

Supervisory Letter

NCUA | Office of Examination & Insurance
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TO: ONES Field Staff

SUBJECT: Capital Planning Under NCUA Rules & Regulations §702 Subpart E

ENCLOSURE: *Principles of Capital Policy and Capital Planning*

This supervisory letter provides guidance to field staff of NCUA's Office of National Examinations and Supervision (ONES) in regard to evaluating and approving a federally insured credit union's capital plan, as required by NCUA Rules and Regulations §702 – *Capital Planning and Stress Testing*.¹ The guidance in this document applies to federally insured credit unions (FICUs) with assets of \$10 billion or more (“covered credit unions”),² and specifically pertains to the capital planning provisions of §702: Section 702.503 – *Capital Policy* and Section 702.504 – *Capital Planning*.

I. Background

Adequate capital is crucial to a credit union's ability to absorb unexpected losses and to continue to lend to creditworthy consumers in times of stress. Capital also protects the National Credit Union Share Insurance Fund (NCUSIF) in the event of credit union losses. NCUA's Capital Planning and Stress Testing Rule reflects that a very large credit union's processes for managing and allocating its capital resources are critical not only to its own health and performance, but also to the NCUSIF.

Thus, the Rule focuses on large credit unions' policies, governance, analysis, and internal planning processes relating to capital, as these elements are key to maintaining adequate capital at each credit union and to protecting the safety and soundness of the industry as a whole.

¹ 12 C.F.R. 702, available online at <http://go.usa.gov/PeF5>.

² Section 702.502 of the Rule defines a “covered credit union” as a federally insured credit union with assets of \$10 billion or more as of March 31 of the current calendar year.

Supervisory letters are issued to credit union field staff by NCUA's Office of Examination & Insurance to address significant policy and procedural matters related to NCUA's supervisory responsibilities. These letters are available on NCUA's website, www.ncua.gov.

NCUA's capital policy and planning Rule is based on three key principles:

1. Sound risk management fundamentals,
2. Effective capital policy and governance, and
3. Comprehensive capital planning and analysis.

These principles are discussed in greater detail in the enclosed white paper, *Principles of Capital Policy and Capital Planning*. The white paper reflects ONES' research into contemporary capital-planning practices and is intended to provide information to credit unions as they develop capital policies and plans in accordance with the Rule.

II. Requirements for Capital Policies and Planning

A. Capital Policy Requirements³

A covered credit union's capital policy should outline its process for capital planning and analysis, and must be consistent with the financial condition, size, complexity, risk profile, scope of operations, and level of capital of the credit union. As part of the policy, covered credit unions are required to establish a governance structure to oversee the capital planning and analysis process that is appropriate for the extent and sophistication of the process (§702.503(a)).

The credit union's board of directors is ultimately responsible for overseeing the capital planning and analysis process, while senior management administers a comprehensive, integrated, and effective process that fits into the broader risk management of the credit union (§702.503(a)). Senior management responsible for capital planning and analysis must provide regular reports on capital planning and analysis to the credit union's board of directors (or a designated committee of the board)⁴ (§702.504(a)).

As required by §702.504(a), a covered credit union's board of directors (or designated committee) must review and approve a capital policy, along with procedures to implement it.

³ Section 702.502 of the Rule defines a "capital policy" as a covered credit union's written assessment of the principles and guidelines used for capital planning, including analyzing capital, establishing capital levels, describing the strategies for addressing potential capital shortfalls, and describing the internal governance procedures around capital policy principles and guidelines.

⁴ Capital planning is an enterprise-wide function, similar to strategic planning or enterprise risk management, that should be performed at the board level. Thus, any committee that is designated to participate in capital planning or policy activities or is responsible for decision making with regard to them should be a board-level committee, not a management committee.

Part 702.503(b)(1)-(7) of the rule list the mandatory elements of a capital policy relating to capital goals and risk limits, limit breaches and contingency plans, governance over capital analysis (including over outside vendors), internal controls and documentation, and capital analysis.

In addition, the capital policy must be reviewed at least annually and updated as necessary to ensure that it remains current with changes in market conditions and the credit union's specific circumstances (§702.503(b)(8)).

B. Capital Planning Requirements⁵

Each covered credit union must develop and maintain a capital plan and submit that plan to NCUA for approval every year by February 28 (or another date, as directed by NCUA) (§702.504(a)(1)). The board, or designated committee of the board, must approve the plan annually and prior to submission to NCUA (§702.504(a)(2)(iii)). The plan must be based on the credit union's financial data as of September 30 of the immediately preceding calendar year (or another date, as directed by NCUA) (§702.504(a)(1)).

The credit union's capital plan needs to be a complete document when submitted to NCUA. While it may incorporate any other relevant plans a credit union may formulate, such as strategic and business plans, the capital plan must include all of the following (§702.504(b)):

1. Quarterly Assessment of Expected Sources and Levels of Stress Test Capital⁶

This assessment must cover the 3-year planning horizon⁷ and reflect the credit union's financial state, size, complexity, risk profile, scope of operations, and existing level of capital, assuming both expected and unfavorable conditions (§702.504(b)(1)).

⁵ Section 702.502 of the Rule defines a "capital plan" as a written presentation of a covered credit union's capital planning strategies and capital adequacy process that includes the mandatory elements set forth in §702.504(b).

⁶ Section 702.502 of the Rules defines "stress test" as the process to assess the potential impact of expected and stressed economic conditions on the consolidated earnings, losses, and capital of a covered credit union over the planning horizon, taking into account the current state of the covered credit union and the covered credit union's risks, exposures, strategies, and activities. "Stress test capital" is defined as net worth (less assistance provided under Section 208 of the Federal Credit Union Act, subordinated debt included in net worth, and NCUSIF deposit) under stress test scenarios.

⁷ Section 702.502 of the Rule defines the "planning horizon" as the period of at least three years over which the relevant projections extend.

The quarterly assessment should also include:

a. Quarterly Projections

The credit union's capital plan should include estimates of projected revenues, losses, reserves, and pro forma capital levels, over each quarter of the planning horizon under both expected and unfavorable conditions⁸ (§702.504(b)(1)(i)).

b. Capital Assessment Processes

A covered credit union's capital plan must include a detailed description of the institution's process for assessing capital adequacy (§702.504(b)(1)(ii)).

2. Plans for Maintaining Stress Test Capital Levels⁹

The credit union's capital plan must discuss how the credit union will, under expected and unfavorable conditions, maintain stress test capital commensurate with all of its risks, including reputational, strategic, legal, and compliance risks (§702.504(b)(2)).

3. Plans for Maintaining Access to Funding

The credit union's capital plan must include a discussion of how the credit union will, under expected and unfavorable conditions, maintain ready access to funding, meet its obligations to all creditors and other counterparties, and continue to serve as an intermediary for its members (§702.504(b)(3)).

4. Plans for Maintaining a Stress Test Capital Ratio¹⁰ of 5% or More

Credit unions that are permitted to conduct their own stress tests per §702.506(c) of the Rule must discuss in their capital plans how the credit union will maintain a stress test capital ratio of at least 5% under baseline, adverse, and severely adverse conditions in each quarter of the 3-year planning horizon (§702.504(b)(4)).¹¹

⁸ Expected and unfavorable conditions are discussed in greater detail in the enclosed *Principles of Capital Policy and Capital Planning*.

⁹ If the credit union conducts its own stress test under §702.506(c), the plan must also include a discussion of how the credit union will maintain a stress test capital ratio of 5% or more under baseline, adverse, and severely adverse conditions in each quarter of the 9-quarter stress test horizon.

¹⁰ Section 702.502 of the Rule defines the "stress test capital ratio" as a covered credit union's stress test capital divided by its total consolidated assets less NCUSIF deposit.

¹¹ Section 702.502 of the Rule defines a "baseline scenario" as a scenario that reflects the consensus views of the economic and financial outlook. An "adverse scenario" is a scenario that is more adverse than that associated with the baseline scenario. A "severely adverse scenario" is a scenario that overall is more severe than that associated with the adverse scenario.

5. Anticipated Business Plan Changes

The capital plan submitted by a covered credit union must discuss any expected changes to the credit union's business plan that are likely to have a material impact on the credit union's capital adequacy and liquidity (§702.504(b)(5)).

6. Testing Programs¹²

The capital plan must include a program to:

- Conduct **sensitivity testing** to analyze the effect on the credit union's stress test capital of changes in variables, parameters, and inputs used by the credit union in preparing its capital plan (§702.504(b)(6)(i)).
- Conduct **reverse stress testing** to identify events and circumstances that cause severely unfavorable outcomes for the credit union (§702.504(b)(6)(ii)).
- Analyze the **impact of credit risk and interest rate risk** to capital under unfavorable economic conditions, both separately and in combination with each other (§702.504(b)(6)(iii)).

If NCUA rejects a credit union's capital plan, the credit union must resubmit it within 90 calendar days of the rejection (§702.505(d)). A resubmitted capital plan must address, at a minimum (§702.504(d)(1) and (2)):

- Deficiencies in the original plan noted by NCUA and
- Remediation plans for any unresolved supervisory issues contributing to the rejection of the original capital plan.

III. Staff Guidance for Review of Capital Policies and Capital Planning

The capital planning provisions of Part 702 Subpart E of NCUA's Rules and Regulations require that each submitted capital plan contain certain elements; however, the rule also gives each covered credit union the latitude within those requirements to develop a capital plan that is appropriate to the credit union's size, risk profile, business plan, and other circumstances.

When reviewing a covered credit union's capital policy and plan, ONES staff will use the following guidance.

¹² The testing requirements are discussed in greater detail in *Principles of Capital Policy and Capital Planning*.

A. Governance over Capital Policy and Planning

A credit union's capital planning and analysis process must be commensurate with the financial condition, size, complexity, risk profile, scope of operations, and level of capital of the covered credit union. When evaluating a credit union's governance over its capital planning and analysis process, ONES staff will ensure the governance is appropriate in terms of scope and sophistication (§702.501(c)).

In general, ONES staff will ensure the following:

- Capital planning and analysis is sufficiently robust and fully demonstrates the impact of unfavorable circumstances that may confront the credit union (§702.504(a)(1)).¹³
- Effective controls are in place to maintain the integrity of the capital planning process (§702.503(b)). A covered credit union's internal control framework should address its entire capital planning process, including the risk measurement and management systems used to produce reports to management and the board (§702.504(a)). The control framework should ensure that all aspects of the process function as intended in support of robust assessments of capital needs.¹⁴
- The credit union has identified any weaknesses or limitations in the capital planning process and developed corresponding remediation plans (§702.504(a)(2)(ii)).

1. Board of Directors

A covered credit union's board of directors has ultimate oversight responsibility and accountability for capital planning (§702.503(a)) and the board, or its designated committee, is required to approve the credit union's capital plan (§702.504(a)(2)(iii)). Therefore, the board must be in a position to make informed decisions on capital adequacy and capital actions. ONES staff will verify that the board of directors receives sufficient information to

¹³ The majority of the analyses required to be addressed in the capital plan must be conducted for both expected and unfavorable conditions. See *Principles of Capital Policy and Capital Planning* for a discussion of how credit unions should approach incorporating expected and unfavorable conditions in the required analyses.

¹⁴ If the credit union has an internal audit function, it should play a key role in evaluating internal capital planning and its various components (§702.503(b)(5)). If the credit union does not have an internal audit function, the board of directors should consider alternative means of having an independent review of the capital planning control framework. Internal audit should perform a review of the full process, not just of the individual components. The periodic internal audit review should ensure that the entire end-to-end process is functioning in accordance with regulatory requirements and the credit union's policies and procedures. Internal audit should monitor the manner in which deficiencies are identified, tracked, and remediated.

understand the credit union's material risks and exposures and to inform and support its decisions on capital adequacy and planning.

- The board should be fully informed of any material assumptions and key drivers of risk used in capital planning analysis, as well as the effect of these assumptions and drivers on any analytical results.
- Key assumptions and results should be evaluated in the context of current and forecasted economic outlooks and the credit union's current risk profile, business activities, and strategic direction.
- The board should be informed by senior management of any limitations and uncertainties within the capital planning process, so it can factor these into its capital decision-making.

In order for the board to meet its obligations, it should receive reports from management at least quarterly, and more frequently when conditions merit. The reports should include information on the impact that changes to key assumptions have on the stress test measures of capital. Also, the board needs to be advised of any actions planned to remedy weaknesses in the credit union's capital planning controls and processes.

2. Senior Management

Senior management is responsible for ensuring that capital planning activities authorized by the board are implemented in a satisfactory manner. In order to fulfill this responsibility, senior management needs to be fully informed about the credit union's capital planning process and ensure that the process has sufficient analytical support.

Senior management must establish a comprehensive, integrated, and effective process that fits into the broader risk management of the credit union (§702.503(a)). Senior management should regularly identify and review business activities and associated risk exposures across the organization, and update risk assessments accordingly. This process includes implementing effective techniques to assess how risk exposures may impact capital, including under stressful economic and market conditions, and might evolve over the regular course of business.

ONES staff should ensure that a covered credit union's risk-identification processes are systematic, repeatable, and able to evaluate the full set of potential exposures stemming from a credit union's lines of business and activities. In particular, the credit union's risk-identification process should carefully evaluate exposures that are highly sensitive to changing economic and financial market conditions during periods of stress.

A credit union's risk-identification and risk-assessment program should consider the risks inherent in new products and activities or any change in business strategy, and assess the potential impact of these activities on capital needs. When new products and services impact the credit union's risk profile, the credit union should reassess its capital adequacy and capital contingency plans.

ONES staff will ensure that covered credit unions document decisions about capital adequacy and capital actions taken by the board of directors and senior management, and that the documentation describes the information used to reach those decisions. Final decisions regarding capital planning made by the board or its designated committee should be recorded and retained in accordance with the credit union's policies and procedures.

B. Capital Policy

The credit union's board or designated committee must approve a comprehensive capital policy (§702.503(b)). The policy should be a distinct, comprehensive written document that addresses the major components of the credit union's capital planning processes and links to and is supported by other policies (*e.g.*, the credit union's policies regarding asset liability management, credit risk management, concentration risk, and internal audit).

ONES staff will ensure the board or designated committee reviews the policy at least annually and updates it as necessary to ensure it remains current with changes in market conditions, credit union products and strategies, credit union risk exposures and activities, the credit union's established risk appetite, and industry practices¹⁵ (§702.503(b)(8)).

ONES staff will confirm the capital policy meets the following requirements (§702.503(b)(1)-(7)):

1. Set goals and limits for capital levels and risk exposure.

Minimum internal capital goals and limits should be specified in the capital policy. These goals should be aligned with the credit union's risk appetite and risk profile, under both expected and unfavorable conditions. They should not be set simply to meet regulatory minimums.

The policy should provide clarity about the credit union's objectives in managing its capital position and explain how the credit union's capital planning practices align with the objective of maintaining sufficient capital to comply with regulatory capital requirements and continue to operate through periods of severe stress. Capital goals

¹⁵ For examples of industry practices, see [Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice](#) (Federal Reserve Board of Governors: August 2013).

should take into consideration forward-looking elements related to the economic outlook, the credit union's financial condition, the potential impact of stress events, and the uncertainty inherent in the capital planning process.

As part of a capital policy review, ONES staff will assess the reasonableness of the capital goals and limits relative to the credit union's unique circumstances.

2. Establish requirements for reviewing and reporting capital levels and breaches of capital limits, with contingency plans for remedying any breaches.

As part of a capital policy review, ONES staff will look for assurance that reporting of capital positions and limit breaches is timely and accurate and gives senior management the opportunity to react before a breach scenario becomes catastrophic. Reports on capital levels and breaches should provide adequate information to enable management to make decisions and take action.

ONES staff will also review a covered credit union's contingency plans and evaluate the extent to which the plans remedy any current or prospective deficiencies in capital position. Staff will also assess the plan's suitability given the credit union's risk profile, financial condition, business model and strategies, overall complexity, and sensitivity to changing conditions.

3. State the governance over the capital analysis process, including all the activities that contribute to the analysis.

ONES staff will review the capital policy to ensure that the capital analysis process is appropriately governed given the credit union's unique characteristics. Staff will look for any gaps in governance that result from relationships with outside vendors that provide data inputs or support to the capital analysis process.

4. Specify capital analysis roles and responsibilities, including controls over external resources used for any part of capital analysis (such as vendors and data providers).

A covered credit union's capital policy should clearly state the responsibility and accountability of each function in the overall capital adequacy assessment process, including capital analysis, capital reporting, and capital adequacy. The role played by each function should be delineated to avoid overlap or lack of clarity.

As part of a capital policy review, ONES staff will assess the delineation of roles, responsibilities, and accountability for all material aspects of the capital planning process. In particular, ONES staff will assess whether or not the policy: 1) addresses the

verification of any data inputs provided by outside parties, and 2) identifies who is responsible for performing the verification.

5. Specify the internal controls that govern capital planning, including review by internal audit, control of changes in capital planning procedures, and required documentation.

Internal controls governing the capital planning process include: internal audit, enterprise risk management, and model validation, among others. As part of a capital policy review, ONES staff will ensure that a credit union's internal control framework covers its entire capital planning process, including internal and external functions that provide data input and support.

ONES staff will assess the role and effectiveness of the credit union's internal controls over the capital planning process. ONES staff will review any internal audit work pertaining to the capital planning process and leverage the work as appropriate in the review of the credit union's capital planning processes.

Credit unions should conduct a review and validation of all models used in internal capital planning. ONES staff will review the credit union's model validation work, assess the independence of model validation, and leverage this information as appropriate in the review of capital processes.

A credit union's risk-management function should be able to assess and report on the risks taken by other areas of the credit union independent of management over those areas. ONES staff will review the risk-management analysis and reports, assess the independence of this function, and leverage this information as appropriate in the review of capital processes.

The capital policy should also address how changes to capital planning procedures are approved and implemented. ONES staff will review the capital policy to ensure that the procedures for changing the capital plan or policy are formalized.

Finally, the capital policy should establish documentation requirements for the capital planning process, the review of capital with respect to risk, the evaluation of internal control functions, capital planning analysis, and decision making that pertains to capital planning. ONES staff will assess whether or not the documentation contains sufficient detail, accurately describes the credit union's practices, allows for review and challenge, and provides relevant information to decision makers.

6. Describe the frequency with which capital analyses will be conducted.

A covered credit union should conduct capital analysis at a frequency consistent with other executive functions and with safe and sound management. As part of a capital policy review, ONES staff will assess the frequency of the analysis, which generally should be performed at least annually or more frequently under certain circumstances (*e.g.*, whenever there are significant changes in financial and economic conditions or the credit union's business plan or strategy).

7. State how capital analysis results are used and by whom.

Capital analysis results are expected to be used by the credit union's senior management and board of directors to assess capital adequacy and evaluate compliance with stated capital goals and limits. A covered credit union's capital policy should establish the roles and responsibilities for positions and/or committees with respect to capital analysis results. ONES staff will assess whether or not the capital policy identifies who receives capital analysis results and what action is triggered when results are generated.

8. Is reviewed at least annually and updated as necessary to ensure that it remains current with changes in market conditions, credit union products and strategies, credit union risk exposures and activities, the credit union's established risk appetite, and industry practices.

The capital policy should establish a minimum frequency (at least annually) and other triggers for when the policy will be reevaluated. Triggers for reevaluating the policy could include changes to the credit union's organizational structure, governance structure, business strategy, capital goals, regulatory environment, or risk appetite.

ONES staff will review the policy to ensure that a minimum frequency for reevaluating the policy is stated and to assess the policy's appropriateness given the credit union's current and anticipated circumstances.

C. Capital Plan

Covered credit unions must submit their capital plan to NCUA for review by February 28 each year (or such later date as directed by NCUA) (§702.504(a)(1)). NCUA will notify in writing the covered credit union of the acceptance or rejection of its capital plan within 90 calendar days of the date of the plan's submission (§702.505(a)).¹⁶

¹⁶ Before taking any action on the capital plan of a federally insured, state-chartered credit union, NCUA will consult and work cooperatively with the appropriate State official.

As part of the review of a credit union's capital plan, ONES staff will conduct a "use test" to ensure that the credit union's capital planning efforts are undertaken in earnest and not simply to satisfy regulatory requirements. NCUA's supervisory expectation is that covered credit unions will implement capital planning as an organization-wide function, similar to strategic planning and enterprise risk management. It is not to be considered a standalone function or performed as a compliance exercise. Nor should capital planning (and related documentation) be performed in reaction to, or in anticipation of, supervisory stress tests. As such, ONES staff will evaluate how well a credit union's capital planning is integrated into other enterprise-wide functions, whether or not it is informed by other high-level functions, and if it complements those functions.

ONES staff will evaluate each credit union's capital plan within the context of the organization's unique needs and circumstances and will apply the following three standards in performing the evaluation:

1. The capital planning process is based on a sound foundation.

The credit union's capital planning and analysis process needs to be sufficiently robust in relation to the credit union's financial and operational complexity and challenges it faces (§702.504(a)(1)). The analysis and supporting critical systems and processes that the capital plan is based on, as well as the methodologies the credit union uses for reviewing capital adequacy, must be reasonable and appropriate to the credit union's business model and circumstances (§702.505(b)(2 & 5)). The data the credit union uses for the analysis must be of sufficient detail and integrity to accurately capture the risks of the credit union (§702.505(b)(3)). Also, any material unresolved supervisory issues associated with the credit union's capital planning process will typically lead to the credit union's plan being rejected (§702.505(b)(1)).

2. The capital plan meets all the requirements of the regulation (§702.505(b)(4)).

Section 702.504(b) of the Rule outlines the mandatory elements of a capital plan. (These elements are also outlined in [B. Capital Plan Requirements](#) on page 3 of this letter.)

3. The capital plan involves safe and sound practices (§702.505(b)(6)).

The covered credit union's capital planning process cannot result in a plan that involves unsafe or unsound practices, or would violate any law, regulation, NCUA order, directive, or any condition imposed by, or written agreement with, NCUA. In determining whether a capital plan would constitute an unsafe or unsound practice, ONES staff will consider whether the covered credit union is and would remain in sound financial condition after giving effect to the capital plan.

IV. Additional Guidance Relevant to Capital Policies and Plans

Additional guidance on capital planning and policy building that may be useful to ONES staff includes:

- NCUA 12 CFR §702, [Capital Planning and Stress Testing](#)
- *Principles of Capital Policy and Capital Planning* (NCUA: September 2014)
- *Examiner's Guide*, [Chapter 16 – Net Worth and Equity Accounts](#)

If you have any questions on the material in this letter, please direct them to your immediate supervisor or field office management.

Sincerely,

Larry Fazio
Director
Office of Examination & Insurance