 Office of Credit Unions Policies and Procedures	POLICY NUMBER
	10810
NET WORTH AND EARNINGS	EFFECTIVE DATE
	11/01/2018
SUBJECT	REVISION DATE
	11/01/2018
Net Worth and Capital	PAGE(S)
	Page 1 of 4

I. PURPOSE


Net worth/Capital is reviewed to evaluate if it is sufficient for the institution's risk profile, to determine whether adequate policies and procedures exist regarding net worth accounts and to ensure compliance with applicable state and federal regulations.

II. PRIMARY REFERENCES / RELATED REGULATIONS

1. Michigan Credit Union Act:
 - a. [Section 342\(30\(i\): Adopting policies](#)
 - b. [Section 361: Capital](#)
 - c. [Section 382: Fiscal year; accounting principles](#)
 - d. [Section 386: Establishment and maintenance of reserves](#)
2. [NCUA Rules and Regulations, Part 702: Capital Adequacy](#)
3. [Regulation D: Reserve requirements of Depository Institutions](#)

III. MINIMUM PROCEDURES

1. Ensure the Board of Directors has established appropriate policies consistent with the institution's financial condition, size, complexity, risk profile, and operations. At minimum, the policy must:
 - a. State goals and limits for capital levels and risk exposure.
 - b. Establish requirements for reviewing and reporting capital levels and breaches of capital limits, with contingency plans for remedying any breaches.
 - c. State the governance over the capital analysis process, including all the activities that contribute to the analysis;
 - d. Specify capital analysis roles and responsibilities, including controls over external resources used for any part of capital analysis (such as vendors and data providers);
 - e. Specify the internal controls that govern capital planning, including review by internal audit, control of changes in capital planning procedures, and required documentation;
 - f. Describe the frequency with which capital analyses will be conducted;
 - g. State how capital analysis results are used and by whom; and
 - h. Be 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.

 Office of Credit Unions Policies and Procedures	POLICY NUMBER
	10810
NET WORTH AND EARNINGS	EFFECTIVE DATE
	11/01/2018
SUBJECT	REVISION DATE
	11/01/2018
Net Worth and Capital	PAGE(S)
	Page 2 of 4


2. To ensure net worth and capital are accurately stated:
 - a. Review the transaction history for applicable general ledger accounts since the previous examination to be sure transactions were appropriate and timely.
 - b. Complete AIREX exam.xls worksheets for all net worth and capital accounts and compare balances to Call Reports and financial statements.

3. To ensure net worth growth is reasonable, evaluate whether asset growth is controlled sufficiently to prevent excessive dilution of the net worth ratio.

4. To ensure net worth is sufficient to support the present and projected credit union's risk profile:
 - a. Calculate the effects on the net worth ratio of all examination adjustments, funding of any shortage in the allowance for loan and lease loss, and known, but unrecorded, losses and liabilities to determine if net worth is sufficient.
 - b. Determine whether net worth is maintained in accordance with NCUA Rules and Regulations, Part 702 for "well capitalized" and determine compliance with Prompt Corrective Action requirements, as applicable.
 - c. Evaluate the risk profile, including consideration of trends, management's plans and strategies, and emerging risks.

5. Determine compliance with Regulation D, as applicable. Two types of reserves apply to credit unions: cash reserves and equity reserves. Cash reserves include transaction account reserves required by Regulation D. Credit unions hold cash reserves in the following forms:
 - a. Vault cash;
 - b. A balance maintained directly with the Federal Reserve Bank (FRB) in the District in which the credit union is located; or
 - c. A pass-through account, which is considered a balance maintained with the FRB.

Cash reserves usually do not apply to smaller credit unions; however, equity reserves apply to all credit unions. Credit unions establish equity reserves (Capital) by segregating part of their net income into reserve and undivided earnings accounts. Equity reserves may be either appropriated or unappropriated.

 Office of Credit Unions Policies and Procedures	POLICY NUMBER
	10810
NET WORTH AND EARNINGS	EFFECTIVE DATE
	11/01/2018
SUBJECT	REVISION DATE
	11/01/2018
Net Worth and Capital	PAGE(S)
	Page 3 of 4

IV. AMENDMENTS TO NCUA RULES AND REGULATIONS, PART 702


1. Examiners should be aware of amendments to NCUA Rules and Regulations, Part 702, which will take effect January 1, 2019. The amendments establish risk-based capital requirements for “complex” federally insured credit unions, among other things. The amendments include the following key changes to the current capital requirements:
 - a. Replaces Part 702’s current risk-based net worth (RBNW) ratio with a new risk-based capital (RBC) ratio for federally insured natural person credit unions with over \$100 million in assets;
 - b. Changes the definition of “complex” credit union, for the purposes of capital requirements, to include credit unions greater than \$100 million in assets;
 - c. Establishes a risk-based capital ratio of 10 percent for well-capitalized credit unions, and 8 percent for adequately-capitalized credit unions;
 - d. Requires higher minimum levels of capital for credit unions with concentrations of assets in real estate loans, commercial loans or non-current loans; and
 - e. Sets forth how NCUA, through its supervisory authority, can address a credit union that does not hold capital that is commensurate with its risk.

2. Under the final rule, a “complex” credit union determines its RBC ratio by calculating the percentage, rounded to two decimal places, of its RBC numerator to its total risk-weighted assets denominator.

V. DEFINITIONS

1. Net worth is defined as all retained earnings which includes undivided earnings, regular reserves, appropriation for non-conforming investments, reserve for contingency, appropriated undivided earnings, equity acquired from merger, net income. Net worth does not include the Allowance for Loan and Lease Loss, accumulated unrealized gain/loss on available for sale securities, and other comprehensive income.

The net worth ratio is defined as total net worth divided by total assets.

 Office of Credit Unions Policies and Procedures	POLICY NUMBER
	10810
NET WORTH AND EARNINGS	EFFECTIVE DATE
	11/01/2018
SUBJECT	REVISION DATE
	11/01/2018
Net Worth and Capital	PAGE(S)
	Page 4 of 4

2. Capital is defined as the total of regular reserves, allowance for loan and lease losses, special reserves, undivided earnings, accumulated unrealized gains or losses on available-for-sale (AFS) securities, and the portion of year-to-date net income that has not yet been closed to the appropriate capital account. Capital accounts provide:
 - a. A reserve for anticipated and unidentified losses;
 - b. A base for future growth;
 - c. A means by which the credit union can meet competitive pressures as they arise; and
 - d. A cost-free source of funds