account will primarily be used for charitable giving. This distinction is generally consistent with the Other Banking Agencies' regulations, which assign a 100 percent risk-weight to community development investment equity exposures.

Without each of the three criteria discussed above, a charitable donation account would primarily be an investment vehicle for a credit union and could present a material risk to the credit union and the NCUSIF. Accordingly, this final rule defines "charitable donation account" as an account that satisfies all of the conditions in 12 CFR 721.3(b)(2)(i), (b)(2)(ii), and (b)(2)(v).

Commercial loan. The Second Proposal defined the new term "commercial loan" 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 have also provided that the term commercial loan excludes loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans.

Public Comments on the Second Proposal

The Board received many comments regarding the proposed new term "commercial loan" and its definition. Several commenters agreed with creating a category of "commercial loans" as distinct from traditional member business loans for purposes of the risk-based capital ratio requirement. At least one commenter stated that, while differentiating between "commercial loans" for risk-based capital purposes and "member-business loans" as defined for lending purposes is appropriate, the subtle differences in these definitions may cause confusion. Similarly, another commenter suggested that even though it would require changes to the call report and how credit union classify these loans, the Board was right to use the broader definition of commercial loans in the proposal because there is no difference in the credit risk of member business loans and commercial loans.

Conversely, other commenters suggested that replacing the term "member business loan," which credit unions and NCUA's regulations already use, with the new term "commercial loan" for purposes of the risk-based capital regulation would cause unnecessary confusion. Other commenters suggested that the proposed definition of "commercial loan" should be revised to be consistent with the definition of "member business loan" in part 723 of NCUA's regulations because they believed the differences between the two definitions were immaterial to a credit union's capital requirement, but would add unnecessary administrative burden to the Call Report.

In addition, a trade association commenter pointed out that the proposed definition of a "commercial loan" specifies that it is a loan "to individuals, sole proprietorships, partnerships, corporations, or other business enterprises," and explicitly excludes loans to CUSOs, first- or junior-lien residential real estate loans,

and consumer loans. The commenter pointed out, however, that the preamble to the Second Proposal seemed to indicate that whether or not a loan is "commercial" will be based exclusively on the purpose of the loan, use of the proceeds, and type of collateral. The Commenter suggested that if a loan can be considered commercial regardless of the type of borrower, the Board should consider removing the list of potential borrowers and simply retaining the exclusions of specific loan types. The commenter suggested further that the proposal specified that a commercial loan is a loan made for "commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes." But, under part 723 of NCUA's regulations, MBLs are made for commercial, corporate, other business investment property or venture, or agricultural purposes.⁸³ The commenter recommending clarifying the alignment of these two definitions in the final rule, and that if the only intended differences in treatment arise from the definitions of loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans, then the Board should consider adopting the member business loan language and retaining those explicit exclusions. At least one commenter also pointed out that current § 723.1(d) and (e) of NCUA's member business lending regulations reference treatment of purchased member and non-member loans and loan participations for risk-weight purposes under part 702, and encouraged the Board to review those sections for consistency with the proposed definition of commercial loan. Another commenter requested that the Board clarify whether the definition of "commercial loans" includes loans to non-profits. One state supervisory authority commenter requested clarification on whether the definition, which lists a number of specific asset types, would include agricultural loans.

Discussion

As stated in the Second Proposal, the new term "commercial loan" and its proposed definition more accurately capture the risks these loans present than the term MBL, and better identifies loans that are made for a commercial purpose and have similar risk characteristics. While there could be some initial confusion associated with the use of this new term, the Board notes that such confusion can be addressed during the implementation period and in guidance before the final rule becomes effective in 2019.

⁸³ 12 CFR 723.1(a).

Guidance contained in the Call Report for the proper reporting of commercial loans will also provide information to credit unions to ensure proper reporting of both “commercial” loans for the purpose of assigning risk weights and the reporting of MBLs for the purpose of monitoring compliance with the statutory limit.

The Board agrees, however, with commenters who suggested that the purpose of a loan determine its classification as a “commercial” loan. The risks associated with a commercial loan are related to its purpose. Moreover, the proposed list of entities that could have received the loans encompassed all possibilities, including non-profit organizations. Thus the removal of the list of parties who could receive the loans would be inconsequential. Accordingly, the Board is amending the definition of “commercial loan” to remove the words “to individuals, sole proprietorships, partnerships, corporations, or other business enterprises.”

The Board maintains, however, that the listing of commercial purposes in the proposed definition was adequate and plainly included agricultural loans if they are granted for a commercial or industrial purpose. Similarly, it is clear that a loan purchased by a credit union, which was made for a commercial purpose, was also included within the proposed definition of a commercial loan, whether it is a loan to member or non-member. Thus no additional changes to the definition are necessary.

Accordingly, this final rule defines “commercial loan” as any loan, line of credit, or letter of credit (including any unfunded commitments) for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. The definition provides further that the term commercial loan excludes loans to CUSOs, first- or junior-lien residential real estate loans, and consumer loans.

Commitment. The Second Proposal defined the term “commitment” 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 Board received no comments on the proposed definition, but has decided to clarify in this final rule that a “commitment” can also refer to funding transactions. Accordingly, this final rule would define “commitment” as any legally binding arrangement that obligates the credit union to extend credit, purchase or sell assets, enter into a borrowing agreement, or enter into a financial transaction.

Consumer loan. The Second Proposal defined the term “consumer loan” 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 have provided 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.

Public Comments on the Second Proposal

The proposed definition of “consumer loan” referenced loans “to one or more individuals . . . including any loans secured by vehicles generally manufactured for personal, family, or household use regardless of the purpose of the loan.” At least one commenter requested that the Board clarify whether the same loan would still be considered a consumer loan if made to an incorporated entity. If the definition is not dependent on the type of borrower, the commenter suggested that the words “one or more individuals” were not necessary. The commenter also requested that the Board clarify the definition of a loan “for the purchase of fleet vehicles,” and, to maximize ease of compliance, recommended the Board incorporate the definition of “fleet” contained in a 2012 NCUA legal opinion directly into the definition.⁸⁴

Discussion

The Board agrees with the commenter who suggested that a consumer loan should be defined by the purpose of the loan and not depend on the type of entity receiving the loan, be it an individual, corporation, or some other business. The material risks associated with holding a prudently underwritten consumer loan are related to its purpose, not on the type of borrower. Accordingly, this final rule amends the proposed definition of consumer loan to remove the words “to one or more individuals” from the definition.

The Board also generally agrees with the commenter who suggested the final rule should further clarify the reference to “fleet vehicles” in the proposed definition of consumer loans. As pointed out by the commenter, NCUA’s General Counsel issued a legal opinion letter in 2012 that interprets the term “fleet” for purposes of § 723.7(e) of

NCUA’s regulations.⁸⁵ The letter provides that a fleet means “five or more vehicles that are centrally controlled and used for a business purpose, including for the purpose of transporting persons or property for commission or hire.” The meaning of the term “fleet,” as used in the proposed definition of consumer loan, should be consistent with the use of the term in § 723.7(e). While the Second Proposal did not propose adopting the definition of “fleet” provided in the 2012 legal opinion letter, the term should have the same meaning. The term does not need to be defined in this final rule. Future changes in market realities surrounding the use of the term “fleet” make adopting a fixed definition of the term impractical. The Board agrees, however, that revising the proposed use of the term “fleet” in the definition of consumer loan to be more consistent with the use of the term fleet in § 723.7(e) will help avoid confusion regarding the term’s meaning. Accordingly, the final rule revises the last clause in the second sentence of the definition of the term “consumer loan” to provide, “and loans for the purchase of one or more vehicles to be part of a fleet of vehicles.”

NCUA will provide separate examiner guidance on the application of the definition of consumer loans to ensure consistent interpretation of the definition in the future. NCUA’s Call Report instructions will also contain appropriate guidance for the proper reporting of consumer loans. For the reasons discussed above, this final rule defines the term “consumer loan” as a loan for household, family, or other personal expenditures, including any loans that, at origination, are wholly or substantially secured by vehicles generally manufactured for personal, family, or household use regardless of the purpose of the loan. The definition provides 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 one or more vehicles to be part of a fleet of vehicles.

Contractual compensating balance. The Second Proposal defined the term “contractual compensating balance” 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.

⁸⁴ NCUA, *Definition of Fleet*, Legal Opinion Letter 12-0764 (Sept. 13, 2012), available at <http://www.ncua.gov/Legal/Pages/OL2012-12-0764.aspx>.

⁸⁵ NCUA, *Definition of Fleet*, Legal Opinion Letter 12-0764 (Sept. 13, 2012), available at <http://www.ncua.gov/Legal/Pages/OL2012-12-0764.aspx>.

The Board received no comments on the definition and has decided to retain the proposed definition in this final rule without change.

Credit conversion factor (CCF). The Second Proposal defined the term “credit conversion factor” as the percentage used to assign a credit exposure equivalent amount for selected off-balance sheet accounts.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Credit union. The Second Proposal defined the term “credit union” as a federally insured, natural-person credit union, whether federally or state-chartered. The proposal would have amended 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 were unnecessary, and could mistakenly be read to limit the definition of “credit unions” to state-chartered credit unions.

The Board received no comments on the proposed revisions to the definition of “credit union” and has decided to retain the proposed definition in this final rule without change.

Current. The Second Proposal defined the term “current,” with respect to any loan, as less than 90 days past due, not placed on non-accrual status, and not restructured.

Public Comments on the Second Proposal

The Board received only a small number of comments on the proposed definition of the term “current.” Most commenters who mentioned it supported the proposed definition of “current.” One credit union commenter, however, suggested that the Board should define “current” as loans that are 60 days past due, which was the period provided in the Original Proposal, because expanding the delinquency loans to 90 days has more risk and greater exposure to potential loss. Another commenter recommended that the definition of “current” be revised so it does not automatically exclude all restructured loans. Another commenter argued that while it is understandable to require a higher risk-weighting for non-current loans, lumping restructured loans into this same category and treatment would be punitive. The commenter suggested that the definition of “restructured loans” be amended to specifically address loans that the commenter referred to as “troubled debt relief assets,” which are loans that have been modified because of financial hardship in the face of some

type of credit impairment. According to the commenter, the Financial Accounting Standards Board already requires excess reserves be held for these assets based on the difference between the net present value of the loans under the original terms versus the modified terms. The commenter contended that credit unions currently hold reserves of over 10 percent against loans that are performing and have very low incidents of future default. Therefore, the commenter concluded, treating a “troubled debt relief asset” as a non-current loan would not reflect the fact that a modification has been made to a loan and it is performing. The commenter suggested that such restructurings aid the future performance of such loans.

Discussion

The Board believes that the proposed definition of “current” is 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,” and aligns well with the definition of “current loan” under the Other Banking Agencies’ regulations.⁸⁶ In general, loans that are more than 90 days past due, or restructured, tend to have higher incidences of default resulting in losses. The proposed definition is consistent with the definition used under the Other Banking Agencies’ risk-based capital rules and is not dependent upon, nor contradictory to, related accounting pronouncements. Additional guidance will be provided to credit unions in the future regarding reporting troubled debt restructuring (TDR) loans through supervisory guidance and in the instructions on the Call Report. Accordingly, the Board has decided to retain the proposed definition in this final rule without change.

CUSO. The Second Proposal defined the term “CUSO” as a credit union service organization as defined in parts 712 and 741.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Custodian. The Second Proposal defined the term “custodian” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Depository institution. The Second Proposal defined the term “depository institution” 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 provided 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 Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Derivatives Clearing Organization (DCO). The Second Proposal defined the term “Derivatives Clearing Organization (DCO)” as having the same definition as provided by the Commodity Futures Trading Commission in 17 CFR 1.3(d).

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Derivative contract. The Second Proposal defined the term “derivative contract” 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 provided 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 also provided 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 or five business days.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Equity investment. The Second Proposal defined the term “equity

⁸⁶ See, e.g., 12 CFR 324.32(k).

investment” as investments in equity securities, and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Equity investment in CUSOs. The Second Proposal defined the term “equity investment in CUSOs” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Exchange. The Second Proposal defined the term “exchange” as a central financial clearing market where end users can trade derivatives.

The Board received no comments on this definition, but has decided to clarify in this final rule that derivatives are engaged in through agreements and not traded like securities. Accordingly, this final rule would define “exchange” as a central financial clearing market where end users can enter into derivative transactions.

Excluded goodwill, and excluded other intangible assets. The Second Proposal defined the term “excluded goodwill” 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 provided further that the term excluded goodwill and its accompanying definition would expire on January 1, 2025.

The Second Proposal would have also defined the 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 provided further that the term excluded other intangible assets and its accompanying definition would expire on January 1, 2025.

Public Comments on the Second Proposal

The Board received many comments regarding the proposed treatment of goodwill and other intangible assets

under NCUA’s risk-based capital requirement. A significant number of commenters requested that the terms “excluded goodwill” and “excluded intangible assets” and their proposed treatment be retained permanently (or, if not retained permanently, commenters requested that the time period during which they are allowed be extended). The specific comments received and a more detailed description of the Board’s response are provided below in the part of the preamble associated with § 702.104(b)(2).

Discussion

The Board generally agrees with commenters who suggested the time periods allowed for these proposed exclusions be extended. The Board added these two definitions to take into account the impact goodwill or other intangible assets recorded from transactions defined as supervisory mergers or combinations have on the calculation of the risk-based capital ratio upon implementation. The proposed exclusions would have applied to supervisory mergers or combinations that were completed prior to the date of publication of this final rule in the **Federal Register**. The proposed exclusion would have ended on January 1, 2025. For the reasons discussed below in the part of the preamble associated with § 702.104(b)(2), the Board has decided to revise the proposed definitions of “excluded goodwill” and “excluded other intangible assets” to extend the period during which credit unions can count these assets in the risk-based capital ratio numerator to January 1, 2029. In addition, the Board is extending the period, after the publication of this final rule in the **Federal Register**, during which credit unions can obtain “excluded goodwill” and “excluded other intangible assets” to 60 days to allow credit unions additional time to adjust to the changes made by this final rule.

Accordingly, this final rule defines “excluded goodwill” as the outstanding balance, maintained in accordance with GAAP, of any goodwill originating from a supervisory merger or combination that was completed on or before a date to be set upon publication, which will be 60 days after publication of this final rule in the **Federal Register**. The definition provides further that the term and definition expire on January 1, 2029.

Similarly, this final rule also defines “excluded other intangible assets” as the outstanding balance, maintained in accordance with GAAP, of any other intangible assets such as core deposit

intangible, member relationship intangible, or trade name intangible originating from a supervisory merger or combination that was completed on or before a date to be set upon publication, which will be 60 days after publication of this final rule in the **Federal Register**. The definition provides further that the term and definition expire on January 1, 2029.

Exposure amount. The Second Proposal defined the term “exposure amount” 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Fair value. The Second Proposal defined the term “fair value” as having the same meaning as provided in GAAP.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Financial collateral. The Second Proposal defined the term “financial collateral” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

First-lien residential real estate loan. The Second Proposal defined the term “first-lien residential real estate loan” 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

GAAP. The Second Proposal defined the term “GAAP” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

General account permanent insurance. The Second Proposal defined the term “general account permanent insurance” 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 the proposed definition, general account permanent insurance would have included direct obligations to the insurance provider. This would have meant that the credit risk associated with general account permanent insurance was to the insurance company, which generally makes such insurance accounts have a lower credit risk than separate account insurance. A separate account insurance is a segregated accounting and reporting account held separately from the insurer’s general assets.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

General obligation. The Second Proposal defined the term “general obligation” as a bond or similar obligation that is backed by the full faith and credit of a public sector entity.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Goodwill. The Second Proposal defined the term “goodwill” 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. The Proposed definition provided further that goodwill does not include excluded goodwill.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Government guarantee. The Second Proposal defined the term “government guarantee” as a guarantee provided by the U.S. Government, FDIC, NCUA or other U.S. Government agencies, or a public sector entity.

Public Comments on the Second Proposal

One state supervisory authority commenter requested clarification on the definition of “government guarantee,” and whether the definition includes any type of guarantee from a state government, state government agency, or municipality.

Discussion

The Board definition of “government guarantee” does include guarantees from a state government, state government agency, or municipality. The definition expressly includes a guarantee provided by a “public sector entity,” which the second proposal defines separately in § 702.2 as a state, local authority, or other governmental subdivision of the United States below the sovereign level. The proposed definition of “public sector entity” would include state governments, state government agencies, and municipalities. Accordingly, the Board has decided to retain the proposed definition of “government guarantee” in this final rule without change.

Government-sponsored enterprise (GSE). The Second Proposal defined the term “government-sponsored enterprise” 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Guarantee. The Second proposal defined the term “guarantee” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Identified losses. The Second Proposal defined the term “identified losses” as those items that have been determined by an evaluation made by

NCUA, or in the case of a state-chartered credit union, the appropriate state official, as measured on the date of examination in accordance with GAAP, to be chargeable against income, equity or valuation allowances such as the allowances for loan and lease losses. The definition provided 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.

Public Comments on the Second Proposal

At least one commenter requested that the Board specify in the definition of “identified losses” that such losses are only chargeable against losses.

Discussion

The commenter’s suggested revision to the proposed definition is not consistent with generally accepted accounting principles. The definition of “identified losses” specifies that it be recorded in accordance with GAAP to appropriately address this matter and any further limiting conditions could run afoul of GAAP reporting. Accordingly, the Board has decided to retain the proposed definition in this final rule without change.

Industrial development bond. The Second Proposal defined the term “industrial development bond” 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Intangible assets. The Second Proposal defined the term “intangible assets” as assets, maintained in accordance with GAAP, other than financial assets, that lack physical substance.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Investment fund. The Second Proposal defined the term “investment fund” as an investment with a pool of underlying investment assets. The proposed definition provided further that the term investment fund includes an investment company that is

registered under section 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Junior-lien residential real estate loan. The Second Proposal defined the term “junior-lien residential real estate loan” as a loan or line of credit secured by a subordinate lien on a one-to-four family residential property. The proposed definition generally included all residential real estate loans that did not meet the definition of a first-lien residential real estate loan because the credit union is secured by a second or subsequent lien on the residential property loan.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Limited Recourse. The Second Proposal did not define the term “limited recourse.”

Public Comments on the Second Proposal

At least one commenter suggested that the Board define “limited recourse” as provided under GAAP and clarify that the definition excludes normal reps and warranties in a loan sale transaction.

Discussion

There is no need to define “limited recourse” because the Second Proposal and this final rule define the term “loans transferred with limited recourse.” That definition provides sufficient information regarding the rule’s use of the term “limited recourse,” and adequately addresses the normal representations and warranties associated with limited recourse. Accordingly, the Board has decided not to separately define the term “limited recourse” in this final rule.

Loan to a CUSO. The Second Proposal defined the term “loan to a CUSO” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change. 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 risk weight of

a loan to a CUSO is normally zero since the consolidation entries eliminate the intercompany transaction.

Loan secured by real estate. The Second Proposal defined the term “loan secured by real estate” 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 provided 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 also provided 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Loans transferred with limited recourse. The Second Proposal defined the term “Loans transferred with limited recourse” as the total principal balance outstanding of loans transferred, including participations, for which the transfer qualified for true sale accounting treatment under GAAP, and for which the transferor credit union retained some limited recourse (*i.e.*, insufficient recourse to preclude true sale accounting treatment). The definition provided 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Mortgage-backed security (MBS). The Second Proposal defined the term “mortgage-backed security” 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.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Mortgage partnership finance program. The Second Proposal defined

the term “mortgage partnership finance program” 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.

Public Comments on the Second Proposal

The Board received several comments on the proposed definition of “mortgage partnership finance program.” One commenter explained that the Federal Home Loan Banks have programs through which they acquire conventional and government-issued residential mortgage loans from certain of their members, called Participating Financial Institutions (PFIs). The commenter explained that the Mortgage Partnership Finance (MPF) Program is offered today by most Federal Home Loan Banks, but that the Federal Home Loan Banks of Cincinnati and Indianapolis each independently operate a similar member product called the Mortgage Purchase Program (MPP). According to the commenter, both the MPP and MPF Programs operate pursuant to Federal Housing Finance Agency regulation and the majority of PFIs that sell mortgage loans under these programs are small to mid-sized community banks, thrifts, and credit unions. Several commenters suggested that NCUA’s proposed definition of “Mortgage Partnership Finance Program,” could be reasonably construed to only apply to MPF Program loans that a credit union services. If the intent of the rule is to treat all MPF program loans the same, regardless of whether the credit union retains or sells the servicing, then the commenters recommended the Board clarify the definition by deleting the words “and servicing them” from the definition of “Mortgage Partnership Finance Program.”

Commenters also suggested that, although the MPP and the MPF Programs are similar in many respects, there is an important difference regarding recourse risk. According to the commenters, the MPF Program achieves credit enhancement by creating a contingent liability for PFIs while the MPP achieves credit enhancement by creating a contingent asset for the PFI. Because credit unions retain recourse risk on MPF loans but not on MPP loans, the commenters recommended

that the Board amend the proposed definition of "Mortgage Partnership Finance Program" to clarify that the term expressly excludes MPP loans. In particular, the commenters recommended that the Board add the words "in a manner other than by establishing a contingent asset for the benefit of or payable to the depository institution" at the end of the definition of Member Partnership Finance Program.

Discussion

The Board generally agrees with the commenters who suggested removing the words "and servicing them" from the proposed definition of "mortgage partnership finance program." The Board's intent is to treat all MPF program loans the same under the final rule regardless of whether the credit union retains or sells the servicing. Accordingly, this final rule revises the definition of mortgage partnership finance program to remove the words "and servicing them."

The Board also agrees with commenters who suggested there is an important difference between the MPP and the MPF Programs regarding recourse risk. MPF loans are not the same as MPP loans with regard to risk because credit unions retain recourse risk through a credit enhancement obligation to the Federal Home Loan Bank for credit losses on MPF loans. Loans sold under the MPP program are risk-weighted based on the contractual recourse obligation, if any. Thus the commenters' suggested change to the definition of MPF Programs is necessary.

Accordingly, this final rule defines "mortgage partnership finance program" 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 institution receives fees for managing the credit risk of the loans. The definition provides further that the credit risk must be shared between the depository institution and the Federal Home Loan Banks.

Mortgage servicing assets. The Second Proposal defined the term "mortgage servicing asset" 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.

The Board received no comments on this definition and has decided to retain

the proposed definition in this final rule without change.

NCUSIF. The Second Proposal defined the term "NCUSIF" as the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Net worth. Generally consistent with the current rule, the Second Proposal defined the term "net worth" 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 section 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 Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Net worth ratio. The Second Proposal defined the term "net worth ratio" as the ratio of the net worth of the credit union to the total assets of the credit union rounded to two decimal places.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

New credit union. The Second Proposal would have revised the definition of "new credit union" by removing the definition provided in current § 702.2 and providing that the term has the same meaning as in § 702.201.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Nonperpetual capital. The Second Proposal defined the term "nonperpetual capital" as having the same meaning as in 12 CFR 704.2.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Off-balance sheet items. The Second Proposal defined the term "off-balance sheet items" as items such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements that are not included on the statement of financial condition, but are normally reported in the financial statement footnotes.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Off-balance sheet exposure. The Second Proposal defined the term "off-balance sheet exposure" as: (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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

On-balance sheet. The Second Proposal defined the term "on-balance sheet" as a credit union's assets, liabilities, and equity, as disclosed on the statement of financial condition at a specific point in time.

The Board received no comments on this definition and has decided to retain

the proposed definition in this final rule without change.

Other intangible assets. The Second Proposal defined the term “other intangible assets” as intangible assets, other than servicing assets and goodwill, maintained in accordance with GAAP. The definition provided further that other intangible assets does not include excluded other intangible assets.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Over-the-counter (OTC) interest rate derivative contract. The Second Proposal defined the term “over-the-counter (OTC) interest rate derivative contract” as a derivative contract that is not cleared on an exchange.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Part 703 compliant investment fund. The Second proposal used the term “part 703 compliant investment fund,” but did not specifically define the term in § 702.2. The discussion in the preamble to the proposal, however, used the term to mean an investment fund that is restricted to holding only investments that are permissible under 12 CFR 703.14(c).

Public Comments on the Second Proposal

The Board received many comments on the risk weights assigned to “part 703 compliant investment funds.” Some of the comments received seemed to indicate that credit unions and other interested parties were unclear regarding the rule’s use of the term. The specific comments received regarding investment funds and part 703 compliance are discussed in more detail below in the part of preamble associated with § 702.104(c).

Discussion

The Board has decided to define the term “part 703 compliant investment funds” in § 702.2 to clarify the meaning of the term and avoid possible confusion in the future. Accordingly, this final rule defines “part 703 compliant investment fund” as an investment fund that is restricted to holding only investments that are permissible under 12 CFR 703.14(c).

Perpetual contributed capital. The Second Proposal defined the term “perpetual contributed capital” as having the same meaning as in 12 CFR 704.2.

The Board received no comments on this definition and has decided to retain

the proposed definition in this final rule without change.

Public sector entity (PSE). The Second Proposal defined the term “public sector entity” as a state, local authority, or other governmental subdivision of the United States below the sovereign level.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Qualifying master netting agreement. The Second Proposal defined the term “qualifying master netting agreement” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Recourse. The second Proposal defined the term “recourse” 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 provided 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 also provided 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 provided that recourse may also exist implicitly if the credit union provides credit enhancement beyond any contractual obligation to support assets it has transferred.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Residential mortgage-backed security. The Second Proposal defined the term “residential mortgage-backed security” as a mortgage-backed security backed by loans secured by a first-lien on residential property.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Residential property. The Second Proposal defined the term “residential property” 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 provided further that the term residential property excludes boats and motor homes, even if used as a primary residence, and timeshare property.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Restructured. The Second Proposal defined the term “restructured,” 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. The definition provided further that the term restructured excludes loans modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program.

Public Comments on the Second Proposal

At least one commenter argued that the definition of the term "restructured," as it applied to loans, and the accompanying footnote in the preamble to the Second Proposal were troublesome.⁸⁷ The commenter believed that the footnote accompanying the preamble discussion on the definition of "restructured" suggested that a loan that was restructured was what FASB calls a TDR. The commenter was confused further by the following statement in the preamble: "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."⁸⁸ According to the commenter, however, such a loan would be treated as a restructured loan for accounting purposes by FASB and under the TDR guidance. To avoid confusion, the commenter recommended that the Board amend the definition of "restructured" to be consistent with the standards and guidance set by FASB.

Discussion

The proposed definition of "restructured" was based on the classification of restructured loans for the purpose of assigning appropriate risk weights. The proposed definition is consistent with the definition used under the Other Banking Agencies' risk-based capital rules and is not dependent upon nor contradictory to related accounting pronouncements. Additional guidance will be provided to credit unions in the future regarding risk-weighting restructured loans through supervisory guidance and in the instructions on the Call Report. Accordingly, the Board has decided to retain the proposed definition of "restructured" in this final rule without change.

Revenue obligation. The Second Proposal defined the term "revenue obligation" as a bond or similar obligation that is an obligation of a public sector entity, but which the public sector entity is committed to repay with revenues from the specific

project financed rather than general tax funds. Generally, such bonds or debts are paid with revenues from the specific project financed rather than the general credit and taxing power of the issuing jurisdiction.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Risk-based capital ratio. The Second Proposal defined the term "risk-based capital ratio" 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).

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Risk-weighted assets. The Second Proposal defined the term "risk-weighted assets" as the total risk-weighted assets as calculated in accordance with § 702.104(c).

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Secured consumer loan. The Second Proposal defined the term "secured consumer loan" 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Senior executive officer. The Second Proposal defined the term "senior executive officer" as a senior executive officer as defined by 12 CFR 701.14(b)(2).

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Separate account insurance. The Second Proposal defined the term "separate account insurance" 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Shares. The Second Proposal defined the term "shares" as deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

The Board received no comments on this definition and has decided to retain

the proposed definition in this final rule without change.

Share-secured loan. The Second Proposal defined the term "share-secured loan" as 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 12 CFR 701.39.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule with the following conforming changes. This final rule amends the definition of share-secured loans to be consistent with the new zero percent risk weight assigned to share-secured loans, where the shares securing the loan are on hold with the credit union, which is discussed in more detail below.

Accordingly, this final rule defines the term "share-secured loan" as a loan fully secured by shares, and does not include the imposition of a statutory lien under § 701.39 of this chapter.

STRIPS. The Second Proposal defined the term "STRIPS" as separate traded registered interest and principal security.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Structured product. The Second Proposal defined the term "structured product" as an investment that is linked, via return or loss allocation, to another investment or reference pool.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Subordinated. The Second Proposal defined the term "subordinated" to 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 provided further that the term subordinated does not apply to securities that are junior only to money market fund eligible securities in the same issuance.

Public Comments on the Second Proposal

At least one commenter recommended the Board more clearly define the term "subordinated" with respect to a "tranche." As discussed in the part of the preamble associated with § 702.104(c)(2), commenters also expressed some confusion regarding NCUA's use of the term "non-subordinated" in the Second Proposal. Additionally, commenters expressed their desire to have the risk-weight assigned to a non-subordinated tranche

⁸⁷ See 80 FR 4339, 4369 (Jan. 27, 2015) (Footnote 119, referred to by the commenter, relates to Financial Accounting Standards Board ASC 310-40, "Troubled Debt Restructuring by Creditors.").

⁸⁸ *Id.* at 4369.

be based on the underlying collateral in the tranche.

Discussion

The Second Proposal defined the terms “subordinated” and “tranche.” These definitions, when read together, make it clear that a subordinated tranche is an investment that has a junior claim to other securities within the same transaction.

The Board agrees, however, that clarifying the definition of “subordinated” to clarify the meaning of the term non-subordinated in § 702.2 will help clarify the meaning of the term for credit unions and other interested parties, and clarify that under this final rule all tranches of investments, regardless of standing, can be risk-weighted using the gross-up approach. As discussed in more detail below, commenters suggested that credit unions be given the option of using the gross-up approach to risk-weight non-subordinated tranches of investments. A non-subordinated instrument is the most senior tranche in a security with a senior/subordinated structure. The Board has decided to further clarify the definition of “subordinated” for credit unions using the gross-up approach for both subordinated and non-subordinated investment tranches. This change will benefit credit unions purchasing non-subordinated tranches of securities collateralized with lower credit risk assets.

Accordingly, this final rule defines the term “subordinated” as meaning, 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 also provides that an investment that does not have a junior claim to other investments in the same issuance on the underlying collateral or assets is non-subordinated. Finally, the definition provides that a security that is junior only to money-market-eligible securities in the same issuance is also non-subordinated.

Supervisory merger or combination. The Second Proposal defined the term “supervisory merger or combination” 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Swap dealer. The Second Proposal defined the term “swap dealer” as having the same meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(ggg).

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Total assets. The Second Proposal retained the definition of “total assets” in current § 702.2, but would have restructured the definition and provided additional clarifying language. The proposal amended the definition to provide that “total assets” means a credit union’s total assets as measured⁸⁹ by either:

- *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;

- *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;

- *Average daily balance.* The credit union’s total assets measured by the average daily balance over the applicable calendar quarter; or

- *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.

Public Comments on the Second Proposal

One commenter suggested that the proposed definition of “total assets” would create inconsistency as to how risk-based capital results are reported and would hinder comparability among credit unions. The commenter recommended that the Board amend the definition to require that total assets be measured by the average of quarter-end balances of the current and three preceding calendar quarters.

Discussion

With the exception of a few non-substantive amendments, the proposed

⁸⁹ 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).

definition of “total assets” is the same as the definition in current § 702.2. In fact, the revision suggested by the commenter above would reduce the number of options available to a credit union in determining which total assets to apply in calculating its net worth ratio. Such a narrowing of the definition is not appropriate. Accordingly, the Board has decided to retain the proposed revisions to the definition in this final rule without change.

Tranche. The Second Proposal defined the term “tranche” as one of a number of related securities offered as part of the same transaction. The definition provided 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 received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

Unfunded commitment. Neither the current rule nor the Second Proposal define the term “unfunded commitment.”

Public Comments on the Second Proposal

At least one commenter recommended that the Board define the term “unfunded commitment” in the final rule because the commenter believed the proposed definition was unclear as to whether a credit union real estate loan pipeline or outstanding auto loan convenience check would be classified as an unfunded commitment.

Discussion

The proposal provides in § 702.2 that “off-balance sheet exposure” means, for unfunded commitments, the remaining unfunded portion of the contractual agreement. The definition of off-balance-sheet exposure defines unfunded commitment, so adding an additional separate definition for unfunded commitment would be redundant. Additional guidance, however, will be included in future supervisory guidance and in the instructions on the Call Report. Accordingly, the Board has decided not to define the term “unfunded commitment” in this final rule.

Unsecured consumer loan. The Second Proposal defined the term “unsecured consumer loan” as a consumer loan not secured by collateral.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule without change.

U.S. Government agency. The Second Proposal defined the term “U.S. Government agency” as an

instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

The Board received no comments on this definition and has decided to retain the proposed definition in this final rule with only minor clarifying amendments. In particular, the Board clarified in the definition that NCUA is a U.S. Government agency, to confirm that NCUA's obligations receive a zero percent risk weight. Accordingly, the final rule defines "U.S. Government agency" as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. The definition provides further that the term "U.S. Government agency" includes NCUA.

Weighted-average life of investments. Under the Second Proposal, the definition of "weighted-average life of investments" and the provisions in current § 702.105 of NCUA's regulation would have been removed completely.

Other than the comments supporting the removal of IRR from NCUA's risk-based capital requirement, the Board received no comments regarding the removal of this definition and has decided to retain the proposed amendment in this final rule without change.

A. Subpart A—Prompt Corrective Action

The Second Proposal would have established a 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 section 216(b)(2) of the FCUA.⁹⁰ The Board received no comments on these revisions and has decided to retain the proposed amendments in this final rule.

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

The Second Proposal retained the requirements of § 702.101 leaving it largely unchanged from current § 702.101, with a few notable exceptions that are discussed in more detail below. The title of proposed § 702.101 would have been changed to "Capital Measures, capital adequacy, 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, proposed § 702.101 would have amended current § 702.101 to include a new capital adequacy provision that was based on a similar provision in FDIC's capital regulations.⁹¹ The new capital adequacy provision was added as proposed § 702.101(b). Paragraphs (b) and (c) of current § 702.101 would have been renumbered as paragraphs (d) and (e). The new capital adequacy provision would not have affected credit unions' PCA capital category, but could have supported the assessment of capital adequacy in the supervisory process (assigning CAMEL and risk ratings).

Public Comments on the Second Proposal

A substantial number of commenters objected to the proposed addition of capital adequacy provisions to § 702.101. Many commenters stated that they were concerned about the subjective nature of the capital adequacy provision. Commenters contended that if a credit union meets the net worth and risk-based capital requirements, NCUA should not have the ability to require the credit union to hold additional capital. Other commenters argued that the proposed capital adequacy provisions could be problematic because they would grant examiners considerable latitude to determine whether a credit union needs more capital even if it is well capitalized according to standard net worth and risk-based capital ratio requirements. Commenters argued that credit unions and the NCUSIF have functioned well without these provisions and NCUA has not provided sufficient justification to support their imposition now. Still other commenters noted that credit unions already provide for capital adequacy through budgeting, ALM planning, liquidity, interest rate risk, and risk management, and speculated that the proposed capital adequacy provision would subject credit unions' capital plans to be judged in an arbitrary and subjective manner by hundreds of different NCUA examiners. The commenters argued that such an approach would provide examiners with too much authority to change the "playing field," especially when there is no independent entity to which a credit union can appeal. At least one commenter suggested that the Board already has this authority so adding to the existing authority would be unnecessary and redundant.

One commenter, however, acknowledged that codifying the additional capital adequacy requirements in § 702.101(b) was reasonable. But the commenter suggested that the standards surrounding the provision's use should be made clear because NCUA already examines credit unions to determine whether they have sufficient net worth relative to risk, and whether credit unions have adequate policies, practices, and procedures regarding net worth and capital accounts.⁹² The commenter noted further, the proposed rule indicates that it "may provide specific metrics for necessary reductions in risk levels, increases in capital levels beyond those otherwise required under part 702, and some combination of risk reduction and increased capital."⁹³ The commenter recommended that the Board clarify how it envisions § 702.101(b) augmenting NCUA's current supervisory process and any enforcement authority the agency holds in conjunction with that process. Another commenter suggested that credit unions with lower risk profiles and/or higher capital levels should be subjected to less rigorous examinations of risk management. The commenter also suggested that credit unions with higher risk levels against a given set of reasonable thresholds, or those with lower capital levels, should have their examination of risk elevated to the risk management specialists within NCUA. The commenter suggested that removing field examiners with little specific knowledge from the examination findings and recommendation process would provide a more consistent exam, and recommended that NCUA produce a set of known, published and reasonable filters to define outlier credit unions, including a cross-risk look at risks due to concentration, low capital or earnings levels, interest rate exposure, credit quality, etc.

At least one commenter questioned the Board's legal authority to adopt a provision that would require individual credit unions to hold capital above that required under the other provisions of the regulation. The commenter acknowledged that the FCUA establishes a risk-based net worth requirement for complex credit unions, but suggested it does not grant NCUA the authority to impose individualized capital requirements on a credit union-by-credit union basis. Another

⁹² See LTCU 00-CU-08 (Nov. 2000); see also NCUA Examiner's Guide, Ch. 16. available at <http://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/chapter16.pdf>.

⁹³ 80 FR 4340, 4359 (Jan. 27, 2015).

⁹⁰ 12 U.S.C. 1790d(b)(2).

⁹¹ 12 CFR 324.10.

commenter suggested if Congress had intended the capital thresholds required under PCA to be minimum requirements, it would have described the classification as minimally capitalized. The commenter maintained that each credit union's long-term desired capital ratio will depend on the credit union's own assessment of the risks it faces, and its tolerance for risk. The commenter recommended the Board delete the capital adequacy provisions, because credit unions' capital plans should not be the subject of examination and supervision, and the goals a credit union establishes for its own capital sufficiency should not become targets or standards for review in an examination.

One commenter requested clarification on how NCUA would coordinate the requirements of this new provision with state regulators for capital planning purposes.

Discussion

The Board has carefully considered the comments above, and disagrees with commenters who suggested that the capital adequacy provisions are unnecessary. As stated in the preamble to the Second 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, 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.

Proposed § 702.101(b) was based on a similar provision in the Other Banking Agencies' rules⁹⁴ and is within the Board's legal authority under the FCUA. The FCUA grants NCUA broad 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.⁹⁵ Requiring credit unions to maintain capital adequacy is part of ensuring safety and soundness, and is not a new concept.⁹⁶ NCUA's long-standing practice has been to monitor and enforce capital adequacy through the supervisory process. Proposed § 702.101(b) would, with the exception of the written capital adequacy plan discussed in more detail

below, merely codify the existing statutory requirement. The proposed new capital adequacy provision would not affect credit unions' PCA capital category, but would support the assessment of capital adequacy in the supervisory process (assigning CAMEL and risk ratings).

Section 206 of the FCUA provides the Board with broad authority to intervene and require credit unions to take actions to correct unsafe or unsound practices, including requiring individual credit unions to hold capital above that required under NCUA's PCA regulation.⁹⁷ And section 209 of the FCUA specifically authorizes the Board to prescribe such rules and regulations as it may deem necessary or appropriate to carry out the provisions of subchapter II of the FCUA, which includes section 206. Accordingly, NCUA clearly has the legal authority to include proposed § 702.101(b) in this final rule.

Accordingly, the Board has decided to retain the proposed capital adequacy provisions in this final rule without change.

101(b) Capital Adequacy

For the reasons discussed above, the new capital adequacy provisions are added as § 702.101(b) of this final rule, and paragraphs (b) and (c) of current § 702.101 are designated as paragraphs (d) and (e) of § 702.101 of this final rule.

101(b)(1)

The Second Proposal would have revised § 702.101(b)(1) to provide: 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.

For the reasons discussed above, the Board has decided to retain the proposed capital adequacy provision in proposed § 702.101(b)(1) in this final rule without change.

101(b)(2)

Proposed § 702.101(b)(2) provided: 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.

Public Comments on the Second Proposal

A significant number of commenters specifically objected to the proposed new provision added as § 702.101(b)(2) that would require complex credit

unions to have a comprehensive written strategy for maintaining an appropriate level of capital. One commenter pointed out that, while the Board has taken steps to closely align this proposal with banking agency requirements in other areas, it has chosen to deviate from that standard to add a written reporting requirement for credit unions under this provision.⁹⁸ The commenter suggested that given that the specific requirements of the proposed capital adequacy plan are not delineated in this proposed rule, but will be subsequently outlined in supervisory guidance, commenters are unable to determine the extent of the burden this requirement might entail. The commenter noted that all credit unions with assets of \$50 million or more are already required to have a written policy on interest rate risk management and a program to implement it effectively,⁹⁹ as well as a written liquidity policy and contingency funding plan.¹⁰⁰ In addition, the commenter noted that the largest credit unions are already required by regulation to maintain a written capital policy and capital plan that is approved annually by NCUA.¹⁰¹ The commenter recommended the Board explain why it felt compelled to add a written requirement to this provision for credit unions, and make every effort to streamline it and other similar requirements to minimize the associated regulatory burden.

One commenter recommended that if the Board adopts a written capital strategy requirement for all complex credit unions, it utilize that written strategy to ensure that credit unions are addressing any heightened risks from loan concentrations. The commenter suggested such an approach should obviate the need for elevated risk weights in connection with real estate and commercial loans by allowing NCUA to address concentration risk in a more targeted way. The commenter suggested further that such an approach would satisfy recommendations from NCUA's Office of Inspector General (OIG) and GAO that NCUA consider concentration risk as it pertains to capital adequacy, without creating a competitive disadvantage for all complex credit unions in relation to their banking counterparts. The commenter also recommended that the Board incorporate any written capital strategy required within the credit

⁹⁸ There is no mandated written element to the corresponding FDIC provision. 12 CFR 324.1(d); 12 CFR 324.100(d).

⁹⁹ 12 CFR 741.3.

¹⁰⁰ 12 CFR 741.12.

¹⁰¹ 12 CFR 702.501 through 702.506.

⁹⁴ See, e.g., 12 CFR 324.10(d)(1) & (2).

⁹⁵ 12 U.S.C. 1786; and 1789.

⁹⁶ See, e.g. 78 FR 55340, 55362 (Sept. 10, 2013).

⁹⁷ 12 U.S.C. 1786.

union's strategic plan, or another existing report in order to minimize duplication of effort across various reporting requirements. In addition, the commenter suggested that an exemption from the requirement be provided to institutions that are already subject to capital planning and stress testing requirements, as the analysis contemplated by this part would already be addressed by those existing requirements. Other commenters contended that the written capital plan requirement is not necessary for the vast majority of complex credit unions based on their management, risk profiles, and current levels of capital. And if NCUA examiners have concerns regarding the credit unions they supervise, those commenters argued, those situations should be addressed on an individual basis and not through rulemaking that would apply universal requirements to all complex credit unions, regardless of how well managed they may be.

At least one commenter stated that while NCUA should be able to access the adequacy of a credit union's capital adequacy plan, safeguards should be put in place to prevent over-zealous examiners from implementing individualized minimum capital requirements during the exam process. Another commenter suggested that the concept of a written strategy was not bad, but that the final rule should provide additional clarity about what exactly would be required under the provision. Yet another commenter asked: What are the components of the "comprehensive written strategy" contemplated under this provision? What are the possible consequences of an examiner determining that a credit union's comprehensive written strategy does not meet the requirements? The commenter requested that the Board provide more description in this area and elaborate on its expectations of credit unions.

Discussion

The Board disagrees with commenters who suggested the requirement that complex credit unions maintain a written capital strategy be removed from the final rule. The supervisory evaluation of a complex credit union's capital adequacy, including the requirement to maintain a written capital strategy, is focused on the credit union's own process and strategy for assessing and maintaining its overall capital adequacy in relation to its risk profile. The supervisory evaluation may include various factors—such as whether the credit union is engaged in merger activity, entering into new activities, introducing new products,

operating in a challenging economic environment, engaged in nontraditional activities, or exposed to other risks like interest rate risk or operational risks. The assessment evaluates the comprehensiveness and effectiveness of the capital planning in light of its activities. An effective capital planning process involves an assessment of the risk to which a credit union is exposed and its process for managing and mitigating those risks, an evaluation of capital relative to those risks, and consideration of the potential impact on earnings and capital from current and prospective economic conditions. Under the proposal, the evaluation of an individual credit union's risk management strategy and process will be commensurate with the credit union's size, sophistication, and risk profile—which is similar to the current supervisory process for credit unions.

For credit unions subject to Capital Planning and Stress Testing under subpart E of part 702 of NCUA's regulations, compliance with § 702.504 will result in compliance with § 702.101(b). Thus, those credit unions subject to the stress testing regulation will not be expected to write redundant capital plans to fulfill the requirements of this final rule.

For other complex credit unions that will be expected to write capital plans, supervisory guidance will be issued to help those credit unions evaluate their compliance with § 702.101(b). The supervisory guidance will also be designed to provide consistency in the examination process.

Accordingly, the Board has decided to retain the proposed capital adequacy provision in proposed § 702.101(b)(1) in this final rule without change.

Section 702.102 Capital Classifications

Under the Second Proposal, the title of § 702.102 would have been changed from "statutory net worth categories" to "capital classifications." The section would have continued to list the five statutory capital categories that are provided in § 216(c) of the FCUA.¹⁰²

The Board received no comments on these revisions and has decided to retain the proposed amendments in this final rule without change.

102(a) Capital Categories

The Second Proposal would have revised current § 702.102(a) to include new minimum risk-based capital ratio levels for complex credit unions. Consistent with section 216(c)(1)(A) through (E) of the FCUA, the minimum net worth ratio levels listed in proposed

§§ 702.102(a)(1) through (5) would have continued to match the ratio levels listed in the statute for each capital category, and would have included 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 new minimum risk-based capital ratio levels included components that required higher capital ratio levels to reflect increased risk due to concentration risk and credit risk.

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

Public Comments on the Second Proposal

The Board received numerous general comments concerning the capital categories. Most of those commenters simply stated that they opposed the proposed two-tiered risk-based capital requirement, believed that the Board generally lacked the legal authority to impose the risk-based capital requirement as proposed, or both. Others specifically suggested that the language in section 216(d) of the FCUA prohibits NCUA from adopting different risk-based capital ratio threshold levels for well capitalized and adequately capitalized credit unions. At least one commenter suggested that section 216(d)(2) expressly ties NCUA's statutory authority to its assessment of whether the 6 percent net worth ratio threshold provides "adequate protection" because the term "adequately capitalized" used in the section refers to the "adequately capitalized" net worth category defined in section 216(c)(1)(B)(i) of the FCUA. The commenter suggested further that the FCUA limits NCUA, in developing the risk-based net worth requirement, to considering only "whether the 6 percent requirement provides adequate protection" against the risks faced by credit unions because section 216(d)(2) speaks only to whether an institution is "adequately capitalized," not "well capitalized." Accordingly, the commenter concludes that NCUA lacks the authority to implement a separate risk-based net worth threshold level for the "well capitalized" net worth category. The commenter argued further that the legislative history of the FCUA suggests that section 216(d) bars NCUA

¹⁰² 12 U.S.C. 1790d(c).

from implementing a separate RBC ratio for “well capitalized” credit unions because an earlier version of CUMAA passed by the House of Representatives provided in relevant part:

[NCUA is authorized to] establish reasonable net worth requirements, *including risk-based net worth requirements* in the case of complex credit unions, *for various categories of credit unions* and prescribe the manner in which net worth is calculated (for purposes of such requirements) with regard to various types of investments, including investments in corporate credit unions, taking into account the unique nature and role of credit unions.¹⁰³

The language quoted above was never included in the Senate version of the CUMAA legislation, which was ultimately enacted, nor was it ever included in the FCUA. The commenter suggested that this legislative change demonstrates Congress’ express consideration and rejection of NCUA’s proposed approach of adopting separate RBC thresholds for “well capitalized” and “adequately capitalized” credit unions.

Another commenter suggested that any credit union, with a 7 percent or higher net worth ratio, that fails to exceed its required risk-based capital ratio level be given consideration in any prompt corrective action required under the risk-based capital regulation. In such a case, the commenter recommended the Board limit the remedy to a capital restoration plan that allows the credit union a reasonable and appropriate period of time to improve its risk-based capital ratio—even as they maintain their statutory net worth ratio above 7 percent.

Discussion

NCUA has the authority to impose the proposed risk-based capital requirement on complex credit unions. For the reasons discussed in both the Second Proposal and above in the legal authority part of this preamble, requiring credit unions to meet different minimum risk-based capital ratio levels to be adequately and well capitalized is consistent with the plain language of section 216 of the FCUA, is “comparable” to the Other Banking Agencies’ PCA regulations, and takes into account the cooperative character of credit unions. Moreover, the Agency is not persuaded by the language quoted above from a prior House bill,¹⁰⁴ which Congress ultimately choose not to include in CUMAA. Contrary to the commenter’s suggestion, Congress’

choice of language in section 216(d) instead of the language in a prior House version of CUMAA does not demonstrate that Congress expressly considered and rejected NCUA’s proposed approach of adopting separate RBC thresholds for well capitalized and adequately capitalized credit unions.

Furthermore, requiring complex credit unions to meet a higher risk-based capital ratio threshold to be classified as well capitalized allows for a graduated scale, which can measure either a decline or improvement in a credit union’s risk-based capital level in relation to the minimum capital requirements. Such a system provides for earlier identification and resolution of credit unions experiencing gradual declines in the level of capital held on a risk-based measure. Under the current rule, a credit union failing the risk-based net worth requirement is immediately subject to the mandatory supervision action for undercapitalized credit unions and may not have been fully aware of their declining capital buffer. The use of a two-tiered risk-based capital measure also allows stakeholders and creditors, such as uninured shareholders, to reasonably compare financial institution capital measures to the minimum regulatory requirements on a risk-based level.

The Agency also questions the legality of the suggestion to amend the final rule to require only a capital restoration plan in cases where a credit union fails to meet or exceed the minimum risk-based capital requirement, but meets or exceeds the 7 percent net worth ratio requirement. Such an approach was not proposed and appears to conflict with the mandatory restrictions on undercapitalized credit unions under section 216(g) of the FCUA.

Accordingly, the Board has decided to retain the proposed capital categories in this final rule without change.

102(a)(1) Well Capitalized

Proposed § 702.102(a)(1) required a credit union to maintain a net worth ratio of 7 percent or greater and, if it were a complex credit union, a risk-based capital ratio of 10 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.¹⁰⁵

Public Comments on the Second Proposal

A substantial number of commenters speculated that the proposed risk-based capital ratio level for well capitalized credit unions would place credit unions at a competitive disadvantage to banks unless all credit unions are given the ability to meet the 10 percent requirement with supplemental (Tier 2) capital, as banks are allowed to do under their rules. The commenters recommended the Board either delay the final release of the risk-based capital rule until it has developed a supplemental capital rule or eliminate the 10 percent risk-based capital ratio requirement and establish a single-tier requirement of 8 percent that aligns with the banking industry’s Tier 1 capital requirement.

A few commenters suggested that, in removing the effect of the capital conservation buffer from the Original Proposal, the Board should have lowered the risk-based capital ratio requirement to 8 percent, not the 10 percent in the Second Proposal. After examining the makeup of capital at credit unions and banks, the commenter suggested that Tier 1 capital is most similar because both credit union and bank Tier 1 capital is comprised of either equity or retained earnings, and both bank and credit union Tier 1 capital represent the strongest form of capital on a financial institution’s balance sheet. Under NCUA’s Second Proposal, credit unions could count their ALLL towards their risk-based capital requirement, which is similar to banks; however, banks have the added benefit of counting supplemental capital as Tier 2 capital. Since NCUA has not yet authorized all credit unions to use secondary capital as part of their capital base for risk-based capital purposes, the commenter claimed the most logical point of comparability between banks and credit unions is Tier 1 capital. The commenter recommended that the Board set the risk-based capital ratio level at 8 percent, which aligns with the banking industry’s Tier 1 risk-based capital ratio level for well capitalized banks, to ensure that credit unions’ and banks’ risk-based capital requirements are comparable. The commenter recommended further that such an approach would eliminate the capital benefit from the ALLL to ensure comparability to the banks’ Tier 1 risk-based capital ratio requirement.

One bank trade association commenter, however, suggested that the Board adopt the same Basel III model that was adopted by prudential banking regulators. The commenter argued the

¹⁰³ H.R. Rep. 105–472, 1998 WL 141880, at *9 (1998).

¹⁰⁴ H.R. Rep. 105–472, 1998 WL 141880, at *9 (1998).

¹⁰⁵ See, e.g., 12 CFR 324.10; 324.11; and 324.403.

NCUA's proposed model would not be the same because under the Second Proposal, credit unions were not subjected to a capital conservation buffer, which banks are. The commenter suggested that, because of this difference, the proposed risk-based capital ratio level required for a credit union to be classified as well capitalized was 50 basis points lower than the analogous requirement applicable to banks under the Other Banking Agencies' regulations. The commenter suggested further that credit unions, with their ability to avoid the payment of U.S. income taxes and retain all their earnings, should not be subject to lower capital requirements than banks while managing the same risk profile as community banks that are subject to taxation.

Other commenters simply stated they believed the proposal did not sufficiently justify assigning a risk-based capital ratio requirement for well capitalized credit unions that is 3 percent higher than the statutory 7 percent net worth ratio level required for a credit union to be classified as well capitalized.

One commenter speculated that the proposed risk-based capital ratio of 10 percent would limit the ability of credit unions to allocate resources as they see fit, directly impacting what credit unions can do for their members because credit unions need flexibility to be successful. The commenter pointed out that credit union management is held accountable by fiduciary responsibility of the Board of Directors, while some are overseen by both Certified Public Accountants' opinion audits and ongoing NCUA examination, and are therefore in the best position to determine the appropriate balance to best serve the needs of their members.

Discussion

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.¹⁰⁶ Moreover, credit unions classified as well capitalized are generally considered financially sound, afforded greater latitude under some other regulatory provisions,¹⁰⁷ and, with

the exception of a small earnings retention requirement, are not subject to mandatory or discretionary supervisory actions. In contrast, credit unions that fall to the undercapitalized category are financially weak and are subject to various mandatory and discretionary supervisory actions intended to resolve the capital deficiency and limit risk taking until capital levels are restored to prudent levels. The lack of graduated thresholds in the current rule's construct for the risk-based net worth requirement does not effectively provide for early reflection through a credit union's net worth category, as suggested in the GAO and OIG reports. Under the current rule, a change in the credit union's risk profile, capital levels, or both, that results in a decline in the credit union's risk-based net worth ratio, does not affect its net worth category until it results in the credit union falling to the point where the situation mandates that harsh supervisory actions be taken.

The Board reasons that the more effective approach and better policy option 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 risk weights included in the Second Proposal were based predominantly on those used by the Other Banking Agencies, as suggested by credit unions and other interested parties who submitted comment letters in response to 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.¹⁰⁸

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.¹⁰⁹ 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. While NCUA's proposed risk weights for various assets could be increased by 20 percent to offset this effect, adjusting the risk weights in this manner would create more difficulty in comparing asset types and risk weights across financial institutions, and lead to misunderstanding.

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

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.

¹⁰⁹ See S. Rep. No. 193, 105th Cong., 2d Sess. § 301 (1998) ("Comparable" here means parallel in substance though not necessarily identical in detail and equivalent in rigor.)

¹⁰⁶ Per the FCUA, "undercapitalized" is the lowest PCA category in which a failure to meet the risk-based net worth requirement can result.

¹⁰⁷ See 12 CFR 745.9-2; and 12 CFR 723.7.

¹⁰⁸ The Other Banking Agencies' Total Risk-Based Capital ratio is the most analogous standard for

to risk, and better inform credit union decision making.¹¹⁰ 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 8 percent, NCUA estimates at most seven credit unions would have the proposed risk-based capital ratio be the governing requirement, with only one credit union currently holding insufficient capital to meet the requirement.

Further, capital is a lagging indicator because it is founded primarily on accounting standards, which by their nature are largely based on past performance. The net worth ratio is even more so a lagging indicator because it applies capital—a lagging measure in itself—to total assets. Thus, the net worth ratio does not distinguish among risky assets or changes in a balance sheet's composition. A risk-based capital ratio is more prospective by accounting for asset allocation choices and driving capital requirements before losses occur and capital levels decline. The more relevant the risk-based net worth requirement is, 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 encourage credit unions to build and maintain capital as they increase risk to be able to absorb any corresponding unexpected losses. A graduated, or tiered, system of capital category thresholds that distinguishes between the well capitalized and adequately capitalized categories will incentivize credit unions to hold sound levels of capital without invoking supervisory action before necessary. While there is no requirement for a credit union to be well capitalized, and there are no supervisory interventions required for a credit union with an adequately capitalized classification,

there are some regulatory privileges and other benefits for a credit union that is well capitalized. Chief among those benefits is the accumulation of sufficient capital to weather financial and economic stress. During the 2007–2009 financial crisis, some credit unions experienced large losses in a compressed timeframe, resulting in a rapid deterioration of net worth. Some credit unions that historically had been classified as well capitalized were quickly downgraded to undercapitalized. As noted in the Second Proposal, 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 12.1 percent). Over the last 10 years, more than 80 percent of all credit union failures involved institutions that were well capitalized in the 24 months immediately preceding their failure. Unlike the net worth ratio, which is indifferent to the composition of assets, a well-designed risk-based net worth requirement should reflect material shifts in the risk profile of assets.

A risk-based capital framework that encourages and promotes capital accumulation benefits not only those credit unions that achieve the well-capitalized classification, but the entire credit union system. Thus, the Board remains committed to implementing the risk-based requirement under a graduated (multi-tiered) capital category framework.

The Board agrees with the commenters who suggested that a 10 percent risk-based capital ratio threshold 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 8 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 final rule, the Board is now more closely aligning NCUA's risk weights with those assigned by the Other Banking Agencies. Therefore, for consistency, the Board reasons that NCUA's risk-based capital ratio threshold levels should likewise align with those of the Other Banking Agencies as closely as possible.

The Board plans to address additional forms of supplemental capital in a separate proposed rule, with the intent to finalize a new supplemental capital rule before the effective date of this risk-

based capital final rule. Therefore there is no need to delay release of this final rule. The Board notes the second risk-based capital proposal invited general comment on supplemental capital much in the way an advanced notice of proposed rulemaking would do. A notice of proposed rulemaking on supplemental capital with specific criteria and requirements is necessary under the Administrative Procedure Act before the Board could issue a final rule. Issuing a new, more specific and detailed proposed rule on supplemental capital will give interested parties full opportunity to comment on it.

Accordingly, the Board has decided to retain proposed § 702.102(a)(1) in this final rule without change.

102(a)(2) Adequately Capitalized

Under the Second Proposal, § 702.102(a)(2) required a credit union to maintain a net worth ratio of 6 percent or greater and, if it were a complex credit union, a risk-based capital ratio of 8 percent or greater to be classified as adequately capitalized. This risk-based capital ratio level is comparable to the 8 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 proposed adequately capitalized risk-based capital ratio level. Therefore, the Board has decided to retain proposed § 702.102(a)(2) in this final rule without change.

102(a)(3) Undercapitalized

Under the Second Proposal, § 702.102(a)(3) would have classified a credit union as undercapitalized if: (1) The credit union has a net worth ratio of 4 percent or more but less than 6 percent; or (2) the credit union, if complex, has a risk-based capital ratio of less than 8 percent.

Other than the comments discussed above and other parts of this preamble, the Board received no comments on the proposed undercapitalized risk-based capital ratio requirement. Therefore, the Board has decided to retain proposed § 702.102(a)(3) without change.

102(a)(4) Significantly Undercapitalized

Under the Original Proposal, proposed § 702.102(a)(4) would have classified a credit union as significantly undercapitalized if:

- The credit union has a net worth ratio of 2 percent or more but less than 4 percent; or

¹¹⁰ The benefits of a capital system better correlated to risk are discussed in the Summary of the Final Rule part of this preamble.

- The credit union has a net worth ratio of 4 percent or more but less than 5 percent, and either—

- o Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111;

- o Materially fails to implement a net worth restoration plan approved by the Board; or

- o Receives notice that a submitted net worth restoration plan has not been approved.

The Board received no comments on the revisions to this paragraph and has decided to retain the proposed amendments in this final rule without change.

102(a)(5) Critically Undercapitalized

Under the Second Proposal, § 702.102(a)(5) classified a credit union as critically undercapitalized if it had a net worth ratio of less than 2 percent. The Second Proposal would have also 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 revisions to this paragraph and has decided to retain the proposed amendments in this final rule without change.

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

The Second 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 on the revisions to this paragraph and has decided to retain the proposed amendments in this final rule without change.

102(c) Non-Delegation

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

The Board received no comments on this paragraph and has decided to retain the paragraph in this final rule without change.

102(d) Consultation With State Officials

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

The Board received no comments on this paragraph and has decided to retain

the proposed amendments in this final rule without change.

Section 702.103 Applicability of the Risk-Based Capital Ratio Measure

The Second Proposal 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 the risk-based capital ratio measure is applicable only if the credit union's quarter-end total assets exceed \$100 million, as reflected in its most recent Call Report.

Public Comments on the Second Proposal

The Board received a large number of comments on proposed § 702.103. Several commenters argued that the FCUA requires the Board to define "complex" credit unions based on the "portfolios of assets and liabilities of credit unions," and that the proposed use of an asset size threshold to define "complex" credit unions would not comply with the statutory requirement.

A substantial number of commenters also stated that they opposed the proposed definition of "complex" credit union because they believed asset size should not be a primary qualifier of a credit union's complexity.

At least one trade association commenter, however, acknowledged that an asset threshold proxy, while less precise than individual balance sheet analysis, would allow for a streamlined application of the rule and would minimize opportunities for arbitrage. The commenter suggested that if the definition of "complex" were tied to specific activities, credit unions could be incentivized, on the margin, to simply avoid those activities in order to avoid the risk-based capital requirements. And such conduct could have unintended consequences and create new unanticipated risks to capital adequacy. Similarly, at least one credit union commenter stated that using an asset size threshold to define complex credit unions would give credit unions a bright line test and eliminate the difficulty of having to anticipate what products and services should be classified as complex. Another credit union commenter suggested that a rule that identified specific types of lending activity that made an institution complex might mask undue concentration risk.

A substantial number of commenters suggested that asset size, if used in the final rule, should be raised to some

amount above \$100 million. Specific threshold amounts suggested by commenters ranged from \$250 million to \$10 billion. Several commenters speculated that refining the complexity analysis and raising the asset size threshold would not considerably increase the risk to the Share Insurance Fund because by the time the final rule is implemented in 2019, an even greater percentage of system assets would be covered. Other commenters maintained that the final rule should only apply to credit unions that meet the same asset size threshold used by the Other Banking Agencies to define small banks. One commenter suggested that the Board should align the definitions of "complex" credit union across all of NCUA's regulations so they are the same, and, at a minimum, the Board should increase the threshold to \$250 million to be consistent with the definition in the derivatives regulation.

Some commenters contended that the proposed list of assets and liabilities identified as complex were much too broad. One commenter suggested that Congress limited the application of risk-based capital to complex credit unions¹¹¹ and directed NCUA to design the risk-based capital standard to protect against material risks that may not be adequately captured by the net worth ratio requirement¹¹² because Congress intended that credit unions be designated as "complex" based on only their involvement in high-risk activities that the net worth ratio requirement may not account for. The commenter noted further that the list of complex assets and liabilities used by the Board to set the asset size threshold at \$100 million included several standard activities that are already contemplated by the statutory net worth ratio requirement. The commenter believed, for example, that real estate loans, investments with maturities greater than five years, and internet banking are staple activities of financial services institutions in today's marketplace and should not be considered complex; and that other activities only become complex when undertaken in significant volumes—for example, a credit union that lends a member \$60,000 to purchase new equipment for his bakery is engaged in member business lending, but that credit union should not be designated as complex by virtue of that single loan. The commenter contended that the size of the portfolio and its significance to the credit union's overall business strategy drives complexity; so the commenter concluded that member

¹¹¹ 12 U.S.C. 1790d(d)(1).

¹¹² 12 U.S.C. 1790d(d)(2).

business, indirect, interest-only, and participation loans should only indicate complexity where the activity exceeds a certain percentage of total assets, and borrowings should only denote complexity where they constitute a significant element of the credit union's funding strategy. Other commenters suggested that a credit union be defined as "complex" only if it engages in three or more of the following assets or liabilities: Member business loans, participation loans, interest-only loans, indirect loans, non-federally guaranteed student loans, borrowings, and derivatives. Still other commenters suggested that the definition of "complex" be based on the following activities: Participation loans, interest-only loans, indirect loans, real estate loans, non-agency mortgage backed securities, non-mortgage related securities with embedded options, collateralized mortgage obligations/real estate mortgage investment conduits, commercial mortgage-related securities, and derivatives.

In addition, commenters argued that because they do not adequately represent complexity, the Board should not use the following assets or liabilities: Real estate loans, obligations fully guaranteed by the U.S. Government, investments with maturities of greater than five years, non-agency mortgage-backed securities, non-mortgage-related securities with embedded options, collateralized mortgage obligations/real estate mortgage investment conduits, commercial mortgage-related securities, and internet banking. In addition, one commenter argued that internet banking, a service that credit unions provide, is neither an asset nor a liability so the FCUA bars NCUA from considering internet banking when considering complexity.

One commenter recommended that the asset size threshold should be set where all or most credit unions are engaged in four or more of the activities the Board identifies as complex. The commenter claimed that the FCUA, which requires NCUA to specify which credit unions are "complex" based on the portfolios of assets and liabilities of credit unions,¹¹³ prohibits a credit union from being classified based on a single complex activity.

Another commenter suggested that using an asset size threshold alone to define complexity was appropriate and that the presence of more complex lending products should not necessarily define a complex credit union because financial institutions in general become

more complex with size and by moving into more complex/sophisticated financial transactions such as mortgage-backed securities, derivatives, loan sales or purchases, mortgage pipelines and servicing assets. The commenter suggested that these types of financial transactions are not ordinary in smaller asset size institutions because they generally require more scale and overhead of a larger institution to manage and understand.

Other commenters recommended that the Board define complexity using a credit union's product offerings, in a manner similar to that used in the current rule. The commenters suggested that the most analogous approach would be a ratio of risk-weighted assets to total assets greater than 67 percent as measure by the proposal's risk weights. At least one of those commenters, however, acknowledged that the 67 percent threshold might not be a meaningful measure of risk, but that using different thresholds yielded similar results.

At least one commenter suggested that all federally insured credit unions with assets of \$500 million or less should be excluded from the definition of "complex," and that only those credit unions with \$500 million or more in assets and that have an NCUA Complexity Index (discussed in the Supplementary Information to the Original Proposal) value of 17 or higher should be required to meet NCUA's risk-based capital requirement. Similarly, another commenter suggested that all federally insured credit unions with assets of \$500 million or less should be excluded from the definition of "complex," and that only those credit unions with \$500 million or more in assets and that have an NCUA Complexity Index value of 20 or higher should be required to meet NCUA's risk-based capital requirement. Yet another commenter suggested that all federally insured credit unions with assets of \$1 billion or less should be excluded from the definition of "complex," and that only those credit unions with assets above \$1 billion and that have an NCUA Complexity Index value of 20 or higher should be required to meet NCUA's risk-based capital requirement.

Additional suggestions provided by commenters for defining credit unions as "complex" included:

- Defining "complex" with attributes such as deposit account features, member services, loan and investment products, and portfolio makeup.
- Defining "complex" based on whether a credit union engages in a combination of activities including, participation loans, non-agency

mortgage-backed securities, repurchase transactions, and derivatives.

- Defining "complex" as credit unions with over \$100 million or more in assets and that provide member business loans and invest in derivatives.
- Defining "complex" as credit unions with \$500 million or more in assets and/or that are engaged in over 50 percent of all of the categories, especially the investment section, noted in the preamble to the Second Proposal.
- Defining "complex" as credit unions with \$500 million or more in assets, and that invest in non-agency mortgage-backed securities and non-mortgage related securities with embedded options.

As an alternative, one trade organization commenter suggested that with credit unions exiting an extreme financial crisis where many of these institutions failed due to lack of high-quality capital and elevated risk profiles, the Board should be focusing its attention on raising the minimum regulatory capital levels for all credit unions.

Other credit union commenters argued that the risk-based capital requirements should apply to all credit unions because recent data on credit union failures contradict claims that there is less risk in credit unions with less than \$100 million in assets. Granted, the commenters suggested, in rural areas and in a few other special circumstances, small credit unions play a crucial role, and in such cases NCUA should offer waivers. A small credit union commenter suggested that many credit unions with \$100 million or less in assets have the same, and often times more, risk on their balance sheets and in their operations than credit unions with over \$100 million in assets. The commenter believed that smaller credit unions engage in complex activities for the following reasons: (1) If they do not offer products and services that the bigger credit unions do, their members will leave and the credit unions will (eventually) be forced to merge (not an outcome they wanted); (2) they need products that increase their income and capital (e.g., business loans, participation loans, and indirect lending); (3) they recognize they do not have the expertise they should have but it is expensive and hard to attract expertise based on their compensation structure. Another credit union commenter claimed that smaller credit unions have failed at a higher rate and have had a higher incidence of catastrophic failure due to a lack of comprehensive internal management and process controls that can lead to fraud. The commenter maintained that a

¹¹³ 12 U.S.C. 1790(d)(1).

credit union charter is a privilege and not a right and that all credit unions should be subject to the same risk-based capital requirements and examination standards.

One commenter suggested that it is very likely that a small credit union could pose a much larger risk to the NCUSIF than a larger credit union, and that using asset size as a threshold for complexity suggests that capital is not as critical for smaller institutions. The commenter suggested further that “complexity” should be defined based on the quality of the management of the risks undertaken by the institution, which is ideally measured by the “M” in the CAMEL rating. The commenter recommended that identifying the credit unions to which the risk-based capital requirement applies is best done through the supervision process so that those credit unions posing a higher risk to the NCUSIF have higher standards and expectations by which to abide. The commenter suggested that this solution would reduce the “broad-brush” effect of the current proposal, applying more stringent standards to those institutions that may benefit from regulatory risk management and thus provide greater protection to the NCUSIF.

A significant number of commenters requested that the asset size threshold, if used, be indexed so that it does not apply to smaller and smaller credit unions through time due to inflation. And at least one 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 thus, should not be subject to risk-based capital requirements. The commenter suggested further that the process for contesting an agency designation of “complex” should be detailed in the final rule.

Discussion

The proposed use of an asset size threshold to define “complex” does comply with section 216 of the FCUA. As discussed in the Legal Authority part of this preamble, section 216(d)(1) directs NCUA, in determining which credit unions will be subject to the risk-based net worth requirement, to base its definition of complex “on the portfolios of assets and liabilities of credit unions.”¹¹⁴ The statute does not require, as some commenters have argued, that the Board adopt a definition of “complex” that takes into account the portfolio of assets and liabilities of each credit union on an individualized basis. Rather, section 216(d)(1) authorizes the Board to develop a single definition of

“complex” that takes into account the portfolios of assets and liabilities of all credit unions. Consistent with section 216(d)(1), the proposed definition of a “complex” credit union included an asset size threshold that, as explained in more detail below, was designed by taking into account the portfolios of assets and liabilities of all credit unions.

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 6 percent. In effect, this means that all credit unions with over \$50 million in assets compute the risk-based net worth requirement to determine if they meet the complex definition.

For reasons described more fully below, the Board maintains 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 is accurate, reduces the complexity of the rule, provides regulatory relief for smaller institutions, and eliminates the potential unintended consequences of having a checklist of activities that would determine whether or not a credit union is subject to the risk-based capital requirement.

Under the Second Proposal, the term “complex” was defined only for purposes of the risk-based capital ratio measure. For the purpose of defining a complex credit union, assets include tangible and intangible items that are economic resources (products and services) that are expected to produce economic benefit (income), and liabilities are obligations (expenses) the credit union has to outside parties. The Board recognizes there are products and services—which under GAAP are reflected as the credit unions’ portfolio of assets and liabilities¹¹⁵—in which credit unions are engaged 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. Thus, credit unions offering such products and services have complex portfolios of assets and liabilities for purposes of NCUA’s risk-based net worth requirement.

Consistent with the Second Proposal, the following products and services, if

engaged in by a credit union, are accurate 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
- Internet Banking

NCUA’s review of Call Report data as of June 30, 2014 and March 31, 2015, showed that all credit unions with more than \$100 million in assets were engaged in offering at least one of the products and services listed above; 99 percent engaged in two or more complex activities, and 87 percent engaged in four or more. On the other hand, less than two-thirds of credit unions below \$100 million in assets were involved in even a single complex activity, and only 15 percent had four or more. Moreover, credit unions with total assets of less than \$100 million are only a small share (approximately 10 percent) of the overall assets in the credit union system—which limits the exposure of the Share Insurance Fund to these institutions. Accordingly, a \$100 million asset size threshold is a clear demarcation above which complex activities are always present, and where credit unions are almost always engaged in multiple complex activities. Additionally, the percentage of credit unions engaged in multiple activities using asset size thresholds above \$100 million does not produce a significant demarcation between credit unions when compared to the differences observed at the \$100 million threshold.

Conversely, using a credit union’s percentage of risk assets to total assets as the factor for determining whether the credit union is complex would require all credit unions to understand, monitor, and apply a complex measure their risk asset to asset ratio each quarter. This would be an additional and unnecessary burden for credit unions below the \$100 million asset size threshold.

¹¹⁵ 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.

¹¹⁴ 12 U.S.C. 1790d(d).

As discussed earlier, \$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. Based on December 31, 2014 Call Report data, this approach exempts approximately 76 percent of credit unions from the regulatory burden associated with complying with the risk-based net worth requirement and capital adequacy plan, 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)¹¹⁶ to the NCUSIF spanning the last 12 years have come from credit unions with assets greater than \$100 million.¹¹⁷

Accordingly, consistent with requirements of § 216(d)(1) of the FCUA, the final rule eliminates current § 702.103(b) and defines all credit unions with over \$100 million in assets as “complex.”

Section 702.104 Risk-Based Capital Ratio

Under the Second Proposal, the Board proposed changing the title of current § 702.104 from “Risk portfolio defined” to “Risk-based capital ratio.” In addition, the Board 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.¹¹⁸ The proposed section would have required all “complex” credit unions to calculate their risk-based capital ratio as directed under 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.

¹¹⁶ Based on an analysis of loss and failure data collected by NCUA.

¹¹⁷ NCUA performed backtesting analysis of Call Report and failure data to determine whether this final regulation would have resulted in earlier identification of emerging risks and possibly reduced losses to the NCUSIF. The impact of the final rule on more recent failures of credit unions with total assets over \$100 million was also evaluated. The testing revealed that maintaining a risk-based capital ratio in excess of 10 percent would have triggered eight out of nine such failing credit unions to hold additional capital, which could have prevented failure or reduced losses to the NCUSIF.

¹¹⁸ 12 U.S.C. 1790d(d).

Public Comments on the Second Proposal

NCUA received many general comments on the proposed § 702.104. Many commenters simply stated that they opposed the new risk-based capital ratio measure altogether, and preferred maintaining the current risk-based net worth measure. Others objected to specific aspects of the calculation, which are discussed in more detail below.

Discussion

As discussed above and in more detail below, the proposed changes are necessary 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. The proposed risk-based capital ratio employed the method for computing the risk-based capital measures used by the Other Federal Banking Agencies: A higher ratio reflects the existence of a higher level of funds available to cover losses in relation to risk-weighted assets. Because the risk weights in the final rule are generally comparable to those used by banks, the risk-based capital ratio will allow an interested party to compare risk-based capital measures across institutions to obtain a relative measure of their financial strength. Additionally, the current risk-based net worth requirement assigns high risk weights to low-credit-risk assets to account for interest rate risk—such as investments in Treasury securities with maturities in excess of five years—which results in a higher risk-based capital requirement for credit unions holding these types of low-credit-risk investments. Thus, the Board concluded it is no longer appropriate to retain NCUA's current risk-based net worth measure.

Consistent with the Second Proposal, this final rule changes the title of current § 702.104 from “Risk portfolio defined” to “Risk-based capital ratio.” In addition, this final rule entirely replaces 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.¹¹⁹

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

Under the Second Proposal, § 702.104(a) provided that to determine its risk-based capital ratio, a complex credit union must calculate the percentage, rounded to two decimal

¹¹⁹ 12 U.S.C. 1790d(d).

places, of its risk-based capital ratio numerator as described in § 702.104(b) to its total risk-weighted assets as described in § 702.104(c). The proposed method of calculating risk-based capital was generally consistent with the methods used in other sectors of the financial services industry.

Other than the comments discussed elsewhere in the preamble, the Board received no comments on the proposed revisions to this paragraph and has decided to retain the amendments in this final rule without change.

104(b) Risk-Based Capital Ratio Numerator

Under the Second Proposal, § 702.104(b) provided that the risk-based capital ratio numerator is the sum of certain specific capital elements listed in § 702.104(b)(1), minus regulatory adjustments listed in § 702.104(b)(2).

Other than the comments discussed elsewhere in the preamble, the Board received no comments on the proposed revisions to this paragraph and has decided to retain the amendments in this final rule without change.

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

Under the Second Proposal, § 702.104(b)(1) 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; secondary capital accounts included in net worth (as defined in § 702.2); and section 208 assistance included in net worth (as defined in § 702.2). Consistent with the Second Proposal, § 702.104(b)(1) listed the elements of the risk-based capital ratio numerator.

Public Comments on the Second Proposal

The Board received a significant number of comments suggesting various amendments or additions to the capital elements included in the Second Proposal, which are discussed in more detail below.

Discussion

The Board generally disagrees with the comments concerning capital elements and has, for the reasons discussed in more detail below, decided to retain the language in proposed § 702.104(b)(1) in this final rule. The Board proposed § 702.104(b)(1) 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. As explained above, the FCUA gives NCUA broad discretion in designing the risk-based net worth requirement.

Accordingly, this final rule incorporates the proposed broadened definition of capital for purposes of calculating the new risk-based capital ratio.

Undivided Earnings

The Second Proposal included undivided earnings 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 Second Proposal in this final rule without change.

Appropriation for Nonconforming Investments

The Second Proposal 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 Second Proposal in this final rule without change.

Other Reserves

The Original Proposal 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 Second Proposal in this final rule without change.

Equity Acquired in Merger

Under the Second Proposal, the risk-based capital ratio numerator included the equity acquired in merger component of the balance sheet. This equity item was used in place of the total adjusted retained earnings acquired through business combinations amount that credit unions currently report on the PCA net worth calculation worksheet in the Call Report. 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, more accurately reflects 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 Second Proposal in this final rule without change.

Net Income

The Second Proposal 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 Second Proposal in this final rule without change.

ALLL

The Second Proposal included the total amount of the ALLL, maintained in accordance with GAAP, in the risk-based capital ratio numerator. Credit unions already expense 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.

Public Comments on the Second Proposal

The vast majority of commenters who mentioned the treatment of ALLL stated that they agreed with its proposed treatment in the Second Proposal. A few commenters, however, did argue that the ALLL should be limited to 1.25 percent of risk assets in determining the risk-based capital ratio numerator. These commenters suggested that if the loan loss reserves are established for identified losses, then they do not possess the essential characteristic of capital—the ability to absorb unidentified losses—and should not be included in the capital base. The commenters suggested further that because it is not always possible to clearly distinguish between identified and unidentified losses, the Other Banking Agencies capped the amount of ALLL being counted as capital at 1.25 percent of risk assets. These commenters argued further that limiting ALLL to 1.25 percent of risk assets would not create a disincentive for complex credit unions to fully fund the ALLL above the 1.25 percent ceiling because complex credit unions are bound by generally accepted accounting principles to fully fund their ALLL, so not doing so would constitute an unsafe and unsound practice. Finally, these commenters argued that removing the 1.25 percent cap on ALLL would

overstate the amount of capital that complex credit unions have available to absorb unexpected losses, and would make the comparison between bank and credit union risk-based capital ratios more difficult.

Discussion

The Board disagrees with the commenters who suggested that the ALLL should be limited to 1.25 percent of risk assets. All of the ALLL, maintained in accordance with GAAP, should be included in the risk-based capital ratio numerator because 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 will allow a properly funded ALLL to somewhat offset the impact of the financial stressors on the risk-based capital ratio. Further, NCUA's supervision process can address any concerns with inclusion of the ALLL, such as ensuring proper funding. Accordingly, the Board has decided to retain this aspect of the Second Proposal in this final rule without change.

Secondary Capital Accounts

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

While there was overwhelming support for allowing credit unions to count secondary capital accounts in the risk-based capital ratio numerator (including support for access for additional forms of supplemental capital), the Board received no comments opposing its inclusion. Accordingly, the Board has decided to retain this aspect of the Second Proposal in this final rule without change.

The Board plans to address comments supporting additional forms of supplemental capital in a separate proposed rule, with the intent to finalize a new supplemental capital rule before the effective date of this risk-based capital final rule.

Section 208 Assistance

The Second Proposal included section 208 assistance that is 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 Second Proposal in this final rule without change.

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

Under the Second Proposal, the risk-based capital ratio numerator did not include the following Call Report equity items: Accumulated unrealized gains (losses) on available for sale securities; accumulated unrealized losses for other than temporary impairment (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.¹²⁰

The Board received no comments on the exclusion of these elements in the risk-based capital ratio numerator. Accordingly, the Board has decided to retain this aspect of the Second Proposal in this final rule without change.

Other Supplemental Forms of Capital

Under the Second Proposal, supplemental forms of capital, other than those discussed above, were not included in the risk-based capital ratio numerator. The Board, however, did specifically request comment on specific detailed questions regarding whether revisions should be made to NCUA's regulations through a separate rulemaking to allow additional supplemental forms of capital to be included in the risk-based capital ratio.

Public Comments on the Second Proposal

A majority of the commenters who mentioned supplemental capital stated that it was imperative the Board consider allowing credit unions ready access to additional supplemental forms of capital. Commenters suggested it was particularly important as risk-based capital goes into effect, as credit unions are at a disadvantage in the financial market because of lack of access to additional capital outside of retained earnings. Commenters suggested that if supplemental capital were to count toward regulatory capital, it would benefit the credit union by allowing it to expand products and services

without diluting its regulatory capital, and it would protect the NCUSIF by incentivizing credit unions to attract private capital that could absorb losses before causing a loss to the Insurance Fund.

Some commenters suggested further that the Board include (as a placeholder in this final rule) supplemental forms of capital, as defined by the Board and approved by NCUA or the appropriate state supervisory authority, in the risk-based capital numerator. Those commenters suggested the specific criteria could then be developed between finalizing the rule and its effective date in 2019.

Other commenters acknowledged that because Congress did not speak directly to the calculation of risk-based capital, the Board need not be limited by section 216(0)(2) of the FCUA in defining what elements, including supplemental capital, constitute the ratio. Several commenters, however, suggested that not allowing all credit unions to use additional supplemental forms of capital to meet their risk-based capital requirements would create a more stringent capital requirement for credit unions, which would place credit unions at a competitive disadvantage to banks. One commenter argued the Board failed to meet the requirement to establish a capital framework that is comparable to the Other Banking Agencies because credit unions will be disadvantaged to banks.

Other commenters recommended that the Board delay the publication of the final risk-based capital rule so that it can coincide with the publication of a final supplemental capital rule.

Discussion

Consistent with the Second Proposal, this final rule would not include additional supplemental forms of capital in the risk-based capital ratio numerator at this time.

The authorization of additional supplemental forms of capital for federal credit unions, and the inclusion of such forms of capital and the various forms of capital authorized for federally insured state-chartered credit unions in the risk-based capital ratio numerator, is beyond the scope of this rulemaking. Delaying the issuance of this final rule until a separate supplemental capital proposal could be issued and then finalized, as several commenters suggested, would only reduce the amount of time credit unions have to prepare to comply with this final rule.

The Board, however, appreciates the comments requesting access to additional supplemental forms of capital for credit unions. Board

Chairman Debbie Matz has formed a working group at NCUA to consult with stakeholders and develop a separate proposed rule regarding supplemental forms of capital that could be included in the numerator of the risk-based capital ratio. The working group has reviewed the comments received on this issue, studied the alternative forms of capital used internationally and within the cooperative system, and obtained additional insight from industry practitioners who were highly interested or experienced with alternative forms of capital.

In the near future, the working group plans to present its recommendations to the Board for revisions that could be made to NCUA's regulations through a separate rulemaking to allow additional supplemental forms of capital to be included in the risk-based capital ratio. The Board's intent is to finalize a new supplemental capital rule before the effective date of this risk-based capital final rule.

The Board also continues to support amending the FCUA to provide all credit unions access to additional supplemental forms of capital that, subject to certain reasonable restrictions and consumer protections, could be counted toward a credit union's net worth ratio requirement and its risk-based capital requirement.

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

Under the Second Proposal, § 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 Second Proposal in this final rule without change.

NCUSIF capitalization deposit. Under the Second Proposal, the NCUSIF capitalization deposit was subtracted from both the numerator and denominator of the risk-based capital ratio.¹²¹ This treatment of the risk-based capital ratio would not have altered the

¹²⁰ The Other Banking Agencies' regulatory capital rules allow institutions to make an opt-out election for similar accounts. See, e.g., 12 CFR 324.22; and 78 FR 55339 (Sept. 10, 2013).

¹²¹ See U.S. Govt. Accountability Office, *Available Information Indicates No Compelling Need for Secondary Capital*, GAO-04-849 (2004), available at <http://www.gao.gov/assets/250/243642.pdf>.

NCUSIF capitalization deposit's accounting treatment for credit unions.

Public Comments on the Second Proposal

The Board received many comments expressing concerns about the Second Proposal's treatment of the NCUSIF capitalization deposit. A minority of commenters suggested that they agreed with the proposed treatment of the NCUSIF deposit. A majority of commenters who mentioned the NCUSIF deposit, however, noted that credit unions treat their NCUSIF capitalization deposit as an asset on their books. Those commenters suggested that while banks expense their deposit insurance and can never reclaim it, a credit union's deposit will be returned if it decides to liquidate, convert to another charter, or convert to private insurance. The commenters recommended that the Board acknowledge the difference in treatment of insurance deposits between the two systems and assign a capital value to the NCUSIF capitalization deposit for credit unions. Another commenter suggested that, compared to banks, credit unions on average have 1 percent less capital than the net worth ratio suggests because credit unions carry the NCUSIF capitalization deposit as an asset: Pre-paid NCUSIF premiums, which the commenter argued should be amortized. The commenter speculated that if credit unions amortized their NCUSIF premium at eight basis points per year, it would have about the same effect as stabilization premiums and credit unions would, over 12 years, write off the deposit. The commenter suggested further that the deposit adds to the risk in economic downturns because it poses the danger of increased pressure on earnings and capital during a financial crisis. Another commenter argued that GAAP recognizes the NCUSIF capitalization deposit as an asset so it does not make sense to treat the deposit as an intangible asset given that it is easily measured and can be returned or refunded. Finally, some commenters recommended that the NCUSIF capitalization deposit be treated as a credit union asset with a risk weighting of 100 percent or lower.

Discussion

As stated in the Second Proposal, the 1997 U.S. Treasury Report on Credit Unions supports NCUA's position of excluding the NCUSIF capitalization deposit from the risk-based capital ratio calculation. The Treasury report concluded that the NCUSIF capitalization deposit is double counted because it is an asset on credit union

balance sheets and equity in the NCUSIF.¹²² The Treasury noted that, in lieu of expensing the NCUSIF capitalization deposit, holding additional capital is necessary to offset the 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.¹²³

The NCUSIF capitalization 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 capitalization 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.¹²⁴ The purpose of the NCUSIF capitalization 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 1 percent NCUSIF capitalization deposit and required NCUSIF premium expenses needed to restore the NCUSIF equity ratio.¹²⁵

The NCUSIF capitalization 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 capitalization 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 capitalization deposit only in the event a solvent credit union voluntarily liquidates, or converts to a bank charter or private insurance.

¹²² U.S. Dep't of Treasury, *Credit Unions* 58 (1997) ("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 [. . .] better ways of protecting the Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.").

¹²³ *Id.* at 4–5 & 55–59.

¹²⁴ 12 U.S.C. 1782(c)(1)(B)(iii).

¹²⁵ NCUA, *Premium Assessments*, Letter to Credit Unions 09–CU–20 (Oct. 2009); NCUA, *Corporate Stabilization Fund Implementation*, Letter to Credit Unions 09–CU–14 (June 2009); NCUA, *Corporate Credit Union System Strategy*, Letter to Credit Unions 09–CU–02 (Jan. 2009).

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

Neither the Second Proposal nor this final rule adjusts for the NCUSIF capitalization deposit twice or puts 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 capitalization deposit should be treated as an investment similar to Federal Home Loan Bank (FHLB) stock. The NCUSIF capitalization 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 capitalization deposit refund. Further, unlike FHLB stock, the NCUSIF capitalization deposit is not an income-producing asset. The deposit has not paid a dividend since 2006. And it 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 capitalization deposit, and does not believe the risk-based capital treatment will lead to a change in how this asset is accounted under GAAP. The Board agrees with the U.S. Treasury position as stated in its 1997 Report on Credit Unions. Treasury stated that expensing the NCUSIF capitalization deposit would not strengthen the NCUSIF. The financial structure of the NCUSIF is reasonable and works well for credit unions.

The assignment of an appropriate risk weight for the NCUSIF capitalization deposit, based on its credit risk, 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 deposit. The NCUSIF capitalization deposit is treated similarly to other intangible assets, (e.g. goodwill and core deposits intangible assets), as they are not available assets upon liquidation.

Accordingly, for all the reasons discussed above, the Board has decided to retain this aspect of the Second Proposal in this final rule without change.

Goodwill and Other Intangible Assets

Under the Second Proposal, goodwill and other intangible assets were 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, however, recognized that requiring the exclusion of goodwill and other intangibles associated with supervisory mergers and combinations of credit unions that occurred prior to this proposal could directly reduce a credit union's risk-based capital ratio. Accordingly, the Board also proposed allowing credit unions to include certain goodwill and other intangibles in the risk-based capital ratio numerator. In particular, the Second Proposal would have excluded from the definition of goodwill, which must be deducted from the risk-based capital ratio numerator, any goodwill or other intangible assets acquired by a credit union in a supervisory merger or consolidation that occurred before the publication of this rule in final form.

The Second Proposal would not have changed the financial reporting requirements for credit unions, which requires they use GAAP to determine how certain intangibles are valued over time. Under the proposal, credit unions would have still been required to account for goodwill in accordance with GAAP, and the amount of excluded goodwill and other intangible assets would have been based on the outstanding balance of the goodwill directly related to supervisory mergers.

The Board proposed allowing the excluded goodwill and other intangible assets to be counted until December 31, 2024, to allow affected credit unions to adjust to this change as they continue to value goodwill and other intangibles in accordance with GAAP. The proposed exclusions would have applied only to goodwill and other intangible assets acquired through supervisory mergers or consolidations and would not have been available for goodwill and other intangible assets acquired from mergers or consolidations that did not meet this definition. This change would have provided affected credit unions time to revise their business practices to ensure goodwill and other intangible assets directly related to supervisory mergers would not adversely impact their risk-based capital ratio.

Public Comments on the Second Proposal

At least one commenter stated that they agreed with the proposed treatment of goodwill and other intangible assets. A significant number of commenters, however, suggested that the Board include all goodwill and other intangible assets in the risk-based capital ratio numerator so long as these intangible assets meet GAAP requirements (subjected to annual goodwill impairment testing). Commenters reasoned that the exclusion of non-supervisory goodwill from the numerator would discourage some well managed and well capitalized credit unions from participating in mergers, and many mergers serve to benefit the members of both the surviving and non-surviving credit union. Similarly, commenters reasoned that mergers can also have a favorable influence on safety and soundness—producing institutions that in combination have stronger financials and are able to weather more extreme economic swings.

At least one commenter suggested that, as an alternative to including all goodwill and intangible assets in the risk-based capital ratio numerator, the Board might limit the retention of non-supervisory goodwill and other intangible assets in the numerator of the risk-based capital ratio for those credit unions that are well capitalized on the basis of the net worth ratio. The commenter suggested further that, at a minimum, non-supervisory goodwill that meets annual impairment testing should be retained in the numerator over a 10-year phase-out period, and all previous supervisory goodwill should be grandfathered without time limit, subject to regular impairment testing. The commenter suggested three reasons for taking such an approach: First, those credit unions that engaged in such transactions almost certainly reduced insurance losses to the Share Insurance Fund, and should not be penalized after the fact. Second, they did so with an understanding of current rules at that time. Many of these transactions would likely not have occurred had the proposed treatment of goodwill been known; so no longer counting this goodwill at some point in the future would be changing the rules midstream. Third, the amount of previous supervisory goodwill is a known, fixed, and relatively small quantity. Only 20 credit unions with more than \$100 million in assets have goodwill amounting to more than 5 percent of net worth, and the average goodwill to net worth ratio at these credit unions is 12.8 percent. Supervisory goodwill likely

represents no more than three quarters of that goodwill (approximately 10 percent of net worth). Considering future growth, the commenter suggested that supervisory goodwill will decline in proportion to net worth and assets going forward, and grandfathering it would protect those credit unions that in the past reduced NCUSIF resolution costs from a cliff reduction in their RBC ratios in the future.

Other commenters suggested that excluding goodwill from the risk-based capital ratio numerator would harm credit unions by: (1) Penalizing credit unions who have recently gone through a merger, and (2) dis-incentivizing merger activity, which could prevent healthy industry consolidation and the combining of unhealthy credit unions with stronger ones in the future. Some commenters suggested that if a well-situated credit union relies on goodwill as a component of a merger, and is no longer able to justify such as a business decision because of a lack of allowance for goodwill, NCUA is then forced to step in, which would negatively impact the NCUSIF and could require the payment of additional premiums by all credit unions. Use of goodwill allows a well-situated credit union to absorb a struggling credit union without negatively impacting the NCUSIF, which the commenter suggested should be incentivized. Thus, the commenter recommended that goodwill arising from both previous and future mergers should continue to be counted without a time limitation, so long as it meets GAAP requirements.

Several commenters suggested that the rule grandfather credit unions that have included goodwill on their books, and not impose the 10-year limit, since it has been used by the credit union in the past and was sanctioned by NCUA. Another commenter suggested that if mergers were part of a strategic plan accomplished before the risk-based capital rule is finalized, then any goodwill acquired through those mergers should be grandfathered.

Some commenters contended that goodwill acquired through a supervisory merger should not be treated differently than goodwill acquired through a strategic merger. Goodwill acquired through both types of mergers have value according to GAAP. One commenter argued that separating goodwill and other intangibles derived through a merger of healthy credit unions versus those assisted by a regulator does not make sense for the following reasons: (1) Some mergers that involve troubled credit unions may have had informal assistance from state or federal regulators, but may not meet the

definition outlined in the proposal as supervisory-assisted. This will create inconsistency in the application of the rule. (2) The treatment is inconsistent and provides potentially more risk to the NCUSIF as the risk-based capital ratio may not reflect the actual risk of future impairment of those assets. (3) The proposal favors troubled credit union mergers while discouraging healthy credit union consolidation due to the negative impact on the risk-based capital ratio. (4) Using a 10-year life for supervisory-assisted transactions provides only temporary relief for those credit unions impacted and it overstates the risk-based capital ratios until the phase-out period is over.

One commenter argued that the proposed treatment of goodwill would place credit unions that acquired failing or insolvent credit unions (under supervisory/emergency merger conditions)—including those where NCUA, the NCUSIF, and the credit union industry realized benefits from the acquisition activities—at a competitive disadvantage. The commenter suggested that the proposed 10-year deferral of goodwill is an equitable solution for those credit unions that acquired failed credit unions and received some level of funded assistance from the NCUSIF, as the amount of goodwill carried on their books would typically be less than goodwill carried by those credit unions that did not receive assistance. The commenter explained that this is due to the fact that the funded amount of assistance from the NCUSIF upon receipt by the continuing credit union is recorded as a reduction to the goodwill determined at the time the failed credit union was acquired. The commenter argued that other credit unions, however, that acquired failed credit unions relying on the current risk-based net worth regulations, but did not receive funded assistance from the NCUSIF would be penalized under the proposed 10-year deferral of goodwill. The commenter speculated that these credit unions would be forced to forgo many opportunities in lieu of having to meet changed regulator risk-based capital targets, while their competitors (for the next 10 years) would have the opportunity to focus on survival, service, product innovation, community reinvestment and growth. Accordingly, the commenter recommended the Board grant a one-time permanent exemption of goodwill to credit unions that made significant, capital-impacting decisions under the current risk-based net worth regulations.

Discussion

There is a high level of uncertainty regarding the ability of credit unions to realize the value of goodwill and other intangibles, particularly in times of adverse conditions. Thus, the proposed approach to other intangibles generally mirrors the treatment by the Other Banking Agencies.¹²⁶

However, as discussed in the definitions part of this rule above, the longer implementation period included in this final rule will serve to mitigate some of the commenters' concerns regarding existing goodwill and other intangibles because it provides affected credit unions more than 13 years to write down the goodwill or otherwise adjust their balance sheet.

While the final rule includes a provision to address goodwill and other intangibles acquired through supervisory mergers and consolidations that were completed 60 days following this rule's publication, the final rule retains 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.

Consistent with the comments, the Board recognizes that only 15 credit unions report total goodwill and intangible assets of more than 1 percent of assets, and notes that the valuation under GAAP of these existing assets will be immaterial by the end of the extended sunset date.

In future combinations, a credit union will need to consider the impacts a combination will have on both its net worth ratio and its risk-based capital ratio. 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.

Accordingly, for all the reasons discussed above, the Board has decided to retain this aspect of the Second Proposal in this final rule without change.

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

The Second Proposal allowed for identified losses, not reflected as

adjustments in the risk-based capital ratio numerator, to be deducted. The inclusion of identified losses 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 Second Proposal in this final rule without change.

104(c) Risk-Weighted Assets

In developing the proposed risk weights included in the Second Proposal, the Board reviewed the Basel accords and the U.S. and various international banking systems' existing risk weights.¹²⁷ The Board considered the comments contained in Material Loss Reviews (MLRs) prepared by NCUA's OIG and comments by GAO in their respective reviews of the financial services industry's implementation of PCA.¹²⁸ The Second Proposal was designed to address credit risk and concentration risk in a manner comparable to the Other Banking Agencies' capital regulations.¹²⁹ As a result, the Second Proposal would have substantially changed how the risk weights for nearly all credit union assets are assigned. For example, instead of assigning an investment a risk weight based on its weighted average life, the Second Proposal assigned risk weights to investments based primarily on the credit quality of the underlying collateral or repayment ability of the issuer. These and other adjustments were intended to address, where possible depending on the particular requirements of section 216 of the FCUA, inconsistencies between the risk weights assigned to assets under the Other Banking Agencies' capital regulations and NCUA's current PCA regulations.

Public Comments on the Second Proposal

The Board received many general comments regarding the proposed risk

¹²⁷ 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>.

¹²⁸ 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).

¹²⁹ See, e.g., 12 CFR 324.32.

¹²⁶ See, e.g., 12 CFR 324.22.

weights. At least one commenter suggested the proposal significantly improved the various risk weightings and that most of the proposed risk weightings seemed appropriate. Most commenters who mentioned the risk weights also acknowledged that the Board had made significant improvements to the risk-weight categories from the original risk-based capital proposal, and many of the adjustments and more detailed asset categories included in the Second Proposal were significant improvements.

A substantial number of the commenters, however, argued that the proposed risk weights remained too high in key areas, given credit unions' level of risk, and suggested they should be lower than what the federal bank regulators require for assets such as mortgage loans, member business loans, servicing and certain investments. These commenters suggested that lower risk weightings for credit union assets are appropriate given their different incentives to manage risk as compared to banks, and lower loss history based on their comparison to the banking industry.

A significant number of commenters complained that the proposed risk-weighting scheme was overly complex. At least one commenter suggested that credit unions have assets on their books at fair value; the change to fair value is accounted for in either the profit and loss statement or in other comprehensive income. The commenter recommended that the Board clarify the application of the risk weight for these assets when a component of their book value has already impacted capital through earnings or other comprehensive income. Other commenters recommended that the risk weights and concentration percentages take into account the standard credit risk factors such as loan-to-value ratio, credit score, origination channel, etc. One commenter suggested that credit risk is a function of underwriting, the economy, loan portfolio diversity, institutional structure, business strategy, profitability demands, time horizons, performance-monitoring capacity, funding stability and other factors. But, the commenter argued, the proposal ignores these local, individual factors in favor of a one-size-fits-all risk weighting.

Interest rate risk. The Board also received many comments regarding the proposed removal of IRR from the risk-weight calculation. A majority of the commenters who mentioned IRR stated that they agreed with the proposed removal of interest rate risk from the

rule. Moreover, they suggested a separate IRR standard was not needed to reasonably account for IRR at credit unions because NCUA's current framework of policies and regulations sufficiently address the risk. One credit union commenter did recommend, however, that NCUA expand the data it gathers in the 5300 Call Reports and use that information to facilitate both RBC compliance and interest rate risk management. The commenter suggested Call Reports also be used to monitor investment losses for credit unions that invest in complex securities, which would show the direction a credit union is trending and provide regulators with an objective basis for determining which credit unions need capital buffers that exceed regulatory minimums.

Concentration risk. The Board received a substantial number of comments regarding the Second Proposal's retention of concentration risk measures in the risk weightings of certain categories of assets. A majority of the commenters who mentioned it suggested that concentration risk is best addressed through the examination process as it is for banks, and thus, should be dropped from the risk weights in the final rule. At least one commenter argued that the proposed concentration threshold requirements violate the FCUA, which requires the Board to "prescribe a system of prompt corrective action" that is "comparable to section 1831o" of the Federal Deposit Insurance Act.

One commenter noted that while NCUA did cite to specific credit union failures that involved high concentrations of certain assets, the Material Loss Reviews associated with those failures revealed that fraud or board mismanagement played a pivotal, if not a determining, role in the failure of the credit unions. Other commenters claimed that, based on 2007 and 2014 data, there was no meaningful difference in the performance of credit unions with higher or lower levels of concentration in mortgages or home equity loans. The proposal would require credit unions to hold more capital than banks at certain levels of asset concentration, which commenters argued would not create a "comparable" capital framework and would put credit unions at a competitive disadvantage. The commenters contended this is particularly true for mortgages and home equity loans where the capital requirements materially increase even at relatively lower levels of concentration (35 percent and 20 percent of assets, respectively).

One commenter claimed the Board did not provide any evidence the

proposed concentration risk thresholds aligned with increased capital at risk, and insisted that the historical loss data provided by NCUA did not support establishing a higher capital standard for credit unions than banks. The commenter argued that the data in the Second Proposal showing the differences in asset concentrations between those credit unions that failed and those that survived was insufficient. And for real estate loans, the commenter claimed the data was inconclusive because credit unions that failed had 58 percent of their assets in real estate whereas those credit unions that survived had 49 percent. While there was a higher concentration of real estate assets for those that failed, the commenter suggested the difference of 9 percent was not a firm basis on which to assert higher concentrations of real estate loans were a significant contributing factor to the credit union's failure such that it warrants higher capital levels for all complex credit unions. Similarly, the commenter argued that the data for commercial loans would not support a concentration risk threshold of 50 percent, and alleged that the Board examined the current level of real estate exposure across the industry and set the capital requirements such that roughly the top 10 percent of the industry would see their capital requirements increase. Further, the commenter argued that the methodology was unsupported by the evidence, that there was no empirical evidence to support that either (a) two standard deviations is the right basis for determining this threshold, or (b) the resultant risk thresholds correlated directly to higher degrees of risk such that additional capital should be held by these institutions. The commenter insisted that, based on the comparability requirement in the FCUA, the Board should eliminate the concentration risk thresholds for these asset classes and set the risk weights equal to those applied to the banking industry (50 percent for mortgages and 100 percent for both home equity loans and commercial loans).

Another commenter noted that the examples given by the Board in support of adopting concentration risk elements did not acknowledge the fact that mortgage and home equity line of credit (HELOC) underwriting standards have tightened, and claimed that credit unions have generally divested away from residential real estate, and that the proposal fails to anticipate where the credit union asset mix will likely migrate in the future. Based on this claim, the commenter speculated that

the proposed concentration limits may not prudently attain the desired goal of portfolio invariance and may, in fact, threaten the long-term viability of many credit unions. The commenter recommended that the Board adopt one of the following alternative approaches: (1) Do away with the concentration risk element altogether; (2) use current demarcation points as a trigger for expanded reporting in the Call Report, thereby allowing NCUA to assess if there is in fact additional risk; or (3) increase the current threshold levels that call for increased weighting—for example, by moving the mortgage threshold to 50 percent to match the commercial loan threshold, and increasing the residential junior lien threshold from 20 percent to 25 percent.

One commenter argued that the proposed approach of including concentration risk thresholds in the risk weights was fundamentally flawed because it considered the relative size of the portfolio and not the benefit of diversification. Another commenter speculated that without more specific information to capture diversification within a lending portfolio,¹³⁰ the proposal would have limited value in providing early warning of truly unsafe concentrations. Instead, the commenter recommended NCUA address outlier credit unions through the timely application of supervisory tools or, if necessary, by applying the capital adequacy planning requirements of section 702.101(b) to credit unions flagged as outliers. The commenter suggested that using capital adequacy plans to address concentration risk would control for asset concentrations that pose safety and soundness risk without placing the wider credit union system at a competitive disadvantage to banks. The commenter speculated further that, given the shifting landscape of the financial services market and the credit union industry, building risk parameters around the current shape of the market may not align with future risks.

Yet another commenter suggested that if concentration risk is maintained in the final rule, the concentration threshold level for all secured loan categories should be 50 percent, and only unsecured loans should have a concentration threshold level below 50 percent.

Finally, one commenter argued that there is no need for the rule to address concentration risk, claiming that concentration risk would address itself since the dollar amount applied against

the risk weight increases as concentration increases.

Discussion

After carefully considering the comments received, the Board generally agrees with commenters who suggested that IRR concerns can be addressed through NCUA guidance, supervision, and other regulations. NCUA's guidance, supervision, and other regulations are designed to address how IRR is managed and reported in a manner that is appropriate to the size, complexity, risk profile, and scope of each credit union's operations. The Board has determined not to include IRR in the risk-based net worth requirement¹³¹ given the other mechanisms available to NCUA to address such risk. NCUA will continue to monitor credit unions' exposure to IRR through the supervision process and plans to provide additional supervisory guidance in the future.

The Board, however, disagrees with commenters who suggested further reductions in the scope of the use of risk weights to address concentration risk. Under the Second Proposal, the Board substantially reduced the risk-based capital requirements related to concentration risk by using one concentration threshold, set at a higher level, for assets that NCUA determined are vulnerable to concentration risk. As stated in the preamble to the Second Proposal, the concept of addressing concentration risk with the assignment of risk weights is consistent with the risk-based net worth requirement under current part 702. Higher risk weights are assigned to real estate loans and MBLs held in higher concentrations under the current rule. Elimination or additional reductions in the concentration risk dimension of the risk-based net worth requirement would be inconsistent with concerns regarding concentration risk raised by GAO and in MLRs conducted by NCUA's OIG.¹³² The preamble also

¹³¹ See 12 U.S.C. 1790d(d)(2) ("The Board shall design the risk-based net worth requirement to take account of any material risks against with the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.").

¹³² 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>; 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

noted that the Basel Committee on Banking Supervision has stated that "risk concentrations are arguably the single most important cause of major problems in banks."¹³³

It is not appropriate to rely solely on the supervisory process to address concentration risk because the holding of additional capital for concentration risk should occur prior to the development of the concentration risk, and is difficult to achieve after a concern with concentration risk is identified during the supervisory process.

The concentration risk thresholds were adjusted in the Second Proposal to focus on material levels of concentration risk and for more consistency with the current effective impact of the concentration risk on capital requirements for commercial loans. As a result of the risk-weight adjustments, very few credit unions would be subject to the marginally higher risk weights due to concentration risk. Credit unions subject to the concentration risk weights will not be placed at a competitive disadvantage, because all banks are required to maintain capital commensurate with the level and nature of all risks, including concentration risk, to which they are exposed.¹³⁴

Regarding support for the risk weights themselves, given the statutory requirement to maintain comparability with the Other Banking Agencies' PCA requirements,¹³⁵ NCUA relied primarily on the 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. The Board, however, did tailor the proposed risk weights for assets unique to credit unions, where contemporary and sustained performance differences existed (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.

The Board generally agrees with commenters who suggested that credit risk factors such as loan-to-value ratio (LTV), credit score, origination and other individual factors are meaningful

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>.

¹³³ 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/bcb128.pdf>.

¹³⁴ See 12 CFR 324.10(d).

¹³⁵ See 12 U.S.C. 1790d(b)(1)(A)(ii).

¹³⁰ For example, diversification based on geography, industry, credit profile, or product type.

and should be evaluated. However, reporting loan data on LTVs and credit scores to NCUA would be administratively burdensome. For example, establishing regulations on how the LTV would be measured would be complex when considering such items as how to take into account private mortgage insurance as the financial strength of mortgage insurers varies, or the LTV of a restructured loan. NCUA also lacks credit union industry data on loan performance based on LTV ratios that could be used to establish a framework for LTV-based risk weights. And risk weights based on LTVs for real estate loans would not be comparable to the risk weight framework used by the other banking agencies.

Accordingly, the Board has decided to maintain the proposed approach to risk-weighting assets in this final rule.

104(c)(1) General

Under the Second Proposal, § 702.104(c)(1) provided that risk-weighted assets include 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). The section provided 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 proposed adding 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.

The Board received no comments on the language in this paragraph of the proposal. Accordingly, the Board has decided to retain the language in this proposed paragraph in this final rule without change.

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

Under the Second Proposal, § 702.104(c)(2) defined the risk categories and risk weights to be assigned to each defined on-balance sheet asset. All on-balance sheet assets

were assigned to one of 10 risk-weight categories.

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

Cash and Investment Risk Weights

Under the Second Proposal, the Board proposed eliminating the process of assigning risk weights for investments based on the weighted average life of investments in favor of a credit-risk centered approach for investments. The credit risk approach to assigning risk weights under the Second Proposal was based on applying lower risk weights to safer investment types and higher risk weights to riskier investment types.¹³⁶ The proposed investment risk weights are similar to the risk weights assigned to investments under the Other Banking Agencies' regulations,¹³⁷ which are based on the credit-risk elements of the issuer, the underlying collateral, and the payout position of the particular type of investment. The proposed changes to the risk weights assigned to investments are outlined in the following table:

SECOND PROPOSAL: RISK WEIGHTS FOR CASH AND INVESTMENTS

Item	Proposed (percent) risk weight
<ul style="list-style-type: none"> • The balance of cash, currency and coin, including vault, automatic teller machine, and teller cash • The exposure amount of: <ul style="list-style-type: none"> ○ 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. 	0
<ul style="list-style-type: none"> • 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: <ul style="list-style-type: none"> ○ 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. 	20
<ul style="list-style-type: none"> • The exposure amount of: <ul style="list-style-type: none"> ○ 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. 	50
<ul style="list-style-type: none"> • The exposure amount of: <ul style="list-style-type: none"> ○ 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. 	100

¹³⁶ 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.

¹³⁷ See, e.g., 12 CFR 324.32.

SECOND PROPOSAL: RISK WEIGHTS FOR CASH AND INVESTMENTS—Continued

Item	Proposed (percent) risk weight
<ul style="list-style-type: none"> • 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 • The exposure amount of equity investments in CUSOs. • The exposure amount of: <ul style="list-style-type: none"> ○ 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 • The exposure amount of any subordinated tranche of any investment, with the option to use the gross-up approach 	<p>150</p> <p>300</p> <p>400</p> <p>¹³⁸ 1,250</p>

Public Comments on the Second Proposal

The Board received many general comments regarding the proposed investment risk weights. At least one commenter maintained that the proposal would unfairly penalize credit unions by using investment risk weights to compensate for interest rate risk, which the commenter argued would create a bias towards lending and against investments. Other commenters, however, suggested that, in general, the revised risk weights for investments were reasonable, including the zero risk weighting for investments issued by the U.S. Government, including NCUA and FDIC. Some commenters suggested the 20 percent weight for government-sponsored enterprises (GSEs) seemed reasonable given that they are quasi-government entities.

The Board also received other comments regarding the risk weights assigned to the following particular investments:

Deposits in banks or credit unions. One commenter contended that the proposed risk weightings for investments were mute on weights for deposits in banks or credit unions. The commenter believed such deposits should have some level of risk weighting, at least for any uninsured amounts on deposit at banks and credit unions, because they can be a part of a smaller credit union’s investment portfolio.

Part 703 compliant investment funds. At least one commenter objected to a default risk weight of 100 percent for part 703 compliant investment funds, and 300 percent for non-part 703 compliant funds. The commenter believed the 200 percent increase in a default risk weight would be punitive

and would create a disadvantage for state-chartered credit unions. The commenter suggested there are several non-conforming, state-authorized investments that are not based in equities or other “volatile and risky investments” and that do not warrant a 300 percent risk weight. The commenter argued further that, by using part 703 as a threshold, the Board was assigning a significantly lower baseline assumption of risk on the basis of the regulator that approved the investment, which would single out state-chartered institutions and force them to undertake look-through calculations on their investments when federal charters may be able to rely on the default risk weight. The commenter recommended that the default thresholds be tied to the underlying holdings and investment strategy of the fund.

At least one commenter recommended that investment funds that hold only investments that qualify for a zero or 20 percent risk weight should receive a 20 percent risk weight regardless of whether the underlying investments are part 703 compliant.

One commenter complained that the proposed risk-weight categories for non-loan investments were too general, lumping together assets with widely varying risks, especially when considering risks beyond those tied to interest rate fluctuations. The commenter suggested that additional risk-weighting tools within categories were needed to properly take account of issuer- and security-specific issues for both debt and equity securities and non-part 703 compliant funds. The commenter speculated further that the proposed approach would discourage responsible employee benefit pre-funding by penalizing those investments, and provide incentives for excessively aggressive equity investing in pursuit of higher returns to offset the especially high reserve requirements. The commenter recommended that the baseline risk weights should be

presumptive only, so that if a credit union can present good reasons why a lower risk weight should be assigned to its investments within a certain category, those lower weights should be applied going forward. Another commenter suggested that, while the proposed 100 percent risk weight assigned to all private issuer corporate debt is not a punitive level, there ought to be some ability for a credit union to demonstrate that the corporate debt it holds qualifies for a lower weighting, closer to the 20 percent for state and local debt, or the 50 percent for revenue bonds, which are limited for repayment to the revenue generated by a specific facility and thus often are in reality private issuer obligations. The commenter believed that a flat 100 percent weighting for all corporate debt takes no account of actual issuer-specific repayment risk, and could serve to distort reasonable investment decisions by credit unions looking to include such issues in their employee benefit pre-funding portfolios. The commenter recommended some issue/ issuer-specific risk assessment be allowed to more rationally, precisely equal risk and risk weights.

Non-significant equity exposures. Several commenters suggested that banks are permitted to apply a 100 percent risk weight to certain equity exposures deemed non-significant. The commenters suggested further that non-significant exposures mean an equity exposure that does not exceed 10 percent of the bank’s total capital. The commenters recommended that NCUA adopt a similar treatment if the publicly traded equities and equity allocation within an investment fund are less than 10 percent of a credit union’s total capital; then a risk weight of 100 percent shall be applied to the equity exposure. The commenters suggested this would reduce the complexity of the look-through approach and simplify the overall risk-weighting process for non-significant equity exposure.

¹³⁸ The 1,250 percent risk-weight amount is based on holding capital dollar-for-dollar at the 8 percent adequately capitalized level for the risk-based capital ratio (8 percent adequately capitalized level * 1,250 percent = 100 percent).

Community development investments. Several commenters suggested that OCC's risk-based capital regulation recognizes the importance of community development investments and assigns a risk weight of 100 percent rather than the standard 300 percent factor. The commenters suggested further that the public policy embraced by OCC with this allowance is to encourage investments to support charitable goals and purposes. Commenters recommended that NCUA embrace a similar policy and assign a risk weight of 100 percent for any equity or corporate bond exposure in a community development investment. The commenters suggested that such treatment would support broader participation by credit unions with community development investments and enhance the goodwill and reputation of the credit union industry as it builds an investment resource to support charitable contributions.

Employee benefit plan investments. Some commenters argued that the 300 percent risk weighting assigned to publicly traded equity investments should be much lower so that credit unions are not unduly limited in their investments for employee benefit funding. One commenter recommended that the Board continue to apply standard risk weights to benefit plan investments. The commenter contended that a 457(b) executive plan is unfunded and does not vest until the employee retires or terminates employment, and the assets underlying such plans generally must remain the property of the credit union until vested and are subject to the claims of general creditors. The commenter speculated further that, if the credit union is put into conservatorship, the investments never transfer to the employee. So, the commenter maintained, it is appropriate for the Board to risk weight such investments as part of the overall balance. The commenter expressed concern that it could be very difficult for NCUA to determine with certainty whether, and to what extent, the credit union held a risk of loss in connection with the investments because employee benefit plans can be tailored to fit the needs of each individual credit union and executive.

One commenter claimed risk weighting all publicly traded equities at 300 percent would be punitive and unjustified by real-world experience with a long list of blue-chip, dividend-paying, financially secure stocks regularly included in credit union client § 701.19 portfolios. The commenter suggested that, as with corporate debt, some tools must be offered to allow a

credit union to obtain relief from the extremely high risk assessment for specific equity issues which are more secure than consumer loans in default, to which the proposal assigns a 150 percent risk weight. The commenter suggested further that relevant factors which could support a lowering of the risk weighting for specific equity investments include the issuer's debt rating, market capitalization and financial condition, history of dividend payments, and absence of financial defaults. The commenter speculated that imposing a blanket 300 percent risk weight on all public equity would create two negative, counterproductive incentives: First, it would discourage any public equity investments, driving down expected overall portfolio return and requiring investment of a larger amount of credit union funds to achieve a needed annual return tied to projected future benefit costs. Second, for those credit unions which do nevertheless include an equity component in their § 701.19 portfolios, there would be pressure to overcome the high reserve ratio by investing in higher-return, higher-risk equities, instead of more stable dividend-paying stocks. The commenter also maintained that the 300 percent risk weight assigned to pre-funded, non-part 703 compliant mutual funds, while subject to reduction under various look-through methods, was unjustifiably high in comparison to the other weights assigned to performing and even non-performing loans.

Publicly traded equity investments. One commenter recommended that all publicly traded equity investments be treated as either available for sale or trading. The commenter suggested that these two methods of accounting require the investment to be recorded at market value, which should be easily determined since they are publicly traded. Thus, the commenter argued, the 300 percent risk weight assigned under the Second Proposal would be excessive, especially given the amount of class B Visa shares held by a significant number of credit unions, and with the employee benefit funding allowed by § 701.19 of NCUA's regulations.

Non-agency ABS structured securities. One commenter suggested that collateral utilized to secure investments included in the non-agency ABS structured securities category could include automobile loans. Because the Second Proposal requires a risk weighting of 75 percent for all current secured consumer loans—and since the risk profile of the underlying collateral does not differ between secured automobile loans and non-agency ABS structured securities

backed by secured auto loans—the commenter recommended the risk weightings for both instruments be set at 75 percent.

Subordinate tranche of any investment. At least one commenter complained that the Second Proposal would assign a risk weighting of 1,250 percent, or require the use of the gross-up approach to determine the overall weighting of this category of investment. The commenter argued that the 1,250 percent risk weighting was punitive in nature and could not be justified from a safety and soundness standpoint because it may appear to represent more than 100 percent of the monies at risk in any one investment.

At least one commenter also objected that, by not including the “simplified supervisory formula approach”¹³⁹ in the Second Proposal, the Board deprived credit unions of a measurement tool that is allowed by the Other Banking Agencies and the Basel Committee on Banking Supervision. The commenter argued that this could represent a competitive disadvantage to credit unions who are evaluating certain investments for inclusion in their strategies. Given the significance of the weighting and the exclusion of the evaluation method, the commenter recommended the 1,250 percent weighting should be eliminated and the Simplified Supervisory Formula Approach be utilized to determine the weighting of investment categories.

One commenter suggested that the Board assign the subordinate tranche of any investments the same risk weight that applies to commercial loans.

Corporate debt. Several commenters maintained that applying high risk weights to investments in the corporate system would penalize credit unions that invest within the industry. Commenters also suggested that the risk weights assigned to corporate paid-in capital should recognize how the stricter regulatory standards for corporate credit unions adopted in 2010 not only mitigate risks to natural-person credit unions, but also protect the NCUSIF from potential losses. Accordingly, some commenters recommended that a lower risk weight of 125 percent be assigned to corporate paid-in capital under the final rule.

One commenter suggested that it would be more reasonable to generally structure risk weights for corporate debt into tiers similar to that of municipal bonds because the proposed structure would make it costly to diversify and gain yield because the risk weights assigned would negate the added yield

¹³⁹ See, e.g., 12 CFR 324.43.

of these bonds. The commenter insisted that, in order to preserve a credit union's ability to diversify and avoid concentration risk in agency or government bonds, more reasonable risk weights should be assigned to different forms of corporate debt. The commenter suggested one alternative option for structuring risk weights for corporate debt would be to create a four-tiered risk classification that would include investment grade and non-investment grade bonds. The commenter noted that the current definition is silent on whether bonds can be non-investment grade. The commenter suggested further that the investment grades could be broken down into high, medium and low investment grade plus non-investment grade for four tiers. According to the commenter, the high grade would be equivalent to an AAA rating, the medium grade would be equivalent to an A rating, the low grade would be equivalent to a BBB rating, and the non-investment grade would be non-investment grade. The commenter recommended these ratings be part of the credit union's internal ratings system for bonds, which would allow for lower risk weights for high-grade bonds at 50 percent, medium-grade bonds at 75 percent, and low-grade bonds at 100 percent.

Discussion

The Board disagrees with commenters who suggested that the proposal would unfairly penalize credit unions by using investment risk weights to compensate for IRR. The Board intentionally removed the weighted average life calculation from the assignment of risk weights to remove the IRR components from the Second Proposal. As stated above, the risk weights assigned to investments were based on credit risk, consistent with the risk weights assigned to investments by the Other Banking Agencies.

The Board disagrees with the commenters who claimed the proposed risk weights assigned to investments were mute on the weights for deposits in banks and credit unions. The Second Proposal assigned a risk weight of zero percent to insured balances from FDIC-insured depositories or federally insured credit unions. Uninsured balances, and all balances due from privately insured credit unions, were risk-weighted at 20 percent. Deposits in a bank that are guaranteed by a state received the same 20 percent risk weight as an investment in a PSE.

The Board disagrees with the commenters who suggested that a 300 percent risk weight for non-part 703 compliant investment funds would be

punitive compared to the 100 percent risk weight for part 703 compliant investment funds. The Board chose to create standard risk weights for investment funds to allow credit unions a simple alternative to calculating the risk weights for such assets using the look-through approaches. Part 703 compliant investment funds were assigned a 100 percent risk weight under the Second Proposal unless they qualified for a lower risk weight because they were limited to holding lower risk-weighted assets. The Board determined that part 703 compliant investment funds should qualify for a maximum 100 percent risk weight under § 702.104(c)(2) because the underlying investments permitted under part 703 of NCUA's regulations were almost exclusively assigned a risk weight of 100 percent or less under the proposal. Non-part 703 investment funds, on the other hand, are potentially more risky, so assigning them a risk weight equivalent to the risk weight assigned to publicly traded equity investments is appropriate. Under the Second Proposal, credit unions were also given the option to calculate the risk weight for any investment fund using one of the look-through approaches, which allow a credit union to risk weight such a fund based on its underlying assets.

The Board disagrees with commenters who claimed the proposed risk weights were too general because they lumped together assets with widely varying risk, and those who suggested including additional risk-weight measures, such as taking into account the specific loan-to-value ratio or FICO scores of the underlying assets. As with loans, the risk weights assigned to investments were generally determined based on the underlying collateral or type of loan, and the relative credit risk. The Board chose not to apply separate risk weights to investments based on additional risk-weighting tools due to the complexity involved and the backward-looking nature of an analysis based on past performance. Adding risk-weighting factors within investment type categories would have been inconsistent with the approach taken by the Other Banking Agencies.

The Board also disagrees with commenters who suggested that credit unions should be able use lower risk weights if they are able to demonstrate that an investment should qualify for a lower-risk weight. Alternative and individualized risk weight mechanisms would be difficult and costly to implement consistently, and would be inconsistent with the Other Banking Agencies' regulations.

Several commenters recommended that the Board apply a 100 percent risk weight to non-significant equity exposures, which would be similar to the approach taken by the Other Banking Agencies. As discussed in more detail below in the part of the preamble associated with § 702.104(c)(3)(i), the Board generally agrees with commenters on this point and has amended this final rule to assign a 100 percent risk weight to non-significant equity exposures. This change is consistent with the Board's objective of assigning risk weights to assets that are similar to the Other Banking Agencies' regulations where the level of risk exposure does not create safety and soundness concerns.

The Board disagrees with commenters who suggested that lower risk weights should be applied to certain types of investments, such as corporate bonds and publicly traded equities, which are generally not available to federal credit unions, simply because they were purchased for employee benefit plans. In particular, several commenters argued that the 300 percent risk weight assigned to publicly traded equity investments should be much lower so that credit unions are not limited in their investments for employee benefits. The proposed risk weights were intended to be applied based on risk, not on use. And, consistent with commenters' suggestions on the Original Proposal, the Board assigned risk weights in a manner similar to the Other Banking Agencies' regulations unless the FCUA or a unique circumstance warranted a different risk weight be adopted. The 300 percent risk weight for non-part 703 compliant investment funds is appropriate when they are used to fund employee benefits because there are few limits on the investments in these types of funds. A credit union may, however, use one of the look-through approaches if the underlying assets have a risk weight of less than 300 percent. Accordingly, for these types of assets, the proposed risk weight reasonably reflects the risks associated with the types of assets available to fund employee benefit plans.

The Board disagrees with the commenter who suggested that a 300 percent risk-weight was excessive for publicly traded equity investments because they are treated as available for sale or trading and recorded at market value. The value at which an equity is recorded does not reflect the risk of loss and does not preclude an equity from losing a substantial amount of its value in the future. The lack of a maturity date, loss position, and unknown

dividends make an equity riskier than many other types of assets.

The Board generally agrees with the commenter who suggested that a senior asset-backed security should have the same risk weight as a similar loan. Such an approach is consistent with the Other Banking Agencies' regulations and focuses on the risk of the underlying collateral. By applying the gross-up approach to a non-subordinated tranche of an investment, a credit union can risk weight a non-subordinated tranche of an investment with the same risk weight as if they had owned the loans directly. Accordingly, this final rule adds non-subordinated tranches of any investments to the 100 risk-weight category and gives credit unions the option to use the gross-up approach.

The Board disagrees with commenters who suggested that the proposed 1,250 percent risk weight was punitive for subordinated tranches of investments. Under the proposal, credit unions were given the option to use the gross-up approach to lower the risk weight of a subordinated tranche of an investment if it did not contain an excessively large amount of leverage. The 1,250 percent risk weight is a reasonable risk weight for subordinated tranches if the credit union is unable, or unwilling to use the gross-up approach. The risk weight is appropriate given the leveraged risk in subordinated tranches, and is consistent with the Other Banking Agencies' regulations.¹⁴⁰ As noted in the Second Proposal, the simplified supervisory formula approach for subordinated tranches permitted under the Other Banking Agencies' capital regulations was not included in the Second Proposal because of its complexity and limited applicability.

The Board also disagrees with commenters who suggested that subordinated tranches of investments should receive the same risk weight as commercial loans. Applying

subordinated tranches of investments the same risk weights as commercial loans would likely fail to account for highly leveraged transactions, and would be inconsistent with the Other Banking Agencies' regulations. The Board also notes that, using the gross-up approach, low-risk subordinated tranches of certain investments could receive risk weights equal to or less than the risk weights assigned to commercial loans.

The Board disagrees with commenters who suggested that assigning high risk weights to investments in the corporate credit union system would penalize credit unions that invest within the industry. The proposed risk weights assigned to nonperpetual capital and perpetual contributed capital at corporate credit unions are 100 percent and 150 percent, respectively. The proposed risk weights were not intended to be a penalty or disincentive for holding any particular assets. Rather, the intent was to assign appropriate risk weights that adequately account for the risk associated with each particular asset. The risk weights for corporate capital investments did take into consideration the stricter regulations commenters cited when seeking lower risk weights. And as a result, this final rule assigns reasonable risk weights to corporate-capital investments given the stricter regulatory requirements applicable to corporate credit unions as compared to the higher risk weights associated with non-publicly traded equity investments under the Other Banking Agencies' regulations.

The Board disagrees with the commenter who suggested that the final rule should assign different risk-weight tiers in corporate debt, similar to municipal bonds. Under the Second Proposal, the risk weight assigned to a corporate debt was consistent with the risk weight assigned to an industrial development bond, which is a type of

municipal bond. An industrial development bond is 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. Typically the ultimate obligation of repayment of the industrial development bond is on a corporation. The 100 percent risk weight for corporate bonds is consistent with the risk weights assigned to industrial development bonds, a tier within municipal bonds, where the ultimate obligation of repayment is a corporate entity. The proposed risk weight for corporate debt is generally consistent with the Other Banking Agencies' regulations. The Board decided not to apply tiers within investment types due to the complexity and the inability to apply a standard and objective approach.

Consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which required agencies to remove all references to credit ratings, this final rule does not use credit ratings to determine risk weights for part 702.¹⁴¹

Commercial Loans

The Second Proposal assigned risk weights to commercial loans in a manner generally consistent with the Other Banking Agencies' capital regulations and the objectives of the Basel Committee on Banking Supervision.¹⁴² The proposal set a single concentration threshold at 50 percent of total assets. Commercial loans that were less than the 50 percent threshold were assigned a 100 percent risk weight, and commercial loans over the threshold were assigned a 150 percent risk weight. Commercial loans that were not current were assigned a 150 percent risk weight.

	Commercial loan concentration (percent of total assets)				
	15%	20%	50%	75%	100%
Effective Capital Rate: ¹⁴³					
Current Rule	6.0	6.5	10.4	11.6	12.2
This Proposal	10.0	10.0	10.0	11.7	12.5

¹⁴⁰ NCUA estimates a *de minimis* number of investments would be subject to the 1,250 risk weight.

¹⁴¹ Public Law 111–203, Title IX, Subtitle C, section 939A, 124 Stat. 1376, 1887 (July 21, 2010).

¹⁴² This is comparable with the other Federal Banking Regulatory Agencies' capital rules. See e.g., 12 CFR 324.32 (Assigns 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)); 78 FR 55339 (Sept. 10, 2013); and 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 percent risk weight of the loans secured.”) available at <http://www.bis.org/publ/bcbs128.htm>.

¹⁴³ The effective capital rate represents the blended percentage of capital necessary for a given level of commercial loan concentration. The calculation uses 10 percent as the level of risk-based capital to be well capitalized.

Public Comments on the Second Proposal

A substantial number of commenters recommended that the risk weights for commercial loans be adjusted downward to levels no more than those in place for banks. Those commenters claimed credit unions do not have higher levels of risk associated with holding commercial loans than banks do. Commenters acknowledged that lower risk weights for higher concentrations of commercial loans would imply lower risk weights for lower concentrations of these loans compared to bank risk weights, but they insisted this disparity would be appropriate given lower loss rates at credit unions. One commenter recommended assigning a lower risk weight, of perhaps 50–75 percent, to secured commercial loans. The commenter explained that in locations where there is a market for certain types of commercial vehicles, a lower risk weight makes more sense. Another commenter recommended the following risk weights for commercial loans be assigned as an alternative: Credit card and other unsecured loans that are less than 50 percent of assets should be assigned a 100 percent risk weight, and such loans that are over 50 percent of assets should be assigned a 150 percent risk weight; new vehicle loans that are less than 50 percent of assets should be assigned a 50 percent risk weight, and such loans that are greater than 50 percent of assets should be assigned a 75 percent risk weight; used vehicle loans that are less than 50 percent of

assets should be assigned a 75 percent risk weight, and such loans that are greater than 50 percent of assets should be assigned a 112 percent risk weight; first-lien residential real estate loans and lines of credit that are less than 50 percent of assets should be assigned a 75 percent risk weight, and such loans that are greater than 50 percent of assets should be assigned a 112 percent risk weight; all other real estate loans and lines of credit that are less than 50 percent of assets should be assigned a 100 percent risk weight, and such loans that are greater than 50 percent of assets should be assigned a 150 percent risk weight.

At least one commenter speculated that the vast majority of credit union member business loans have real estate as collateral, while commercial bank loans are typically collateralized with receivables, etc. The commenter noted that under the banking agencies' rules, commercial loans made by banks are assigned a 100 percent risk weight. The commenter argued, however, that NCUA's risk weight for member business loans should be lowered from 100 percent to 75 percent to account for the fact that credit union member business loans are safer than commercial loans made by banks.

Some commenters complained that the proposal did not account for the different types of commercial loans made by credit unions. Commenters also speculated that credit unions chartered for the purpose of making MBLs would be unfairly penalized under the proposal.

Discussion

The Board disagrees that concentration thresholds for commercial loans should vary based on the business purpose or underlying collateral. The Agency did not pursue the alternative commercial risk weights suggested by commenters because such alternatives would be extremely difficult to implement consistently across all credit unions. 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 regulations. All commercial asset classes experience performance fluctuations with variations in business cycles. Some sectors that had historically 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.¹⁴⁴

Contemporary variances between bank and credit union losses on commercial loans are not substantial enough to warrant assigning lower risk weights to commercial loans held by credit unions. As stated in the Second Proposal, and as further clarified below using data to match the asset breakouts within the FDIC Quarterly Banking Profile, 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
[2012, 2013, 2014]**

	Credit unions >\$100M in assets	Banks \$100M to \$10B in assets	Banks \$1B to \$10B in assets
Commercial & Industrial ¹⁴⁵ .....	.....	0.61	0.42
Member Business Loans ¹⁴⁶	0.52		

Further, credit unions' long-term historical MBL losses are somewhat understated because 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.¹⁴⁷

Residential Real Estate Loans

The Second Proposal assigned risk weights to residential real estate loans that are generally consistent with those assigned by the Other Banking

Agencies.¹⁴⁸ The proposal set the first- and junior-lien residential real estate loan concentration thresholds at 35 percent and 20 percent of total assets respectively. Current first-lien residential real estate loans that were less than 35 percent of assets were assigned a 50 percent risk weight, and

¹⁴⁴ NCUA, *Taxi Medallion Lending*, Letter to Credit Unions 14–CU–06 (April 2014); FDIC, *Prudent Management of Agricultural Credits Through Economic Cycles*, Financial Institution Letter FIL–39–2014 (July 16, 2014).

¹⁴⁵ See Yearend FDIC Quarterly Banking Profiles 11 (2012, 2013, & 2014).

¹⁴⁶ See NCUA Financial Performance Report using year end data for credit unions with assets greater than \$100 million.

¹⁴⁷ 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. See Department of the Treasury, *Credit Union Member Business Lending* (Washington, DC January 2001).

¹⁴⁸ See, e.g., 12 CFR 324.32(g).

those equal to or greater than 35 percent of assets were assigned a 75 percent risk weight. Current junior-lien residential real estate loans that were less than 20 percent of assets were assigned a 100 percent risk weight, and those equal to or greater than 20 percent of assets were assigned a 150 percent risk weight.

PROPOSED RESIDENTIAL REAL ESTATE LOAN CONCENTRATION THRESHOLDS AND RISK WEIGHTS

	50%	75%	100%	150%
First-Lien	Current <35% of Assets ...	Current ≥35% of Assets.		
Junior-Lien			Current <20% of Assets ...	Current ≥20% of Assets.

In addition, under the Second Proposal, first- and junior-lien residential real estate loans that are not current were assigned 100 percent and 150 percent risk weights, respectively.

Public Comments on the Second Proposal

A majority of the commenters who mentioned these loans recommended that the concentration risk component be removed entirely from the risk weights for first- and junior-lien residential real estate loans. One commenter expressed concern that the high risk weights assigned to certain first-lien residential real estate loans and certain junior-lien residential real estate loans could negatively impact mortgage lending in the communities served by credit unions. The commenter argued that the proposal did not appear to address the underlying attributes of the mortgages nor the degree in which they may be match funded, which could thereby restrict lending and curtail profitability and capital growth at well managed, risk-averse credit unions. Accordingly, the commenter recommended that the Board reconsider and revise the risk weights for mortgage loans held on balance sheet to be more consistent with the requirements of the Other Federal Banking Agencies. Similarly, a substantial number of credit union commenters suggested that the risk weights for mortgage loans be adjusted downward to levels no more than those in place for banks because they claimed credit unions do not have higher levels of risk associated with holding these assets. Another commenter argued that the risk weights assigned to real estate loans were arbitrary because: (1) The vast majority of MBLs are collateralized with real

estate at a loan-to-value ratio of 75 percent or less; (2) the vast majority of home equity loans are first mortgages with a loan-to-value ratio of 80 percent or less; and (3) some increased risk is associated with junior lien mortgages, but it is not extensive or widespread. Yet another commenter suggested that the final rule assign risk weights to these assets by including a study of loss history and the market where a credit union operates.

Several commenters recommended further that consideration be given to incorporating loan-to-value ratios, credit scores, salability of the loan to secondary mortgage market participants, and the size of loans in the proposed risk weighting. One commenter suggested that both junior- and first-lien residential real estate loans amortize over time, lessening their credit risk profile, and in the case of junior liens, over time they can become first liens, at which point the risk weightings become too conservative. The commenter maintained that this reduction in risk was not accounted for under the Second Proposal.

One commenter suggested that the Board consider lower risk weightings for loans with private mortgage insurance or government guarantees.

One commenter suggested that one-to-four-family non-owner occupied real-estate-backed loans should be treated as a separate category and not count toward the premium of 75 percent risk weight when real estate loans comprise over 35 percent of assets. From a concentration risk standpoint, commercial loans are already limited by a statutory cap under the FCUA at 12.25 percent for the majority of credit unions.

Some commenters argued that the proposal would exacerbate the burden

and costs credit unions are already facing under the Dodd-Frank Act regulations by requiring higher levels of capital for those credit unions that hold first-lien residential real estate loans in excess of 35 percent of total assets. Those commenters speculated that the increased capital cost based upon concentration risk will put credit unions at a competitive disadvantage to other financial institutions that do not have higher risk weightings for holding higher concentrations of loans.

Similarly, some commenters argued that the proposal would exacerbate the burden and costs credit unions are already facing under the Dodd-Frank Act regulations by requiring higher levels of capital for those credit unions that hold junior-lien residential real estate loans in excess of 20 percent of total assets. Those commenters maintained that the increased capital cost based upon concentration risk puts credit unions at a competitive disadvantage to other financial institutions that do not have higher risk weightings for holding higher concentrations of loans.

Discussion

The Board has considered the comments received, but, as stated in the proposal, the contemporary variances between bank and credit union losses on real estate loans are not substantial enough to warrant assigning lower risk weights. As stated in the Second Proposal and as further clarified below using data to match the asset breakouts within the FDIC Quarterly Banking Profile, credit unions' real estate loss experience is comparable to community banks after adjusting for asset size.

3 YEAR AVERAGE LOSS HISTORY ¹⁴⁹

[2012, 2013, 2014]

	Credit unions >\$100M in assets	Banks \$100M to \$10B in assets	Banks \$1B to \$10B in assets
All real estate loans	0.33	0.36	0.38

¹⁴⁹ See yearend FDIC Quarterly Banking Profiles for 2012, 2013, and 2014, page 11 and NCUA

Financial Performance Report (FPR) using year end

data for credit unions with assets greater than \$100 million.

3 YEAR AVERAGE LOSS HISTORY ¹⁴⁹—Continued
[2012, 2013, 2014]

	Credit unions >\$100M in assets	Banks \$100M to \$10B in assets	Banks \$1B to \$10B in assets
Other 1–4 family residential loans .....	.....	0.30	0.37
First mortgage loans	0.24		
Home equity loans .....	.....	0.52	0.51
Other real estate loans	0.63		

Higher capital requirements for concentrations of real estate loans exist in the current rule, and completely eliminating them would be a step backwards in matching risks with minimum risk-based capital requirements. Credit unions with high real estate loan concentrations are particularly susceptible to changes in the economy and housing market.

NCUA currently reviews credit concentrations during examinations as commenters recommended. As discussed in the summary section, however, 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.¹⁵⁰

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 credit concentration risk. NCUA's OIG completed several MLRs that 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.¹⁵¹ In addition, in 2012, GAO recommended that NCUA address the credit concentration risk concerns raised by the NCUA OIG.¹⁵² The 2012 GAO report notes credit concentration risk contributed to 27 of 85 credit union

failures that occurred between January 1, 2008, and June 30, 2011. The report also indicated that the Board should revise NCUA's PCA regulation so that the minimum net worth levels required under the rule emphasize credit concentration risk. So eliminating the concentration dimension for risk weights entirely would be inconsistent with the concerns raised by GAO and the MLRs conducted by NCUA's OIG.

The proposed risk weights would not 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.

The Board agrees with commenters that credit scores, loan underwriting, portfolio seasoning, and portfolio performance are appropriate measures to evaluate a specific credit union's 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 an 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 unwieldy for NCUA to enforce minimum capital requirements.¹⁵³ 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.¹⁵⁴ Credit unions should use criteria from their own internal risk models and loan underwriting in developing their internal risk management systems.

The Board likewise 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. There is no historical data across institutions upon which to base varying risk weights according to LTVs and other underwriting criteria (such as 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.

Junior-lien residential real estate loans continue to warrant a higher risk weight based on loss history. Call Report data indicate credit unions over \$100 million in asset size reported nearly three times the rate of loan losses (0.63 percent) on other real estate loans¹⁵⁵ when compared to first mortgage real estate loans (0.24 percent) during the past three years. The final base risk weight for junior-lien residential real estate loans is comparable to the risk weight assigned by the Other Banking Agencies.¹⁵⁶

¹⁵⁰ See 12 U.S.C. 1790d(d)(2).

¹⁵¹ See NCUA, *Material Loss Review of Cal State 9 Credit Union*, OIG–10–03 (April 14, 2010); NCUA, *Material Loss Review OF Beehive Credit Union*, OIG–11–07 (July 7, 2011); and NCUA, *Material Loss Review OF Ensign Federal Credit Union*, OIG–10–15 (September 23, 2010), available at <http://www.ncua.gov/about/Leadership/CO/OIG/Pages/MaterialLossReviews.aspx>.

¹⁵² See U.S. Govt. Accountability Office, *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO–12–247 (2012), available at <http://www.gao.gov/products/GAO-12-247>.

¹⁵³ 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.")

¹⁵⁴ 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.")

¹⁵⁵ Junior-lien real estate loans are currently reported on the Call Report as part of "other real estate loans."

¹⁵⁶ See, e.g., 12 CFR 324.32(g)(2).

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.¹⁵⁷ Under the Second Proposal, a current secured consumer loan received a risk weight of 75 percent, and a current unsecured consumer loan was assigned a 100 percent risk weight.

Public Comments on the Second Proposal

One commenter claimed the risk weightings assigned to secured and unsecured consumer loans at credit unions would be more restrictive than the comparable risk weightings applicable to community banks. To remain competitive, the commenter recommended that the proposed risk weights should be changed to be more in line with Basel III instead of being more restrictive. Other commenters argued that based on the historical performance of credit unions in managing consumer loan risk, the Board should assign a 50 percent risk weight to secured consumer loans and a 75 percent risk weight to unsecured consumer loans. These commenters speculated that if the risk weights proposed for consumer loans were adopted, some credit unions would have to reduce the services they are currently able to provide to members.

Discussion

The Board disagrees with the commenter who claimed the proposed risk weight assigned to consumer loans that are current is more restrictive than the corresponding risk weight assigned to such loans for community banks. The risk weight for secured consumer loans in the Second Proposal and in this final rule is 75 percent, which is less than the 100 percent risk weight assigned to such loans held at community banks under the Other Banking Agencies' regulations. The risk weight for unsecured consumer loans that are current is identical to the corresponding risk weight for such loans held at community banks.

Comparisons of historical losses on consumer loans between credit unions and banks is difficult due to differences in Call Report data, but generally the difference in historical performance measured by loss history is not significant. Accordingly, the Board has decided to maintain the consumer loan

risk weights contained in the Second Proposal.

Non-Current Consumer Loans

The risk-based net worth measure in NCUA's current PCA regulation does not assign a higher risk weight to non-current consumer loans. Increasing levels of non-current loans, however, are an indicator of increased risk. To reflect the impaired credit quality of past-due loans, the Second Proposal required credit unions to assign a 150 percent risk weight to loans (other than real estate loans) that are 90 days or more past due, in nonaccrual status, or restructured.

Public Comments on the Second Proposal

One commenter suggested that consumer loans that are not current (90 days past due), could be assigned a 100 percent risk weight, instead of a 150 percent risk weight, given the historically low default rate of these loan types, strong underwriting and possible further protection by underlying collateral. At least one commenter maintained that with ALLL calculations already in place to account for higher charge offs, the proposed risk weight for non-current loans would be unnecessarily high and would ultimately hurt credit union members. Other commenters speculated that the proposed risk weights would force credit unions to pull back lending to low-income communities for fear of carrying delinquent (non-current) loans at elevated risk weightings.

Discussion

The proposed risk weight of 150 percent is warranted because non-current consumer loans have a higher probability of default when compared to current consumer loans. Non-current consumer loans are more likely to default because repayment is already impaired, making them one step closer to default compared to current consumer loans. As stated in the Second Proposal, the Board assigned a higher risk weight on past-due exposures to ensure sufficient regulatory capital for the increased probability of unexpected losses on these exposures, which results in a risk-based capital measure that is more responsive to changes in the credit performance of the loan portfolio. The higher risk weight will capture the risk associated with the impaired credit quality of these exposures. Moreover, the 150 percent risk weight is consistent with the risk weights used under Basel III and the Other Banking Agencies.¹⁵⁸

The Board disagrees with commenters who speculated that the proposed risk weights would limit credit unions' ability to assist low-income members. The removal of the ALLL cap will reduce the impact of non-current loans to the risk-based capital ratio.

Accordingly, this final rule retains the 150 percent risk weight for consumer loans that are not current.

Loans to CUSOs, and CUSO Investments

Under the Second Proposal, investments in CUSOs were assigned a risk weight of 150 percent and loans to CUSOs were assigned a risk weight of 100 percent.

Public Comments on the Second Proposal

Commenters generally maintained that the proposed risk weight for investments in CUSOs was too high. A majority of the commenters who mentioned it suggested that the risk weight for CUSO investments was too high and should be the same as for CUSO loans, or less. A substantial number of commenters argued that given the unique position of CUSOs as cooperative cost-saving structures in the credit union system, the Board should use its statutorily granted discretion to draw distinctions between CUSOs and private equity investments held by banks. Commenters maintained that not only must CUSOs provide NCUA with open access to their books and records, but CUSOs will be required to register directly with NCUA and, if complex, report audited financial statements and customer information.¹⁵⁹ Commenters reasoned that this heightened supervisory oversight compared to general investment exposures, combined with the limits on credit union investment powers, makes a 100 percent risk weight more appropriate. The commenters suggested further that, given the limits on credit union investment powers, the vast majority of credit unions with unconsolidated equity investments in CUSOs would fall within the "non-significant" exception under the banking regulations for investments aggregating less than 10 percent of total assets, and would receive a 100 percent risk weight. Therefore, the commenters reasoned, adjusting the CUSO investment weighting to 100 percent would better reflect the role of CUSOs in the credit union industry while still aligning in practice with treatment of similar exposures in banks.

Other commenters stated that they supported the proposed treatment of

¹⁵⁷ Per Call Report data for years ending December 31, 2012, 2013, and 2014, consumer loans were greater than 40 percent of loans in credit unions with total assets greater than \$100 million.

¹⁵⁸ See, e.g., 12 CFR 324.32(k).

¹⁵⁹ 12 CFR part 712; and 12 CFR 741.222.

consolidated CUSO investments and loans in which no separate risk weighting would apply. One commenter suggested that, if GAAP is followed for the valuation of CUSOs, the proper valuation of the asset should allow for the lowering of the risk weight from the proposed 150 percent risk weight. Several commenters contended that the 150 percent risk weight assigned to unconsolidated CUSO investments, which applies to the accumulated and undistributed earnings of these CUSOs under GAAP, is inappropriate because it would require credit unions to set aside additional capital, beyond what they initially invested, to cover retained earnings to support future growth of these CUSOs. These commenters recommended that the Board reduce the risk weight to 100 percent, or, if not lowered, to risk weight only the initial investment by the credit union and not the appreciation of that investment over time.

One commenter argued that the risk weight assigned to unconsolidated investments in CUSOs would be counter-productive. The commenter claimed that the Board presented only anecdotal and unsubstantiated references to what it considers “substantial CUSO losses” over the last decade as justification for CUSO regulations and assigning a 150 percent risk weight to CUSO investments. The commenter contended that no detailed statistics have been provided to justify these losses as substantial, and the commenter would challenge any such claim because they were not able to substantiate any losses of a significant nature through credit union investment in CUSOs over the past 10 years. The commenter recommended the Board investigate the industry benefits of CUSOs and the relatively immaterial level of CUSO investment impact on the NCUSIF before finalizing the current proposed risk weights for CUSO investments.

Other commenters suggested that assigning a 150 percent risk weight to multi-credit union owned CUSOs, which are important collaborative tools for credit unions, is not reflective of the actual systemic risk CUSOs pose. The commenters explained that, overall, based on 2014 data, federally insured credit unions in total have less than 22 basis points of their assets invested in CUSOs, including fully consolidated CUSO investments. Therefore, the commenters asserted, CUSO investments are not a systemic risk to the NCUSIF.

One commenter pointed out that the proposal stated that the risks associated with CUSOs are similar to the risks

associated with third-party vendors. However, the commenter could not find any references in the proposal that would account for the risks posed by non-CUSO third-party vendors. The commenter claimed that only CUSOs were singled out for their supposed risk, and argued that was not adequate justification for the risk weight assigned to CUSO investments.

Some commenters argued that the proposal cited FDIC’s capital regulation in saying that risk weights should be set based on the risk of loss and not the size of exposure. Those commenters suggested, however, that FDIC agrees that non-significant investment exposures in unconsolidated equity of a privately held company should be risk weighted at 100 percent. The commenters recommended the Board look deeper into the FDIC definition of “non-significant” and how it translates to unconsolidated CUSO investments. In the commenters’ opinion, the statutory and regulatory structure of CUSO investments make such investments non-significant using the FDIC definition, and thereby should be assigned only a 100 percent risk weight.

One commenter suggested that investments in CUSOs should carry a 100 percent risk weighting based on the following risk-mitigating factors: (1) GAAP requires credit unions to evaluate the asset for potential impairment; (2) the majority of CUSOs are limited liability corporations (LLCs) and the credit union would be protected under the LLC structure; and (3) the stated purpose of NCUA’s CUSO rule is to reduce risk exposure to credit unions. Another commenter suggested that investments in and loans to CUSOs should be equally risk weighted. The commenter recommended assigning a 75 percent risk weight due to the expertise that is brought to the business strategy within the relevant business model that they are operating within and to encourage the use of the cooperative business model. Other commenters suggested that CUSOs should be risk weighted based on type: Operational CUSOs should receive a 50 percent risk weight, fee-generating CUSOs should receive a zero percent risk weight, and start-up CUSOs should receive a 100 percent risk weight.

Several commenters suggested that instead of assuming that all CUSOs are inherently risky, the proposal should be primarily concerned with the riskiness of the services provided by a CUSO and how dependent a credit union is on CUSO investments. One commenter suggested that in order to minimize the impacts of the proposal, CUSOs would be required to give excess earnings back

to the credit unions to reduce their CUSO exposure. This would result in reduced services for the credit union.

Discussion

The Board has carefully considered the comments received. As discussed in more detail below in the part of this preamble associated with § 702.104(c)(3)(i), under this final rule a credit union’s investments in CUSOs will receive a 100 percent risk weight if the credit union has non-significant equity exposures.¹⁶⁰

The Board relied 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 100 percent risk weight if its equity exposures are non-significant or a 150 percent risk weight if its equity exposures are significant, 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 to many credit unions. However, an equity investment in a CUSO is an unsecured, at-risk equity investment in a 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. The position can grow in proportion to assets over time. In setting capital standards (such as Basel and FDIC), the risk of loss—not the size of the

¹⁶⁰ A credit union has “non-significant equity exposures” if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union’s capital elements of the risk-based capital ratio numerator.

exposure—is central to determining the risk weight. 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.¹⁶¹

The Second Proposal noted that the risk weight should be higher than 100 percent given that an 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. 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. It may be possible, however, to make more meaningful risk distinctions in the future between the risk various types of CUSOs pose once NCUA's CUSO registry is in place and sufficient trend information has been collected.

Under the Second 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.¹⁶² 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. Under the Other Banking Agencies' regulations, an equity investment in a CUSO would be treated the same as an equity investment in a non-publicly traded entity (with 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 believes that a

simplified lower-risk-weight approach is appropriate when the entire amount of equity exposures within the credit union are not significant.

Accordingly, this final rule retains the proposed 100 percent risk weight assigned to loans to CUSOs, and retains the 150 percent risk weight assigned to investments in CUSOs if the equity exposure is significant. As discussed in more detail below, however, this final rule reduces the risk weight assigned to investments in CUSOs to 100 percent for complex credit unions with non-significant equity exposures.

Mortgage Servicing Assets (MSAs)

The Second Proposal would have assigned a 250 percent risk weight to MSAs to address the complexity and volatility of these assets.

Public Comments on the Second Proposal

A significant number of commenters maintained that the 250 percent risk-weight assigned to MSAs would reduce the ability of credit unions to grant mortgage loans, engage in loan participations, and retain servicing of their member loans, and that it would likely also prevent credit unions from using mortgage servicing rights as a hedge against future rate changes. Accordingly, they argued the proposed risk weighting for MSAs, which would be the same as for banks, would be too high and should be significantly lower. One commenter suggested that, because much of the risk associated with holding MSAs relates to the volatility of their market value with changes in interest rates, credit unions that book MSAs at, or close to, their current market value are at a greater risk of loss in a falling interest rate scenario. One commenter suggested further that those institutions that book MSAs more conservatively have a built-in book-to-market value cushion to absorb normal downward fluctuations in market value and are in a better position to recapture their investment over a shorter period of time. The commenter stated that in a rising-rate environment, the value of MSAs and the corresponding cushion grow and the risk declines. Consequently, the commenter contended, a flat 250 percent in all circumstances would be punitive for those credit unions that conservatively book MSAs, particularly in a low-interest-rate or low-refinance environment. The commenter maintained that it is important to note that the operational risks associated with MSAs are not avoided by holding originated mortgage loans in portfolio, yet the risk weights of portfolio

mortgage loans varies from 50 percent to 75 percent, despite the fact that such assets are burdened with a multitude of other risks not inherent in MSAs.

One commenter observed that for sound asset, liability, and liquidity management purposes, some credit unions sell nearly all of their mortgage loan production into the secondary market and retain a sizable portion of the servicing rights for member service and risk mitigation purposes, the latter in terms of the stability of earnings from the aggregate of mortgage-related activities over time. The commenter maintained that these credit unions' MSA-portfolio market values are evaluated independently each quarter, with the market value consistently representing more than the stated book values, representing sizable off-balance sheet assets. The commenter recommended that the risk weight for MSAs be based on a reasonable formula related to the ratio of book value to market value and in any case not exceed a 75 percent risk weight.

Several commenters argued that MSAs are salable and, consistent with GAAP, they are evaluated for potential impairment. Accordingly, they argued MSAs should be assigned a risk weight of 100 percent. One commenter suggested that the risk weight for MSAs should be no more than 150 percent. Another commenter suggested that MSAs should be assigned the same risk weight that is assigned to mortgage loans held in portfolio and that are under 35 percent of assets. At least one commenter recommended that, if a 250 percent risk weight is adopted for MSAs, a lower risk weight of 100 percent should be assigned to MSAs on loans sold without recourse, but that are serviced by the credit union.

Other commenters suggested that if a credit union is following GAAP, it must record mortgage servicing as an asset that then requires a valuation be done every year, and if as an asset it does not meet the actual valuation reflected it must be written down to the audited value.

One commenter argued that weighting MSAs at 250 percent would penalize those credit unions who lowered their interest rate risk on their balance sheet by selling their longer-term, fixed-rate real estate loans. Another commenter suggested that the 250 percent risk weight would pressure credit unions to sell the servicing rights on mortgages they originate, effectively forcing credit unions to end a significant member relationship many credit unions have with their members, in order to manage interest rate risk.

¹⁶¹ 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.

¹⁶² See, e.g., 12 CFR 324.52.

One commenter claimed that MSAs only have two significant risks associated with them: (1) Prepayment penalties, and (2) operational/reputational risk. Both risks, the commenter suggested, are relatively easily mitigated because prepayment risk can be mitigated by maintaining a viable origination pipeline, and operational/reputational risk can be mitigated by maintaining a good system of internal controls. Moreover, the commenter argued MSAs provide a significant, reliable source of fee revenue for many credit unions, which is generated from fees that are paid by investors, not by members.

Discussion

The 250 percent risk weight factors in the relatively greater risks inherent in MSAs, and maintains comparability with the risk weight assigned to these assets by the Other Banking Agencies.¹⁶³ As noted in the preamble to the Second Proposal, MSAs typically lose value when interest rates fall and borrowers refinance or prepay their mortgage loans, leading to earnings volatility and erosion of capital. 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 agrees with commenters that MSAs may provide some hedge against falling rates under certain circumstances, 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, the commenters' argument is no longer directly applicable.

NCUA does not agree with commenters who speculated that the proposed 250 percent risk weight assigned to this relatively small asset class would significantly dis-incentivize 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 stringent) risk weights for MSAs for some time and continue to sell loans and retain MSAs.

The January 1, 2019 effective date for this final rule provides credit unions more than three years to adjust to these new requirements and provides credit unions with a phase-in period comparable to that given to banks following a similar change to the Other Banking Agencies' capital regulations.¹⁶⁴

Other On-Balance Sheet Assets

The Second Proposal assigned specific risk weights to additional asset classes, which are discussed in more detail below. Under the proposal, all assets listed on the statement of financial condition not specifically assigned a risk weight under proposed § 702.104 were assigned a 100 percent risk weight.¹⁶⁵

Public Comments on the Second Proposal

The Board received several comments regarding the proposed risk weights for other on-balance sheet assets.

Some commenters opposed the Second Proposal's risk weighting of 20 percent for share-secured loan balances and member business (commercial) loans secured by compensating balances. By contrast, the commenters observed the comparable risk weight for community banks is zero percent if the cash is on deposit in the bank, which is appropriate given there is no risk. Thus, the commenters recommended that loan balances secured by shares or compensating balances on deposit at the originating credit union be reduced to a zero percent weighting, and loan balances secured by compensating balances on deposit at another financial institution be weighted at the proposed 20 percent.

One commenter agreed that the Board's efforts to align the risk-based capital regulation more closely with the Other Banking Agencies' regulations were appropriate. The commenter suggested that, absent a compelling rationale for different treatment between the two systems, regulators should strive to maintain equal treatment for equal risks in all depository institutions. The commenter also recommended that principal-only STRIPS be risk-weighted based on the underlying guarantor or collateral.

Some commenters suggested that imposing risk-based capital limitations on charitable donation accounts would contravene the appeal for credit unions

to put money into these investments to fund charitable activities. Those commenters recommended that the Board amend the final rule to do one of the following: (1) Exempt CDAs from the risk-based capital regulation because the Board effectively balanced safety and soundness with effectuating credit unions' charitable intent when it passed the CDA regulation; (2) Assign a 100 percent risk weight to any equity or corporate bond exposure in a CDA investment; (3) Apply a 100 percent risk weight to non-significant equity exposures because banks are permitted to apply a 100 percent risk weight to certain equity exposures deemed non-significant. Those commenters suggested that such treatment would support broader participation by credit unions with community development investments and enhance the goodwill and reputation of the credit union industry as it builds an investment resource to support charitable contributions.

One commenter maintained that the Second Proposal would require a credit union to reduce its capital (in the numerator) by the amount of the underfunded portion of the pension plan, but was silent on how to reflect an overfunded pension asset. The commenter recommended that NCUA provide specific guidance on the treatment of an overfunded pension asset. Specifically, the commenter recommended the Board eliminate the inconsistent treatment by removing the overfunded pension asset from both the numerator and the denominator.

A state supervisory authority commenter requested clarification on the risk weighting treatment of credit union deposits in the Bank of North Dakota. The commenter noted that the Bank is state-owned, and its deposits are neither federally nor privately insured, but are backed by a guarantee from the State of North Dakota. The commenter acknowledged it is a unique institution, and thus was unsure which risk weighting would apply to the deposits. The commenter suggested the deposits are low risk due to the guarantee by the state, and recommended it be afforded a 20 percent or lower weighting.

At least one commenter recommend that the Board define auto and credit card servicing assets and assign them risk weights consistent with the risk weighting assigned to mortgage servicing assets.

One commenter contended that the "full look-through" approach described under the Second Proposal failed to apply risk weights to mutual fund investments in a consistent manner to the holding of the same securities by

¹⁶⁴ See, e.g., 12 CFR 324.1(f).

¹⁶⁵ This is comparable to the Other Banking Agencies' capital rules, which maintained the 100 percent risk weight for assets not assigned to a risk weight category. See, e.g., 12 CFR 324.32; and 78 FR 55339 (Sept. 10, 2013).

¹⁶³ See, e.g., 12 CFR 324.32(l)(4)(i).

credit unions directly. The commenter explained that, for example, a credit union that holds "U.S. Treasuries and Government Securities" would assign a risk weight of zero percent to such holdings. By contrast, an investment fund, with similar U.S. Treasuries and Government Securities, would have a risk weight of 20 percent assigned to this asset. The commenter suggested this disparity in the treatment of the same asset when held by two different entities unnecessarily discriminates against a credit union's investments in mutual funds by penalizing the credit union for making the same investment indirectly that they could otherwise make directly. The commenter suggested further that the added layer of risk that the Second Proposal assumed will be present for indirect investments is not a factor with mutual funds, because they provide daily redemption at net asset value and generally provide sold share proceeds to the investor on the next business day. The commenter recommended that the Board revise the rule so that mutual fund risk weights are consistent with the risk weights on the underlying instruments. The commenter also recommended that the Board adopt a full look-through approach that is attuned to the distinctions between underlying assets that would allow low-risk mutual funds to carry risk ratios ranging between zero percent and 20 percent based upon the actual risk ratio of their holdings.

One commenter suggested that the proposal was silent on how to risk weight loans held for sale, and recommended the Board assign a risk weight of 25 percent to loans held for sale.

At least one commenter suggested that, under the Second Proposal, current non-federally insured student loans would be assigned a 100 percent risk weight, despite other potential sources of insurance. The commenter asked whether there should be a distinction, at least for insured private student loans, and whether insured private student loans should be assigned a 50 percent risk weight and uninsured private student loans at 100 percent. The commenter suggested that, at some credit unions, private student loans are not only insured by an independent insurance company, but reinsured with three separate carriers. In such a situation, the commenter suggested that a 100 percent risk weighting seemed excessive.

Discussion

The Board generally agrees with the commenter who suggested that principal-only mortgage-backed-security

STRIPS should be risk weighted based on the underlying collateral, which would more closely align NCUA's regulations with the Other Banking Agencies' rules. Principal-only mortgage-backed-security STRIPS are purchased at a discount to par, and par is paid to the investor over the life of the bond. As with other mortgage-backed securities, the timing of the repayment of par is the primary risk when credit risk is not considered. Absent credit risk, the investor receives par. This is not the case with interest-only mortgage-backed-security STRIPS, where an investor can receive less than the amount paid even without a credit event. Accordingly, this final rule assigns non-subordinated principal-only mortgage-backed-security STRIPS a risk weight based on the underlying collateral.

The Board also agrees with commenters who suggested the risk weight for certain accounts used for charitable purposes should be aligned with the 100 percent risk weight assigned to community development investments under the Other Banking Agencies' regulations. Charitable donation accounts are limited to 5 percent of net worth, which limits the risks of such accounts to the Share Insurance Fund. In addition, charitable donation accounts are required to be transparent segregated accounts, which enables NCUA to ensure that such accounts comply with applicable laws through supervision. As explained above and in more detail below, this final rule would permit credit unions to assign a 100 percent risk weight to CDAs.

The Board disagrees with the commenter who recommended removing overfunded pension assets from both the numerator and denominator. Under the Second Proposal, overfunded pension assets were not included in the risk-based capital ratio numerator or denominator, primarily because they are not disclosed on the financial statement as an asset, so there is no need to remove them from the calculation. Overfunded pension assets were excluded completely from the proposed risk-based capital calculation, and their inclusion in the final rule would add only needless complexity and could create volatility in the risk-based capital ratio.

The Board disagrees with the commenter who suggested that any investment fund holding assets that are assigned a zero percent risk weight should receive a zero percent risk weight. As discussed in the Second Proposal, assets assigned a zero percent risk weight that are held in an

investment fund are considered indirect obligations. The risk weight assigned to an investment fund that holds zero percent risk-weighted assets is 20 percent even though the underlying investments consist of zero risk-weighted assets due to the investment's structure as an investment fund. This is consistent with the Other Banking Agencies' regulations.

The Board agrees with the commenter who suggested that the final rule should clarify the timing of holding reports used for the full look-through approach. As explained in more detail below, new appendix A to part 702 now clarifies which holding report should be used for the full look-through approach.

The Board has decided to reduce the risk weight in the final rule for share-secured loans, where the shares securing the loan are on deposit at the credit union, to zero percent since the risk of loss is more a function of operational risk than credit risk. The Board maintained the 20 percent risk weight for share-secured loans where the collateral deposit is at another depository institution due to the added credit risk of the depository institution. The resulting risk weights for share-secured loans are more consistent with the Other Banking Agencies' related risk weights.

Loan servicing assets associated with credit card loans or auto loans are different than loan servicing assets associated with mortgages because of the much shorter duration of the associated cash flows. Since shorter-term assets are individually assigned a risk weight, they default to the 100 percent risk weight assigned to all other assets, which is a reasonable risk weight based on the general credit quality associated with the underlying consumer loans. The 100 percent risk weight is appropriate for this class of assets because the difference between the book balance of some particular fixed assets and the value of the assets in the event of liquidation can be substantial. For example, in an area that has experienced a decline in the value of real estate, the book value of a fairly recently constructed credit union headquarters could be well below the fair value. 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 is appropriate when considering that most assets in this group are predominately non-earning assets which can hinder a credit union's ability to increase capital. Further, the proposed risk weights match the risk weights in

the Other Banking Agencies' capital regulations.¹⁶⁶

This final rule 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. 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. Accordingly, consistent with the Second Proposal, this final rule assigns loans held for sale a risk weight based on the loan's type.

Non-federally guaranteed student loans are appropriately classified under current consumer loans due to the higher risks (default risk and extension risk) associated with this product.

104(c)(2)(i) Category 1—Zero Percent Risk Weight

Proposed § 702.104(c)(2)(i) provided 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.

For the reasons explained above, the Board decided to remove the proposed language excluding directly and unconditionally guaranteed principal-only mortgage-backed-security STRIPS that were an obligation of the U.S. Government, its central bank, or a U.S. Government agency. The final rule also adds the word "security" after the word "mortgage-backed" for clarity and consistently.

In addition, the Board decided to lower the risk weight for share-secured loans, where the shares securing the loan are on deposit with the credit

union, to zero percent. Assigning a zero percent risk weight to share-secured loans under such circumstances is consistent with the risk weight assigned to such loans under the Other Banking Agencies.

Accordingly, § 702.104(c)(2)(i) of this final rule provides 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.
 - Share-secured loans, where the shares securing the loan are on deposit with the credit union.
- 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 interest-only mortgage-backed-security STRIPS.

- Federal Reserve Bank stock and Central Liquidity Facility stock.

- Insured balances due from FDIC-insured depositories or federally insured credit unions.

104(c)(2)(ii) Category 2—20 Percent Risk Weight

Proposed § 702.104(c)(2)(ii) provided 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.¹⁶⁷

- 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.

¹⁶⁷ This would include the NCUA Guaranteed Notes (NGNs), which are an obligation of the NCUA and are backed by the full faith and credit of the United States.

- The portions of outstanding loans with a government guarantee.
- The portions of commercial loans secured with contractual compensating balances.

For the reasons explained above, the Board has decided to remove the proposed language excluding conditionally guaranteed principal-only mortgage-backed-security STRIPS that were an obligation of the U.S. Government, its central bank, or a U.S. Government agency. In addition, the Board decided to add the word "security" after the word "mortgage-backed" for clarity and consistently. The Board also decided to revise the language regarding investment funds to clarify that the 20 percent risk weight includes only investment funds with portfolios permitted to hold only investments that are authorized under 12 CFR 703.14(c).

Accordingly, § 702.104(c)(2)(ii) of this final rule provides 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 interest-only mortgage-backed-security STRIPS.

- A non-subordinated obligation of a GSE other than an equity exposure or preferred stock, excluding interest only GSE mortgage-backed-security STRIPS.

- Securities issued by PSEs that represent general obligation securities.

- Part 703 compliant investment funds that are restricted to holding only investments that qualify for a zero or 20 percent risk weight under § 702.104.

- Federal Home Loan Bank stock.

- The balances due from Federal Home Loan Banks.

- The balance of share-secured loans, where the shares securing the loan are on deposit with another depository institution.

- The portions of outstanding loans with a government guarantee.

- The portions of commercial loans secured with contractual compensating balances.

104(c)(2)(iii) Category 3—50 Percent Risk Weight

Proposed § 702.104(c)(2)(iii) provided 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

¹⁶⁶ See, e.g., 12 CFR 324.32(l).

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.

For the reasons explained above, the Board has decided to remove the proposed language excluding conditionally guaranteed principal-only mortgage-backed-security STRIPS that were non-subordinated, non-U.S. Government agency or non-GSE guaranteed residential mortgage-backed securities. In addition, the Board decided to add the word “mortgage-backed-security” before the word “STRIPS” for clarity and consistency.

Accordingly, § 702.104(c)(2)(iii) of this final rule provides 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 securities, excluding interest-only mortgage-backed-security STRIPS.

104(c)(2)(iv) Category 4—75 Percent Risk Weight

Proposed § 702.104(c)(2)(iv) provided 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.

For the reasons explained above, the Board has decided to retain this proposed section in the final rule without change.

104(c)(2)(v) Category 5—100 Percent Risk Weight

Proposed § 702.104(c)(2)(v) provided 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.
 - Interest-only mortgage-backed-security STRIPS.
 - Part 703 compliant investment funds, with the option to use the look-through approaches in § 702.104(c)(3)(iii)(B) of this section.

- Corporate debentures and commercial paper.
 - Nonperpetual capital at corporate credit unions.¹⁶⁸
 - General account permanent insurance.
 - GSE equity exposure or preferred stock.
 - Non-subordinated tranches of any investment, with the option to use the gross-up approach in paragraph (c)(3)(iii)(A) of this section.
 - All other assets listed on the statement of financial condition not specifically assigned a different risk weight under this subpart.
- As discussed in more detail below, however, this final rule reduces the risk weight assigned to CUSO investments, corporate perpetual capital, and other equity investments to 100 percent for complex credit unions with non-significant equity exposures.¹⁶⁹

- Corporate debentures and commercial paper.
- Nonperpetual capital at corporate credit unions.¹⁶⁸
- General account permanent insurance.
- GSE equity exposure or preferred stock.
- Non-subordinated tranches of any investment, with the option to use the gross-up approach in paragraph (c)(3)(iii)(A) of this section.
 - All other assets listed on the statement of financial condition not specifically assigned a different risk weight under this subpart.

As discussed in more detail below, however, this final rule reduces the risk weight assigned to CUSO investments, corporate perpetual capital, and other equity investments to 100 percent for complex credit unions with non-significant equity exposures.¹⁶⁹

104(c)(2)(vi) Category 6—150 Percent Risk Weight

Proposed § 702.104(c)(2)(vi) provided 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.¹⁷⁰
 - Equity investments in CUSOs.¹⁷¹

As discussed in more detail below, however, this final rule reduces the risk weight assigned to CUSO investments, and corporate perpetual capital, to 100 percent for complex credit unions with

¹⁶⁸ Subject to non-significant equity exposure risk-weight under § 702.104(c)(3)(i).

¹⁶⁹ A credit union has “non-significant equity exposures” if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union’s capital elements of the risk-based capital ratio numerator.

¹⁷⁰ Subject to the lower 100 percent non-significant equity exposure risk-weight under § 702.104(c)(3)(i).

¹⁷¹ Subject to the lower 100 percent non-significant equity exposure risk-weight under § 702.104(c)(3)(i).

non-significant equity exposures.¹⁷² For the reasons explained above, the Board has decided to retain this proposed section in the final rule without change.

104(c)(2)(vii) Category 7—250 Percent Risk Weight

Proposed § 702.104(c)(2)(vii) provided that a credit union must assign a 250 percent risk weight to the carrying value of mortgage servicing assets (MSAs) held on-balance sheet.

For the reasons explained above, the Board has decided to retain this proposed section in the final rule without change.

104(c)(2)(viii) Category 8—300 Percent Risk Weight

Proposed § 702.104(c)(2)(viii) provided 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).

For the reasons explained above, the Board has decided to retain this proposed section in the final rule with only minor conforming changes.

Accordingly, § 702.104(c)(2)(viii) of this final rule provides 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.¹⁷³
- Investment funds that do not meet the requirements under 12 CFR 703.14(c), with the option to use the look-through approaches in § 702.104(c)(3)(iii)(B).
- Separate account insurance, with the option to use the look-through approaches in § 702.104(c)(3)(iii)(B).

104(c)(2)(ix) Category 9—400 Percent Risk Weight

Proposed § 702.104(c)(2)(ix) provided 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.

For the reasons discussed above, the Board has decided to retain this proposed section in the final rule without change.¹⁷⁴

104(c)(2)(x) Category 10—1,250 Percent Risk Weight

Proposed § 702.104(c)(2)(x) provided 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).¹⁷⁵

For the reasons discussed above and in additional detail below, the Board has decided to retain this proposed section in the final rule with only minor conforming changes to the cross citations.

104(c)(3) Alternative Risk Weights for Certain On-Balance Sheet Assets

Proposed § 702.104(c)(3) provided 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. These alternative approaches provide a credit union with the ability to risk weight certain assets based on the underlying exposure of the subordinated tranche or investment fund without exposing the NCUSIF to additional risk.

Other than the comments already discussed above, the Board received few comments on this section of the proposal and has decided to retain the proposed gross-up approach and look-through approaches in this final rule with only minor changes, which are discussed in more detail below. In addition, this final rule restructures proposed § 702.104(c)(3).

As explained in more detail below, this final rule restructures the provisions in § 702.104(c)(3) to renumber the gross-up and look-through approaches and add in alternative risk-weighting methodologies for non-significant equity exposures and certain types of charitable donation accounts. These changes are in response to public comments received on the Second Proposal and, as explained below,

¹⁷⁴ Subject to lower 100 percent non-significant equity exposure risk-weight under § 702.104(c)(3)(i).

¹⁷⁵ 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.

would only lower the risk weights assigned to certain on-balance sheet assets under certain circumstances.

104(c)(3)(i) Non-Significant Equity Exposures

Under the Other Banking Agencies' capital regulations, banks are permitted to assign a 100 percent risk weight to equity exposures when the aggregate amount of the exposures does not exceed 10 percent of the bank's total capital. The Board did not include a similar approach in the Second Proposal because it would have added significant complexity to the rule. As previously discussed, however, a significant number of commenters requested that NCUA's risk-based capital requirement include an alternative risk-weighting methodology, similar to that provided under the Other Banking Agencies' capital regulations, for non-significant equity exposures at credit unions.

Applying a 100 percent risk weight to an equity exposure, provided the exposure does not exceed 10 percent of the sum of the credit union's capital elements of the risk-based capital ratio numerator, will provide relief to certain credit unions holding limited amounts of higher-risk equity assets on their books. Such an approach is generally consistent with the Other Banking Agencies' regulations and will not increase risk weights for any equity exposures held by credit unions.

Accordingly, this final rule adds the following provisions assigning alternative risk weights to non-significant equity exposures.

104(c)(3)(i)(A) General

Section 702.104(c)(3)(i)(A) of this final rule provides that notwithstanding the risk weights assigned in § 702.104(c)(2), a credit union must assign a 100 percent risk weight to non-significant equity exposures.

104(c)(3)(i)(B) Determination of Non-Significant Equity Exposures

Section 702.104(c)(3)(i)(B) of this final rule provides that a credit union has non-significant equity exposures if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union's capital elements of the risk-based capital ratio numerator (as defined under paragraph § 702.104(b)(1)).

104(c)(3)(i)(C) Determination of the Aggregate Amount of Equity Exposures

As discussed above, § 702.104(c)(3)(i)(C) of this final rule provides that when determining the aggregate amount of its equity exposures, a credit union must include

¹⁷² A credit union has "non-significant equity exposures" if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union's capital elements of the risk-based capital ratio numerator.

¹⁷³ Subject to the lower 100 percent non-significant equity exposure risk-weight under § 702.104(c)(3)(i).

the total amounts (as recorded on the statement of financial condition in accordance with GAAP) of the following:

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

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

104(c)(3)(ii) Charitable Donation Accounts

Under the Other Banking Agencies' capital regulations, banks are permitted to apply a 100 percent risk weight to equity exposures that qualify as community development investments. The Board did not include a similar approach in the Second Proposal because credit unions do not hold community development investments in the same manner banks do. As previously discussed, however, a significant number of commenters requested that NCUA's risk-based capital requirement include an alternative risk-weighting methodology, similar to that provided under the Other

Banking Agencies' capital regulations, for charitable donation accounts.

The Board believes charitable donation accounts held at credit unions are similar enough in purpose to community development investments held at banks to warrant a 100 percent risk weight. Under this final rule, a credit union can choose whether to apply the 100 percent risk weight because the account may be entitled to a lower risk weight based on the investments held in the account. As explained in the definitions part of the preamble, the 100 percent risk weight would apply only to accounts that meet the definition of a "charitable donation account" and the criteria provided therein. These limits are prudent and provide credit unions the option of applying the 100 percent risk weight, if they choose.

Accordingly, this final rule revises § 702.104(c)(3)(ii) to provide that notwithstanding the risk weights assigned in § 702.104(c)(2), a credit union may assign a 100 percent risk weight to a charitable donation account.

104(c)(3)(iii) Alternative Approaches

As discussed above, this final rule reorganizes § 702.104(c)(3) and moves proposed §§ 702.104(c)(3)(i) and (ii) under § 702.104(c)(3)(iii) with only non-substantive conforming changes. Instead of citing to FDIC's regulations, this final rule incorporates the text explaining how to apply the gross up approach¹⁷⁶ and the look through approaches¹⁷⁷ into appendix A to part 702 of NCUA's regulations. As discussed below, to incorporate the full text of §§ 324.43(e) and 324.53 into NCUA's regulations, the Board made some minor conforming changes to the language and numbering used in the section. Other than the changes discussed above, no substantive changes are intended by these revisions.

Accordingly, § 702.104(c)(3)(iii) of this final rule provides that, notwithstanding the risk weights

assigned in paragraph (c)(2) of this section, a credit union may determine the risk weight of investment funds, and non-subordinated or subordinated tranches of any investment as provided below.

104(c)(3)(iii)(A) Gross-Up Approach

Proposed § 702.104(c)(3)(i) provided 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. When calculating the risk weight for a subordinated tranche of any investment using the proposed gross-up approach, a credit union must have the following information:

- The exposure amount of the subordinated tranche;
- The current outstanding par value of the credit union's subordinated tranche;
- The current outstanding par value of the total amount of the entire tranche where the credit union has exposure;
- The current outstanding par value of the more senior positions in the securitization that are supported by the subordinate tranche the credit union owns; 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:¹⁷⁸

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
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%

¹⁷⁶ 12 CFR 324.43(e).
¹⁷⁷ 12 CFR 324.53.

¹⁷⁸ More simple terminology than the FDIC rule language is used to make this example easier to follow.

		Calculation	Result
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 million. Conversely, under the 1,250 percent risk weight approach, the credit union would be required to risk weight the subordinated tranche at \$50 million (1,250 percent times \$4 million). This example shows the benefit to credit unions of the proposed inclusion of the gross-up approach.

In the case of master trust¹⁷⁹ type structures and structured products,¹⁸⁰ credit unions should calculate the pro-rata share of the more senior positions using the prospectus and current servicing/reference pool reports.

The Board received few comments objecting to allowing credit unions to use the gross-up approach, and has decided to retain the option of using the gross-up approach in this final rule. The final rule, however, incorporates the text of § 324.43(e) into NCUA's regulations instead of simply citing to FDIC's regulations. As discussed above, this final rule also would permit credit unions to use the gross-up approach to

¹⁷⁹ 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.

¹⁸⁰ Structured products may allocate losses based on other securities or a reference pool. The credit union should calculate the pro-rata senior tranche based on the amount the subordinated tranche would support if it were an actual tranching security.

risk-weight a non-subordinated tranche of any investment.

Accordingly, § 702.104(c)(3)(iii)(A) of this final rule provides that a credit union may use the gross-up approach under appendix A of this part to determine the risk weight of the carrying value of non-subordinated or subordinated tranches of any investment.

104(c)(3)(iii)(B) Look-Through Approaches

Proposed § 702.104(c)(3)(ii) provided 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. In particular, for purposes of applying risk weights to investment funds, the Board proposed giving 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 included these alternative approaches to make NCUA's risk-based capital requirement more comparable to the Other Banking Agencies' regulations and to grant credit unions additional flexibility.

The first of the three full look-through approaches under 12 CFR 324.53

required 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 required a credit union to use the information provided in the investment fund's prospectus. The minimum risk weight for any investment fund asset was 20 percent, regardless of which approach was used.

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.¹⁸¹

The following examples outline each of the three proposed look-through approaches:

Full look-through approach. The full look-through approach allowed 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 were required to use the most recently available holdings reports when utilizing the full look-through approach.

¹⁸¹ 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.

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 ¹⁸²	Risk weight %	Dollar risk weight
US Treasury Notes	50	\$5,000,000	20 ¹⁸³	\$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 ¹⁸⁴	2.5	250,000	1,250	3,125,000
Totals .....	.....	10,000,000	56 ¹⁸⁵ (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 allowed 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 follows:

CREDIT UNION INVESTMENT: \$10,000,000

Permissible investments	Fund limits (% of fund)	Risk weight
US Treasury Notes	100	186 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	187 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 allowed 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
US Treasury Notes	100	20 ¹⁸⁸	\$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	1,250 ¹⁸⁹	1,000,000	12,500,000
Total .....	.....	158 ¹⁹⁰ (weighted average risk weight).	10,000,000	15,800,000 (Amount of Risk Assets)

¹⁸² Fund holdings (percent of fund) multiplied by the credit union investment.

¹⁸³ Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

¹⁸⁴ Use 1,250 percent risk weight or gross-up calculation.

¹⁸⁵ 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).

¹⁸⁶ Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

¹⁸⁷ Use 1,250 percent risk weight unless the prospectus limits gross-up risk weight.

¹⁸⁸ Minimum 20 percent risk weight for assets in an investment fund, even if the individual risk weight is zero percent.

¹⁸⁹ Use 1,250 percent risk weight unless the prospectus limits gross-up risk weights.

¹⁹⁰ The weighted average risk weight was calculated by dividing the amount of risk assets (\$15,800,000) by the credit union exposure (\$10,000,000).

Using the example above, the investment fund would have a weighted average risk weight of 158 percent using the alternative modified look-through approach. In this case, the credit union would most likely use a 100 percent standard risk weight for part 703 compliant investment funds or the alternative modified look-through approach for risk weights for investment funds that are not compliant with part 703.

Public Comments on the Second Proposal

The Board received a few comments relating to the proposed use of the look-through approaches. Most of these comments were addressed above. At least one commenter, however, suggested that the Board clarify that the timing of the most recent available holding reports are to be used by credit unions applying the full look-through approach.

Discussion

The Board received no comments objecting to allowing credit unions to use the look-through approaches, and has decided to retain the option of using the gross-up approach in this final rule. The final rule incorporates the relevant text of § 324.53 into NCUA's regulations instead of simply citing to FDIC's regulations and makes other minor conforming edits. In response to the comments received, the Board has also added language in paragraph (b)(2)(ii) of appendix A below to clarify which holding reports should be used when calculating a risk-weight using the full-look-through approach. The methodology for applying the look-through approaches is added to new appendix A to part 702, which is discussed in more detail below.

Accordingly, § 702.104(c)(3)(iii)(B) provides that a credit union may use one of the look-through approaches under appendix A part 702 to determine the risk weight of the exposure amount of any investment funds, the holdings of separate account insurance, or both.

104(c)(4) Risk Weights for Off-Balance-Sheet Activities

Under the Second Proposal, § 702.104(c)(4) provided 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.

Public Comments on the Second Proposal

The Board received several comments regarding the proposed risk weights assigned to off-balance-sheet items. At least one commenter agreed with requiring capital for most off-balance-sheet activities. But the commenter suggested that credit unions should not be required to hold capital for off-balance-sheet exposures that are unconditionally cancellable (without cause), especially if the exposure is for less than one year. The commenter recommended that the Board adopt a more bank-like off-balance-sheet risk-based capital regime for such exposures. Another commenter stated that the proposal identifies the use of a 10 percent credit conversion factor for all noncommercial unused lines of credit, but noted that community banks utilize various credit conversion factors ranging from zero percent to 50 percent depending on whether the commitment is unconditionally cancellable (zero percent), conditionally cancellable within one year (20 percent), or conditionally cancellable beyond one year (50 percent). The commenter suggested that the design and inclusion of cancellation language in lending contracts is to mitigate the overall potential risk associated with unfunded amounts, and the type and extent of the specific language helps outline the extent and timeframe of the risk

associated within each lending contract. As such, the commenter recommended that the credit conversion factors utilized by the community banks be adopted by NCUA to help ensure that the inherent risk embedded within specific cancellation language in lending contracts be accurately identified and risk weighted.

At least one commenter recommended that the Board lower the credit conversion factor for unfunded consumer loans. Other commenters recommended unfunded, unconditionally cancellable commitments should be risk weighted at zero percent.

Some commenters noted that under the proposal, the Board differentiates between partial recourse loans executed under the Federal Home Loan Banks' Mortgage Partnership Finance (MPF) Program and all other partial recourse lending programs. Commenters suggested that, although the MPF program loans enjoy a lower 20 percent credit conversion factor (CCF) compared to the 100 percent CCF applied to other partial recourse loans, credit unions that hold a contractual exposure amount that is less than 20 percent of the outstanding loan balance will have to hold more capital for MPF loans than for other partial recourse arrangements. For example, a \$100,000 loan sold with a 3 percent contractual exposure would have an off-balance-sheet value of \$3,000 if it were a normal recourse loan and \$20,000 if it were an MPF loan.¹⁹¹ Since MPF loans include a fixed contractual exposure amount, the commenter suggested there does not appear to be a strong justification for differentiating this loan program from other partial recourse loan arrangements. Even though this adjusted calculation may track historical losses in the MPF program more closely, commenters suggested that the Board consider whether it is appropriate to incorporate individualized risk weights for specific counterparties.

One commenter suggested that the proposed treatment of the MPF Program does not address the complexity and risks associated with the program, and would prevent credit unions from selling loans in the secondary market that have no recourse at all and therefore pose no risk to the credit union. Under the Second Proposal, the capital requirement (after a credit

¹⁹¹ The MPF program takes the outstanding loan balance multiplied by a 20 percent CCF (100,000 * .20 = 20,000), while other partial recourse loans take the maximum contractual exposure multiplied by a 100 percent CCF (3,000 * 1 = 3,000). Both loans would be subject to a 50 percent risk-weight as a first-lien residential real estate loan.

conversion factor) is derived from the total outstanding principal balance of all loans sold under the MPF Program. The commenter suggested it is important to note that the MPF Program is actually composed of several different types of loan purchase programs, some of which have a limited recourse component and some that do not. The commenter suggested further that each loan sold under an MPF program that includes a credit-risk sharing component undergoes an FHLB calculation that assigns a specific dollar amount for credit enhancement to that loan. And some loans with very low credit risk may have no credit enhancement assigned, while other loans with characteristics of higher credit risk are assigned a higher credit enhancement. According to the commenter, the total of these credit enhancement calculations, which is tracked by the FHLB and available online, is the maximum amount of risk for which a credit union is liable. The commenter suggested that in some cases, the results of the calculation for a particular loan may determine whether that loan is sold under the MPF Xtra Program (with no credit enhancement) or under a different MPF program that includes some form of credit enhancement. The commenter contended that, by lumping all MPF loans into one calculation, the proposal would significantly alter an institution's analysis of how to price and sell individual loans without any benefit to the institution or to NCUA in managing risk. As an alternative, the commenter suggested the credit conversion and risk weight be applied to the total credit enhancement under the MPF program for which a credit union is liable, instead of to the loan balances.

Discussion

The small credit conversion factor for unused consumer lines of credit provides for the potential swift shift in credit risk that can occur when consumers access the lines. The other alternative credit conversion factors that include a determination of the term of the outstanding guarantee add additional complexity to the assignment of credit conversion factors and could result in a less consistent application of assigned risk weights even with expanded supervisory guidance.

The definition of the (MPF) Program will provide for assignments of proper risk weights in transactions where credit unions receive fees for managing the credit risk of the loans. Under the MPF Program, credit unions retain recourse risk through a credit enhancement obligation to the FHLB for credit losses on certain loans. For loans sold to the

FHLB that do not meet the definition of MPF loans, the risk weight is based on the maximum contractual amount of the credit union's exposure. In a loan sale transaction that creates no contractual exposure, the risk-weight would be zero. Supervisory guidance and Call Report instructions will be provided to ensure proper treatment of loans transferred under the FHLB programs and all other loans transferred with limited recourse.

The proposed risk weights for off-balance-sheet activities will be retained, as they are clear and generally comparable to those assigned under the Other Banking Agencies' regulations.

104(c)(5) Derivatives

Proposed § 702.104(c)(5) would have provided that a complex credit union must assign a risk-weighted amount to any derivative contracts as determined under 12 CFR 702.105.

For the reasons discussed below, the Board has decided to retain this proposed section in the final rule without change.

Current § 702.105 Weighted-Average Life of Investments

As discussed above, proposed new § 702.105 would have replaced 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 have been removed from part 702 altogether.

The Board received no comments objecting to this change and has decided to retain this change in the final rule.

Section 702.105 Derivatives Contract

Under the Second Proposal, § 702.105 assigned risk weights to derivatives in a manner generally consistent with the approach adopted by FDIC in its interim final rule regarding regulatory capital.¹⁹² The NCUA Board proposed to focus only on interest-rate-related derivatives in the rule and referred credit unions to FDIC's rules for all non-interest-rate-related derivatives. The Board made this distinction because federal credit unions are restricted to interest-rate-related contracts under NCUA's final derivatives rule, which was approved in January 2014. Federally insured state-chartered credit unions, however, may have broader authorization to use non-interest-rate contracts if approved by the respective state supervisory authorities.

Public Comments on the Second Proposal

The Board received a few general comments on proposed § 702.105. One commenter recommended that the Board, rather than just cross-citing to FDIC's regulations, incorporate the FDIC risk weights for non-interest-rate derivatives into NCUA regulations verbatim. The commenter suggested that although the vast majority of credit unions will probably not engage in this activity, its inclusion in NCUA's regulations would ease the regulatory burden for credit unions and examiners in finding and citing the appropriate authority. The commenter cautioned, however, that the Board should not create its own risk-weight system for non-interest-rate-related derivatives. The commenter suggested that, given the complex nature of derivatives, modifying the established regulatory framework could result in unintended consequences for credit unions engaged in that activity. In addition, state regulators have experience supervising derivative activity in state-chartered banks within the FDIC framework, which will help facilitate effective state supervision for credit unions with minimum confusion.

Another commenter complained that the risk-weight calculations for derivatives were too complicated. The commenter suggested that derivatives, per GAAP, are fair valued daily, monthly, quarterly, and yearly, and reflected as an asset or a liability, while their impact runs through earnings or equity. Accordingly, the commenter recommended the Board apply a simpler formula to assess risk-based capital for derivatives, using a credit conversion factor to the notional amount and then applying a risk-weighted factor. Another commenter suggested that the Board simplify the calculation for derivatives based on the percentage of potential future exposure.

Discussion

The Board has considered the comments suggesting the derivatives calculations be simplified. But given the number of variables to be considered for risk weighting—which include the type of derivative (interest rate or other), the legal agreement governing the transactions (qualified master netting agreement), the type of collateral to be used to satisfy margin movements, the method the credit union will use for collateral risk mitigation, and the counterparty approach (dealer or exchange)—it is impractical to simplify the calculation any further given the number of options that need to be

¹⁹² See 78 FR 55339 (Sept. 10, 2013).

considered. Therefore the Board has maintained the proposed approach in this final rule.

Consistent with NCUA's recently finalized derivatives rule,¹⁹³ the Board is now adopting 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.¹⁹⁴ 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 final rule focuses only on interest-rate-related derivatives and refers credit unions to FDIC's rules for all non-interest-rate-related derivatives. The final rule makes 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 supervisory authorities. NCUA is not aware of any non-interest-rate derivative contracts being used by federally insured, state-chartered credit unions (per Call Report data).

OTC Derivatives Transaction Risk Weight

Under the Second Proposal, a credit union would have undertaken the following process to determine the risk weight for OTC derivative contracts. To determine the risk-weighted asset amount for a derivatives contract a credit union must first determine its exposure amount for the contract. The credit union must then recognize the credit mitigation of financial collateral, if qualified, and 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 proposal required 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) potential future exposure, 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.

Under the proposal, the net CCE would have been 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 have been calculated as described in proposed § 702.105(a)(2)(ii)(B).

Under the 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.

Under the proposal, if a derivatives contract were 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 (a)(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 proposal, which is discussed in more detail below.

The Board received no comments objecting to this particular approach and has decided to retain the proposed process to determine the risk weight for OTC derivatives contracts in this final rule without change.

Cleared Derivatives Risk Weight

Proposed § 702.105 would have adopted an approach to assign risk weights to derivatives that is generally consistent with the approach adopted

by the Other Banking Agencies.¹⁹⁵ Under the Second Proposal, a credit union was required to calculate a trade exposure amount, determine the risk mitigation of any financial collateral, and multiply that amount by the applicable risk weight. Such an approach allowed 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, the proposed approach also accounted for the risk of loss associated with collateral posted by a credit union.

The Board received no comments objecting to this particular approach and has decided to retain the proposed process to determine the risk weight for cleared derivatives in this final rule without change.

Trade Exposure Amount

Under the Second Proposal, the trade exposure amount would have been equal to 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 took into account the exposure amount of the derivatives transaction and the exposure associated with any collateral posted by the credit union. This is the same approach employed by the Other Banking Agencies.¹⁹⁶

The Board received no comments objecting to this particular approach and has decided to retain the proposed process to determine the trade exposure amount in this final rule without change.

Cleared Transaction Risk Weights

Under the Second Proposal, after a credit union determines its trade exposure amount, it would have been 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 proposal required credit unions to apply a 2 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 have been required to conduct a sufficient legal review and determine that the agreement to prevent risk of loss is legal, valid, binding, and enforceable. If a credit union did not

¹⁹³ See 78 FR 55339 (Sept. 10, 2013).

¹⁹⁴ See 78 FR 55339 (Sept. 10, 2013).

¹⁹⁵ See 78 FR 55339 (Sept. 10, 2013).

¹⁹⁶ See, e.g., 12 CFR 324.35.

meet either or both of these requirements, the credit union would have to apply a 4 percent risk weight to the transaction.

The differing risk weights for cleared transactions took 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. This is the same approach employed by the Other Banking Agencies.¹⁹⁷

The Board received no comments objecting to this particular approach and has decided to retain the proposed process to determine the risk weights for cleared transactions in this final rule without change.

Collateralized Transactions

Under the Second Proposal, the Board 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 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.

The Board received no comments objecting to this particular approach and, consistent with the proposal, has decided to permit a credit union to recognize risk-mitigating effects of financial collateral in OTC transactions in this final rule without change.

Risk Management Guidance for Recognizing Collateral

Under the Second Proposal, before a credit union could recognize 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 proposed including this concept in the rule so that credit unions could accurately recognize the risk mitigation benefit of collateral. This is the same approach taken by the Other Banking Agencies.

The Board received no comments objecting to this particular approach and has decided to retain the proposed approach to risk management for recognizing collateral in this final rule without change.

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 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.
- Lines 8 through 16 are calculations based on the approach and types of agreement, collateral, fair values and notional amounts of the credit union derivatives transactions.

¹⁹⁷ See, e.g., 12 CFR 324.35.

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 be uncollateralized for the daily margin requirement while OTC minimum thresholds are negotiated

Federally Insured, State-Chartered Credit Unions' Derivative Transactions

Under the Second Proposal, the Board included language that would require federally insured, state-chartered credit unions (FISCU) to calculate risk weights in accordance with FDIC's rules for derivatives transactions that are not permissible under NCUA's derivatives rule. As noted above, one commenter requested that NCUA incorporate all of FDIC's language into the final RBC rule. FDIC's rules for derivatives are very detailed and lengthy. Incorporating these rules into this final rule would add unnecessary complexity. Further, as the options available to FISCU are based on state laws, it would be a very time-consuming and expensive process to monitor FDIC's rules to make future conforming changes in NCUA's risk-based capital regulations. For these reasons, the Board is retaining the cross-reference and is not incorporating the text of FDIC's derivatives regulations into this final rule.

Current Section 702.106 Standard Calculation of Risk-Based Net Worth Requirement

The Second Proposal 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 Second Proposal, on the other hand, contained only a single measurement for calculating a credit union's risk-based capital ratio. Accordingly, current § 702.106 will no longer be necessary.

The Board received no comments on this particular revision and has decided to eliminate current § 702.106 from this final rule as proposed.

Current Section 702.107 Alternative Component for Standard Calculation

The Second Proposal would eliminate current § 702.107 regarding the use of alternative risk weight measures. The Board observed that 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.

The Board received no comments on this particular revision and has decided to eliminate current § 702.107 from this final rule as proposed.

Current Section 702.108 Risk Mitigation Credit

The Second Proposal would eliminate 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 received no comments on this particular revision and has decided to eliminate current § 702.107 from this final rule as proposed.

Section 702.106 Prompt Corrective Action for Adequately Capitalized Credit Unions

The Second Proposal renumbered current § 702.201 as proposed § 702.106, and would have made 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 also remove the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Section 702.107 Prompt Corrective Action for Undercapitalized Credit Unions

The Second Proposal renumbered current § 702.202 as proposed § 702.107, and made 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 also remove the requirement that undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Section 702.108 Prompt Corrective Action for Significantly Undercapitalized Credit Unions

The Second Proposal renumbered current § 702.203 as proposed § 702.108, and made 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 also remove the requirement that significantly undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Public Comments on the Second Proposal

One state agency commenter noted that under the proposal, credit unions classified as significantly undercapitalized or worse would be required to restrict member business loans. The commenter acknowledged that it may be prudent to limit member business lending in some such cases, but felt there could be instances in which rational loan workout agreements require additional loans be granted to protect the cash flow or collateral position on loans already granted. The commenter suggested that forcing a restriction without some element of discretion on the part of the state examiner or federal examiner and corresponding state regulatory official and NCUA regional office may have the unintended consequence of artificially creating a liquidity problem for a borrower, and potentially jeopardizing the collection of existing credits. The commenter recommended that the decision to limit any type of lending be done on a case-by-case basis rather than a sweeping decision to be applied to all regardless of the circumstances.

Discussion

The Board is bound by statute because section 216(g)(2) of the FCUA provides in relevant part:

[A]n insured credit union that is undercapitalized may not make any increase in the total amount of member business loans (as defined in section 107A(c) of this title) outstanding at that credit union at any one time, until such time as the credit union becomes adequately capitalized.

The statutory language does not preclude a credit union from entering into loan workout agreements provided the total amount of member business loans outstanding, including unused commitments, does not increase. Accordingly, the Board has retained the language in proposed § 702.108 in this final rule without change.

Section 702.109 Prompt Corrective Action for Critically Undercapitalized Credit Unions

The Second Proposal renumbered current § 702.204 as proposed § 702.109, and made 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 also remove the requirement that critically undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Section 702.110 Consultation With State Official on Proposed Prompt Corrective Action

The Second Proposal renumbered current § 702.205 as proposed § 702.110, and made only minor conforming amendments to the text of the section.

Public Comments on the Second Proposal

One state supervisory authority commenter pointed out that, under the proposal, authority to approve certain actions (such as net worth restoration plans, earnings retention waivers, etc.) must come from the NCUA Board, after consulting with the state regulator. The commenter recommended, however, that the authority to approve actions may be better placed with NCUA regional directors, after consulting with the state regulator. The commenter suggested that most states have a long and well established working relationship with regional offices, and regional directors should be in a better position to evaluate the reasonableness of this type of request.

Discussion

The Board appreciates the commenter's suggestion, but declines to make the recommended change at this time. However, the Board may choose to delegate its authority to approve actions under this section to regional directors without having to change NCUA's regulations. Accordingly, the Board has decided to retain proposed § 702.110 in this final rule without change.

Section 702.111 Net Worth Restoration Plans (NWRPs)

The Second Proposal renumbered current § 702.206 as proposed § 702.111, and made only minor conforming amendments to the text of most of the subsections, with a few exceptions discussed in more detail below.

The Board reviewed the comments received on this section, which are discussed in more detail below, and has decided to adopt proposed § 702.111 in this final rule without change.

111(c) Contents of NWRP

Under the Second Proposal, § 702.111(c)(1)(i) provided 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 Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

111(g)(4) Submission of Multiple Unapproved NWRPs

Under the Second Proposal, § 702.111(g)(4) provided 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.¹⁹⁸ The proposed amendments were 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.

Public Comments on the Second Proposal

At least one commenter claimed that a number of credit unions are not aware of proposed new § 702.111(g)(4) because NCUA led them to believe that the rule only applied to complex credit unions. The commenter suggested that NCUA has significant latitude to approve or deny net worth restoration plans, even if a credit union submits a plan that meets the stated requirements. The commenter opposed including the new provision in the final rule, and recommended the Board include safeguards to ensure that credit unions acting in good faith are able to successfully submit NWRPs. Another commenter contended that the Board presented no evidence that submitting multiple net worth restoration plans represents an unsafe and unsound condition.

Discussion

The failure of a credit union to prepare an adequate net worth restoration plan places the credit union in violation of the FCUA requiring submission of an acceptable plan within the time allowed. The submission and rejection of multiple plans results in delays in resolving the problem of insured credit unions. Accordingly, to further ensure compliance with the FCUA, the Board has decided to adopt proposed § 702.111(g)(4) in this final rule without change.

The Board clarifies, however, that non-complex credit unions will not be

expected to address risk-based capital in net worth restoration plans.

111(j) Termination of NWRP

Under the Second Proposal, § 702.111(j) provided that, for purposes of part 702, an NWRP terminates once the credit union has been classified as adequately capitalized or well capitalized for four consecutive quarters. The proposed paragraph also provided, 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 was intended to provide clarification for credit unions on the timing of an NWRP's termination.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Section 702.112 Reserves

The Second Proposal renumbered current § 702.401 as proposed § 702.112. Consistent with the text of current § 702.401(a), the proposal also would require that each credit union establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or, in special cases, by the Board or appropriate state official.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Regular Reserve Account

As mentioned above, the proposed rule would eliminate current § 702.401(b) regarding the regular reserve account from the earnings retention process. 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.

The Board received no comments on the elimination of current § 702.401(b) and has decided to adopt the proposed revision in this final rule without change.

Section 702.113 Full and Fair Disclosure of Financial Condition

The Second Proposal renumbered current § 702.402 as proposed § 702.113, and made only minor conforming

amendments to the text of the section with the exception of the changes to proposed § 702.113(d) that are discussed in more detail below.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

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 current § 702.402(d)(4), 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 current § 702.402(d)(4), which provides that adjustments to the valuation ALLL will be recorded in the expense account "Provision for Loan and Lease Losses." This change is intended to clarify that the ALLL is to be maintained in accordance with GAAP, as discussed above.

The Board received no comments on these proposed revisions and has decided to adopt the proposed amendments in this final rule without change.

(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 italicized words "and lease" and "timely and" would be added 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, these changes are intended 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.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

(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 change is intended to provide full

¹⁹⁸ 12 U.S.C. 1786; and 1790d.

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.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

(d)(3)

Proposed § 702.113(d)(3) retained the language in current § 702.401(d)(5) with no changes.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

Section 702.114 Payment of Dividends

The Second Proposal renumbered current § 702.402 as proposed § 702.114 and made amendments to the text of paragraphs (a) and (b).

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

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 proposed § 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. Because of the removal of the regular reserve account, and to conform to GAAP, the proposal would amend the language to 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.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

114(b) Payment of Dividends and Interest Refunds

The Second Proposal would eliminate the language in current § 702.403(b) and replace it with a new provision. Proposed new § 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). Proposed paragraph (b) would have provided further that the request for written approval must include the plan for eliminating any negative retained earnings balance.

The Board received no comments on this section and has decided to adopt the proposed amendments in this final rule without change.

B. Subpart B—Alternative Prompt Corrective Action for New Credit Unions

Consistent with the Second Proposal, this final rule adds new subpart B, which contains most of the capital adequacy rules that apply to "new" credit unions. The current net worth measures, net worth classification, and text of the PCA requirements applicable to new credit unions are renumbered. They remain mostly unchanged from the current 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 exceeded 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 an unsafe and unsound condition.

(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

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.301 as § 702.201. The final rule also clarifies that a credit union may not regain a designation of "new" after reporting total assets in excess of \$10 million.

Section 702.202 Net Worth Categories for New Credit Unions

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.302 as § 702.202, and makes 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

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.303 as § 702.203, and makes only minor conforming amendments to the text of the section. Consistent with the regular reserve requirement in current § 702.401(b), this final rule also removes the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.204 Prompt Corrective Action for Moderately Capitalized, Marginally Capitalized or Minimally Capitalized New Credit Unions

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.304 as § 702.204, and makes 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), this final rule removes the requirement that such credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.205 Prompt Corrective Action for Uncapitalized New Credit Unions

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.305 as proposed § 702.205, and makes only minor conforming amendments to the text of the section.

Section 702.206 Revised Business Plans (RBPs) for New Credit Unions

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.306 as § 702.206, makes mostly minor conforming amendments to the text of the section, and adds new § 702.206(g)(3). Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), this final rule also removes 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

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, § 702.206(g)(3) of this final rule provides 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.¹⁹⁹ As explained in the preamble to the Second Proposal, 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. This amendment is intended clarify that submitting multiple RBPs that are rejected by NCUA, or a state official, because of the failure of the credit union to produce an acceptable RBP is an unsafe and unsound practice and may subject the credit union to further actions as permitted under the FCUA.

Section 702.207 Incentives for New Credit Unions

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.307 as proposed § 702.207, and makes only minor conforming amendments to the text of the section.

Section 702.208 Reserves

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule adds new § 702.208 regarding reserves for new credit unions. Also, consistent with the text of the current reserve requirement in § 702.401(a), this final rule requires 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 the part of the preamble associated with § 702.112 above, this final rule eliminates 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 will be eliminated upon the effective date of this final rule. Upon the effective date of this final rule, a federal credit union should close out its regular reserve

balance into undivided earnings. A federally insured state-chartered credit union, however, may still maintain a regular reserve account if required under state law or by its state supervisory authority.

Section 702.209 Full and Fair Disclosure of Financial Condition

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, this final rule renumbers current § 702.402 as § 702.209 and makes 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

The Board received no comments on this section. Accordingly, consistent with the proposed elimination of the regular reserve requirement, § 702.209(d) of this final rule removes the language in current § 702.402(d)(4), 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 final rule removes current § 702.402(d)(3), which provides that adjustments to the valuation ALLL will be recorded in the expense account "Provision for Loan and Lease Losses." As discussed in the preamble associated with § 702.113, the changes to this section emphasize the need to record the ALLL in accordance with GAAP.

(d)(1)

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, current § 702.401(d)(1) is renumbered as § 702.209(d)(1) and amended to provide that charges for loan and lease losses shall be made *timely and* in accordance with GAAP. This final rule adds 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 is 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)

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, current § 702.401(d)(2) is renumbered as § 702.209(d)(2) and is amended to provide that the ALLL must be maintained in accordance with GAAP. This change is intended to provide full and fair disclosure to credit union members, 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)

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, current § 702.401(d)(5) is renumbered as § 702.209(d)(3) and retains the language with no changes.

Section 702.210 Payment of Dividends

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, the language in current § 702.403 is incorporated into new § 702.210 of this final rule.

210(a) Restriction on Dividends

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, § 702.210(a) provides that, for new 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

The Board received no comments on this section. Accordingly, consistent with the Second Proposal, § 702.210 provides 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 B of part 702 unless the appropriate regional director and, if state-chartered, the appropriate state official, has given prior written approval (in an RBP or otherwise). Paragraph (b) provides further that the request for written approval must include the plan for eliminating any negative retained earnings balance.

C. Appendix A to Part 702—Alternative Risk Weights for Certain On-Balance Sheet Assets

As discussed in the part of the preamble that discusses § 702.104(c)(3) of this final rule, the Board is adding new appendix A to part 702 of NCUA's regulations. As previously stated, this final rule allows credit unions to

¹⁹⁹ 12 U.S.C. 1786 and 1790d.

determine the risk weight of certain investment funds, and the risk weight of a subordinated tranche of any investment instead of using the risk weights assigned in § 702.104(c)(2). This final rule incorporates the relevant portions of §§ 324.43(e) and 324.53 of FDIC's regulations, which were incorporated only by reference in the Second Proposal, into new appendix A of part 702 of NCUA's regulations. To incorporate the text of FDIC's regulations into NCUA's regulations, the Board had to make some minor conforming changes to the proposed language incorporated into appendix A. No substantive changes to the proposed methodology for calculating the gross-up and look-through approaches are intended.

Accordingly, Appendix A to part 702 of this final rule provides that instead of using the risk weights assigned in § 702.104(c)(2), a credit union may determine the risk weight of certain investment funds, and the risk weight of non-subordinated or subordinated tranches of any investment as provided below.

(a) Gross Up-Approach

(a)(1) Applicability

Paragraph (a)(1) of appendix A provides that: Section 702.104(c)(3)(iii)(A) of part 702 provides that, a credit union may use the gross-up approach in this appendix to determine the risk weight of the carrying value of non-subordinated or subordinated tranches of any investment.

(a)(2) Calculation

Paragraph (a)(2) of appendix A provides, to use the gross-up approach, a credit union must calculate the following four inputs:

- Pro rata share, which is the par value of the credit union's exposure as a percent of the par value of the tranche in which the securitization exposure resides;
- Enhanced amount, which is the par value of tranches that are more senior to the tranche in which the credit union's securitization resides;
- Exposure amount, which is the amortized cost for investments classified as held-to-maturity and available-for-sale, and the fair value for trading securities; and
- Risk weight, which is the weighted-average risk weight of underlying exposures of the securitization as calculated under this appendix.

(a)(3) Credit Equivalent Amount

Paragraph (a)(3) of appendix A provides that the "credit equivalent

amount" of a securitization exposure under this part equals the sum of:

- The exposure amount of the credit union's exposure; and
- The pro rata share multiplied by the enhanced amount, each calculated in accordance with paragraph (a)(2) of appendix A to part 702.

(a)(4) Risk-Weighted Assets

Paragraph (a)(4) of appendix A provides, to calculate risk-weighted assets for a securitization exposure under the gross-up approach, a credit union must apply the risk weight required under paragraph (a)(2) of appendix A to part 702 to the credit equivalent amount calculated in paragraph (a)(3) of appendix A to part 702.

(a)(5) Securitization Exposure Defined

Paragraph (a)(5) of appendix A provides, for purposes of paragraph (a) of appendix A to part 702, "securitization exposure" means:

- A credit exposure that arises from a securitization; or
- An exposure that directly or indirectly references a securitization exposure described in first element of this definition.

(a)(6) Securitization Defined

Paragraph (a)(6) of appendix A provides, for purposes of paragraph (a) of appendix A to part 702, "securitization" means a transaction in which:

- The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
- Performance of the securitization exposures depends upon the performance of the underlying exposures; and
- All or substantially all of the underlying exposures are financial exposures (such as loans, receivables, asset-backed securities, mortgage-backed securities, or other debt securities).

(b) Look-Through Approaches

(b)(1) Applicability

Paragraph (b)(1) of appendix A provides: Section 702.104(c)(3)(iii)(B) provides that, a credit union may use one of the look-through approaches in appendix A to part 702 to determine the risk weight of the exposure amount of any investment fund, or the holding of separate account insurance.

(b)(2) Full Look-Through Approach

(b)(2)(i) General

Paragraph (b)(2)(i) of appendix A provides, a credit union that is able to

calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund may set the risk-weighted asset amount of the credit union's exposure to the fund equal to the product of:

- The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the credit union; and
- The credit union's proportional ownership share of the fund.

(b)(2)(ii) Holding Report

Paragraph (b)(2)(ii) of appendix A provides, to calculate the risk-weighted amount under paragraph (b)(2)(i) of appendix A, a credit union should:

- Use the most recently issued investment fund holding report; and
- Use an investment fund holding report that reflects holdings that are not older than six months from the quarter-end effective date (as defined in § 702.101(c)(1) of part 702).

(b)(3) Simple Modified Look-Through Approach

Paragraph (b)(3) of appendix A provides that under the simple modified look-through approach, the risk-weighted asset amount for a credit union's exposure to an investment fund equals the exposure amount multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(b)(4) Alternative Modified Look-Through Approach

Paragraph (b)(4) of appendix A provides that under the alternative modified look-through approach, a credit union may assign the credit union's exposure amount to an investment fund on a pro rata basis to different risk weight categories under subpart A of part 702 based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The paragraph provides further that the risk-weighted asset amount for the credit union's exposure to the investment fund equals the sum of each portion of the exposure amount assigned to an exposure type multiplied by the applicable risk weight under subpart A of this part. The paragraph also notes that if the sum of the investment limits for all exposure types within the fund exceeds 100

percent, the credit union must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under subpart A of this part and continues to make investments in order of the exposure type with the next highest applicable risk weight under subpart A of this part until the maximum total investment level is reached. The paragraph also provides that if more than one exposure type applies to an exposure, the credit union must use the highest applicable risk weight. Finally, the paragraph provides that a credit union may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

D. Other Conforming Changes to the Regulations

The Board received only one comment on this section. The commenter expressed concern that the references to the risk weightings for member business loans under § 723.1(d) and (e) were confusing and should be eliminated because of the proposed rule's use of the term "commercial loan," instead of member business loans, in assigning risk weights. The Board generally agrees with the commenter's concerns and has revised § 723.1(d) and (e) to remove the words referring to the risk-weighting standards for member business loans. Accordingly, consistent with the Second Proposal, this final rule makes minor conforming amendments to §§ 700.2, 701.21, 701.23, 701.34, 703.14, 713.6, 723.1, 723.7, 747.2001, 747.2002, and 747.2003.

V. Effective Date

How much time would credit unions have to implement these new requirements?

In the preamble to the Second Proposal, the Board proposed an effective date of January 1, 2019 to provide credit unions and NCUA a lengthy implementation period 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.

Public Comments on the Second Proposal

The Board received many comments regarding the proposed effective date of the final rule. Several commenters suggested that given the significant operational implications for both credit

unions and the NCUA, a 2019 effective date is appropriate. Those commenters suggested the proposed effective date would allow credit unions to adjust their balance sheets and strategic plans to achieve a well-capitalized standard under the rule without disrupting member products and services. Commenters also noted that the proposed effective date aligns with the implementation timeframe of the Other Banking Agencies and, thus, would avoid creating a competitive disadvantage across competing financial services entities.

A substantial number of other commenters, however, requested that the effective date be delayed until 2021 to coincide with refunds the commenters expect to receive from the Corporate Stabilization Fund. The commenters suggested the refunds will be important to those credit unions that will need to increase capital levels in order to comply with the new regulation.

Other commenters argued that the proposed timeframe was insufficient given the significance of the impact of the proposed requirements and the length of time it would take credit unions to adjust their business strategies, portfolios and capital to best position themselves relative to the rule. Commenters complained the task would be burdensome for credit unions given their limited options for raising capital when compared to banks, which were afforded seven years to fully implement BASEL III. Accordingly, those commenters recommended various extended implementation periods ranging from five years to seven years, or phase-in periods over a similar timeframe.

One commenter speculated that extending the implementation until 2019 would create a dual standard for credit unions near threshold levels. The commenter asked: What measure should be the plan for the coming 2–3 years? The commenter acknowledged that for some credit unions, the change will result in better risk-based capital levels than under the current rule. But the commenter argued that fixing the current capital levels under rules being phased out could cause real harm to memberships and credit union health.

Several commenters noted that the Financial Accounting Standards Board (FASB) plans to replace the current credit impairment model with a current expected credit loss model. Commenters suggested further that any final rule issued by FASB will require NCUA and FASB harmonization with respect to forecasting models utilized by credit unions to reduce conflicts between

examination guidance. Accordingly, commenters recommended that the NCUA Board delay implementation of any final risk-based capital rule until the final FASB rule has been fully implemented by credit unions.

One commenter recommended that IRR, access to additional supplemental forms of capital, and risk-based share insurance premium changes are likely in the near future, the Board should delay finalization and implementation of the proposed rule until a comprehensive analysis can be conducted to ensure an integrated, aligned approach to risk-based capital. The commenter contended that addressing interest rate risk, supplemental capital, risk-based share insurance premiums and risk-based capital in silos will not create the most efficient and effective solution.

Discussion

The proposed January 1, 2019 effective date provides credit unions with more than three years to ramp up implementation, which should be more than sufficient time to make the necessary adjustments to systems and operations before the effective date of this final rule. In addition, as noted above, the effective date generally coincides with the full phase-in of FDIC's capital regulations. In response to commenters who asked the Board to phase in the implementation, the Board found that phasing in the new capital rules for credit unions would add additional complexity with minimal benefit.

Further, it would be inappropriate to delay implementation due to potential changes in accounting that may be forthcoming, and the elimination of the cap on the amount of the ALLL will reduce the impact of the announced change in maintaining the ALLL.

Accordingly, this final rule will become effective on January 1, 2019.

VI. Impact of This Final Rule

This final rule will apply to credit unions with \$100 million or greater in total assets. As of December 31, 2014, there were 1,489 credit unions (23.7 percent of all credit unions) with assets of \$100 million or greater. As a result, approximately 76 percent of all credit unions will be exempt from the risk-based capital requirement.²⁰⁰ A net of 16 complex credit unions with total assets of \$9.8 billion would have a

²⁰⁰ The proposed risk-based capital requirements applied only to credit unions with assets of \$100 million or more, compared to the Other Banking Agencies' rules that apply to banks of all sizes. There were 1,872 FDIC-insured banks with assets less than \$100 million as of December 2014.

lower capital classification as a result of this rule with a capital shortfall of approximately \$67 million.²⁰¹ Approximately 98.5 percent of all complex credit unions will remain well

capitalized.²⁰² The aggregate and average RBC ratios for complex credit unions are 17.9 and 19.2 percent respectively.²⁰³ As shown in the table below most complex credit unions will

have a risk-based capital ratio well in excess of the 10 percent needed to be well capitalized.

DISTRIBUTION OF NET WORTH RATIO AND FINAL RISK-BASED CAPITAL RATIO

Number 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	<7%	7%–9%	9%–10.5%	10.5%–12%	>12%
RBC Ratio	<10%	10%–12%	12%–13.5%	13.5%–15%	>15%
Net Worth Ratio	14	297	449	334	395
Final RBC Ratio	23	107	140	194	1,025

Public Comments on the Second Proposal

The Board received a substantial number of comments regarding NCUA’s estimates of the impacts of the Second Proposal. Most commenters who mentioned the impacts of the proposal suggested the rule would have negative impacts on the credit union industry. Numerous commenters speculated that the proposal would unjustifiably slow credit union growth in the future, and that the funds used to meet the newly proposed requirements could otherwise be used to make loans to consumers or small businesses, or be used in other productive ways. Commenters also speculated that the requirements in the proposal would restrict credit union lending to consumers by forcing credit unions to maintain capital on their books rather than lending to their members. At least one commenter recommended that the Board more thoughtfully consider the actual market effect on the credit union industry and produce more reasonably calibrated risk weights based on the cooperative nature of credit unions. The commenter recommended that the Board also reconsider the value of concentration escalators and provide empirical data that reflect what actual additional risk is created based on concentration of certain asset categories. Other commenters claimed the higher capital levels that would be required under the proposal would reduce the amount of support, both monetary and operational, that larger credit unions have historically provided to their smaller counterparts, which would put additional strain on the finances and operations of many smaller credit unions.

One credit union trade association commenter speculated that under the proposal, the number of credit unions downgraded would more than double during a downturn in the business cycle. Under the commenter’s analysis, 45 credit unions would have been downgraded during the most 2007–2009 financial crisis if this proposal had been in place in 2009. According to the commenter, of those 45 credit unions, 41 would be well capitalized today. The commenter suggested that to have avoided a downgrade, those credit unions would have had to increase their capital by \$145 million, or an average of \$3.2 million per credit union. The commenter stated that almost all of the credit unions that would have been downgraded (95 percent) are well capitalized or adequately capitalized today. The commenter claimed this empirically proves that the proposal is unnecessary and unduly burdensome, as it would further strain the credit union system during a financial downturn. The commenter estimated that, in order to satisfy the proposal’s well capitalized threshold, credit unions would need to hold at least an additional \$729 million. The commenter estimated further that, to satisfy the proposal’s adequately capitalized threshold, credit unions would need to hold at least an additional \$260 million.

Another commenter argued that the Board’s cost estimates failed to include the one-time costs that would be incurred by the entire credit union industry in system changes, additional reports, potential additional segregation and segmentation of the balance sheet, etc. in order to fill out the new Call Report forms. The commenter speculated that such costs will far

outweigh the costs that the Board has identified in the proposal.

Yet another commenter maintained that, according to the proposal, most complex credit unions are currently well capitalized under both the net worth ratio and the proposed risk-based capital ratio. The commenter calculated that as of September 30, 2014, complex credit unions had an average net worth ratio of 10.7 percent and a risk-based capital ratio of 19.3 percent, both well in excess of guidelines identifying well capitalized status. The commenter suggested that only 19 complex credit unions would fall from well capitalized status under the proposal. Thus, the commenter concluded that the costs associated with the proposal seemed excessive given how extremely well capitalized the credit union industry is today under current guidelines.

One credit union commenter suggested that for the risk-based capital requirement to be effective, it would have to be more complex. The commenter explained that this would mean requiring more information on the Call Report and adding new categories of loans in the final rule. Another credit union commenter supported making the risk-based capital framework as complicated as it needs to be to more accurately reflect the unique needs and structure of the credit union industry.

Several commenters noted that in March 2015, FASB announced expectations to finalize the standard for timely financial reporting of credit losses in the third quarter of 2015. Commenters recommended the Board consider the possible effects of the FASB proposal in relation to NCUA’s risk-based capital regulations and remove any duplicative regulatory burdens that may be created.

²⁰¹ In the second proposal using data as of December 31, 2013, NCUA estimated less than 20 credit unions would experience a decline in their capital classification with a capital shortfall of \$53.6 million.

²⁰² Of the 1,489 impacted credit unions, only 23, or 1.54 percent, would have less than the 10 percent risk-based capital requirement to be well capitalized. Of these, seven have net worth ratios less than 7 percent and therefore are already categorized as less than well capitalized.

²⁰³ In the second proposal, based on December 2013 Call Report data, NCUA estimated the aggregate average risk-based capital ratio would be 18.2 percent with an average risk-based capital ratio of 19.3 percent.

A significant number of commenters requested that the Board minimize the burden on credit unions of expanding the Call Report. Several commenters suggested the Board consider an approach where credit unions would have the option of providing the additional, detailed information required under the proposal. One commenter suggested such an approach could be accomplished by including additional optional data fields within the Call Report, similar to the approach used by FDIC. The commenter suggested further that any changes required of a credit union require the expenditure of resources, and in a time when many credit unions are struggling to comply with existing rules from NCUA and other regulators, the Board should consider any alternatives that will reduce the burden of this rule on credit unions. Another commenter contended that NCUA's current estimate of the public burden of collecting information for the Call Report grossly understates the actual amount of time required. The commenter suggested that the variety of data needed to generate a quarterly Call Report takes employees from some credit unions 66 hours (10 times NCUA's current 6.6 hour estimate). The commenter recommended the Board consider the time and resources dedicated to producing the additional Call Report data required by the

proposal and focus on minimizing that burden and impact to credit unions. At least one commenter recommended that any Call Report updates required by this rulemaking be made available to credit unions at least six months before the effective date of the final rule.

Discussion

The Board has considered the comments received and recognizes that unduly high minimum regulatory capital requirements and unnecessary burdens could lead to less-than-optimal outcomes. Thus, as discussed throughout this preamble and in the Paperwork Reduction Act section to follow, the Board has made appropriate efforts to target the impacts and reduce the burdens of this final rule. This final rule only targets outlier credit unions with insufficient capital relative to their risk. The final rule meets Congress' express purpose of prompt corrective action ". . . to resolve the problems of insured credit unions at the least possible long-term cost to the Fund,"²⁰⁴ by establishing a risk-based capital requirement which will reduce the likelihood that a credit union will become undercapitalized and eventually fail at a cost to the Fund.

The Board's elimination of the 1.25 percent of risk-assets cap on the amount of ALLL in the risk-based capital ratio numerator will reduce the impact of the

risk-based capital ratio during economic downturns when credit unions are more likely to be funding higher levels of loan losses. Removal of the ALLL cap will also mitigate concerns with FASB's proposed related changes to GAAP.²⁰⁵ A reduction in capital ratios during economic downturns is a normal result for both the risk-based capital ratio and the net worth ratio. The capital adequacy requirement will enhance a credit union's ability to measure and plan for economic downturns.

Sound capital levels are vital to the long-term health of all financial institutions. Credit unions are already expected to incorporate into their business models and strategic plans provisions for maintaining prudent levels of capital. This final rule ensures minimum regulatory capital levels for complex credit unions will be more accurately correlated to risk. The final rule achieves a reasonable balance between requiring credit unions posing an elevated risk to hold more capital, while not overburdening lower-risk credit unions.

As indicated in the table below, according to the impact measure used in the Second Proposal, 72 complex credit unions would have had higher capital requirements due to the risk-based capital ratio requirement based on December 31, 2014 data.²⁰⁶

DISTRIBUTION OF RISK-BASED LEVERAGE EQUIVALENT RATIO²⁰⁷

RBC ratio—leverage equivalent	<6%	6–7.5%	7.5–8.5%	8.5–9.5%	9.5–11%	>11%	Average
Number of CUs	816	601	57	11	4	0	5.90%

Using another more conservative measure developed based on suggestions received from commenters, NCUA identified 308 credit unions, or 20 percent of all complex credit unions, that are likely to have a higher minimum capital requirement under the risk-based capital ratio requirement being adopted under this final rule.²⁰⁸ While up to 20 percent of credit unions are likely to have the risk-based capital

ratio as the binding constraint, only 20 of those credit unions have an estimated risk-based capital ratio below 10 percent.²⁰⁹

NCUA's latest analysis concludes it is reasonable for the risk-based capital ratio requirement to be the primary determinant of the capital requirement for about 20 percent of complex credit unions because these 308 credit unions have an average risk-weighted assets to total assets ratio of 72 percent—which is

significantly higher than the 59 percent average ratio for all complex credit unions.

As noted earlier, concentration risk is a material risk addressed in this final rule. Based on December 31, 2014 Call Report data, if this final rule were effective today, NCUA estimates that the additional capital required for concentration risk would have the following impact:

²⁰⁴ 12 U.S.C. 1790d(a)(1).

²⁰⁵ See Financial Standards Accounting Board, Proposed Accounting Standards Update, *Financial Instruments—Credit Losses, Subtopic 825–15* (Dec. 20, 2012).

²⁰⁶ The method used in the Second Proposal was calculated by taking 10 percent of estimated risk assets divided by total assets with results exceeding 7.5 percent indicating the risk-based capital requirement is the higher minimum-capital requirement.

²⁰⁷ This computation calculates the amount of capital required by multiplying the estimated 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.

²⁰⁸ Calculated based on a positive result to the following formula: ((risk-weighted assets times 10 percent) – allowance for loan losses – equity acquired in merger – total adjusted retained earnings acquired through business combinations + NCUA share insurance capitalization deposit + goodwill + identifiable intangible assets) – (total assets times 7 percent).

²⁰⁹ Also, given the new treatment of non-significant equity exposures, which could not be estimated due to existing data limitations, this impact may be further reduced.

Concentration threshold	Number of credit unions with total assets greater than \$100 million as of 12/31/2014	Percentage of 1,489 credit unions with total assets greater than \$100 million
First-Lien Residential Real Estate (>35% of Total Assets)	135	9.1
Junior-Lien Residential Real Estate (>20% of Total Assets)	57	3.8
Commercial Loans (using MBLs as a proxy) ²¹⁰ (>50% of Total Assets)	12	0.8

The Board considered the impact of the individual data items necessary to compute the risk-based capital ratio. Many commenters' requests for further stratification of risk weights were determined to create a data burden in excess of the benefits. All revisions to the Call Report will be subject to the publication and opportunity for comment process in accordance with the requirements of the Paperwork Reduction Act of 1994 to obtain a valid control number from the U.S. Office of Management and Budget (OMB). Interested parties are invited to submit written comments to each notice of information collection that NCUA will submit to OMB for review.

VII. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a final rulemaking, an agency prepare and make available a final regulatory flexibility analysis that describes the impact of the final 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 million²¹¹) and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

Public Comments on the Second Proposal

A small credit union commenter suggested that while credit unions with less than \$100 million in assets are not subject to the requirements of this proposal, there is great apprehension among small credit unions that NCUA examiners will require them to meet the

basic requirements in the risk-based capital rule.

Several commenters contended that NCUA's current estimate of the public burden of collecting information for the Call Report grossly understates the actual amount of time required. At least one commenter suggested that the variety of data needed to generate a quarterly Call Report takes employees from some credit unions 66 hours (10 times NCUA's estimate of 6.6 hours).

Discussion

The amendments this final rule makes to part 702 primarily affect complex credit unions, which are those with \$100 million or more in assets. The revised risk-based capital requirement and capital adequacy plan under this final rule do not apply to small credit unions.

NCUA recognizes that because many commenters suggested NCUA collect more granular data for credit union Call Reports, small credit unions with assets less than \$50 million could be affected if they are asked to assemble and report additional data. NCUA, however, will make every reasonable effort to redesign the Call Report system so that all credit unions with \$100 million or less in assets are not unnecessarily burdened by the data requirements that apply to complex credit unions. NCUA plans to propose information collection changes to reflect the new requirements of this final rule in the future, and publish the regulatory reporting requirements separately—including the steps NCUA has taken to minimize the impact of the reporting burden on small credit unions—for comment.

In addition, this final rule makes a number of minor changes to current part 702 of NCUA's regulations including:

- Part 702—Reorganizing and renumbering part 702, including sections of the part applicable to small credit unions.
- Section 702.2—Making minor amendments to certain definitions applicable to all credit unions under part 702.
- Section 702.111(g)(4) & 702.206(g)(3)—Making minor clarifications regarding the submission of multiple unapproved NWRPs or RBPs.

- Sections 702.112 & 702.208—Eliminating the regular reserve account requirement for all credit unions.

- Sections 702.113(d) & 702.209(d)—Making minor amendments to the treatment of loan and lease losses.

- Section 702.114 & 702.210—Making minor amendments to part 702 regarding the payments of dividends for all credit unions.

- Section 702.201—Making minor revisions to the definition of "new credit union."

NCUA believes the one time burden associated with the policy review and revisions related to these amended provisions will be one hour for small credit unions. Accordingly, the effects of this final rule on small credit unions are minor.

Based on the above assessment, the Board certifies that this final rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or increases an existing burden.²¹² 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 changes made to part 702 by this final rule will impose new information collection requirements.

NCUA determined that the proposed changes to part 702 would 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 in the Second Proposal estimated that all 6,554 credit unions would have to amend their procedures and systems for preparing Call Reports. NCUA proposed addressing the costs and providing notice of the particular changes that would be made in other collections, such as the NCUA Call Report and Profile as part of its regular amendments separate from this proposed rule.

²¹⁰ Using MBL data as the current Call Report does not capture "commercial loan" data as defined in this final rule.

²¹¹ On September 24, 2015, the Board published Interpretative Ruling and Policy Statement 15-1, which amends the definition of small credit unions for purposes of the RFA to credit unions with assets of less than \$100 million. 80 FR 57512 (Sept. 24, 2015). This change, however, does not take effect until November 23, 2015, which is after the date this rule is scheduled to be voted on by the Board.

²¹² 44 U.S.C. 3507(d); 5 CFR part 1320.

NCUA also estimated that approximately 21.5 percent, or 1,455 credit unions, would be defined as “complex” under the proposed rule and would have additional data collection requirements related to the new risk-based capital requirements.

NCUA’s Total Estimated One-Time Costs of the Second Proposal:

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 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.

Public Comments on the Second Proposal

A significant number of commenters maintained that the proposal did not incorporate the estimated burden for establishing a comprehensive written strategy for maintaining an appropriate level of capital and other changes to a complex credit union’s operations other than data collection. Commenters suggested the effects of the proposal would be a greater burden for complex credit unions upon the implementation year and for ongoing years. Commenters noted that NCUA’s final rule on Capital Planning and Stress Testing estimated 750 hours of paperwork burden in the initial year and 250 hours in subsequent years, and suggested it was unclear how the requirements of the Second Proposal would differ from the final rule on Capital Planning and Stress Testing in terms of burden. Using the cost estimate previously utilized by NCUA for the final rule on Capital Planning and Stress Testing, one commenter suggested a more reasonable estimate for this proposal would be \$23,926 per credit union or \$34.8 million to the industry for the initial year of the final RBC rule. The commenter also suggested there would be an ongoing annual cost of \$7,975 per credit union or \$11.6 million to the industry, which, over a five-year period, would have a cumulative cost to the industry of approximately \$81.2 million.

In addition, several commenters contended that NCUA’s current estimate of the public burden of collecting information for the Call Report grossly understates the actual amount of time required. At least one commenter suggested that the variety of data needed to generate a quarterly Call Report takes employees from some credit unions 66 hours (10 times NCUA’s estimate 6.6 hours).

Discussion

The final changes will result in some costs for complex credit unions associated with updating internal policies, including a comprehensive strategy for maintaining an appropriate level of capital, the cost estimates for which are discussed in more detail below. Further, there will be marginal costs associated with updating data collection and reporting systems for the NCUA Call Reports. The changes to the Call Reporting requirements, however, will be handled as part of NCUA’s regular Call Report updates separately from this proposed rule. The information collection requirements for the Call Report are approved by OMB under Control No. 3133–004.

In response to commenters who believe all complex credit unions will need substantial time to establish and maintain a comprehensive written capital strategy, NCUA field staff report that many well-managed complex credit unions already have comprehensive strategies for maintaining appropriate levels of capital. Further, commenters compared the burden of the Capital Planning and Stress Testing hours; however, for the vast majority of complex credit unions, the written capital strategy will not necessarily approach the complexity and more rigorous requirements associated with stress testing.

NCUA has updated its PRA analysis based on December 2014 Call Report data. Again, NCUA will make every effort to redesign the Call Report system so that small credit unions are not unnecessarily burdened by the data requirements that apply to complex credit unions.

The final rule contains minor changes to §§ 702.2, 702.111(g)(4), 702.206(g)(3), 702.112, 702.208, 702.113(d), 702.209(d), 702.114, 702.210, and 702.201 for which all credit union’s should be aware. The information collection requirements contained in 702.111(g)(4) and 702.206(g)(3) are generally related to information collected under OMB Control No. 3133–0154.

NCUA estimates that 1,489 credit unions defined as “complex” will have additional data collection requirements related to the new risk-based capital requirements. This slight increase from 1,455 credit unions in the Second Proposal occurred as some credit unions that had assets of less than \$100 million grew in size and now meet the definition of “complex.”

As a result, NCUA’s Total Estimated One-Time Costs based on the December

2014 Call Report data have changed slightly:

One-time burden for policy review and revision:

- 40 hours times 1,489 complex credit unions. The total one-time cost for complex credit unions totals 59,560 hours or \$1,898,174, an average of \$1,275 per credit union.
- 1 hour times 4,784 non-complex credit unions. The total one-time cost for credit unions with \$100 million or less in assets totals 4,784 hours, for a total estimated cost of \$152,562.

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 final 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 final rule.

Assessment of Federal Regulations and Policies on Families

NCUA has determined that this final 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 October 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 21 U.S.C. 4311–4312.

§ 701.21 [Amended]

■ 4. Amend § 701.21(h)(4)(iv) by removing “§ 702.2(f)” and adding in its place “§ 702.2”.

§ 701.23 [Amended]

■ 5. Amend § 701.23(b)(2) by removing the words “net worth” and adding in their place the word “capital”, and removing the words “or, if subject to a risk-based net worth (RBNW)

requirement under part 702 of this chapter, has remained ‘well capitalized’ for the six (6) immediately preceding quarters after applying the applicable RBNW requirement”.

§ 701.34 [Amended]

■ 6. Amend § 701.34 as follows:

■ a. In paragraph (b)(12) 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”.

■ c. 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 §§ 702.101, 702.202, and subparts A and B to read as follows:

Sec.

702.1 Authority, purpose, scope, and other supervisory authority.

702.2 Definitions.

Subpart A—Prompt Corrective Action

702.101 Capital measures, capital adequacy, effective date of classification, and notice to NCUA.

702.102 Capital classification.

702.103 Applicability of the risk-based capital ratio measure.

702.104 Risk-based capital ratio.

702.105 Derivative contracts.

702.106 Prompt corrective action for adequately capitalized credit unions.

702.107 Prompt corrective action for undercapitalized credit unions.

702.108 Prompt corrective action for significantly undercapitalized credit unions.

702.109 Prompt corrective action for critically undercapitalized credit unions.

702.110 Consultation with state officials on proposed prompt corrective action.

702.111 Net worth restoration plans (NWRP).

702.112 Reserves.

702.113 Full and fair disclosure of financial condition.

702.114 Payment of dividends.

Subpart B—Alternative Prompt Corrective Action for New Credit Unions

702.201 Scope and definition.

702.202 Net worth categories for new credit unions.

702.203 Prompt corrective action for adequately capitalized new credit unions.

702.204 Prompt corrective action for moderately capitalized, marginally

capitalized, or minimally capitalized new credit unions.

702.205 Prompt corrective action for uncapped new credit unions.

702.206 Revised business plans (RBP) for new credit unions.

702.207 Incentives for new credit unions.

702.208 Reserves

702.209 Full and fair disclosure of financial condition.

702.210 Payment of dividends.

Subpart A—Prompt Corrective Action**§ 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.

§ 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 that chartered the affected credit union.

Call Report means the Call Report required to be filed by all credit unions under § 741.6(a)(2) of this chapter.

Carrying value means the value of the asset or liability 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.

Charitable donation account means an account that satisfies all of the conditions in § 721.3(b)(2)(i), (b)(2)(ii), and (b)(2)(v) of this chapter.

Commercial loan means any loan, line of credit, or letter of credit (including any unfunded commitments) for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. 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, purchase or sell assets, enter into a borrowing

agreement, or enter into a financial transaction.

Consumer loan means a loan for household, family, or other personal expenditures, including any loans that, at origination, are wholly or substantially 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 one or more vehicles to be part of a fleet of 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 or five business days.

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 enter into derivative transactions.

Excluded goodwill means the outstanding balance, maintained in accordance with GAAP, of any goodwill originating from a supervisory merger or combination that was completed on or before December 28, 2015. This term and definition expire on January 1, 2029.

Excluded other intangible assets means the outstanding balance, maintained in accordance with GAAP, of any other intangible assets such as core deposit intangible, member relationship intangible, or trade name intangible originating from a supervisory merger or combination that was completed on or before December 28, 2015. This term and definition expire on January 1, 2029.

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 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.

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.

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 institution receives fees for managing the credit risk of the loans. The credit risk must be shared between the depository institution 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 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.

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.

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.

Part 703 compliant investment fund means an investment fund that is restricted to holding only investments that are permissible under § 703.14(c) of this chapter.

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, 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. An investment that does not have a junior claim to other investments in the same issuance on the underlying collateral or assets is non-subordinated. A Security that is junior only to money market eligible securities in the same issuance is also non-subordinated.

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 measured¹ 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. U.S. Government agency includes NCUA.

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.

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).

(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	And does not meet the criteria to be classified as well capitalized.
Adequately Capitalized	6% or greater	And	8% or greater	
Undercapitalized	4% to 5.99%	Or	Less than 8%	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.
	Significantly Undercapitalized.		2% to 3.99% .....		N/A .....
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:
 - (1) Cash, currency and coin, including vault, automatic teller machine, and teller cash.
 - (2) share-secured loans, where the shares securing the loan are on deposit with the credit union.

(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 interest-only mortgage-backed-security 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 interest-only mortgage-backed-security STRIPS.

(2) A non-subordinated obligation of a GSE other than an equity exposure or preferred stock, excluding interest-only GSE mortgage-backed-security STRIPS.

(3) Securities issued by PSEs that represent general obligation securities.

(4) Part 703 compliant investment funds that are restricted to holding only investments that qualify for a zero or 20 percent risk-weight under this section.

(5) Federal Home Loan Bank stock.

(C) The balances due from Federal Home Loan Banks.

(D) The balance of share-secured loans, where the shares securing the loan are on deposit with another depository institution.

(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 interest-only mortgage-backed security 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) Interest-only mortgage-backed security STRIPS.

(3) Part 703 compliant investment funds, with the option to use the look-through approaches in paragraph (c)(3)(iii)(B) 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.

(8) Non-subordinated tranches of any investment, with the option to use the gross-up approach in paragraph (c)(3)(iii)(A) of this section.

(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 investments, other than a CUSO investment.

(B) Investment funds that do not meet the requirements under § 703.14(c) of this chapter, with the option to use the look-through approaches in paragraph (c)(3)(iii)(B) of this section.

(C) Separate account insurance, with the option to use the look-through approaches in paragraph (c)(3)(iii)(B) 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)(iii)(A) of this section.

(3) *Alternative risk weights for certain on-balance sheet assets—(i) Non-significant equity exposures.—*(A) *General.* Notwithstanding the risk weights assigned in paragraph (c)(2) of this section, a credit union must assign a 100 percent risk weight to non-significant equity exposures.

(B) *Determination of non-significant equity exposures.* A credit union has non-significant equity exposures if the aggregate amount of its equity exposures does not exceed 10 percent of the sum of the credit union's capital elements of the risk-based capital ratio numerator (as defined under paragraph (b)(1) of this section).

(C) *Determination of the aggregate amount of equity exposures.* When determining the aggregate amount of its equity exposures, a credit union must include the total amounts (as recorded on the statement of financial condition in accordance with GAAP) of the following:

(1) Equity investments in CUSOs,

(2) Perpetual contributed capital at corporate credit unions,

(3) Nonperpetual capital at corporate credit unions, and

(4) Equity investments subject to a risk weight in excess of 100 percent.

(ii) *Charitable donation accounts.*

Notwithstanding the risk weights

assigned in paragraph (c)(2) of this section, a credit union may assign a 100 percent risk weight to a charitable donation account.

(iii) *Alternative approaches.*

Notwithstanding the risk weights assigned in paragraph (c)(2) of this section, a credit union may determine the risk weight of investment funds, and non-subordinated or subordinated tranches of any investment as follows:

(A) *Gross-up approach.* A credit union may use the gross-up approach under appendix A of this part to determine the risk weight of the carrying value of non-subordinated or subordinated tranches of any investment.

(B) *Look-through approaches.* A credit union may use one of the look-through approaches under appendix A of this part to determine the risk weight of the exposure amount of any investment funds, the holdings of separate account insurance, or both.

(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.

§ 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.

(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 $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$, where:

(1) Agross equals the gross PFE (that is, the sum of the PFE amounts as determined under paragraph (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.

(2) *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

TABLE 1 TO § 702.105—CONVERSION FACTOR MATRIX FOR INTEREST RATE DERIVATIVE CONTRACTS²

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

(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.

² Non-interest rate derivative contracts are addressed in paragraph (d) of this section.

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 a 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 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 12 CFR part 324, 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 FISCO.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before permitting a federally insured state-chartered credit union to decrease its earnings retention under paragraph (b) of this section.

(d) *Periodic review.* A decision under paragraph (b) of this section to permit a credit union to decrease its earnings retention is subject to quarterly review and revocation except when the credit union is operating under an approved net worth restoration plan that provides for decreasing its earnings retention as provided under paragraph (b) of this section.

§ 702.107 Prompt corrective action for undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111, *provided however*, that a credit union in this category having a net worth ratio of less than five percent (5%) which fails to timely submit such a plan, or which materially fails to implement an approved plan, is classified significantly undercapitalized pursuant to § 702.102(a)(4)(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.

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 uncapped new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the effective date of classification as uncapped, 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 uncapped 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 uncapped new credit union that remains uncapped one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as uncapped; 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 uncapped, 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 uncapped federal credit union.* In lieu of paragraph (c) of this section, an uncapped 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 then-present approved business plan;

(ii) The effective date of classification as less than adequately capitalized if the credit union has no then-present approved business plan; or

(iii) The effective date of classification as less than adequately capitalized if the credit union has increased the total amount of member business loans in violation of § 702.204(a)(3).

(2) *Exception.* The NCUA Board may notify the credit union in writing that its RBP is to be filed within a different period or that it is not necessary to file an RBP.

(3) *Failure to timely file plan.* When a new credit union fails to file an RBP

as provided under paragraphs (a)(1) or (a)(2) of this section, the NCUA Board shall promptly notify the credit union that it has failed to file an RBP and that it has 15 calendar days from receipt of that notice within which to do so.

(b) *Contents of revised business plan.* A new credit union's RBP must, at a minimum—

(1) Address changes, since the new credit union's current business plan was approved, in any of the business plan elements required for charter approval under chapter 1, section IV.D. of appendix B to part 701 of this chapter, or for state-chartered credit unions under applicable state law;

(2) Establish a timetable of quarterly targets for net worth during each year in which the RBP is in effect so that the credit union becomes adequately capitalized by the time it no longer qualifies as "new" per § 702.201;

(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.

Subparts C and D—[Removed]

■ 9. Remove subparts C and D.

Subpart E—[Redesignated as Subpart C]

■ 10. Redesignate subpart E, consisting of §§ 702.501–702.506, as subpart C, consisting of §§ 702.301–702.306.

§ 702.504 [Amended]

■ 11. Amend newly redesignated § 702.504(b)(4) by removing the citation “§ 702.506(c)” and adding in its place “§ 702.306(c)”.

§ 702.505 [Amended]

■ 12. Amend newly redesignated § 702.505(b)(4) by removing the citation “§ 702.504” and adding in its place “§ 702.304”.

■ 13. Appendix A to part 702 is added to read as follows:

Appendix A to Part 702—Gross-Up Approach, and Look-Through Approaches

Instead of using the risk weights assigned in § 702.104(c)(2) a credit union may determine the risk weight of certain investment funds, and the risk weight of a non-subordinated or subordinated tranche of any investment as follows:

(a) Gross-up approach—(1) Applicability. Section 702.104(c)(3)(iii)(A) of this part provides that, a credit union may use the gross-up approach in this appendix to determine the risk weight of the carrying value of non-subordinated or subordinated tranches of any investment.

(2) Calculation. To use the gross-up approach, a credit union must calculate the following four inputs:

(i) Pro rata share, which is the par value of the credit union's exposure as a percent of the par value of the tranche in which the securitization exposure resides;

(ii) Enhanced amount, which is the par value of tranches that are more senior to the tranche in which the credit union's securitization resides;

(iii) Exposure amount, which is the amortized cost for investments classified as held-to-maturity and available-for-sale, and the fair value for trading securities; and

(iv) Risk weight, which is the weighted-average risk weight of underlying exposures of the securitization as calculated under this appendix.

(3) Credit equivalent amount. The “credit equivalent amount” of a securitization exposure under this part equals the sum of:

(i) The exposure amount of the credit union's exposure; and

(ii) The pro rata share multiplied by the enhanced amount, each calculated in accordance with paragraph (a)(2) of this appendix.

(4) Risk-weighted assets. To calculate risk-weighted assets for a securitization exposure under the gross-up approach, a credit union must apply the risk weight required under paragraph (a)(2) of this appendix to the credit equivalent amount calculated in paragraph (a)(3) of this appendix.

(5) Securitization exposure defined. For purposes of this this paragraph (a), “securitization exposure” means:

(i) A credit exposure that arises from a securitization; or

(ii) An exposure that directly or indirectly references a securitization exposure described in paragraph (a)(5)(i) of this appendix.

(6) Securitization defined. For purposes of this paragraph (a), “securitization” means a transaction in which:

(i) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(ii) Performance of the securitization exposures depends upon the performance of the underlying exposures; and

(iii) All or substantially all of the underlying exposures are financial exposures (such as loans, receivables, asset-backed securities, mortgage-backed securities, or other debt securities).

(b) Look-through approaches.—(1) Applicability. Section 702.104(c)(3)(iii)(B) provides that, a credit union may use one of the look-through approaches in this appendix to determine the risk weight of the exposure amount of any investment fund, or the holding of separate account insurance.

(2) Full look-through approach. (i) *General.* A credit union that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund may set the risk-weighted asset amount of the credit union's exposure to the fund equal to the product of:

(A) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the credit union; and

(B) The credit union's proportional ownership share of the fund.

(ii) *Holding report.* To calculate the risk-weighted amount under paragraph (b)(2)(i) of this appendix, a credit union should:

(A) Use the most recently issued investment fund holding report; and

(B) Use an investment fund holding report that reflects holding that are not older than 6-months from the quarter-end effective date (as defined in § 702.101(c)(1)).

(3) Simple modified look-through approach. Under the simple modified look-through approach, the risk-weighted asset amount for a credit union's exposure to an investment fund equals the exposure amount multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(4) Alternative modified look-through approach. Under the alternative modified look-through approach, a credit union may assign the credit union's exposure amount to an investment fund on a pro rata basis to different risk weight categories under subpart A of this part based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the credit union's exposure to the investment fund equals the sum of each portion of the exposure amount assigned to an exposure type multiplied by the applicable risk weight under subpart A of this part. If the sum of the investment limits for all exposure types within the fund exceeds 100 percent, the credit union must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under subpart A of this part and continues to make investments in order of the exposure type with the next highest applicable risk weight under subpart A of this part until the maximum total investment level is reached. If more than one exposure type applies to an exposure, the credit union must use the highest applicable risk weight. A credit union may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 14. 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]

■ 15. 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

■ 16. 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).

■ 17. Amend § 713.6 as follows:

- a. In paragraph (a)(1), revise the table; and
- b. In paragraph (c) remove the words “net worth” each place they appear and add in their place the word “capital”, and remove the words “or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this

chapter, has remained ‘well capitalized’ for the six (6) immediately preceding quarters after applying the applicable RBNW requirement.”.

§ 713.6 What is the permissible deductible?

(a)(1) * * *

Assets	Maximum deductible
\$0 to \$100,000	No deductible allowed.
\$100,001 to \$250,000	\$1,000.
\$250,000 to \$1,000,000	\$2,000.
Over \$1,000,000	\$2,000 plus 1/1000 of total assets up to a maximum of \$200,000; for credit unions that have received a composite CAMEL rating of “1” or “2” for the last two (2) full examinations and maintained a capital classification of “well capitalized” under part 702 of this chapter for the six (6) immediately preceding quarters the maximum deductible is \$1,000,000.

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PART 723—MEMBER BUSINESS LOANS

■ 18. The authority citation for part 723 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1757A, 1766, 1785, 1789.

§ 723.1 [Amended]

- 19. Amend § 723.1 as follows:
 - a. In paragraph (d) remove the words “and the risk weighting standards of part 702 of this chapter”; and
 - b. In paragraph (e) remove the words “and the risk weighting standards under part 702 of this chapter”.

§ 723.7 [Amended]

■ 20. Amend § 723.7(c)(1) by removing the words “as defined by § 702.102(a)(1)” and adding in their place the words “under part 702”.

PART 747—ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS

■ 21. 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]

■ 22. Amend § 747.2001(a) by removing the citation “702.302(d)” and adding in its place the citation “702.202(d)”.

§ 747.2002 [Amended]

■ 23. Amend § 747.2002(a) by removing the words “§§ 702.202(b), 702.203(b) and 702.204(b)” and adding in their place the words “§ 702.107 (b), 702.108(b) or 702.109(b)”, and by removing the words “§ 702.304(b) or § 702.305(b)” and adding in their place the words “§ 702.204(b) or § 702.205(b)”.

§ 747.2003 [Amended]

■ 24. Amend § 747.2003(a) by removing the citation “702.302(d)” and adding in its place the citation “702.202(d)”.

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