NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **January 2001** **LETTER NO.: 01-CU-01**

TO: **Federally Insured Credit Unions**

SUBJ: **Prompt Corrective Action (PCA) Implementation Information**

ENCL:
(1) Attachment A: PCA Net Worth Calculation Worksheet
(2) Attachment B: Standard Components of RBNW Requirement
(3) Attachment C: PCA Frequently Asked Questions
(4) Appendix

This letter provides credit unions with additional information regarding the implementation of *NCUA Rules & Regulations Part 702 Prompt Corrective Action (PCA)*. This letter also addresses several frequently asked questions (FAQs) pertaining to key areas of PCA.

Credit unions should gain an understanding of how PCA will apply to them. However, for the majority of credit unions, PCA generally will not entail more than the **quarterly measurement of the net worth to total assets ratio (NWR).** In addition, credit unions greater than $10 million in assets must also **review their Risk Based Net Worth (RBNW) Requirement, but only for the quarters that they are required to complete a Call Report.**

Based on June 2000 Call Report information, NCUA estimates that 95% of all federally insured credit unions will **not** be directly affected by PCA. This means 95% of all credit unions will not be subject to any mandatory or discretionary supervisory actions under PCA. This is because under most circumstances, PCA supervisory actions will not apply until a credit union’s NWR falls below 7%. Presently, less than 5% of credit unions have a NWR below 7%. The average NWR is nearly double at 13.9%.

Implementation

NCUA and State Supervisory Authorities (SSAs) will officially begin classifying credit unions based upon their net worth ratio (NWR) during the first quarter of 2001. NCUA will base this classification on data credit unions report in the December 2000 Call Report, reflecting activity for the fourth quarter of 2000.

Net Worth Ratio (NWR)
To aid credit unions in measuring the NWR, NCUA has developed a ***PCA Net Worth Calculation Worksheet*** and added it to the Call Report for initial release in December 2000. The PCA Worksheet contains all NWR components (Please see Attachment A of this letter). **It automatically will compute your credit union's NWR and provide your Net Worth Classification** after you complete pages 1 through 14 of the *PC 5300* Automated Call Report System. Hence, no additional input is required. However, at its option, the credit union may elect among three alternative methods of calculating total assets that involve averaging instead of the default denominator quarter-end total assets.

For manual Call Report filers, NCUA will compute your NWR with information you entered manually on pages 1 through 14 of the Call Report.

As noted in Section 702.101(c)(1), if your NWR places the credit union in a lower net worth category at the time you file a Call Report, you are not required to inform NCUA or your SSA.

However, as noted in Section 702.101(c)(2), semiannual Call Report filers must inform NCUA and the appropriate state official if state-chartered, of a change in the NWR that places the credit union in a lower net worth category during the March and September quarters. If your credit union only files a Call Report semi-annually, you may choose to copy the PCA Net Worth Calculation Worksheet and use it to compute your NWR manually for the March and September quarters.

Risk-Based Net Worth (RBNW) Requirement
For credit unions exceeding $50 million in assets, NCUA and SSAs will begin implementing the Risk Based Net Worth (RBNW) requirement for "complex" credit unions using data from the March 2001 Call Report that will reflect activity for the first quarter of 2001. For all other credit unions exceeding $10 million in assets, the RBNW requirement first will be implemented using data from the June 2001 Call Report, that will reflect activity for the second quarter of 2001.

Page 4 of this letter is a copy of the RBNW Calculation Requirement Worksheet. For your information, it displays and sums the standard components of the RBNW Calculation and follows the PCA Net Worth Worksheet in the December 2000 Call Report. Again, no additional input is required. NCUA is providing this calculation as a sample only for December 2000.

Beginning with the March 2001 Call Report, the results of the RBNW Requirement Calculation will appear on line 13 of the PCA Net Worth Calculation Worksheet.

As noted above, all credit unions with assets greater than $10 million are required to review their RBNW requirement at the time of their required Call Report filing. Accordingly, those credit unions between $10 million and $50 million in asset size only will review their RBNW Requirement Calculation semiannually. However, a credit union less than $50 million in assets still has the option of voluntarily filing a Call Report during the March and September quarters to demonstrate either that it has met, or is no longer subject to, an RBNW requirement.

Summary
All credit unions should obtain an understanding of Part 702. For the majority of credit unions, practical experience with PCA may be limited to the procedures highlighted above. Please be familiar with them. For those credit unions interested in more detailed discussion of common PCA questions, please review the NCUA PCA FAQs in Attachment C. You can obtain additional copies of Part 702 and other NCUA Rules and Regulations from NCUA's Website at www.ncua.gov.

NCUA and State Supervisors will work closely with credit unions during the coming months to help ensure a smooth implementation period.

If you have any questions, please contact your examiner, NCUA regional office, or state supervisory authority.

Sincerely,

______/S/__________________________
Yolanda T. Wheat
Chairwoman
National Credit Union Administration Board

Enclosures

(Attachment A)
PCA NET WORTH CALCULATION WORKSHEET
(AUTOMATED – NO INPUT NECESSARY)

Credit Union Name:____Federal Charter/Certificate Number:________________

- ***No credit union is required to provide input on this page.***
- ***Electronic Filers:* Information entered on preceding schedules will populate line items below on the PC 5300 Automated System, excluding optional items 9, 10 and 11.**
- ***Manual Call Report Filers*: Leave this page blank or use it as a manual net worth calculation worksheet.**
- ***Optional Items 9, 10 and 11:* All credit unions may choose to enter one of the Total Assets Elections as described below.**

NET WORTH TO TOTAL ASSETS RATIO

NUMERATOR: NET WORTH

	Amount	Acct. Code
1. Undivided Earnings		940
2. Regular Reserves		931
3. Appropriation for Non-Conforming Investments (SCU ONLY)		668
4. Other Reserves (Appropriations of Undivided Earnings)		658
5. Uninsured Secondary Capital (Low Income Designated Credits Unions Only). . .		925
6. Net Income (unless this amount is already included in Undivided Earnings)		602
7. TOTAL NET WORTH (Sum of items 1-6)		997

DENOMINATOR: TOTAL ASSETS

	Amount	Acct. Code
8. Total Assets (quarter-end).		010

Total Assets Elections (Optional)
Retain line 8 quarter-end total assets above as net worth ratio denominator, or select one of the total assets computation options below by inputting the result in the appropriate line item. Line 12 below will compute your net worth ratio using line 8 quarter-end total assets as your denominator unless you enter an amount in line 9, 10 or 11.

	Amount	Acct. Code
9. Average of Daily Assets over the calendar quarter		010A
10. Average of the three month-end balances over the calendar quarter		010B
11. Average of previous four quarter-end balances.		010C

	Amount	Acct. Code
12. Net Worth Ratio (Line 7 divided by line 8, 9, 10 or 11)		998
13. Risk Based Net Worth (RBNW) Requirement (**Provided for sample purposes only**, please see next page for detail).	**Will be used in 2001**	999
14. Net Worth Classification if credit union is not *new*. (See NCUA Rules & Regulations Part 702.102).		700
15. Net Worth Classification if credit union is a *new* credit union. *New* means credit union is less than $10 million in assets <u>and</u> was chartered in the last 10 years. (See NCUA Rules & Regulations Part 702.302).		701

(Attachment B)

<u>FOR SAMPLE PURPOSES</u>

<u>WILL NOT BE USED UNTIL 2001</u>

STANDARD COMPONENTS OF

RISK BASED NET WORTH (RBNW) REQUIREMENT

(AUTOMATED – NO INPUT NECESSARY)

Credit Union Name:____Federal Charter/Certificate Number:_________________

<u>The information below is provided only for your information.</u> <u>No credit union is required to provide input on this page.</u> ***Information entered on preceding schedules will populate the line items below on the PC 5300 Automated System. Manual Call Report filers will also leave these items blank.***

A RBNW Requirement is only applicable for those credit unions with assets greater than $10,000,000 and a RBNW Requirement Calculation greater than six percent.

A	B	C	D	E	F
Risk portfolio	*Dollar balance*	*Amount as percent of quarter-end total assets*	*Risk weighting*	*Amount times risk weighting*	*Standard component*
Quarter-end total assets Assets, line 29 (Acct. code 010)		100.0000 %			
(a) Long-term real estate loans Sched A Line 3 (Acct. code 710) less: Sched A Line 9 (Acct. code 718) Sched A Line 11 (Acct. code 712) Threshold amount: 0 to 25% Excess amount: over 25%			.06 .14		
(b) MBLs outstanding Sched B line 3 (Acct. code 400) Threshold amount: 0 to 12.25% Excess amount: over 12.25%			.06 .14		
(c) Investments *Weighted-average life*: Schedule C Line 12 0 to 1 year (Acct code 799A) >1 year to 3 years (Acct. code 799B) >3 years to 10 years (Acct. code 799C) >10 years (Acct. code 799D)			.03 .06 .12 .20		
(d) Low-risk assets Assets line 1 (Acct. code 730A) plus: Assets line 27 (Acct. code 794)			.00		
Sum of risk portfolios (a) through (d) above					
(e) Average-risk assets Assets, line 29 (Acct. code 010) less: Risk portfolio items (a) through (d) above (f) Loans sold with recourse Sched G, line 2.B. (Acct. code 819) (g) Unused MBL commitments Sched G lines 1 A.,B, (Acct. codes 814, 814A)			.06 .06 .06		
(h) Allowance (Credit limited to 1.5% of loans) Assets, line 23 (Acct. code 719)			(1.00)		
Sum of standard components: **RBNW requirement (Acct code 999)**					

(Attachment C)

Prompt Corrective Action (PCA) Frequently Asked Questions (FAQs)

SUBJECT: RESERVE TRANSFERS

1. **Question:** Under PCA, are there credit unions that will have to make earnings transfers to the *regular reserve* account and, if so when will they have to start making the transfers?

> **Answer:** Yes. However, no credit union will have to make a reserve transfer until March 31, 2001, unless a State Supervisor imposes a more stringent requirement for their respective state-chartered credit unions.
>
> Section 702.201(a) provides that beginning with the effective date of a net worth classification as “adequately capitalized” (NWR > = 6% and < 7%) or lower a federally insured credit union must increase its net worth (dollar amount of net worth) quarterly by an amount equivalent to at least $1/10^{th}$ percent (.1%) of its total assets for the current quarter, and must quarterly transfer that amount to its *regular reserve* account (or more by choice) until it is “well capitalized” (NWR > = 7%).
>
> **For most credit unions that become “adequately capitalized” or below as of the December 31, 2000, calendar quarter, the effective date of their net worth classification will be January 31, 2001.** As provided in Section 702.101(b)(1), this is the last day of the calendar month following the end of the calendar quarter.
>
> **In this case, the credit union is not required to make a reserve transfer until March 31, 2001.** However, some credit unions prefer to close their books monthly. Accordingly, such a credit union may also fulfill the earnings transfer requirement by making commensurate monthly transfers. If the credit union makes monthly transfers to the *regular reserve*, this would commence January 31, 2001.

2. **Question:** How will the earnings transfer requirement differ from the previous reserving methodology that the former Section 116 of the Federal Credit Union Act prescribed?

> **Answer:** First, the PCA criterion for reserving is different. As noted above, Section 702.201(a) provides that a credit union must increase its *regular reserve* account when its NWR falls below 7%. In contrast, Section 116 required a credit union to increase its *regular reserve* account when the ratio of “statutory reserves” to “risk assets” fell below required thresholds.

Under the PCA earnings retention requirement, the sequence of journal entries will remain as it was under the former Section 116 reserving methodology. The credit union will close *income & expense* accounts into *net income*, post *net income (loss*) into *undivided earnings*, and then make the reserve transfer. **However, unlike the former Section 116 method, the credit union will not credit *undivided earnings* to recover the *provision for loan and lease losses expense.***

In addition, as noted above in question #1, a credit union must increase its net worth (dollar amount) quarterly by .1% of its *total assets* for the current quarter, and transfer that amount to its *regular reserve* account. In contrast, under the previous Section 116 method, the reserve transfer was a percentage of gross income.

Remember that when a credit union computes its net worth ratio (NWR) for the current quarter, it has the option to choose among three alternative methods for calculating *total assets.*

However, if the credit union elects one of the alternative methods to compute its NWR, it must also use this *total assets* election for purposes of computing the reserve transfer amount for the current quarter. For example, if the credit union chooses *average daily assets*, its reserve transfer will be .1% of *average daily assets*. Or, if the credit union makes no optional *total assets* election, by default its transfer amount will be .1% of *quarter-end total assets*.

Finally, under the PCA earnings retention requirement, the reserve transfers do not commence until the quarter subsequent to the quarter the credit union's net worth classification first falls to "adequately capitalized" or below. In contrast, under the former Section 116 methodology, the credit union increased its *regular reserve* account the same quarter "statutory reserves" fell below required thresholds.

Under PCA, there is always a quarter lag effect. For example, as shown in the table below, a credit union whose net worth category declines to "adequately capitalized" in the first quarter of 2001 makes no transfer of earnings in that quarter because the effective date of the net worth classification is 4/30/2001. The credit union makes the transfer (attributable to the first quarter classification) by the end of the second quarter based on total assets for the then-"current quarter," (i.e., total assets as of 6/30/2001). Assuming the credit union remains "adequately capitalized" in the second and third quarters, the transfer (attributable to each quarter's classification) will be made by the end of the next quarter based on total assets for the then-"current quarter," (i.e., total assets as of 9/30/2001 and 12/31/2001, respectively).

EXAMPLE OF PCA QUARTERLY TRANSFER OF EARNINGS TO NET WORTH

Quarter	-1st-	-2nd-	-3rd-	-4th-
Quarter-end date	3/31/2001	6/30/2001	9/30/2001	12/31/2001
Effective date	4/30/2001	7/31/2001	10/31/2001	1/31/2002
Assets in $	2,000,000	2,300,000	2,600,000	2,900,000
Net Worth in $	122,000	140,300	163,800	190,400
Net worth ratio	6.1%	6.1%	6.3%	6.5%
Amount of transfer @ .1% x assets	None	2,300	2,600	2,900

Because the transfer is always attributed to the prior quarter's net worth classification, it makes no difference if the credit union's net worth ratio exceeds 7 percent during the quarter in which the transfer is actually made. The classification as "well capitalized" does not become effective until the last day of the month following the quarter after which the credit union may discontinue making transfers.

3. **Question:** Does Part 702 now require credit unions to close their books on a quarterly basis?

Answer: No. A credit union can compute its net worth ratio (NWR) and, if necessary, make an earnings transfer without actually closing its books. The net worth ratio is defined as *Retained Earnings* under *Generally Accepted Accounting Principles (GAAP),* divided by *total assets*. A credit union can simply calculate *GAAP Retained Earnings* during an interim period, as if the books were closed, but without actually closing the books. A credit union would determine its net worth as *undivided earnings*, appropriations of *undivided earnings*, plus *year-to-date net income*. This amount would then become the Net Worth numerator divided by the *total assets* denominator.

As noted above in question 1, Section 702.201(a) provides that if the credit union's NWR is less than 7%, upon the effective date of this net worth classification the credit union would make the transfer of *undivided earnings* to the *regular reserve* in the amount of .1% of its *total assets*. A credit union can make this allocation **without** closing its books.

4. **Question:** When can a credit union make a charge to its *regular reserve*? Must the credit union deplete its other reserve accounts before making a charge to the *regular reserve*? When can a credit union access *secondary capital*?

Answer: Section 702.401(c) provides that the board of directors of a federally insured credit union can authorize charges to the *regular reserve* for losses as long as the charges do not cause the credit union's net worth classification to fall below “well capitalized.” Otherwise, such charges must first be approved by the appropriate NCUA regional director, or if the credit union is state chartered, by the appropriate state official.

A credit union must first deplete its *undivided earnings* and *other reserves* before it can charge its *regular reserve*. Section 702.403(a) provides that a credit union can pay dividends from undivided earnings only. Further, Section 702.401(b) provides that the purpose of the *regular reserve* is to absorb **losses that exceed *undivided earnings*** and other appropriations of *undivided earnings*. (These are long-standing NCUA regulations and have not changed under PCA.)

In addition, a credit union also must first deplete all *undivided earnings* and *regular reserves* before it can access *secondary capital*.

5**. Question:** What happens if the credit union is not able to make the minimum earnings transfer?

Answer: The credit union can request a reduction below the minimum. Section 702.201(b) provides that on a case-by-case basis and subject to quarterly review, the NCUA Board may permit the credit union to quarterly transfer an amount less than .1% of its total assets. The credit union would seek written approval from its Regional Director or from NCUA through its State Supervisor as appropriate.

6. **Question:** Credit unions required to complete Net Worth Restoration Plans (NWRP) must project their quarterly earnings transfer in the NWRP. Can a credit union base its earnings transfer projection on the assumption the transfer will be less than the required minimum?

Answer: Yes. A credit union need not make the minimum reserve transfer each and every quarter the NWRP is in place. Although Congress has instructed NCUA that a reduction from the minimum requirement cannot go below zero, a credit union may still seek a reduction below zero for one or more quarters provided that the reduction does not go below zero *on average* for four consecutive calendar quarters. Please see Section 702.206(c)(1)(ii) for specific requirements.

SUBJECT: NET WORTH RESTORATION PLANS

7. **Question:** Regarding, Net Worth Restoration Plans (NWRP), what are the time limits for a credit union to become “adequately capitalized” (NWR = 6%)?

Answer: There is no prescribed time limit to fully return to “adequate capitalization.” The Credit Union Membership Access Act (CUMAA) is silent as to any required length of time NCUA or the SSA must prescribe for a credit union to return to “adequate capitalization.” Credit unions that are less than “adequately capitalized” must develop net worth restoration plans based on the individual circumstances of the credit union. NCUA and the SSAs will evaluate on a **case-by-case basis** the reasonableness of the assumptions and the timeframes on which each credit union bases its projected return to “adequate capitalization.”

However, prompt remedy is the spirit of PCA. The potential severity of certain supervisory actions available in the lower net worth classifications is likely to require more structured time frames to insure progression and viability.

For example, as noted in Section 702.204(c)(3), entitled “Mandatory Liquidation after 18 months,” a credit union can remain “critically undercapitalized” (<2% NWR) only for a limited period before mandatory liquidation must take place (with certain exceptions). Hence, the NWRP must demonstrate how the credit union will reach a 2% NWR within a specific time frame.

8. **Question:** If a credit union employs a risk management process that measures Net Economic Value (NEV) for various scenarios (e.g., changes in NEV for a 300 basis point “shock” in interest rates) and a test shows that NEV would fall below 6%, would the credit union automatically be required to implement a NWRP?

Answer: Generally, the answer is no. Section 702.202 (a)(2) requires a credit union to submit a net worth restoration plan if its book net worth ratio (NWR) falls below 6%. Capital, in the context of NEV means the economic value (or, mark-to-market value) of net worth, not book net worth.

However, NEV may become a supervisory issue. If the credit union has excessive economic value exposure to interest rates this may result in a finding of an unsafe or unsound condition or practice. Section 702.101(b), indicates the NCUA board has the discretion to reclassify a credit union to a lower net worth category based on supervisory criteria other than net worth, i.e., if the credit union has an unsafe or unsound condition or practice. Operating with a negative NEV at current interest rates may result in a finding of an unsafe and unsound condition or practice for a federally-insured credit union.

SUBJECT: ACCOUNTING ISSUES

9. **Question:** How do donations to a credit union affect net worth under GAAP and under the "Other Comprehensive Basis of Accounting" (OCBOA)?

> **Answer:** Under GAAP, donations to a credit union in the form of cash or other assets (e.g., fixed assets) are reported as "contributions" and are recognized as revenues of the period. The credit union would close them from net income into undivided earnings. Thus, net worth includes these amounts.
>
> The important thing to remember is that the cash or other assets the credit union receives must belong to the credit union unconditionally in order to be considered a "contribution" under GAAP. If there are any conditions, it cannot be accounted for as a donation.
>
> A credit union with "Donated Equity," as provided for under earlier Regulatory Accounting Practices (RAP) accounting treatment, should close out the remaining balance directly to undivided earnings via a prior period adjustment. No credit union with assets of $10,000,000 or greater should have a balance in "Donated Equity."

10. **Question:** Does the implementation of the new PCA requirements afford an opportunity under Statement of Financial Accounting Standard (SFAS) No. 115 to sell Held-to-Maturity (HTM) securities or transfer them to another classification without calling into question the HTM classification?

> **Answer:** Credit unions should consult with an independent accountant in making this determination in light of FASB restrictions on transferring out of HTM before maturity, and the initial effects of applying PCA to your Credit Union's specific circumstances. NCUA does not believe the majority of credit unions could effectively make this argument although a few may be able to do so. The SFAS 115 conditions may be narrower than they first appear. SFAS 115, paragraphs 8e & 8f may be relevant. Permissible reasons to reclassify HTMs before maturity include:
>
> Paragraph 8e: "A significant increase by the regulator in the industry's capital requirements that causes the credit union to downsize by selling HTM securities."
>
> As an example of these circumstances, under Section 702.202(a)(3) a credit union with a NWR of less than 6% would be subject to an asset growth restriction. According to June 2000 data, 167 federally insured credit unions have a NWR of less than 6%. Thus, paragraph 8e could potentially apply to a

small percentage of credit unions if they have HTM securities and an intent to sell or transfer them. The reclassification would only be permitted if it met the 8e criteria, and then, only in the first quarter of adopting PCA.

Paragraph 8f: "A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes."

Upon implementation of the Risk Based Net Worth (RBNW) requirement, NCUA will employ risk weightings to credit union investment portfolios. A RBNW requirement is applicable only if the credit union is greater than $10 million in asset size and its RBNW exceeds 6%. Seventy-four percent of credit unions with HTM investments are currently greater than $10 million in asset size. Current aggregate data indicates that only about 512 credit unions would have an applicable RBNW requirement. NCUA estimates that eighty-two percent of credit union investments will have relatively low risk weightings of between 3% and 6%. The burden under paragraph 8f is “a significant increase”.

Credit union’s that are advised by an independent accountant that they qualify under GAAP for a transfer or sale of HTM investments must do so within one quarter of RBNW implementation.

SUBJECT: RISK-BASED NET WORTH (RBNW) REQUIREMENT

11. **Question:** The risk based net worth (RBNW) requirement specifies that all investments be risk weighted according to weighted-average life. Many credit unions consider weighted-average life a type of measurement for mortgage-backed securities only. How is weighted average life calculated for other types of investments?

Answer: *Weighted-average life (WAL)* may be used to measure all investment types. For example, the *WAL* of a bullet maturity instrument is the time remaining to maturity. The appendix at the end of the FAQ section contains a sample WAL calculation.

Beginning in December 2000, the Call Report instructs credit unions to report all investments in the appropriate maturity range according to WAL. Using WAL, most categories of investments will remain in the same maturity range as the credit union reported during previous Call Report reporting periods. However, please note that the maturity range of some of the following investment types potentially may change from previous reporting periods:

- Mutual Funds (Registered investment companies) and Common Trust Investments (Collective investment funds). Use maximum weighted average life as disclosed in a prospectus or trust instrument, but if not disclosed, report in the 3-10 year range. (Previously, these investments were all reported in the Less than one (1) year range.)

The following three are also exceptions to weighted-average life:

- Capital in mixed-ownership Government corporations and corporate credit unions. This includes corporate credit union membership capital (MC) and corporate credit union paid in capital. (Report as greater than one (1) year, but less than or equal to three (3) years.)
- Investments in CUSOs. (Report as greater than one (1) year, but less than or equal to three (3) years.)
- Other equity securities. (Report as Greater than ten (10) years.)

Page 10a of the Call Report Instructions contains a table that outlines how credit unions will report different investment types according to WAL.

12. **Question:** How often must a credit union compute its Risk Based Net Worth (RBNW) Requirement?

Answer: All credit unions regardless of asset size, must compute a net worth ratio each quarter. However, as noted on page one of this letter, **only credit unions over $10 million in asset size** must review an RBNW requirement, and only for the quarters that they are required to complete a Call Report.

NCUA modified the required frequency of computing the RBNW requirement from each quarter to only those quarters the credit union files its Call Report. The Call Report will compute the RBNW requirement thus reducing the reporting burden on credit unions. However, a credit union less than $50 million in assets still has the option of voluntarily filing a Call Report during the March and September cycles to demonstrate either that it has met, or is no longer subject to, an RBNW requirement.

Section 702.101 indicates all credit unions that are "complex" must determine their RBNW requirement each quarter. However, Section 702.103 indicates that a credit union will compute its RBNW coincidental with its Call Report filing.

NCUA issued a technical change in the September 2000 Federal Register to clarify that the schedule for computing the RBNW requirement tracks a credit union's schedule for filing the Call Report.

13. **Question:** How does the RBNW requirement affect participation loans? How are loans sold with recourse risk-weighted?

Answer: In short, the portion of the loan participation that remains on the credit union's balance sheet is risk weighted according to loan-type, such as "Long-Term Real Estate Loans," "Member Business Loans Outstanding," or as

"Average-Risk Assets" for consumer loans. Portions of participations not present on the credit union's balance sheet are risk-weighted at 6% if the credit union retains recourse.

The entire amount of a loan sold with recourse is subject to the 6% risk weighting regardless whether the credit union retains full recourse. Credit unions that fail their RBNW requirement because of substantial recourse loan capital charges may seek relief by applying for a Risk Mitigation Credit under Section 702.108.

14. **Question:** Are pension plan investment assets subject to risk weighting as investments under the Risk-Based Net Worth (RBNW) Requirement?

Answer: No. NCUA does not consider pension plan assets to be credit union investments. Pension plan assets do not put credit union capital or member shares at risk. For purposes of the RBNW requirement calculation, pension plan assets would be included in the *Average-Risk Assets* standard component. Accordingly, all pension plan assets will receive a risk weighting of 6%. The credit union would report these as *Other Assets* on the Call Report. Hence, there would be no corresponding reporting by weighted-average life on the Call Report Investment Schedule.

SUBJECT: MISCELLANEOUS

15. **Question:** Under what circumstances would the results of an examiner's review and recalculation of a credit union's net worth ratio (NWR) during an examination change the effective date of the net worth classification?

Answer: First, **it's important to remember that the examiner is recalculating the credit union's most recent quarter-end NWR, not the NWR as of the examination date**. PCA requirements are based upon quarter-end NWR calculations.

Therefore, these circumstances only would apply when the credit union either made an error in its most recent quarter-end NWR calculation or did not provide for full and fair disclosure for the quarter-end reporting period, and either situation resulted in the credit union erroneously being placed in a higher net worth category. Examples of such circumstances might be reporting unrealized gains on available for sale securities as *undivided earnings* on the Call Report or understating the *Allowance for Loan & Lease Losses* Account as of the previous quarter-end date.

Under these circumstances, Section 702.101(b)(2) provides that the effective date of a credit union's net worth classification would be the date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination. For purposes of this part, NCUA will consider the PCA effective date to be the date the credit union receives its exam report.

However, if the examiner discovers errors, omissions or other findings that would result in a lower NWR ratio, but the source of these events took place **after** the most recent quarter-end NWR measurement period, these modifications will **not** be reflected in the NWR until the credit union's next quarter-end measurement date.

Any NWR an examiner computes as of the effective date of the exam is only an indicator of what the credit union's NWR and corresponding net worth classification might be as a result of the credit union's **next** quarter-end measurement.

16. **Question:** If a credit union's NWR as of quarter-end places the credit union in a net worth category that would subject it to mandatory supervisory actions (MSAs), and the credit union's net worth ratio (NWR) increases to over 7% two weeks after the quarter-end, would the credit union still be subject to the MSAs?

Answer: Yes. Whichever category a credit union is classified in as a result of its NWR at quarter end, the credit union will be subject to the MSAs applicable to that category, beginning the effective date following the quarter-end.

17. **Question:** Is net worth replacing net capital?

Answer: Yes. The quarterly Net Worth-to-Total Assets Ratio is the primary measure that drives PCA. NCUA issued a revised Letter to Credit Unions 00-CU-08 addressing CAMEL ratings in November 2000. This letter supersedes Letter No. 161. It indicates that NCUA will no longer use a Capital-to-Assets Ratio or a Net Capital-to-Assets Ratio in the examination. This will provide for simplification and uniformity of measure. In addition, NCUA modified all other ratios that contained capital in the calculations to use net worth instead.

Appendix

Sample Weighted-Average Life Calculation

Weighted-average life is defined as the weighted-average time to the return of a dollar of principal. It is calculated by:

- Multiplying each portion of principal received by the time as which it is received (column C = A x B, below).
- Summing the Totals of Time x Principal (Column C) and Principal (Column B).
- Dividing the Total of Time x Principal (Column C) by Total Principal (Column B).

Weighted-Average Life Calculation
Amortizing Debt Obligation or Deposit

A	B	C
Time (Years)	**Principal**	**Time x Principal C = (A x B)**
1	40	40
2	30	60
3	20	60
4	10	40
Total	100	200

$$\text{WAL} = \frac{\text{Sum of (Time x Principal)}}{\text{Total Principal}} = \frac{200}{100} = 2 \text{ Years}$$

Weighted-Average Life Calculation
Non-Amortizing Debt Obligation or Deposit

A	B	C
Time (Years)	**Principal**	**Time x Principal C = (A x B)**
1	0	0
2	0	0
3	0	0
4	100	400
Total	100	400

$$\text{WAL} = \frac{\text{Sum of (Time x Principal)}}{\text{Total Principal}} = \frac{400}{100} = 4 \text{ Years}$$