# Proposed Risk-Based Capital Rule For Credit Unions

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# Why is the NCUA Proposing this Rule?

- Current net worth and risk-based net worth (used for "complex" credit unions) ratios were implemented in 2000
- Proposed rule is more consistent with corporate credit unions and banks
- NCUA believes the new risk-based capital will more accurately reflect potential risks within credit unions
- Intended to help credit unions absorb more losses and to minimize losses to the NCUSIF
- Comment period ends 90 days after publication in Federal Register (it has not been published in the register yet)
- http://webapps2.ncua.gov/ncua.rbnw.web.ui/

# Who is Affected by the Proposed Rule?

- Federally insured credit unions with total assets > $50M
- “New” credit unions will have minimal changes to ratios
- NCUA regulates 6,753 federally insured credit unions
- Approximately 2,237 credit unions with assets > $50M
  - These credit unions hold 94% of total credit union assets
- Over 90% of these eligible credit unions would be classified as “well capitalized” under the proposed rule
- 189 credit unions would fall to “adequately capitalized”
- 10 credit unions would fall to “under capitalized”

Quoted amounts are based on June 30, 2013 data used the NCUA’s analysis

# Polling Question

Have you used the NCUA's online calculator yet?

Yes

No

# What are the Basics of the Calculation?

- The numerator starts with total equity and removes items that would not be available to cover losses, such as goodwill and other intangible assets, along with the NCUSIF deposit. A benefit is given for the ALLL (limited to 1.25% of risk assets)
- The denominator consists of total assets and a risk-weighting is applied to each asset type. The lower anticipated risk, the lower the risk weight. For example, cash has a risk-weighting of zero, whereas delinquent loans have a risk-weighting of 150%
- Off Balance Sheet items, such as open lines of credit are also included in the denominator based on a conversion factor or the likelihood that the commitment will become an asset

# How did the NCUA Create the Proposed Risk Rankings?

- Reviewed BASEL risk-rankings for banks
- Reviewed US and Int'l banking risk-rankings
- Incorporated current RBNW calculation for "complex" credit unions
- BASEL risk ratios focus on credit risk
- NCUA weightings were selected to not only cover credit risk, but to other risks as well:
  - Concentration Risk
  - Market Risk
  - Interest Rate Risk
  - Operation Risk
  - Liquidity Risk

# Example of Current RBNW Calculation

| A | B | C | D | E | F |
|---|---|---|---|---|---|
| Risk Porfolio | Dollar Balance | % of Assets | Risk Weighting | Asset % times Risk Weighting | Standard Component |
| Total Assets | 500,000,000 | 100.0 | | | |
| (a) Long-term R/E Loans: | | | | | |
| Threshold 0% to 25% | 65,000,000 | 13.0 | 6.00 | 0.78 | 0.78 |
| Excess Amount: over 25% | | | 14.00 | - | |
| (b) MBL's outstanding | | | | | |
| Threshold 0% to 15% | 15,000,000 | 3.0 | 6.00 | 0.18 | 0.18 |
| Threshold >15% to 25% | | | 8.00 | - | |
| Excess Amount: over 25% | | | 14.00 | - | |
| (c) Investments: | | | | | |
| zero to 1 year WAL | 65,000,000 | 13.0 | 3.00 | 0.39 | 1.99 |
| >1 year to 3 years WAL | 55,000,000 | 11.0 | 6.00 | 0.66 | |
| >3 years to 5 years WAL | 25,000,000 | 5.0 | 12.00 | 0.60 | |
| >5 years to 10 years WAL | 10,000,000 | 2.0 | 12.00 | 0.24 | |
| >10 years WAL | 2,500,000 | 0.5 | 20.00 | 0.10 | |
| (d) Low Risk Assets | 12,500,000 | 2.5 | - | | 0.00 |
| (e) Average Risk Assets | 250,000,000 | 50.0 | 6.00 | | 3.00 |
| (f) Loans Sold with Recourse | 5,000,000 | 1.0 | 6.00 | | 0.06 |
| (g) Unused MBL Commitments | 2,500,000 | 0.5 | 6.00 | | 0.03 |
| (h) ALLL (limited to 1.5% of loans) | (5,000,000) | (1.0) | 100.00 | | (1.00) |
| Sum of Standard Components | | | | | 5.04 |

# What is the NCUA's Desired Outcome of the Proposed Risk Rankings?

- Less concentration in real estate and MBLs
- Shorter-term loans
- Shorter-term investments
- Higher liquidity
- Understanding of complex investments, if purchased

# Risk-Based Capital Ratios

| | Net Worth Ratio | Risk-Based Capital Ratio* | Conditions |
|---|---|---|---|
| Well Capitalized | 7% or above | 10.5% or above | Must pass both net worth ratio and risk-based capital ratio |
| Adequately Capitalized | 6% to 6.99% | 8% to 10.49% | Must pass both net worth ratio and risk-based capital ratio |
| Undercapitalized | 4% to 5.99% | Less than 8% | Must pass both net worth ratio and risk-based capital ratio |
| Significantly Undercapitalized | 2% to 3.99% | N/A | Or if undercapitalized at <5% net worth and fails to timely submit or materially implement an approved net worth restoration plan |
| Critically Undercapitalized | Less than 2% | N/A | None |

* Applies only to credit unions with quarter-end assets exceeding $50 million (“complex” credit unions

# Risk-Based Capital Rule

## Bank Comparison Table

| | | Current | New | | | |
|---|---|---|---|---|---|---|
| | | Adequately Capitalized | Under Capitalized | Adequately Capitalized | Well Capitalized | Adequate w/buffer |
| Common Equity Tier | RWA | NA | 3.0% | 4.5% | 5.0% | 7.0% |
| Tier One | RWA | 4.0% | 4.0% | 6.0% | 8.0% | 8.5% |
| Total Capital | RWA | 8.0% | 6.0% | 8.0% | 10.0% | 10.5% |
| Leverage (Tier 1) | Avg Total | 4% or 3% | 3.0% | 4.0% | 5.0% | 6.5% |

# Risk-Based Capital Rule

## Payout Limitations

| **Capital Conservation Buffer** (as a percentage of standardized or advanced total risk-weighted assets, as applicable) | **Maximum Payout Ratio** (as a percentage of eligible retained income) |
|---|---|
| > 2.5% | No payout ratio limitation applies |
| ≤ 2.5% and > 1.875% | 60% |
| ≤ 1.875% and > 1.25% | 40% |
| ≤ 1.25% and > 0.625% | 20% |
| ≤ 0.625% | 0% |

# Capital Conservation Buffer

## Maximum Payout Ratio

**(No Payout Ratio Limitation Applies)**

| Transition Period | Capital Conservation Buffer | Minimum Total Capital Ratio | Total Minimum Ratio + Buffer |
|---|---|---|---|
| Jan 1, 2014 | - | 8.000% | 8.000% |
| Jan 1, 2015 | - | 8.000% | 8.000% |
| Jan 1, 2016 | 0.625% | 8.000% | 8.625% |
| Jan 1, 2017 | 1.250% | 8.000% | 9.250% |
| Jan 1, 2018 | 1.875% | 8.000% | 9.875% |
| Jan 1, 2019 | 2.500% | 8.000% | 10.500% |

# Discretionary Risk-Based Capital Ratio

- The proposed risk-based capital ratios are minimums
  - The NCUA has stated that higher ratios may be required on an institution by institution case depending on the risk assets and how the credit union operates
  - BASEL III also gives the Agencies the same discretion to require higher ratios depending on the bank

# Risk-Based Capital Numerator

| Additions | Deductions |
|---|---|
| Undivided earnings (includes any regular reserve) | NCUSIF deposit |
| Appropriations for non-conforming investments | Goodwill |
| Other reserves | Other intangible assets |
| Equity acquired in merger | Identified losses not reflected as adjustments to components of the risk-based numerator |
| Net income | |
| ALLL (limited to 1.25% of risk assets) | |
| Secondary capital accounts included in net worth | |
| Section 208 assistance included in net worth (as defined in 702.2) | |

# Risk-Based Capital Numerator

The risk-based capital numerator would NOT include the following Call Report equity items:

- Accumulated unrealized gains (losses) on available for sale securities
- Accumulated unrealized losses for OTTI on debt securities
- Accumulated unrealized net gains (losses) on cash flow hedges
- Other comprehensive income not consistent

# Risk-Weight Categories and Associated Risk-Weights

**Category 1: Risk Weight - 0**

- Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit, and currency supplied from automatic teller machines
- NCUSIF capitalization deposit
- U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS)
- Non-delinquent student loans unconditionally guaranteed by a U.S. government agency

# Risk-Weight Categories and Associated Risk-Weights

**Category 2: Risk Weight – 20%**

- Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts.
- The total amount of investments with a weighted-average life of one year or less
- Residential mortgages guaranteed by the federal government through the FHA or the VA

# Risk-Weight Categories and Associated Risk-Weights

**Category 2: Risk Weight – 20% (cont.)**

- Cash equivalents (investments with original maturities of three months or less). Cash equivalents are short-term, highly liquid non-security investments that have an original maturity of 3 months or less at the time of purchase, are readily convertible to known amounts of cash, and are used as part of the credit union's cash management activities.
- Loans guaranteed 75% or more by the SBA, U.S. Department of Agriculture, or other U.S. Government agency.

# Risk-Weight Categories and Associated Risk-Weights

**Category 3: Risk Weight – 50%**

- The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years.

- The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.

# Risk-Weight Categories and Associated Risk-Weights

**Category 4: Risk Weight – 75%**

- The total amount of investments with a weighted-average life of greater than 3 years, but less than or equal to five years.
- Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans (excluding loans reported as MBLs).
- Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.

# Risk-Weight Categories and Associated Risk-Weights

**Category 5: Risk Weight – 100%**

- Corporate credit union nonperpetual capital
- The total outstanding principal amount loaned to CUSOs
- Current and non-delinquent first mortgage real estate loans greater than 35% of total assets
- Delinquent first mortgage real estate loans
- Other real estate-secured loans less than or equal to 10% of assets
- MBLs less than or equal to 15% of assets

# Risk-Weight Categories and Associated Risk-Weights

**Category 5: Risk Weight – 100% (cont.)**

- Loans held for sale
- The total amount of any foreclosures and repossessed assets
- Land and building, less depreciation on building
- Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation
- Current non-federally insured student loans
- All other assets not specifically assigned a risk-weight but included on the balance sheet

# Risk-Weight Categories and Associated Risk-Weights

**Category 6: Risk Weight – 125%**

- Total amount of all other real estate-secured loans greater than 10% of assets and less than or equal to 20% of assets

# Risk-Weight Categories and Associated Risk-Weights

**Category 7: Risk Weight – 150%**

- The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years
- Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as MBLs)

# Risk-Weight Categories and Associated Risk-Weights

## Category 7: Risk Weight – 150% (cont.)

- The total amount of all other real estate-secured loans greater than 20% of assets

- Any MBLs greater than 15% of assets and less than or equal to 25% of assets

# Risk-Weight Categories and Associated Risk-Weights

## Category 8: Risk Weight – 200%

- Corporate credit union perpetual capital
- The total amount of investments with a weighted average live of greater than 10 years
- The total amount of MBLs great than 25% of assets, other than MBLS included in Category 3

# Risk-Weight Categories and Associated Risk-Weights

**Category 9: Risk Weight – 250%**

- The total value of investments in CUSOs
- The total value of mortgage servicing assets

# Risk-Weight Categories and Associated Risk-Weights

**Category 10: Risk Weight – 1,250%**

- An asset backed investment for which the credit union is unable to demonstrate, as required (under 702.104d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance
  - A 1,250% risk weight is equivalent to holding capital equal to 100% of the investment's balance sheet value

# Risk-Weights for Off-Balance Sheet Activities

- Risk-weighted amounts for all off-balance sheet items are determined by multiplying the notional principal, or face value, by the appropriate conversion factor and the assigned risk-weight.
  - A 75% conversion factor with a 50% risk-weight for first mortgage real estate loans transferred with limited recourse (FHLB MPF loans)
  - A 75% conversion factor with a 100% risk-weight for other real estate, MBL, and student loans sold with limited recourse
  - A 75% conversion factor with a 75% risk-weight for all other loans sold with limited recourse
  - A 75% conversion factor with a 100% risk-weight for unfunded MBL commitments
  - A 10% conversion factor with a 75% risk-weight for unfunded non-business commitments (where the commitment is not immediately cancelable)

# Representations and Warranties

The off balance sheet rule would expressly exclude loans sold to the secondary market that feature representations and warranties customarily required by the U.S. Government (e.g., Ginnie Mae) and government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac)

# Conversion Factor for Derivatives Contracts

| Remaining Maturity | Interest rate risk hedge derivatives | All other derivatives |
|---|---|---|
| One year or less | 0.00 | 0.10 |
| Greater than one year and less than or equal to five | 0.005 | 0.12 |
| Greater than five years | 0.015 | 0.15 |

# Misc Items

- A “regular reserve” account will no longer be required – this account will be closed out to undivided earnings
- Online calculator is not completely accurate; not all data is broken out on the call report at the necessary level to calculate some items
  - The call report will be adjusted to ask for these break outs when the rule has been finalized

# Implications

- Proposed rule affects interest rate risk and ALM strategies
- Affects loan pricing strategies
- Regulatory ROE

# Polling Question

Considering the strategies you would need to undertake in order to position your institution as "well capitalized" under the proposed rule, what do you feel would be a reasonable timeframe in which to implement the new ratios?

- 0 months – I'm ready now
- 12 - 18 months
- 2 - 3 years
- 4 - 5 years
- More than 5 years

# Wilary Winn Risk Management

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