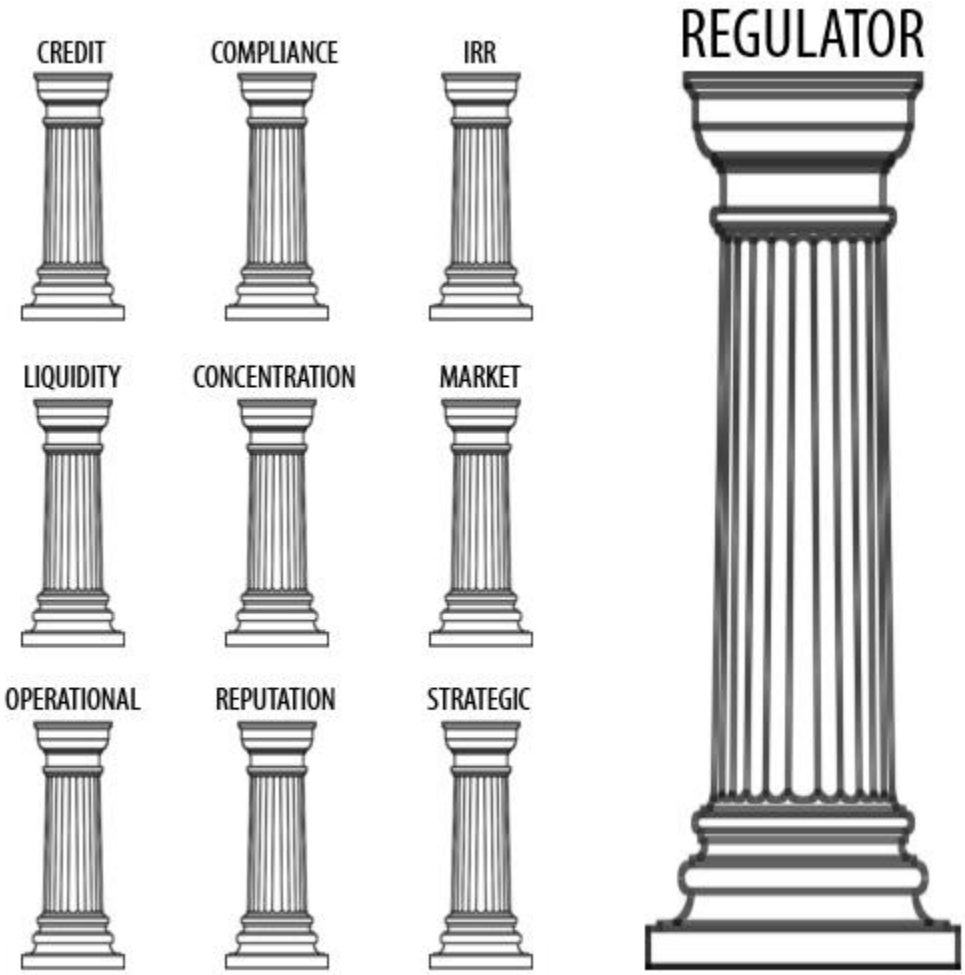

The 10th Risk

Opinion and Guide to the NCUA's Proposed Risk Based Capital Rule

Authored by: Jim Vilker, NCCO, VP of Professional Services, CU*Answers
Patrick Sickels, Internal Auditor, CU*Answers

CU*ANSWERS
A Credit Union Service Organization

AuditLink
CU*ANSWERS Management Services

Contents

Opinion Letter

A RISK ASSESSMENT OF THE PROPOSED RULE ON RISK-BASED CAPITAL

Never in the history of NCUA rule-making has it been necessary to classify a regulator as a risk to the credit union. However, we are not in normal times and the NCUA's actions over the last few years are indicative of a governmental agency whose mission is to manage all the perceived risk out of a credit union's operations.

The proposed Risk-Based Capital (RBC) rule allows for an examiner to arbitrarily choose RBC weights or minimum risk-based ratio based upon their findings. Credit unions that at the beginning of the exam are considered well-capitalized could by the end of the exam be immediately placed into prompt corrective action (PCA).

The NCUA has outlined areas which allow the examiner to increase minimum capital, but refuses to restrain examiner requirements for the amount of capital the credit union must maintain. So let us call a spade a spade. The RBC regulation is ***not*** *about capital at all; it is about the NCUA putting a credit union into PCA so that all NCUA recommendations, regardless of whether they are to the benefit of the credit union, become backed by regulatory enforcement powers.*

This white paper will detail the areas outlined in the regulation which pose risk to the credit union based upon examiner discretionary powers, and then describe the tactics to take today to proactively and offensively analyze and mitigate those risks.

Regardless of the outcome of the comments submitted on the final regulation and coupled with the reality that NCUA regulators make very few changes based upon credit unions concerns, it would be prudent to assess the risk that a rogue finding on an exam could cause a credit union to fall under the control of the NCUA even when evidence of risk to the Share Insurance Fund is scant or conflicting.

Regulators as the 10th Risk

MANAGING THE RISK THAT AN EXAMINER BRINGS TO YOUR ORGANIZATION

The existing nine risks that NCUA requires credit unions to understand, assess, manage and mitigate on an enterprise level include: Credit, Compliance, IRR, Liquidity, Concentration, Market, Operational, Reputation, and Strategic risk. This regulation introduces an entirely new risk the must be evaluated and assessed. The "10th" risk: Regulator. Understanding this risk can help prepare your commentary to the NCUA.

To identify the risk to your credit union:

Address each area of discretionary examiner assessment for override

Use a standard tabular format as those used for other risks e.g. BSA/AML/OFAC

Identify areas that are Low, Moderate, or High risk to the credit union's business strategy

Assess this new risk against the credit union's current condition using the nine areas of risk listed prior and understand your circumstances. Are there:

Prior exam recommendations, DORs and LUAs?

Any disagreements on areas such as concentrations, IRR, liquidity, ALLL funding, branching, mergers?

Recent changes in credit union's product structure, loan, or investment strategy?

Strategic and planned changes in the credit union's financial condition and structure (including growth through mergers)?

Changes in the broader economy or local market trends?

Over the next 18 months, credit unions should consider taking the following steps to mitigate the risk:

Documenting your assessment and getting early buy in from the NCUA

Begin educating the Board of Directors of the necessary actions to avoid the risk

Understanding the new risk of the RBC to the ongoing business strategy of the credit union

Delineating the additional enforcement powers the NCUA has

What management decision-making capability may need NCUA approval?

What requirement does this place on the minimum ongoing earnings of the credit union?

At your next exam, speak candidly with the examiner about the potential to have additional RBC to understand how the rule would be used.

Current Capitalization Requirement Rules

THRESHOLDS AND ENFORCEMENT ACTIONS

Although reasonable parties can debate the value of the current capitalization requirements federally insured credit unions (FICUs) must meet, at least the calculations are quite simple and easy to understand.

Under the current part 702 of the NCUA's regulations, most FICUs must divide their Total Net Worth (Account Code 997 on the 5300 report) by Total Assets (Account Code 010 on the 5300 report) to obtain their Net Worth Ratio. For example:

Table 1: Standard Well Capitalized Credit Union Calculation

	Acct Code	Amount
Total Net Worth	997	$10,000,000
Total Assets	010	$100,000,000
Net Worth Ratio		**10%**

The Net Worth Ratio must be greater than 7% for a credit union to be considered Well-Capitalized. Any credit union that does not meet this 7% threshold will fall into a different category.

Table 2: Capitalization Definitions under part 702

§702 STATUTORY DEFINITION	NET WORTH RATIO
WELL CAPITALIZED	7% OR ABOVE
ADEQUATELY CAPITALIZED	6% TO 6.99%
UNDERCAPITALIZED	4% TO 5.99%
SIGNIFICANTLY UNDERCAPITALIZED	2% TO 3.99%
CRITICALLY UNDERCAPITALIZED	LESS THAN 2%

Table 3: Adequately Capitalized Credit Union Calculation

	Acct Code	Amount
Total Net Worth	997	$6,500,000
Total Assets	010	$100,000,000
Net Worth Ratio		**6.5%**

Once a FICU falls below 7%, by law the NCUA is authorized to take Prompt Corrective Action, or PCA. Depending on the level of the credit union's capitalization, the NCUA has increasing power to control the operations of the institution, or merge/liquidate the credit union out of existence.

Adequately Capitalized credit unions must increase on a quarterly basis its Net Worth "by an amount equivalent to at least 1/10th percent (0.1%) of its total assets." In addition, the credit union must also on a quarterly basis transfer that amount from "undivided earnings to its regular reserve account" until the credit union is back to being Well-Capitalized. For example, the Adequately Capitalized credit union in Table 3 would need to increase its Total Net Worth every quarter by $100,000 (and transfer the same to the regular reserve account) until it reaches the Well-Capitalization threshold. If an Adequately Capitalized credit union fails to meet these requirements, the institution can be *reclassified* (and therefore subject to far more restrictions) as Undercapitalized or worse.

Undercapitalized credit unions must fulfill the Adequately Capitalized requirements and in addition must submit a Net Worth Restoration Plan (NWRP) that is approved by the NCUA. In addition, the NCUA has discretion to require prior NCUA approval of new branches/lines of business, the NCUA may restrict certain transactions, prohibit growth and/or prohibit certain other activities, and dismiss directors and/or officers.

Significantly and *Critically Undercapitalized* credit unions face even more restrictions, and are also at risk of merger or liquidation.

Prompt Corrective Action and the New Rule

Prompt Corrective Action is very dangerous for any FICU and its management. The NCUA has very broad power to take serious action against credit unions who fall into PCA and fail to meet the requirements of the law. For example, an Adequately Capitalized credit union that misses its Net Worth quarterly target by even a single dollar could be categorized as Undercapitalized, granting the NCUA the power to dismiss directors and officers and restrict lines of business to members.

Moreover, directors and officers may face litigation from the NCUA. If a credit union fails, the NCUA may initiate a legal case against a credit union's directors and officers to cover losses not covered by insurance. Credit union directors and officers can be sued for breaches of fiduciary duties.

With the direct threat of PCA, why did the NCUA find it necessary to expand the reach of part 702 and impose additional regulatory burdens on credit unions? Part of the answer lies in a Government Accounting Office (GAO) report issued in 2012. Entitled *Earlier Actions are Needed to Better Address Troubled Credit Unions*, this report was critical of the NCUA's use of PCA, and recommended specific changes to how the NCUA used PCA:

> *To improve the effectiveness of the PCA framework, we recommend that the Chairman of NCUA consider additional triggers that would require early and forceful regulatory actions, including the indicators identified in this report. In considering these actions, the Chairman should make recommendations to Congress on* ***how to modify PCA for credit unions****, and if appropriate, for corporates.* [Page 43]

The NCUA responded to this report by fully agreeing with these recommendations, in other words to modify the current rules and expand the reach of PCA. The new proposed 702 rules are the result of this recommendation.

It is important to realize that the net effect of this regulation will be to ***increase the number of credit unions subject to PCA***. Therefore, every credit union will have increased risk that this new regulation will subject their operations to NCUA control. That is the *purpose* of the legislation.

FICUs subject to this new rule need to be aware of the rule's mechanics and its quirks. The credit union needs to regularly calculate its current and future positions with respect to the RBC requirements and incorporate these into both planning sessions and contingency planning.

How the New Proposed RBC Rule Works

The proposed RBC rule works similarly to, but in a significantly more complex way than the current Net Worth Ratio rule. There is still a ratio to calculate, but with several additional formulas to be accounted for.

The numerator is broken into four categories: liabilities, equity, contra assets, and other assets. At the most basic level, having this number be as large as possible (just as having the Net Worth be as large as possible is key for the current calculations).

Table 4: Numerator for the New RBC Rule

LIABILITIES	
Subordinated Debt included in Net Worth	Acct_925A2
Subordinated Debt (non low income and non-208)	Acct_867B2
EQUITY	
Undivided Earnings	Acct_940
Regular Reserve	Acct_931
Appropriations for Non-Conforming Investments	Acct_668
Other Reserves	Acct_658
Equity Acquired in Merger	Acct_658A
Net Income	Acct_602
CONTRA ASSETS	
ALLL (limited to 1.25% of risk assets/denominator)	Acct_719
OTHER ASSETS	
Goodwill	Acct_009D2
Identifiable Intangible Assets	Acct_009D1
National Credit Union Share Insurance Fund	Acct_794

Although credit unions do get to add their ALLL to this figure, it is capped out at 1.25% of risk-weighted assets (thus a credit union with $80,000,000 in risk-based assets with a fully-funded ALLL would be able to add $1,000,000 to the numerator calculation). Although the numerator calculations are quite a step up in complexity, it is on the denominator side where things can get very challenging and require extremely careful accounting.

Table 5: Denominator for the New RBC Rule

	PROPOSED RISK WT
CASH	
Cash on Hand	0
INVESTMENTS	
0 - 1 Year	0.2
> 1 to 3 Years	0.5
> 3 to 5 Years	0.75
> 5 to 10 Years	1.5
> 10 Years	2
Corporate CU Member Capital	1
PIC/ Perpetual Contributed Capital	2
LOANS	
Nondelinquent Nonfederally Guaranteed Student Loans	1
Nondelinquent Other Loans	0.75
Reportable Delinquent Other Loans	1.5
Nondelinquent 1st Mortgage Real Estate Loans (excluding Member Business Loans secured by Real Estate) < 25% of Assets	0.5
Nondelinquent 1st Mortgage Real Estate Loans (excluding Member Business Loans secured by Real Estate) Excess of 25 - 35% of Assets	0.75
Nondelinquent 1st Mortgage Real Estate Loans (excluding Member Business Loans secured by Real Estate) Excess of 35% of Assets	1
Other Real Estate Loans and Delinquent Real Estate Loans Less than >10% of Assets	1
Other Real Estate Loans and Delinquent Real Estate Loans Excess of 10-20% of Assets	1.25
Other Real Estate Loans and Delinquent Real Estate Loans Excess of 20% of Assets	1.5
Small Business Administration Loans	-0.8
Member Business Loans Less than >15% of Assets	1
Member Business Loans Excess of 15-25% of Assets	1.5
Member Business Loans Excess of 25% of Assets	2
OTHER ASSETS	
National Credit Union Share Insurance Fund	-1
Goodwill	-1
Identifiable Intangible Assets	-1
Investment in Credit Union Service Organization	2.5
Mortgage Servicing Rights	2.5
All Other Assets	1
OFF BALANCE SHEET ITEMS	
Loans Sold with Recourse	0.75
Unfunded Commitments on Business Loans (75% conversion)	1
Unfunded Commitments for Non-Business Loans (10% conversion)	0.75

Credit unions must look at their assets and multiply them by an arbitrary risk weight set by the NCUA's tables. The larger the weight, the riskier the NCUA views the asset held by the credit union.

For example, let's say a FICU has $100,000,000 in assets (Acct_010) and $15,000,000 in Other Real Estate Loans. Under the proposed RBC rule, the calculation would look like this:

Table 6: RBC Denominator Calculation Example (Other Real Estate)

Other Real Estate Loans and Delinquent Real Estate Loans Less than >10% of Assets	1	$10,000,000
Other Real Estate Loans and Delinquent Real Estate Loans Excess of 10-20% of Assets	1.25	$6,250,000
TOTAL		**$16,250,000**

Instead of having the Other Real Estate portfolio add $15,000,000 to the denominator, this credit union will add $16,250,000, reflecting the new RBC risk weights.

If a $100,000,000 FICU had $25,000,000 in Other Real Estate loans their RBC calculation would add $30,000,000 to the denominator ($10,000,000 x1 + $10,000,000 x1.25 [$12,500,000] + $5,000,000 x1.5 [$7,500,000]). The smaller the numerator and the larger the denominator the more likely a FICU will find itself in PCA.

A quick review of Table 5 shows the areas the NCUA has the most concern about. Investments with maturities greater than 5 years, Other Real Estate loans that are greater than 10% of Total Assets, Delinquent loans (meaning 60+ days overdue), Member Business Loans greater than 15% of Total Assets, mortgage servicing assets, and investment in CUSOs all take high risk weights.

The threshold number for Well Capitalization and therefore no PCA is a ratio of **10.5%**. Anything less than that and the credit union is subject to PCA *even if* its Net Worth Ratio is greater than 7%. In fact, all FICUs should be aware that the old capital requirements are not eliminated by the new RBC rules. Instead, FICUs must pass *both* the old and the new RBC requirements to be well capitalized; in other words, the new rules increase the chances that a credit union will be subject to PCA.

Table 7: New RBC Capitalization Categories

A credit union's capital classification is	Net worth ratio	Risk-based capital ratio	And subject to following condition(s)
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%	LESS THAN 8%	*Or if 'under-capitalized at < 5% net worth and fails to timely submit or materially implement an approved net worth restoration plan.*
CRITICALLY UNDERCAPITALIZED	LESS THAN 2%	LESS THAN 8%	*None.*

FICUs can go the NCUA website and check to see how they might do with the new regulations based on the latest call report. However, credit unions also need to be sure they understand this figure is going to fluctuate based on the changes to the credit union's balance sheet and economic conditions which might affect payment on loans.

Examples of the New RBC Rules at Work

For the purposes of this example, let's assume a FICU with a Net Worth Ratio over 7%, a numerator value of $12,250,000 and a denominator value of $106,250,000 (assume omitted balance sheet items have a value of zero). In this case, the FICU would be considered "Well-Capitalized" as the ratio between a numerator of $12,250,000 and a denominator of $106,250,000 is 11.5%, a 1% increase over the 10.5% minimum threshold.

Table 8: RBC Example 1 – Well-Capitalized FICU

EQUITY	**12,000,000**
Undivided Earnings	10,000,000
Regular Reserve	2,000,000
CONTRA ASSETS	**750,000**
ALLL (limited to 1.25% of risk assets/denominator)	750,000
OTHER ASSETS	**-500,000**
National Credit Union Share Insurance Fund	-500,000
NUMERATOR	**12,250,000**

INVESTMENTS				**22,250,000**
Account	**Value**		**Proposed Risk Weight**	**Calculation**
0 - 1 Year	20,000,000		0.20	4,000,000
> 1 to 3 Years	10,000,000		0.50	5,000,000
> 3 to 5 Years	5,000,000		0.75	3,750,000
> 5 to 10 Years	5,00,0000		1.50	7,500,000
> 10 Years	500,000		2.00	1,000,000
Corporate CU Member Capital	1,000,000		1.00	1,000,000
LOANS				**79,500,000**
Account	**Value**		**Proposed Risk Weight**	**Calculation**
Nondelinquent Other Loans	20,000,000		0.75	15,000,000
Nondelinquent 1st Mortgage Real Estate Loans (excluding Member Business Loans secured by Real Estate)	40,000,000			
	25,000,000	< 25% of Assets	0.50	12,500,000
	10,000,000	Excess of 25 - 35% of Assets	0.75	7,500,000
	5,000,000	Excess of 35% of Assets	1.00	5,000,000
Other Real Estate Loans and Delinquent Real Estate Loans	30,000,000			
	10,000,000	< 10% of Assets	1.00	10,000,000
	10,000,000	Excess of 10 - 20% of Assets	1.25	12,500,000
	10,000,000	Excess of 20% of Assets	1.50	15,000,000
Member Business Loans	2,000,000			
	2,000,000	< 15% of Assets	1.00	2,000,000
OTHER ASSETS				**4,500,000**
Account	**Value**		**Proposed Risk Weight**	**Calculation**
National Credit Union Share Insurance Fund	500,000		-1.00	-500,000
Goodwill	0		-1.00	0
Identifiable Intangible Assets	0		-1.00	0
Investment in Credit Union Service Organization	2,000,000		2.50	5,000,000
Mortgage Servicing Rights	0		2.50	0
All Other Assets	0		1.00	0
DENOMINATOR				**106,250,000**

However, let's assume the FICU has the same numerator of $12,250,000 but has significantly more in investments with long term maturity. Such a scenario was relatively common during the Great Recession where credit unions invested in long term securities for yield.

Table 9: RBC Example 2 - FICU with Long Term Investments

INVESTMENTS			37,450,000
Account	**Value**	**Proposed Risk Weight**	**Calculation**
0 - 1 Year	1,000,000	0.20	200,000
> 1 to 3 Years	10,000,000	0.50	5,000,000
> 3 to 5 Years	5,000,000	0.75	3,750,000
> 5 to 10 Years	5,000,000	1.50	7,500,000
> 10 Years	10,000,000	2.00	20,000,000
Corporate CU Member Capital	1,000,000	1.00	1,000,000
PIC/ Perpetual Contributed Capital	0	2.00	0

Although the credit union in example 1 has more dollars in investments ($41,500,000) than the credit union in example 2 ($32,000,000), the second credit union has a much higher Investments denominator calculation. This is due to the fact that the risk weight on investments with very short maturities is much lower than that of long term maturities. If all other calculations remained exactly the same, the FICU in example would be ***immediately subject to PCA*** as its RBC ratio would be 10.1%, below the minimum threshold of 10.5%.

Table 10: RBC Example 3 - Increased Delinquencies

LOANS				90,250,000
Account	**Value**		**Risk Weight**	**Calculation**
Nondelinquent Nonfederally Guaranteed Student Loans	0		1.00	0
Nondelinquent Other Loans	14,000,000		0.75	10,500,000
Reportable Delinquent Other Loans	6,000,000		1.50	9,000,000
Nondelinquent 1st Mortgage Real Estate Loans (excluding Member Business Loans secured by Real Estate)	30,000,000			
	25,000,000	< 25% of Assets	0.50	12,500,000
	5,000,000	Excess of 25 - 35% of Assets	0.75	3,750,000
	0	Excess of 35% of Assets	1.00	0
Other Real Estate Loans and Delinquent Real Estate Loans	40,000,000			
	10,000,000	< 10% of Assets	1.00	10,000,000
	10,000,000	Excess of 10 - 20% of Assets	1.25	12,500,000
	20,000,000	Excess of 20% of Assets	1.50	30,000,000
Small Business Administration Loans	0		-0.80	
Member Business Loans	2,000,000			
	2,000,000	< 15% of Assets	1.00	2,000,000

In this final example everything else remained constant, but the credit union suffered a spate of 60+ day delinquencies due to economic conditions in its area. Although the total *amount* of loans is the same from example 1, the delinquencies change increases the denominator risk by roughly $20 million. The example 3 credit union would have a RBC of 10.45%, and would be ***immediately subject to PCA***.

Discretionary Authority Under RBC

EXAMINERS WILL HAVE SIGNIFICANT POWER EVEN OVER "WELL CAPITALIZED" FICUS

Hidden within the myriad of ratios and risk weights of the new regulation are broad discretionary powers examiners will have access to even over credit unions that pass both the Net Worth Ratio and RBC tests. This is the one area that will drive a credit union's risk analysts over the edge. NCUA states in the regulation the following relative to how they will determine the minimum capital requirements for a FICU:

"Proposed §702.105(c) would provide that the appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria, and that the decision is necessarily based, in part, ***on a subjective judgment grounded in agency expertise*** *[emphasis added]. The proposed rule provides the following additional factors that may be considered by NCUA in making its determination:*

• The urgency of those circumstances or potential problems.

• The overall condition, management strength, and future prospects of the credit union and, if applicable, its subsidiaries, affiliates, and business partners.

• The credit union's liquidity, capital, and other indicators of financial stability, particularly as compared with those of similarly situated credit unions.

• The policies and practices of the credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices."

This "subjective judgment" clause adds broad authority to examiners. In effect, there is no way to determine what the minimum number will be or how far the NCUA can move a FICU down the PCA chart of capitalization definitions. Once the credit union is placed into PCA, however, the NCUA has the additional powers granted to them to dictate what the credit union can or must do.

To properly assess the risk and make the determination if the credit union could be held to higher standards we must first understand all the areas where additional capital may be deemed necessary.

105(a) General

Proposed §702.105(a) would provide that the rules and procedures specified in this paragraph apply to the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirement(s) that would otherwise apply to the credit union under this part.

105(b) Appropriate Considerations for Establishing Individual Minimum Capital Requirements

A credit union is receiving special supervisory attention.

A credit union has or is expected to have losses resulting in capital inadequacy.

A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk.

A credit union has poor liquidity or cash flow.

A credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance.

A credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit.

A credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms.

A credit union has inadequate underwriting policies, standards, or procedures for its loans and investments.

A credit union has failed to properly plan for, or execute, necessary retained earnings growth.

A credit union has a record of operational losses that exceeds the average of other similarly situated credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

There is a great deal of examiner flexibility in the interpretation of these rules. For example, what constitutes "poor liquidity or cash flow"? What should be considered "inadequate underwriting policies, standards, or procedures"?

The fact is credit unions will need to be highly attuned to the reports issued by examiners, especially with respect to DOR or LUA findings. A credit union that sees this kind of language on its findings needs to be highly alert and assume the examiners are setting up scenarios under 702.105(b) where it may modify the credit union capital requirements and use these findings to push the credit union into PCA. Credit unions need to consider fighting results it does not agree with or remediating those findings prior to the next Safety and Soundness examination cycle.

In the proposed RBC regulation, the NCUA listed several risks for all FICUs; in some cases these are ALM concerns, but note that the NCUA also has concerns when a credit union moves beyond the usual in its offerings and services:

A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, ***certain risks arising from nontraditional activities*** *or similar risks, or a high proportion of off-balance sheet risk. [emphasis added]*

This is yet another area where credit unions need to be watching findings closely. Because "nontraditional activities" can encompass a wide range of business that is perfectly normal for a particular FICU to engage in, if these words appear on a report after a Safety and Soundness exam the credit union needs to take significant care in addressing those terms with the examination team.

Asset Backed Investment Risk Weight

THE DANGEROUS ISSUE OF ASSET BACKED INVESTMENTS

The NCUA has a special risk weight option for asset backed investments. The NCUA will create a huge multiplier for FICUs who do not meet the "comprehensive understanding" test for asset-backed investments:

§702.104(c)(2)(x)
Credit unions must assign a 1,250 percent risk-weight to an asset-backed investment for which the credit union is unable to demonstrate, as required under §702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance. A 1,250 percent risk-weight is equivalent to holding capital equal to 100 percent of the investment's balance sheet value.

To show "comprehensive understanding" the credit union must follow the rules of 702.104(d):

Proposed § 702.104(d)(2) would provide that a credit union must demonstrate its comprehensive understanding of each asset-backed investment exposure under § 702.104(d)(1) by:

- *Conducting an analysis of the risk characteristics of an investment's exposure prior to acquiring the investment and documenting such analysis within three business days after acquiring the exposure, considering:*

  Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

  Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

  Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and

  For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and

- *On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure.*

Credit unions need to be aware there is a good deal of "soft" requirements here, such as what might constitute "relevant market data." This is not an academic issue: a credit union with $1,000,000 in asset-backed investments that ran afoul of 702.104(c)(2)(x) would see this weighted at $12,500,000. That alone might be enough to send the credit union right into PCA.

Assessing the Discretionary Smorgasbord

IS A FICU AT LOW OR HIGH RISK?

In assessing this list, each one should be broken out individually and reviewed based upon its own components. For example, concentration risk is used to define levels of risk.

Low Risk

The credit union has adopted a policy and monitors for all concentrations of loans exceeding 100% of net worth on a quarterly basis.

The policy has been vetted by examiners and no findings or recommendations have been brought to the attention of the BOD or management.

No concentration exceeds 200% of net worth with the exception of a well-diversified consumer secured and unsecured portfolio.

Concentrations of real estate loans, indirect, or MBL's do not exceed 250% of net worth, and the credit union has not focused its lending factory upon only one of those lines for the upcoming annual.

Moderate Risk

The credit union has a solid concentration risk policy but does not verify if policy limits are trending towards maximum on any type of frequency.

Currently the real estate portfolio is considered to be at a high level in relationship to net worth exceeding 350%.

Recommendations in the last exam pointed to this concentration and asked that a plan be put in place to stem this growing trend.

The portfolio has gone through extensive testing relative to credit and asset quality and results were all positive. A plan is in place to show a full understanding of the portfolio and areas to mitigate the risk but has yet to be vetted by the examiners.

High Risk

The credit union has exceeded Board established limits or has been written up in prior exams for having a high concentration of net worth in real estate, MBLs, or indirect loans.

The historical loss ratios in one or more of the portfolios would indicate that underwriting quality remains in question and the prediction is the additional losses are expected.

In addition, the credit union has been required by the NCUA that additional monitoring be put in place outside normal monitoring best practices and the credit union has not fully implemented those tools.

Success in managing exams will come from (1) having a strong Net Worth Ratio, (2) having a strong RBC ratio, (3) promptly remediating examiner findings that show a real risk to the credit union, (4) challenging examiner findings that are mistaken or do not present Safety and Soundness risk, and (5) having several contingency plans and acting on those once it appears that a real danger exists to the credit union. Remember always that Safety and Soundness means risk to the Share Insurance Fund, and the examiners are likely to be most responsive to credit unions that address this risk.

ASSESSING ASSET-BACKED INVESTMENT RISK

Below are examples of how a credit union may want to assign the risk level based upon NCUA requiring additional capital for the types of investments the credit unions has.

Low Risk

The credit union has a laddered CD portfolio which has no options associated with it and has maturities ranging from one to three years.

Other investments may include GSE Bonds with bullet maturities or very plain vanilla corporate debt with AAA ratings.

There have been no findings on prior exam reports, rate shocks are not necessary as the investments are held to maturity, and the credit unions SIRTT ratio has remained below 100%.

The policy has been vetted by examiners and no findings or recommendations have been brought to the attention of the BOD or management.

Currently, the real estate portfolio is considered to be at a high level in relationship to net worth exceeding 350%.

Recommendations in the last exam pointed to this concentration and asked that a plan be put in place to stem this growing trend.

Moderate Risk

The credit union has purchased asset backed securities but has not purchased any with exotic options. However, the credit union has gone out longer on the curve since the last exam but no weighted average lives exceed 5 years.

The three hundred basis point shock does indicate some loss but no more than 25% of the market value of the security.

Exam findings have not been critical of the credit unions investment strategy relating to DORs, but there have been recommendations in the past relative to the management of IRR, Liquidity, and/or calculation of the NEV.

High Risk

The credit union has a large percentage of its portfolio in asset backed securities, which has drawn the attention of examiners in prior exams.

The credit union has outstanding DORs relative to the understanding of the investments and has not demonstrated the reasons for purchasing or holding the investment.

The credit union has begun to move out longer on the yield curve and has invested a significant amount (in comparison to net worth) in securities with weighted average lives greater than 5 years.

The investments also demonstrate excessive market price deterioration in the 300 and 500 basis point rate shock.

Recommendations of examiners have alluded to the fact the credit union is not managing IRR or Liquidity, and found significant flaws in the assumptions used for ALM modeling relating to shock tests and NEV.

Concluding Remarks

THE DANGEROUS NEW WORLD OF RBC

So what should the credit union do if it discovers medium or high risk in the balance sheet? If, for example, a credit union had high risk in the investment portfolio, one recommendation would be to actually apply the weights to the investments and determine what the new RBC number would be. In the event the calculation places the FICU in a bad definition, consider the impact of the classification on the credit union's business strategy and the burden the determination would place on the operations and management of the credit union.

Document the plan and include this section as part of the overall assessment, and report it to your Board of Directors. Also, consider asking the NCUA examiner in charge during the next exam cycle what is the probability the credit union actually being placed in one of the lower categories. Understand the implications and come to an agreement that this will not happen to the credit union if you continue on the same investment strategy path.

There will be credit unions that ignore the dangers of RBC and misunderstand the new powers that examiners have, even if the credit union is dangerously close to the RBC threshold. Credit unions need to be aware that even if the institution has strong financials in 2014, conditions can change quickly. FICUs need to be very cognizant of the changes to the rules regarding credit union balance sheets and the new powers examiners have even when the institution meets the new tests.