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Part III

National Credit Union Administration

12 CFR Parts 702, 741 and 747

Prompt Corrective Action; Final Rule

12 CFR Part 702

Prompt Corrective Action; Risk-Based; Net Worth Requirement; Proposed Rule

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 702, 741 and 747

Prompt Corrective Action

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: In 1998, Congress amended the Federal Credit Union Act to establish minimum capital standards for federally-insured credit unions and to require the NCUA Board to adopt, by regulation, a system of ''prompt corrective action'' to restore the capital level of credit unions which become inadequately capitalized. The NCUA Board issued a proposed rule combining the components of prompt corrective action expressly prescribed by statute with those the statute required NCUA to develop to suit the distinctive needs and characteristics of credit unions. As revised to reflect public comments and to incorporate other improvements, the final rule establishes a comprehensive framework of mandatory and discretionary supervisory actions indexed to five statutory net worth categories; an alternative system of prompt corrective action for credit unions which meet the statutory definition of ''new''; conforming reserve and dividend payment requirements; and procedures for reviewing and enforcing directives imposing prompt corrective action.

DATES: Effective August 7, 2000.

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SUPPLEMENTARY INFORMATION:

I. Background

A. The Credit Union Membership Access Act

On August 7, 1998, Congress enacted the Credit Union Membership Access Act, Pub. L. 105–219, 112 Stat. 913 (1998). Section 301 of the statute added a new section 216 to the Federal Credit Union Act (''FCUA''), 12 U.S.C. 1790d (hereinafter referred to as ''CUMAA'' or ''the statute'' and cited as ''§ 1790d''). Section 1790d requires the NCUA Board to adopt by regulation a system of ''prompt corrective action'' (''PCA'') to restore the net worth of federally-insured ''natural person'' credit unions which become inadequately capitalized. The purpose of PCA is to ''resolve the problems of insured credit unions at the least possible long-term loss to the [National Credit Union Share Insurance Fund (''NCUSIF'')].'' § 1790d(a)(1).

The statute designates three principal components of PCA: (1) A framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions which CUMAA defines as ''new''; and (3) a risk-based net worth requirement to apply to credit unions which NCUA defines as ''complex.'' The first and second principal components are the subject of this final rule. In formulating the rule, NCUA was required to consult with the Secretary of the Treasury, the Federal banking agencies, and State officials having jurisdiction over federally-insured, State-chartered credit unions. CUMAA § 301(c).

For credit unions other than those which meet the statutory definition of a ''new'' credit union, CUMAA mandated a framework of mandatory and discretionary supervisory actions indexed to five statutory net worth categories. The mandatory actions and conditions triggering conservatorship and liquidation are expressly prescribed by statute. § 1790d(e), (f), (g), (i); 12 U.S.C. 1786(h)(1)(F), 1786(a)(3)(A)(1). To supplement the mandatory actions, the statute charged NCUA with developing discretionary actions which are ''comparable'' [1] to the ''discretionary safeguards'' available under section 38 of the Federal Deposit Insurance Act (''FDIA § 38'')—the statute that applies PCA to other federally-insured depository institutions.[2] 12 U.S.C. 1831o; § 1790d(b)(1)(A); S. Rep. No. 193, 105th Cong., 2d Sess. 12 (1998) (S. Rep.); H.R. Rep. No. 472, 105th Cong., 2d Sess. 23 (1998) (H. Rep.).

For credit unions which CUMAA defines as ''new''—those which have been in operation less than ten years and have $10 million or less in assets—the statute directed NCUA to develop an alternative system of PCA to apply in lieu of the system of PCA for all other federally-insured credit unions. § 1790d(b)(2)(A); *see also* U.S. Dept. of Treasury, *Credit Unions* (Washington, D.C. 1997) at 79. Although CUMAA prescribes no specific attributes for this component of PCA, it instructs NCUA to recognize that ''new'' credit unions initially have no net worth, need reasonable time to accumulate net worth, and need incentives to become ''adequately capitalized'' by the time they reach either ten years in operation or exceed $10 million in assets (*i.e.,* no longer meet the definition of ''new''). § 1790d(b)(2)(B).

For credit unions which NCUA defines as ''complex'' according to the risk level of their portfolios of assets and liabilities, CUMAA directed NCUA to develop an additional, risk-based net worth (''RBNW'') requirement to apply to credit unions in the ''well capitalized'' and ''adequately capitalized'' net worth categories. § 1790d(d)(1). Credit unions which fail to meet their RBNW requirement are classified to the ''undercapitalized'' net worth category. § 1790d(c)(1)(C)(ii). The RBNW requirement for ''complex'' credit unions is the subject of a separate proposed rule found elsewhere in this issue of the **Federal Register**.

In addition to the principal components of PCA, CUMAA required NCUA to implement an independent appeal process by which credit unions and dismissed officials affected by PCA can challenge material supervisory decisions by NCUA staff, § 1790d(k), and to provide notice and an opportunity for a hearing to challenge NCUA Board decisions to reclassify a credit union to a lower net worth category on safety and soundness grounds. § 1790d(h).

Except for the RBNW requirement (which has a separate, later deadline for adopting a final rule, and a later effective date), CUMAA set February 7, 2000, as the deadline for NCUA to adopt a final rule establishing a system of PCA for credit unions, and August 7, 2000, as the effective date of the final rule. CUMAA § 301(d)(1) and (e)(1). With adoption of the final rule, NCUA is required to file a report with Congress explaining how the final rule accommodates the cooperative character of credit unions, CUMAA § 301(f)(1), how it differs from FDIA § 38, and the reasons for those differences. CUMAA § 301(f)(2); S. Rep. at 19; H.R. Rep. at 23.

B. Notice of Proposed Rulemaking

On October 29, 1998, NCUA commenced rulemaking by issuing an Advance Notice of Proposed Rulemaking (''ANPR'') soliciting public comment not only on the RBNW requirement for ''complex'' credit unions (as CUMAA required), but also regarding the alternative system of PCA

[1] ''Comparable'' is defined as ''parallel in substance (though not necessarily identical in detail) and equivalent in rigor.'' S. Rep. at 12.

[2] Section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831o, was added by section 131 of the Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 102–242, 105 Stat. 2236 (1991). The Joint Final Rule implementing FDIA § 38, 12 U.S.C. 1831o, is published at 57 FR 44886 (Sept. 29, 1992).

for ''new'' credit unions and the contents, criteria, and deadlines for submission of a net worth restoration plan. 63 FR 57938 (October 29, 1998); CUMAA § 301(d)(2)(A). The great majority of the 34 comment letters NCUA received by the January 27, 1999, deadline addressed the RBNW requirement for ''complex'' credit unions.

On May 3, 1999, NCUA issued a proposed part 702 establishing an overall system of PCA and an alternative system for ''new'' credit unions, as well as conforming reserve and dividend payment requirements, and an independent process for appealing decisions to impose PCA. 64 FR 27090 (May 18, 1999). The proposed rule reflected comments, which NCUA had received in response to the ANPR, regarding the net worth restoration plan and the alternative system of PCA for ''new'' credit unions.

To make PCA workable, fair and effective in light of the cooperative character of credit unions, *see* S. Rep. at 14, NCUA solicited broad public comment on the proposed rule, emphasizing the need for input on the non-statutory provisions which Congress gave NCUA the authority to develop, and thus, to modify—the contents and criteria for approval of a net worth restoration plan; deadlines for submitting and approving a plan; the alternative system of PCA for ''new'' credit unions; the various discretionary supervisory actions comparable to FDIA § 38; and the procedures for appeal. On August 10, 1999, the NCUA Board extended the comment period on the proposed rule by 15 days, to and including August 31, 1999. 64 FR 44663 (August 17, 1999).

By the close of the comment period, NCUA received 84 public comment letters on the proposed rule. Comments were submitted by 33 federal credit unions, 19 state credit unions, 2 corporate credit unions, 4 credit union industry trade associations, 15 state credit union leagues, 3 banking industry trade associations, an association of state credit union supervisors, a credit union service center (shared branch network), and a state banking commissioner. In addition, one comment letter each was submitted by a law firm, an accounting firm, 2 consultants and a broker-dealer which each service credit union clients.

Many of the comments advocated abandoning or departing drastically from provisions of the proposed rule which Congress expressly prescribed and which, therefore, the NCUA Board lacks discretion to modify.[3] These provisions include the definition of net worth, the structure and corresponding net worth ratios of the five statutory net worth categories, the four ''mandatory supervisory actions,'' and the conditions triggering discretionary and mandatory conservatorship and liquidation. A significant number of comments also addressed the RBNW requirement for ''complex'' credit unions, even though that topic was expressly excluded as a subject for comment.

The preamble to the final rule does not address the comments urging drastic modification of the statutory provisions of the rule, nor those concerning the RBNW requirement.[4] All other comments are analyzed generally in section II. below, except for comments of the banking industry trade associations, which are addressed separately in section H. below.

C. Principal Differences Between Proposed Rule and Final Rule

As revised to incorporate public comments and improvements initiated by NCUA staff, the final rule differs from the proposed rule in the following principal respects:

1. *Quarterly net worth determination.* Under the proposed rule, a credit union's net worth classification was generally determined monthly (to coincide with most credit unions' monthly dividend period). The final rule determines that classification on a quarterly basis, primarily using data from a ''PCA Worksheet'' to be filed with the Call Report. § 702.101.

2. *Notice of change in net worth category.* Under the proposed rule, a credit union was required to notify NCUA whenever its net worth classification declined. The final rule relies on the ''PCA Worksheet'' filed with a credit union's Call Report to notify NCUA of a decline in net worth classification. § 702.101(c)(1). Thus, separate notice to NCUA now is generally required only from semi-annual Call Report filers when the ''PCA Worksheet'' reveals a decline in classification in the first and third quarters for which they do not file a Call Report. § 702.101(c)(2).

3. *Choice of methods to calculate total assets.* To calculate total assets, the proposed rule used the average of total assets as reported on a credit unions most recent four quarterly Call Reports or two semiannual Call Reports, as the case may be. To compensate for seasonal fluctuations in assets, the average over the most recent four quarters is retained in the final rule, but is no longer coupled with Call Report filings. § 702.2(j)(1)(i). To compensate for month-end fluctuations, the final rule adds three options for determining a credit union's total assets—monthly average over the quarter, daily average over the quarter, and quarter-end balance—to use for all purposes other than the RBNW requirement. § 702.2(j)(1)(ii)–(iii). A credit union may elect a method from among the four options to apply for each quarter. § 702.2(j)(2).

4. *Exceptions to asset growth restriction.* Under the proposed rule, the ''mandatory supervisory action'' restricting growth in assets pending approval of a net worth restoration plan was an absolute bar. The final rule excepts from that restriction accounts receivable, accrued income on loans and investments, cash and cash equivalents, and total loans outstanding. § 702.202(a)(3)(ii). However, total loans outstanding under this exception are limited to the sum of total assets plus the quarter-end balance of unused commitments to lend and unused lines of credit. Credit unions which avail themselves of these exceptions cannot offer rates on shares in excess of prevailing market rates, and cannot open new branches. These exceptions are intended to permit a credit union largely to continue normal business operations pending approval of its net worth restoration plan.

5. *''First tier'' and ''second tier'' of ''undercapitalized'' category.* To distinguish between credit unions which are nearly ''adequately capitalized'' (6% net worth ratio) and, in contrast, those which are nearly ''significantly undercapitalized'' (4% net worth ratio), the ''undercapitalized'' category has been divided into a ''first tier'' (5% to 5.99% net worth ratio) and a ''second tier'' (4% to 4.99% net worth ratio). A ''first tier'' credit union is subject to ''discretionary supervisory actions'' (''DSAs'') applicable in the

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[3] Examples of such comments include: (1) Impose PCA in response to unsafe and unsound practices rather than a decline in net worth; (2) judge the adequacy of net worth by CAMEL ratings; (3) link the prescribed net worth ratios corresponding to each net worth category to ''a market index''; (4) upgrade net worth category classification to reflect ''favorable financial performance'' unrelated to net worth; (5) exempt ''adequately capitalized'' credit unions from the statutory requirement to transfer earnings to net worth; (6) exempt ''undercapitalized'' credit unions from statutory member business loan (''MBL'') restriction; (7) exempt certain types of MBLs from statutory MBL restriction; (8) redefine ''new'' credit unions as those having *either* $10 million or less in assets *or* less than 10 years in operation, but not both; and (9) give ''new'' credit unions more than 10 years to become ''adequately capitalized.''

[4] For this reason, references to the total number of comments received on a topic may not equal the number of comments specifically discussed in the preamble.

''undercapitalized'' category only if it fails to comply with any of the four ''mandatory supervisory actions'' or fails to implement an approved net worth restoration plan. § 702.202(c). A ''second tier'' credit union is subject to the applicable DSAs regardless of compliance with other requirements of PCA. § 702.202(b).

6. *''Discretionary supervisory actions'' for ''undercapitalized'' credit unions.* The final rule deletes from the ''undercapitalized'' category the discretion to order a new election of a credit union's board of directors, and generally revises the DSAs to more closely parallel the criteria and limitations in the corresponding ''discretionary safeguards'' in FDIA § 38. *E.g.,* §§ 702.202(b)(5), 702.203(b)(10). Under the final rule, NCUA is no longer required to exhaust the other DSAs available in that category before imposing the DSAs requiring dismissal of a director or senior officer, or hiring of a qualified senior officer. § 702.202(b)(7)–(8). In addition, the final rule now permits NCUA to impose ''other action to better carry out the purpose of PCA'' regardless whether that action is ''no more severe'' than any DSA available in that category. § 702.202(b)(9).

7. *''Discretionary supervisory actions'' for ''new'' credit unions.* For ''new'' credit unions only, the final rule makes all fourteen DSAs available if a credit union with a net worth ratio of less than 6% falls short of its quarterly net worth targets, regardless of net worth category classification. § 702.304(b).

8. *Net worth restoration plans.* The proposed rule allowed 45 days to submit a net worth restoration plan and 60 days for NCUA to decide to approve it. Under the final rule, the time for submitting a plan is effectively extended because the 45-day period commences not at quarter-end, but on the effective date of a credit union's net worth classification—the last day of the month following the quarter-end. § 702.206(a)(1). The time for NCUA to decide whether to approve a plan is reduced to 45 days from the date of receipt. § 702.206(f)(1). If no decision is made during that time, the credit union's plan is deemed approved. § 702.206(f)(1). Finally, in the event NCUA authorizes new forms of regulatory capital for credit unions, the availability of that capital to absorb losses is expressly prescribed in the final rule as a factor in evaluating a credit union's net worth restoration plan. § 702.206(e).

9. *Ombudsman input in review of ''discretionary supervisory actions.''* The proposed rule required NCUA to provide a credit union with advance notice of its intention to issue a DSA, and the opportunity to persuade the NCUA Board either not to issue, or to modify, the proposed DSA; and if still issued, to persuade the NCUA Board to modify or rescind that DSA. The final rule enhances these opportunities by permitting credit unions to request NCUA's ombudsman to make a recommendation on its behalf to the NCUA Board. § 747.2002(g).

The final rule will first apply according to the net worth ratio reported in the ''PCA Worksheet'' incorporated in the Call Report due to be filed January 22, 2001, reflecting activity in the fourth quarter of 2000. To acclimate credit unions to PCA, however, a sample ''PCA Worksheet'' with instructions is planned for introduction in September 2000. This will give credit unions the opportunity to determine on a trial basis their pre-PCA net worth classification for the third quarter of 2000.

II. Subpart-by-Subpart Analysis of Comments

To enhance the final rule's user-friendliness, part 702 has been reorganized into five subparts, each of which follows the natural sequence of implementation. In addition, many individual provisions of each subpart have been reorganized and/or rewritten to clarify and simplify implementation.

Following the general provisions which apply to all components of the final rule, Subpart A addresses the five statutory net worth categories and the means by which a credit union determines its classification among them. § 702.101 *et seq.* Subpart B establishes a comprehensive framework of ''mandatory supervisory actions'' (''MSAs'') and DSAs indexed to the five net worth categories, and implements statutory criteria triggering discretionary conservatorship and liquidation, and mandatory liquidation of a ''critically undercapitalized'' credit union. § 702.201 *et seq.* This subpart also sets forth the requirements for a net worth restoration plan. § 702.206. For credit unions which CUMAA defines as ''new,'' subpart C establishes an alternative system of PCA consisting of a separate structure of net worth categories, corresponding MSAs and DSAs, and incentives for ''new'' credit unions to build net worth. § 702.301 *et seq.*

In addition to the substantive components of PCA, subpart D restates reserve and dividend payment requirements, modified to reflect repeal of FCUA § 116, 12 U.S.C. 1762, and to facilitate CUMAA's earnings retention requirement. § 702.401 *et seq.* Finally, subpart L of part 747 establishes procedures for challenging and enforcing NCUA decisions imposing PCA. 12 CFR 747.2001 *et seq.*

A. General Provisions

1. Section 702.1—Authority, Purpose, Scope, et al.

Section 702.1 establishes the statutory authority, purpose, and scope of the implementing regulations for PCA—part 702 and subpart L of part 747. Three commenters suggested expanding the scope of PCA to address problem resolution, unsafe and unsound practices, and administrative actions such as mergers. NCUA lacks the authority to expand the scope of PCA beyond its defining statutory objective—net worth restoration. [5]

2. Section § 702.2—Definitions

Section 702.2 of the proposed rule established definitions for terms used throughout part 702, to which commenters suggested a variety of modifications, as follows:

''*Appropriate regional director.*'' While the proposed rule defined an ''appropriate State official,'' 64 FR at 27108, it lacked a parallel definition for the NCUA regional director having jurisdiction over a federal credit union. In anticipation that certain authority under part 702 will be delegated to NCUA's regional directors, the final rule defines an ''appropriate regional director'' as having ''jurisdiction over federally-insured credit unions in the state where the affected credit union is principally located.'' § 702.2(a).

''*Credit Union.*'' One commenter indicated that readers could inadvertently interpret the proposed definition of a ''credit union,'' 64 FR at 27108, to include both non-federally insured credit unions and corporate credit unions. NCUA agrees and has modified the definition to incorporate the FCUA's definition, 12 U.S.C. 1752(6), which makes clear that part 702 applies to federally-insured ''natural person'' credit unions, regardless whether State- or federally-chartered. § 702.2(c). Corporate credit unions are excluded consistent with CUMAA. 12 U.S.C. 1790d(m).

''*CUSO.*'' The proposed definition of a credit union service organization relied on the definition of a credit union service contract in 12 CFR 701.26. 64 FR at 27108. One commenter predicted an

[5] PCA does expressly address safety and soundness in one respect—a credit union which fails to correct an unsafe or unsound practice or condition may be reclassified to the next lower net worth category. § 1790d(h); §§ 702.102(b), 702.302(d).

unintended exclusion: that CUSOs which meet a non-conforming definition under State law will fall outside the proposed rule's definition. To encompass CUSOs as defined under both federal and State law, the final rule is condensed to incorporate by reference 12 CFR 712, which sets forth the attributes of CUSOs for federally-chartered credit unions, and expanded to include CUSOs as defined ''under [any] state law'' for State-chartered credit unions. § 702.2(d).

''*Net Worth.*'' For the numerator of the net worth ratio, the proposed rule incorporated the definition of ''net worth'' prescribed by CUMAA, § 1790d(o)(2): retained earnings as determined under Generally Accepted Accounting Principles (''GAAP'').[6] 64 FR at 27108. *See also* 12 U.S.C. 1757a(c)(2) (parallel definition of ''net worth''). Independent of suggestions to establish additional sources of net worth (addressed in section A.3. below), nine commenters recommended modifying the proposed definition of that term. Two commenters found the American Institute of Certified Public Accountants (''AICPA'') definition of ''net worth'' to be clearer, yet still consistent with CUMAA. [7] Four commenters advocated including the allowance for loan and lease losses (''ALL'') in ''net worth,'' while another took no position but wished to know whether or not the ALL is included. Two commenters recommended including donated equity in net worth.

In response to these comments, the definition of ''net worth'' is amplified and revised as follows in the final rule. § 702.2(f). First, the definition now refers to ''the retained earnings balance of the credit union *at quarter-end*'' to correspond to the quarterly measurement of the credit union's total assets. *See* §§ 702.2(j), 702.101. Second, the definition incorporates the AICPA definition of retained earnings—''undivided earnings, regular reserves and any other appropriations designated by management or regulatory authorities''—and makes clear that ''net worth'' consists of ''only undivided earnings and appropriations of undivided earnings.'' Thus, ''net worth'' includes amounts the credit union had previously closed from net income into undivided earnings; it excludes balance sheet items which, because they do not meet this criterion, fall outside the GAAP definition of retained earnings. Third, because provisions to the ALL are expense items that reduce undivided earnings, and the ALL is not an appropriation from undivided earnings, the final rule expressly clarifies that ''net worth'' does not include the ALL.

Under GAAP, donations to a credit union in the form of cash or other assets (*e.g.,* fixed assets), which are reported as ''contributions,'' are recognized as revenues of the period. The credit union therefore would close them from net income into undivided earnings. Thus, such donations already are reflected in the credit union's retained earnings balance, thereby satisfying the criterion for inclusion in net worth.[8] In contrast, Regulatory Accounting Practice (''RAP'') treats donations of cash differently than tangible assets. Like GAAP, RAP includes cash donations reported as ''contributions'' in net worth. But RAP treats donations of *tangible* assets as ''donated equity,'' excluding such amounts from current income and undivided earnings. As a result, these donations are not reflected in retained earnings and cannot be included in net worth.[9]

As discussed in section B.2. below, the statutory definition of ''net worth'' does not reflect accumulated unrealized gains and losses on available-for-sale securities (Call Report account no. 945) in the credit union's portfolio.

''*Shares.*'' The proposed rule incorporated the definition of ''insured shares'' in 12 CFR 741.4(b)(2). 64 FR at 27108. The sole comment on this definition urged expanding it to encompass ''jumbo'' certificates of deposit as well as deposit accounts that bear contractual interest. NCUA concurs and has revised the definition of ''shares'' to include any depository account authorized by federal or state law. § 702.2(i).

''*Total assets.*'' To compensate for seasonal fluctuations in total assets, the proposed rule defined ''total assets''—the denominator of the net worth ratio—as the average of total assets reported either in the most recent four quarterly Call Reports or the most recent two semi-annual Call Reports, as the case may be. 64 FR 27108. Two commenters supported the use of averaging of assets in general instead of relying only on the period-end balance. Referring to the ''mandatory supervisory action'' restricting asset growth, a commenter observed that averaging historical data would restrict asset growth more than a simple quarter-end total. In contrast, three commenters supported allowing credit unions to use their discretion to decide the number of months over which to average total assets.

Three commenters insisted that averaging of month-end balances would not sufficiently offset quarter-end distortions in the share balance due to the influx of payroll deposits, and advocated a daily average balance of assets to achieve this objective. Commenters suggested various averaging periods—any three of the last four quarters, the most recent five quarterly Call Reports or most recent three semi-annual Call Reports, and a period of months determined by the credit union not to exceed 24 months.

Two commenters pointed out that the language of two of the MSAs—the transfer of earnings to the regular reserve, and the asset growth restriction—was inconsistent with the proposed definition of ''total assets.'' 64 FR at 27108. Another commenter objected that the proposed definition failed to delineate between the period used to calculate total assets and the effective date of the calculation.

The final rule retains ''the average of the quarter-end balances of the four most recent calendar quarters'' as one option for calculating total assets. § 702.2(j)(1)(i). This method no longer depends on the Call Report fling schedule, however, because all credit unions will be required to complete a quarterly ''PCA Worksheet,'' or otherwise calculate their net worth ratio, regardless whether they file Call Reports quarterly or semiannually. To compensate for transactional fluctuations at month-ends during a quarter, the final rule adds three options for determining a credit union's total assets—monthly average over the quarter, daily average over the quarter, and quarter-end balance-to use for all

[6] CUMAA allows an exception for low income-designated credit unions only: their net worth includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders and the NCUSIF. § 1790d(o)(2)(B). Secondary capital accounts do not fall within the defintion of GAAP retained earnings.

[7] AICPA, *Audits of Credit Unions* (May 1998 ed.) at 121.

[8] A contribution is an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or materials and supplies, intangible assets, services, and unconditional promises to give those items in the future. Statement of Financial Accounting Standards (''SFAS'') No. 116, ''Accounting for Contributions made and Contributions Received,'' provides generally that ''contributions'' received or made are appropriately recognized as either revenues or expenses in the period received or made, at their fair values. This accounting treatment meets the criterion noted above for inclusion in retained earnings or ''net worth.''

[9] This result may influence credit unions to choose GAAP instead of RAP. Once a credit union which follows RAP switches to GAAP, it may make a prior period adjustment that would increase or decrease undivided earnings for the cumulative net amount of the contributions, thereby increasing or decreasing net worth.

purposes other than the RBNW requirement. § 702.2(j)(1).

At the end of each quarter, a credit union may elect a method of calculating ''total assets'' from among the four options the final rule offers. § 702.2(j)(2). The method selected must be used uniformly for that quarter for all purposes under part 702 except the RBNW requirement for ''complex'' credit unions (§§ 702.103–702.106). *Id.*

Finally, a commenter urged NCUA to specify the Call Report accounts that are included in ''net worth,'' and another objected to the regulatory burden involved in computing net worth. To reduce that burden, NCUA plans to include a ''PCA Worksheet'' in the Call Report to facilitate calculating and applying ''total assets'' on a quarter-by-quarter basis under the method chosen. Credit unions which file a Call Report semi-annually will have the option to complete and maintain internally a ''PCA Worksheet'' for the first and third quarters, or to otherwise calculate the net worth ratio. *See* § 702.101(c)(2).

3. Alternative Sources of Capital

By statute, the net worth of credit unions is limited to retained earnings under GAAP, § 1790d(o)(2), which consists exclusively of undivided earnings, regular reserves and any other appropriations designated by management or regulatory authorities. § 702.2(f). The sole exception is that uninsured secondary capital accounts are included in the net worth of low income-designated credit unions. § 1790d(o)(2)(B). This led numerous commenters to urge NCUA to develop and authorize alternative vehicles for raising capital to augment the net worth of ''natural person'' credit unions. The commenters suggested, for example, secondary capital accounts, paid-in-capital accounts, membership capital accounts, net worth certificates, perpetual debt, annual membership fees to be recorded as revenue,[10] and various types of uninsured share accounts.

While NCUA may have the statutory authority to permit new sources of capital,[11] CUMAA's express, limited definition of net worth—retained earnings under GAAP—clearly precludes NCUA from classifying such capital as net worth for PCA purposes. § 1790d(o)(2). As noted earlier, a credit union cannot include in retained earnings items that it had not previously closed from net income into undivided earnings. Except for annual membership fees, none of the proposed alternative sources of capital meets this criterion.

Commenters and others contend that the reason CUMAA expressly includes uninsured secondary capital accounts in the net worth of low income-designated credit unions, § 1790d(o)(2)(B), simply is to confirm that, at present, only those credit unions are authorized to offer secondary capital accounts. This exception for secondary capital, it is claimed, leaves the door open for NCUA to include in net worth other forms of regulatory capital established by NCUA, or authorized by State law and recognized by NCUA. NCUA's research supports the opposite view—that Congress intended to make an exception exclusively for low income-designated credit unions, not generally for yet to be established sources of regulatory capital. To expand the statutory definition of net worth to include proposed new sources of capital would require Congress to amend the FCUA expressly to that effect.

Should experience under part 702 demonstrate that additional sources of capital would be prudent and beneficial for credit unions, NCUA would consider proposals to establish such new forms of ''regulatory capital.'' In that event, NCUA also would consider whether to support Congressional action to include ''regulatory capital'' within the net worth of federally-insured credit unions.

In the interim, NCUA recognizes that regulatory capital, if authorized, would be available to absorb losses which the NCUSIF otherwise would absorb, despite not being included in net worth. To that end, the final rule is revised to establish as a criterion in evaluating net worth restoration plans the type and amount of any forms of regulatory capital as may be established by NCUA regulation, or authorized by State law and recognized by NCUA, which a credit union holds, and its ability to minimize possible long-term losses to the NCUSIF while the credit union takes steps to become ''adequately capitalized.'' § 702.206(e). *See also* § 703.306(d).

Finally, a commenter urged NCUA to establish a cooperative fund to which credit unions could contribute ''net worth'' to be accessed by other credit unions as needed. While it is not appropriate for NCUA to sponsor such a fund, it certainly would be an appropriate private sector initiative for credit unions which are authorized to contribute to such a fund.

B. Subpart A—Net Worth Classification

1. Section 702.3—Net Worth Measures

CUMAA expressly prescribes the exclusive measures which determine a credit union's net worth category classification—a credit union's net worth ratio and, if ''complex,'' its RBNW requirement. § 1790d(c); § 702.101(a). One commenter nonetheless advocated making a credit union's income, as reflected by income simulation models, a factor in determining its net worth category classification, insisting that the net worth ratio is too narrow a measure. Although income simulation models are a valid tool in assessing safety and soundness independently of PCA, CUMAA does not give NCUA discretion to establish additional criteria for determining a credit union's net worth category classification.

2. Section 702.101—Measures and Effective Date of Net Worth Classification

Effective date. The proposed rule provided that a credit union generally would be deemed to have notice of its net worth ratio and corresponding net worth category classification as of ''the last day of the credit union's most recent dividend period for regular shares, but no less frequently than quarterly.'' [12] 64 FR at 27108. Since most credit unions have a monthly dividend period for regular shares, this effectively required monthly measurement of the net worth ratio.

Twenty-five commenters addressed this provision. Two were unable to distinguish between ''notice'' and the ''effective date'' of classification, while one predicted that credit unions will find it difficult to determine net worth on their own. Two commenters supported the ''effective date'' provision while fourteen commenters opposed it. The opponents felt that determining net worth monthly was too frequent and,

[10] FCUA § 109(a) allows federal credit unions to charge ''a uniform entrance fee if required by the board of directors.'' 12 U.S.C. 1759(a).

[11] FCUA § 107 permits NCUA to authorize regulatory capital in the form of shares and subordinated debt. NCUA may authorize a federal credit union to (1) ''receive from its members from other credit unions, from an officer, employee or agent of those nonmember units of Federal, Indian Tribal, or local governments and political subdivisions thereof, * * * [shares, share certificates, and share draft accounts]; subject to such terms, rates and conditions as may be established by the board of directors, *within limitations prescribed by the [NCUA] Board'';* and (2) ''borrow *in accordance with such rules as may be prescribed by the [NCUA] Board,* from any source, in an aggregate amount not exceeding * * * 50 per centum of its paid-in and unimpaired capital and surplus.'' 12 U.S.C. 1757(7), 1757(9) (emphasis added).

[12] In infrequent cases, a credit union would have notice of a decline in its net worth category classification through or as a result of its most recent final report of examination (indicating a flaw in calculating in net worth ratio, for example), or when it was notified by NCUA that it had been reclassified to a lower net worth category on safety and soundness grounds. § 702.101(b)(2)–(3).

therefore, too burdensome. Various alternatives were suggested—quarterly net worth determination, annual net worth determination, net worth determination to coincide with the Call Report periods, modification of the Call Report to incorporate the formula for calculating the net worth ratio, with an abbreviated March 30 and September 31 version of the Call Report for semiannual filers to file. In addition, the commenters insisted that more time is needed between the period-end when net worth is determined and the effective date of classification, when a credit union must undertake the applicable ''mandatory supervisory actions.''

In response to these concerns, NCUA has modified and improved upon the proposed rule in two key ways. First, to reduce the frequency of measuring net worth, the final rule determines a credit union's net worth ratio at the end of each calendar quarter to coincide with the end of the Call Report period, without regard to the credit union's dividend period for regular shares. § 702.101(a). Moreover, to ease the burden of calculating the net worth ratio, NCUA plans to incorporate within the Call Report a ''PCA Worksheet'' which quarterly and semi-annual filers may rely upon to compute the net worth ratio on their own. For the first and third quarters, semiannual filers will have the option to complete and maintain a corresponding ''PCA Worksheet'' (instead of filing it with NCUA) or to otherwise calculate their net worth ratio.

Second, the final rule no longer deems a credit union to ''have notice of its net worth ratio'' as of a certain date, but instead, establishes an ''effective date'' of net worth classification. The ''effective date'' of a credit union's classification within a net worth category—the date by which it must undertake the actions applicable to credit unions in that category—generally is ''the last day of the month following the calendar quarter'' for which the credit union's net worth ratio is determined. § 702.101(b)(1). This extends to approximately thirty days the period between quarter-end and the effective date—more time than is permitted to file the corresponding Call Report.

Notice by credit union of change in net worth category. The proposed rule generally gave credit unions 15 days from the last day of the most recent dividend period for regular shares to notify NCUA of a change in net worth ratio if that change ''places the credit union in a lower net worth category.'' 64 FR 27108. Three commenters urged a role reversal in this regard—that NCUA should inform credit unions when their net worth classification changes. This is no longer necessary because the final rule eases the burden on credit unions substantially by making the period for measuring a credit union's net worth coincide with the Call Report period, and incorporating the ''PCA worksheet'' in the Call Report which already is required to be filed with NCUA (except by semiannual filers for the March 31 and September 30 quarters).

The requirements to notify NCUA of a change in category classification are modified accordingly. The ''PCA Worksheet'' filed with the Call Report will give notice to NCUA of a change in net worth ratio from quarter to quarter, and any resulting change in classification. Thus, credit unions are no longer required to give separate notice to NCUA of a change in net worth category for the quarters for which they file a Call Report. § 702.101(c)(1). This leaves two instances where the final rule requires a credit union to give separate notice to NCUA—semiannual Call Report filers whose net worth classification declines in the first and third quarters, and those whose classification declines due to recalculation of their net worth ratio by or as a result of an examination report. § 702.101(c)(2)–(3). In all cases, written notice to NCUA is required only to report a decline in net worth *category,* not merely a change in net worth ratio.

On a related issue of ''notice,'' one commenter asked whether a less than ''adequately capitalized'' credit union should inform its membership of its net worth category classification. There is no requirement for a credit union to disclose its net worth classification. However, an independent accountant who renders an opinion on the credit union's financial statements, in following Generally Accepted Auditing Standards (GAAS), may choose to disclose the credit union's classification in a footnote. In addition, Call Report data used to calculate a credit union's net worth ratio is publicly available.

Adjustment of net worth ratio. CUMAA's definition of ''net worth''—GAAP retained earnings—does not encompass items of ''other comprehensive income'' such as accumulated unrealized gains and losses on ''available-for-sale'' (AFS) securities in a credit union's investment portfolio (Call Report account no. 945). *See* Statement of Financial Accounting Standards (''SFAS'') No. 130, ''Reporting Comprehensive Income.'' Thus, while such unrealized gains and losses are not reflected in the numerator of the net worth ratio, they *are* reflected in the denominator—total assets. As a result, when the fair value of AFS securities falls, the credit union's net worth ratio is artificially overstated.[13] *See* 64 FR at 27093 & n.8. To remedy this distortion, the proposed rule gave NCUA latitude ''to adjust a credit union's net worth ratio to reflect the impact of accounting adjustments made for items of 'other comprehensive income'.'' 64 FR at 27108.

While five commenters supported this remedy in whole or in part, seventeen predicted that the market volatility of AFS securities would adversely impact net worth. Credit unions wishing not to reflect unrealized losses in net worth, it is claimed, would be tempted to inappropriately classify their securities as ''held-to-maturity'' under SFAS No. 115.[14] NCUA shares this concern. Moreover, its own research discloses that, at present, the proposed adjustment would have a limited impact—just a single credit union would be reclassified to a lower net worth category if the adjustment were applied to reflect an unrealized loss. Therefore, the final rule abandons the ''adjustment of net worth ratio'' provision, leaving the denominator of the net worth ratio unaffected. Yet, to not take account of the impact of material unrealized losses on investment securities, regardless of accounting classification, would pose a relevant, tangible risk to the NCUSIF. Accordingly, NCUA plans to address unrealized losses which are sufficiently material to affect a credit union's net worth classification as a safety and soundness concern.

Reclassification based on supervisory criteria other than net worth. The proposed rule gave NCUA discretion to reclassify a credit union to the next lower net worth category (but not lower than ''significantly undercapitalized'') if it determined, after notice and opportunity for a hearing, that the credit union either was ''in an unsafe or

[13] For example, assume a credit union has retained earnings under GAAP of $6500 and total assets of $100,000; it would have a net worth ratio of 6.5% and would be classified ''adequately capitalized.'' If, during the next quarter, the credit union experiences an $8,000 decrease in the fair value of its AFS securities, that unrealized loss would be reflected in total assets (the denominator of the net worth ratio), reducing them to $92,000, but would not be reflected at all in retained earnings (the numerator of the net worth ratio), which still would be $6500. As a result, the credit union would have a net worth ratio of 7.06% and be classified ''well capitalized'' despite having sustained a decline in the fair value of its AFS securities.

[14] SFAS No. 115, ''Accounting for Certain Investments in Debt and Equity Securities,'' provides for classification of securities as either ''held-to-maturity,'' ''available-for-sale,'' or ''trading.''

unsound condition'' or ''has not corrected an unsafe or unsound practice.'' 64 FR at 27109. Following CUMAA's mandate, this section is modeled on a parallel provision of FDIA § 38. § 1790d(h); 12 U.S.C. 1831o(g).

NCUA received various comments suggesting modifications to the grounds for reclassification under this provision. One advocated establishing precise criteria defining an unsafe or unsound practice or condition to ensure that the discretion to reclassify a credit union to a lower net worth category is exercised equitably. Given the historically subjective and sometimes unique nature of safety and soundness issues, NCUA prefers to review individual situations on a case-by-case basis, rather than to rely on objectively quantifiable standards which might limit the latitude to respond to an unsafe or unsound practice or condition.

Another commenter urged NCUA to revise the reclassification provision to exempt a credit union which is complying with an approved net worth restoration plan. To do so would make section 702.102(b) inconsistent with the parallel provision of FDIA § 38, which CUMAA instructs NCUA to follow. 12 U.S.C. 1831o(g). In addition, CUMAA is clear that PCA is available to address safety and soundness problems in addition to, not instead of, supervisory actions. § 1790d(n); § 702.1(d). In practice, however, adherence to an approved net worth restoration plan which provides for correcting such conditions and problems will mitigate against the need to exercise the discretion to downgrade a credit union.

Two commenters expressed concern about abuse of the reclassification authority. One worried that it will be used as a pretext to force a supervisory assisted merger. Another noted that the proposed provision puts no limit on how frequently within a given period of time a credit union can be reclassified downward, theoretically permitting an ''adequately capitalized'' credit union to be downgraded repeatedly in a relatively short period until it is ''significantly undercapitalized'' on the basis of the same or similar offending practices or conditions.

NCUA acknowledges these concerns, but believes the opportunities for abuse of the reclassification authority are minimal. First, the opportunity to force an assisted merger by reclassification is limited to a single instance—reclassification from ''undercapitalized'' to ''significantly undercapitalized.'' The statutory authority to insist on merger as a last resort to spare the credit union from conservatorship or liquidation is available only in the ''significantly undercapitalized'' and ''critically undercapitalized'' categories, §§ 702.203(c), 702.204(c), and part 702 does not authorize reclassification to the latter category on safety and soundness grounds. § 702.102(b). Second, NCUA is prohibited from delegating its authority to reclassify on safety and soundness grounds. § 1790d(h)(2); § 702.102(c). Absent exceptional circumstances, the NCUA Board does not anticipate using its authority under § 702.102(b) to reclassify a credit union downward by more than a single category in a 12-month period regardless of the variety and number of unsafe or unsound conditions or practices. As a final measure of protection against abuse, subpart L of part 747 provides a reclassified credit union the opportunity for a hearing to challenge the reclassification. § 747.2003.

C. Subpart B—Mandatory Supervisory Actions

1. Section 702.201—Earnings Transfer to Regular Reserve

The first of the four MSAs prescribed by CUMAA requires all but ''well capitalized'' credit unions to annually transfer earnings equivalent to 0.4% of total assets to net worth. § 1790d(e)(1). An exception to that minimum is allowed, subject to periodic review, if necessary to avoid a significant redemption of shares. § 1790d(e)(2). For the purpose of measuring total assets, the proposed rule used the average of total assets as set forth in the most recent four quarterly Call Reports or most recent two semi-annual Call Reports, as the case may be. 64 FR at 27109. The annual sum was to be transferred to the regular reserve at a monthly or quarterly rate corresponding to the dividend period for regular shares, but no less frequently than quarterly. An exception to the 0.4% minimum was permitted on a case-by-case basis, subject to a minimum quarterly review, if the statutory prerequisites were met. *Id.*

Two commenters construed the proposed provision to permit only ''adequately capitalized'' credit unions to seek a reduction below the minimum amount of the earnings transfer, making the rule inconsistent with CUMAA. In fact, a reduction below the minimum percentage equivalent of total assets is available to all credit unions having a net worth of less than 7%. In the final rule, the criteria for approval and review of such a reduction are fully set forth in § 702.201, which applies to ''adequately capitalized'' credit unions.[15] The criteria are incorporated fully by reference in sections 702.202(a)(1), 702.203(a)(1), 702.204(a)(1) which apply to ''undercapitalized,'' ''significantly undercapitalized'' and ''critically undercapitalized'' credit unions, respectively.

Eleven commenters addressed the rate of transfer prescribed in the proposed rule. Three commenters were comfortable with a monthly reserve transfer, but the vast majority contended that the monthly rate was too frequent and too burdensome. One of these suggested that the earnings transfer coincide with the filing of the Call Report.

In response to comments and on NCUA's own initiative, the final rule restructures this MSA to establish a single, uniform schedule for transferring earnings to net worth, to conform with other provisions of the rule. First, the required minimum earnings transfer to the regular reserve now takes place at a uniform quarterly rate of 0.1% of ''total assets for the current quarter,'' without regard to the dividend period for regular shares. § 702.201(a). Second, as the basis for calculating the quarterly equivalent of 0.1% of ''total assets for the current quarter,'' the final rule relies on whichever method of calculating its total assets—the average of the most recent four calendar quarter-end balances, the monthly average over the quarter, the daily average over the quarter, or the quarter-end balance—the credit union has chosen under section 702.2(j).

The final rule bases the quarterly equivalent of 0.1% of total assets on the credit union's ''total assets *for the current quarter,*'' not its total assets solely at the end of the quarter in which it first became ''adequately capitalized'' or lower. This means that the amount of the increase in net worth will fluctuate quarterly as the 0.1% equivalent of total assets is recalculated for each succeeding quarter in which a transfer is required (until the credit union is ''well capitalized''.) As total assets increase or decrease quarter by quarter, the amount represented by 0.1% of assets will fluctuate accordingly. These modifications conform to the Call Report schedule now used to determine

[15] Following the practice originated under former FCUA § 116, 12 U.S.C. 1762(b) (repealed), for seeking ''§ 116 assistance,'' NCUA plans to require credit unions to apply to the appropriate Regional Director when seeking a reduction below the minimum quarterly reserve transfer. At the request of a commenter, the burden of preparing a request for a ''reduction in earnings transfer'' is addressed in the Paperwork Reduction Act notice in section III. below.

net worth classification on a calendar quarter basis.

For example, as shown in Table 1 below, a credit union which declines to ''adequately capitalized'' in the first quarter of 2001 makes no transfer of earnings in that quarter because the effective date of 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.

TABLE 1 – EXAMPLE OF 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, when the credit union may discontinue making the transfer.

Finally, one commenter inquired whether the proposed rule should be modified to permit the transfer of the equivalent of more than 0.1% of its total assets per quarter, should a credit union's board of directors elect to do so. The final rule has been revised to indicate that a credit union ''must increase its net worth quarterly by an amount equivalent to *at least* 1/10th percent (0.1%) of its total assets for the current quarter'' and then ''must quarterly transfer that amount (*or more by choice*) to its regular reserve,'' but cannot be compelled to transfer more than 0.1% of its total assets. § 702.201(a) (emphasis added).

2. Sections 702.202(a)(2), 702.206—Net Worth Restoration Plans

Deadlines. The proposed rule generally established a period of 45 calendar days from quarter-end to submit an NWRP; if that deadline was not met, an additional 15 days was allowed. *Id.* Fourteen commenters sought a longer period for filing an NWRP—four suggesting 60 days; three suggesting 90 days; four simply seeking more time; and three advocating 45 to 60 days following the end of a reasonable time period for closing the books and preparing financial statements. There were no comments on the additional 15-day period.

The final rule effectively extends the period for filing an NWRP as the commenters urged. Section 702.101(b)(1) establishes that the effective date of net worth classification is the last day of the month following the quarter-end at which the net worth ratio is determined, thus inserting an interval of approximately 30 days. Accordingly, section 702.206(a) is revised to commence the original 45-day period on the effective date of net worth classification, rather than at quarter-end. This gives credit unions a maximum of approximately 75 days from quarter-end to timely file an NWRP. With the additional 15-day period available to credit unions which fail to file timely, § 702.206(a)(4), the final rule allows a maximum of approximately 90 days to file an NWRP.

The proposed rule established a period of 60 calendar days after receiving an initial NWRP for NCUA to notify the credit union of its approval or disapproval, and to provide reasons in the event of the latter. 64 FR at 27112. Three commenters urged NCUA to shorten the period for evaluating NWRPs. Two commenters were content to leave the evaluation period at 60 days, provided that the final rule allows the credit union to operate under a submitted NWRP pending NCUA's decision, and deems the NWRP approved if there is no decision within the 60-day period.

In view of the need for promptness inherent in PCA, NCUA concludes that it is unfair to give credit unions less time to submit an NWRP than NCUA has to evaluate it. Therefore, the period for NCUA to evaluate an NWRP has been shortened to 45 calendar days from the day the NWRP is received. § 702.206(f)(1). The credit union still may not operate under the submitted NWRP during this period. However, if no decision is made at the expiration of 45 days, however, the final rule provides that the NWRP is deemed approved. § 702.206(f)(2).

Finally, one commenter proposed supplementing the existing requirement that NCUA seek and consider the appropriate State official's views when evaluating an NWRP submitted by a federally-insured, State-chartered credit union (''FISCU''). In those cases, the commenter urged, NCUA should be required to promptly notify the State official of its decision to approve or disapprove the FISCU's NWRP. The final rule has been modified accordingly. § 702.206(f)(3).

Assistance to small credit unions. CUMAA expressly provides that ''upon timely request by a credit union with total assets of less than $10 million,'' NCUA shall ''assist that credit union in preparing [an NWRP].'' § 1790d(f)(2). The final rule conforms to this mandate. § 702.206(b). Similarly, assistance in the form of training to prepare and revise a business plan (the equivalent of an NWRP for ''new'' credit unions) will be available to ''new'' credit unions under subpart C of part 702. § 702.309(a). A commenter insisted that NCUA provide assistance in preparing an NWRP to any credit union, regardless of asset size. NCUA declines to exceed the statutory mandate in this regard absent evidence

that credit unions generally lack the ability to prepare an NWRP themselves.

Contents: The proposed rule required an NWRP to specify: (1) The steps the credit union will take to become ''adequately capitalized''; (2) a timetable for increasing net worth annually; (3) plans to comply with the mandatory and discretionary supervisory actions imposed on the credit union; (4) the types and levels of activities in which the credit union will engage; (5) the projected amount of its earnings transfer to the regular reserve; and (6), if the credit union has been reclassified on safety and soundness grounds, the steps it will take to correct the unsafe or unsound practice(s) or condition(s). Pro-forma financial statements covering the next two years also were required. 64 FR 27112.

Eight commenters found the proposed content requirements too inflexible, suggesting that share growth be allowed even when it causes a temporary decline in net worth ratio. *Compare* § 702.202(a)(3)(i). Similarly, twelve commenters suggested that an NWRP which permits asset growth to create earnings is preferable to one which simply shrinks the balance sheet to increase net worth. Another commenter discouraged reliance on a uniform timetable for increasing net worth that applies to all credit unions.

The proposed rule required ''a timetable for increasing net worth for each year in which the [NWRP] will be in effect.'' 64 FR 27112. To allow for greater flexibility over the duration of an NWRP, the final rule now requires ''a quarterly timetable for the steps the credit union will take to increase its net worth ratio so that it becomes 'adequately capitalized' by the end of the term of the NWRP, and to remain so for four (4) consecutive calendar quarters.'' 702.206(c)(1)(i). Thus, a credit union must specify the steps it will take to increase its net worth ratio by the end of the term of the NWRP, but need not pledge to increase its net worth ratio in each quarter or year the NWRP is in effect. The final rule also adds the caveat for credit unions that qualify as ''complex'' that the RBNW requirement ''may require a net worth ratio higher than six percent (6%) to become 'adequately capitalized.''' *Id.*

The proposed rule required financial data accompanying an NWRP to comply with GAAP. 64 FR at 27112. The final rule abandons this requirement to conform with NCUA policy requiring only Call Reports submitted by credit unions having $10 million or more in assets to adhere to GAAP. 12 CFR 741.6(b).

One commenter asked that NCUA enumerate in the final rule examples of steps for building net worth that a credit union should include in its NWRP. Consistent with NCUA's belief that there is no ''one size fits all'' prescription for restoring net worth, neither the proposed nor the final rule sets a standardized duration for all NWRPs, nor enumerates the steps that may or may not be appropriate for all credit unions to implement. The preferred approach is for a credit union to develop a unique NWRP prescribing individualized, positive steps to restore net worth, which NCUA will evaluate on a case-by-case basis.

The proposed rule required an NWRP to be accompanied by pro forma financial statements ''covering the next 2 years.'' 64 FR at 27112. One commenter apparently inferred from this that NWRPs are limited to a term of two years, and suggested permitting a term of up to 5 years. In fact, neither the proposed nor the final rule set a time limit for NWRPs; to do so would be inconsistent with the flexible approach needed for an NWRP to succeed. To confirm that the term of an NWRP is not linked to the period covered by supporting pro forma financial statements, NCUA has modified the final rule to require pro forma financial statements for *a minimum* of 2 years. § 702.206(c)(2). Ideally, the accompanying pro forma financial statements will cover the entire period of the NWRP.

The proposed rule required an NWRP to specify ''how the credit union will comply with the mandatory and discretionary supervisory [actions] imposed on it under [part 702].'' 64 FR at 27112. This led three commenters to infer that this required an NWRP to cover all possible discretionary actions, rather than only those NCUA actually has imposed on it. The final rule is revised to confirm that an NWRP need only address the discretionary supervisory actions actually ''imposed on it by the NCUA Board.'' § 702.206(c)(1)(iii).

Critria for approval. To the single criterion prescribed by CUMAA for approving an NWRP—that it ''is based on realistic assumptions and is likely to succeed in restoring * * * net worth''—the proposed rule added that an NWRP must (1) comply with the content requirements for an NWRP; (2) not unreasonably increase the credit union's risk exposure; and (3) be supported by appropriate assurances that the credit union will comply with the NWRP until the credit union has remained ''adequately capitalized'' for four consecutive calendar quarters. 64 FR at 27112.

One commenter urged NCUA to add, as a criterion in evaluating an NWRP, ''the limited ability of credit unions to raise net worth.'' NCUA declines to make this an explicit criterion because the entire system of PCA for credit unions already reflects the distinctions between credit unions and other depository institutions. A principal one of these is the limited ability of credit unions to raise capital. Moreover, to maintain a flexible process for evaluating NWRPs, the criteria for approving an NWRP has deliberately been held to a minimum, and the proposed rule deliberately articulates those criteria in general terms.

The final rule abandons the criterion requiring ''appropriate assurances from the credit union that it will comply with the plan until it has remained 'adequately capitalized' for four consecutive quarters.'' 64 FR at 27112. This criterion was adapted from FDIA § 38, which requires such ''appropriate assurances'' to be secured by a financial guarantee of compliance. 12 U.S.C. 1831o(e)(2)(C)(ii). NCUA never considered demanding a financial guarantee of compliance from credit unions because part 702 elsewhere provides remedies for failure to implement an NWRP. § 747.2005(b)(2). However, the objective of remaining ''adequately capitalized'' for four consecutive quarters is valid and properly belongs in an NWRP's timetable of steps for increasing the net worth ratio. Therefore, the final rule inserts that objective as a timetable requirement among the contents of an NWRP. § 702.206(c)(1)(i).

One commenter asked how frequently NCUA plans to review implementation of an NWRP to determine material compliance by the credit union. *See* § 702.102(a)(4)(ii)(B). NCUA believes that assessing the implementation and results of an NWRP is a supervision issue to be dealt with at the regional level on a case-by-case basis. Therefore, the final rule sets no schedule or standards for measuring material compliance with an NWRP.

The final rule introduces a new criterion for evaluating an NWRP—the impact of ''regulatory capital'' in any form that may become established by NCUA regulation, or authorized by State law and recognized by NCUA, but which is not included in net worth.[16] § 702.206(e). NCUA recognizes that

[16] At present, only secondary capital accounts established for low-income designated credit unions under 12 CFR 701.34 qualify as net worth. § 1790d(o)(2)(B).

regulatory capital, if established, would be available to absorb losses which the NCUSIF otherwise would absorb. Thus, the final rule adds the following criterion: ''To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become 'adequately capitalized,' the NCUA Board shall, in evaluating an NWRP under [section 702.206], consider the type and amount of any [such] forms of regulatory capital * * * which the credit union holds, but which is not included in net worth.'' § 702.206(e). This also is a criterion in evaluating a revised business plan submitted by a ''new'' credit union. § 703.306(d).

3. Section 702.202(a)(3)—Restriction on Asset Growth

The third of four MSAs prescribed by CUMAA requires a credit union having a net worth ratio of less than 6% to ''not generally permit its average total assets to increase,'' except as provided in an approved NWRP, and so long as assets and net worth increased at the rate the NWRP prescribes. § 1790d(g)(1). To compute ''average total assets,'' the proposed rule used the average of total assets reported in the most recent four quarterly Call Reports or most recent two semi-annual Call Reports. 64 FR 27109. Pending approval of such an NWRP, the proposed rule absolutely barred asset growth, allowing no exceptions. *Id.*

Seventeen comments addressed the mandatory asset growth restriction. Three commenters objected to basing ''average total assets'' on the prior four quarters. One objected that doing so would penalize credit unions whose assets had grown over the past year, compelling them to immediately reduce actual total assets to the average. The more a credit union's assets had increased, the greater the impact of a reduction to the average. As explained earlier, the final rule offers four options for measuring ''average total assets.'' The method a credit union chooses under section 702.2(j) will establish the asset growth ''ceiling.'' § 702.202(a)(3).

Many commenters condemned the rigidity of the asset growth restriction pending approval of an NWRP, observing that it is essentially a freeze on total assets that is detrimental to credit unions. For example, one commenter pointed out that the restriction, as proposed, prohibits the collection of interest income, which would increase a credit union's net worth—precisely the objective of PCA. Another cited revenue from lending as an ''important driver'' of return on average assets that should not be restricted. Another favored excepting U.S. Treasury securities and IRA accounts from the definition of ''total assets'' to allow for asset growth outside the NWRP. Eleven commenters advocated allowing an exception to the restriction when asset growth creates earnings. Allowing exceptions for this purpose, they urge, is preferable to shrinking the balance sheet to increase the net worth ratio. In this regard, NCUA recognizes that member allegiance to credit unions may cause member share accounts to grow even when rates are below prevailing market rates.

In response to these comments and on its own initiative, NCUA reconsidered the statutory language which provides that a credit union shall ''not generally permit its average total assets to increase.'' § 1790d(g)(1). As the Senate Banking Committee has acknowledged, ''[t]he term 'generally' allows the NCUA to make carefully delineated exceptions to the asset growth restrictions if the exceptions are consistent with the purpose of [§ 1790d].'' S. Rep. at 14. NCUA is convinced that absolute application of the asset growth restriction is inconsistent with the purpose of PCA because it would bring to a halt a credit union's normal business operations. This has led NCUA to relax the asset growth restriction by making carefully delineated exceptions, available under certain conditions, pending approval of an NWRP.

The final rule is revised to allow total assets to increase, pending approval of an NWRP, by reason of increases in the following categories. First, total accounts receivable and accrued income on loans or investments. This exception allows the accrual of income items, which increases net worth. § 702.202(a)(3)(ii)(A)(*1*). Second, cash and cash equivalents. This exception permits continued receipt of member deposits (for example, automated clearing house payroll deposits) and collection of cash payments of interest income. § 702.202(a)(3)(ii)(A)(*2*). Third, total loans outstanding, subject to a maximum equivalent to the sum of total assets plus the quarter-end balance of unused commitments to lend and unused lines of credit. § 702.202(a)(3)(ii)(A)(*3*). Under this exception, a credit union may make loans in the normal course of business from liquid assets available at the time it is classified ''undercapitalized'' or lower, and to honor unused commitments (such as unused revolving loans or unused commitments for member business loans) existing at that time.

These exceptions to the asset growth restriction in section 702.202 are available provided the credit union does not offer rates on shares in excess of prevailing rates on shares and deposits in its relevant market area, and does not open new branches. § 702.202(a)(3)(ii)(B). A credit union which does not avail itself of the exceptions is not subject to the limitations on rates and branching.

4. Section 702.204(a)(4)—Restriction on Member Business Loans

The last of the four ''mandatory supervisory actions'' prescribed by CUMAA prohibits credit unions having a net worth ratio of less than 6% from ''mak[ing] any increase in the total amount of member business loans * * * outstanding at that credit union at any one time.'' The restriction takes effect regardless whether the credit union has reached the statutory ceiling on member business loans (''MBLs'') in 12 U.S.C. 1757a(a)(1). § 1790d(g)(2).

The proposed rule followed Title II of CUMAA, 12 U.S.C. 1757a(b), in exempting from the MBL restriction credit unions chartered for the purpose of making, or that have a history of primarily making, MBLs, or which are designated low income, or which qualify as community development financial institutions. 64 FR at 27109. NCUA declines the invitation by two commenters to expand the exemption to include *any* credit union which makes MBLs. To so drastically extend the exemptions would neutralize this MSA in derogation of CUMAA. § 1790d(n).

The final rule is revised to clarify the MBL restriction in three ways. § 702.202(a)(4). First, to expressly confirm that for PCA purposes the definition of MBLs includes unused MBL commitments, unless otherwise noted. Second, to impose the restriction on the dollar amount of member business lending, rather than linking it to an average or a percentage of total assets. Third, to indicate that the ''total dollar amount of [MBLs]'' is measured ''as of the preceding quarter-end,'' *i.e.,* the quarter-end preceding the effective date of classification of the credit union as ''undercapitalized''' or lower.

D. Subpart B—Discretionary Supervisory Actions

Table 1 below displays the fourteen DSAs which the final rule applies as indicated to the ''undercapitalized,'' ''significantly undercapitalized'' and ''critically undercapitalized'' net worth categories. All fourteen DSAs apply in the ''moderately capitalized'' and lower net worth categories (<6% net worth ratio) of the alternative system of PCA for ''new'' credit unions. § 702.304(b). Because DSAs are available only as

necessary to carry out the purpose of PCA, NCUA generally does not anticipate resorting to the DSAs available in a particular net worth category unless a credit union fails to timely implement or comply with an approved NWRP, which includes its timetable of steps to increase its net worth ratio.

TABLE 2 – DISCRETIONARY SUPERVISORY ACTIONS IN FINAL RULE

	Discretionary Supervisory Actions in Final Rule	*Applicable in which statutory net worth categories*	*Originates in final rule section #*
1.	Requiring prior approval for acquisitions, branching, new lines of business.	"Undercapitalized" and below.	702.202(b)(1)
2.	Restricting transactions with and ownership of CUSO	"Undercapitalized" and below.	702.202(b)(2)
3.	Restricting dividends or interest paid	"Undercapitalized" and below.	702.202(b)(3)
4.	Prohibiting or reducing asset growth	"Undercapitalized" and below.	702.202(b)(4)
5.	Alter, reduce or terminate activity by credit union or CUSO	"Undercapitalized" and below.	702.202(b)(5)
6.	Prohibiting nonmember deposits	"Undercapitalized" and below.	702.202(b)(6)
7.	Ordering new election of board of directors	"Significantly undercapitalized" and below.	702.203(b)(7)
8.	Dismissing individual director or senior executive officer	"Undercapitalized" and below.	702.202(b)(7)
9.	Employing qualified senior executive officers	"Undercapitalized" and below.	702.202(b)(8)
10.	Other action to carry out PCA	"Undercapitalized" and below.	702.202(b)(9)
11.	Restricting a senior executive officer's compensation	"Significantly undercapitalized" and below.	702.203(b)(10)
12.	Requiring merger if grounds exist for conservatorship or liquidation	"Significantly undercapitalized" and below.	702.203(b)(12)
13.	Restrictions on payments on uninsured secondary capital	"Critically undercapitalized."	702.204(b)(11)
14.	Requiring NCUA prior approval for certain operations (e.g., amending charter or bylaws, changing accounting methods, material transactions)	"Critically undercapitalized."	702.204(b)(12)

Consistent with its statutory mandate, NCUA attempted in the proposed rule to craft DSAs which are "comparable" with the "discretionary safeguards" available under the system of PCA that applies to banks, yet which suit the distinctive needs and characteristics of credit unions. *See* § 1790d(b)(1)(A). The DSAs are allocated among the statutory net worth categories (Table 3) approximately as they are allocated among the net worth categories in FDIA § 38, 12 U.S.C. 1831o.

TABLE 3 -- DISCRETIONARY SUPERVISORY ACTIONS APPLICABLE TO STATUTORY NET WORTH CATEGORIES

Statutory net worth category	*Applicable "discretionary supervisory actions"*
"Undercapitalized"	• Requiring prior approval for acquisitions, branching, new lines of business. • Restricting transactions with and ownership of CUSO. • Restricting dividends or interest paid. • Prohibiting or reducing asset growth. • Alter, reduce or terminate activity by credit union or CUSO. • Prohibiting nonmember deposits. • Dismissing an individual director or senior executive officer. • Employing qualified senior executive officers. • Other action to carry out PCA.
"Significantly Undercapitalized"	*All DSAs in "undercapitalized" category plus:* • Ordering new election of board of directors. • Requiring merger if grounds exist for conservatorship or liquidation. • Restricting a senior executive officer's compensation.
"Critically Undercapitalized"	*All DSAs in "significantly undercapitalized" category plus:* • Restrictions on payments on uninsured secondary capital. • Requiring NCUA prior approval for certain operations.

1. Section 702.204(b) and (c)—"First Tier" and "Second Tier" of "Undercapitalized" Category

An overwhelming number of commenters objected, with respect to DSAs, that the "undercapitalized" category generally treats a credit which is just a few basis points short of a 6% net worth ratio, *i.e.,* nearly "adequately capitalized," as harshly as a credit union which is just a few basis point above a 3.99% net worth ratio, *i.e.,* nearly "significantly undercapitalized." One commenter went further, observing that there was insufficient differentiation among the range of DSAs available in each of the three categories.

To correct this inequity, eight commenters advocated that DSAs should not be available at all to be imposed on credit unions in the "undercapitalized" category. Eighteen commenters urged imposing a moratorium on the imposition of DSAs for a period of time to allow the "mandatory supervisory actions" to succeed in restoring net worth. Seven commenters suggested that the final rule should exempt a credit union from DSAs when "normal growth" in assets alone depresses its net worth ratio below 6 percent. Two commenters urged NCUA to abandon DSAs altogether and to rely instead on its statutory authority to reclassify a credit union to the next lower net worth category on grounds of an unsafe or unsound practice or condition. § 702.102(b).

In considering these comments, NCUA notes that the "discretionary safeguards" under the banks" system of PCA—to which DSAs are required to be "comparable"—generally do not become available until an institution's net worth falls below 4%.[17] Therefore, to provide a degree of relief to credit unions marginally below a 6% net worth ratio, the final rule divides the "undercapitalized" category into a "first tier" and a "second tier" only for purposes of imposing DSAs. The "first tier" consists of credit unions having a net worth ratio of between 5% and 5.99%, as well as those "complex" credit unions which are classified "undercapitalized" by reason of failing to meet an RBNW requirement. The "second tier" consists of credit unions having a net worth ratio of 4% to 4.99%.

Under the final rule, a credit union which is in the "first tier" of the "undercapitalized" category is subject to the DSAs applicable in that category (lines 1–6 and 8–10, Table 2 above) only if it fails to comply with any of the four applicable MSAs (*i.e.,* submit NWRP, earnings transfer to net worth, asset growth restriction, and MBL restriction) or fails to timely implement an approved NWRP, which includes meeting the timetable of steps to increase its net worth ratio. § 702.202(c).

[17] FDIA § 38's five capital categories are denominated identically to CUMMA's five net worth categories. *Compare* 12 U.S.C. 1831o(b)(1) *with* § 1790d(c)(1). However, the "leverage ratios" corresponding to each capital category were established by the Federal banking agencies rather than by FDIA § 38 itself, whereas CUMAA itself established the net worth ratios corresponding to each net worth category. *Compare* Joint Final Rule, 57 FR at 44867 *with* § 1790d(c)(1). FDIA § 38 generally classifies an institution as "adequately capitalized," and thus no longer subject to "discretionary safeguards," when its leverage ratio reaches 4%. 57 FR at 44867. *See, e.g.,* 12 CFR 325.103(b)(2)(A). In contrast, CUMAA does not classify a credit union as "adequately capitalized" until its net worth ratio reaches 6%. § 1790d(c)(1)(B). Significantly, CUMAA requires part 702 to be "comparable" to FDIA § 38 itself, rather to the Joint Final Rule. § 1790d(b)(1)(A)(ii). Thus, the DSAs prescribed in the final rule are "comparable" by corresponding category—rather than by equivalent leverage ratio in the Joint Final Rule—to the "discretionary safeguards" in FDIA § 38.

A credit union which is in the ''second tier'' of the ''undercapitalized'' category is subject to all of the DSAs available in that category regardless whether it is in compliance with the applicable MSAs and is timely implementing an approved NWRP. § 702.202(b). Moreover, CUMAA expressly classifies to the ''significantly undercapitalized'' category any credit union in the ''second tier'' (4 to 4.99% net worth ratio) which fails to timely submit an NWRP for approval, or materially fails to implement an approved NWRP. § 1790d(c)(1)(C); § 702.202(a)(2).

TABLE 4 – "FIRST TIER" AND "SECOND TIER" OF "UNDERCAPITALIZED" NET WORTH CATEGORY

"Under-capitalized" net worth category	*Net worth ratio*	*Mandatory Supervisory Actions (MSAs)*	*DSAs for "undercapitalized" category (Table 2, lines 1-6, 8-10)*	*DSAs are Available . . .*
"First tier" §702.202(c)	5% to 5.99% or fails RBNW requirement	① Submit NWRP ② Earnings transfer ③ Asset growth restriction ④ MBL restriction	All except "ordering new election of board of directors" (line 7, table 2)	Only when CU fails to comply with any of four MSAs or fails to implement NWRP.
"Second tier" §702.202(b)	4% to 4.99%	① Submit NWRP ② Earnings transfer ③ Asset growth restriction ④ MBL restriction	All except "ordering new election of board of directors" (line 7, table 2)	Regardless whether CU complies with MSAs ② thru ④. Reclassification to "significantly undercapitalized" if CU fails to timely submit NWRP or materially fails to implement NWRP.

2. Revisions to Individual Discretionary Supervisory Actions.

Comments on the DSAs in the proposed rule, 64 FR at 27096–27098, generally fall into two categories—those wishing that a specific DSA would more closely parallel its corresponding "discretionary safeguard" under the banks' system of PCA, and those wishing NCUA would further modify specific DSAs to suit credit unions. The final rule does some of both.

Requiring prior approval for acquisitions, branching, new lines of business. The proposed rule gave NCUA the discretion to prohibit a credit union from, among other things, "directly or indirectly, acquiring any interest in a CUSO or credit union" unless it is "consistent with and will further the objectives of [an approved NWRP]." 64 FR at 27096, line 1. Although no comments addressed this DSA, NCUA has decided that the limitation on acquiring interests in a CUSO or credit unions was too narrow, and should be expanded to prohibit acquiring an interest in "any business entity or financial institution." In the final rule, this DSA has been modified accordingly. § 702.202(b)(1).

Prohibiting or reducing asset growth. Separately from the MSA restricting asset growth, the proposed rule authorized NCUA to prohibit growth in all or a category of assets, or require the credit union to reduce all or a category of assets. 64 FR 27097, line 4. Characterizing this DSA as a potential threat to a credit union's survival, several commenters encouraged NCUA to be flexible in imposing this DSA when a credit union is properly implementing an approved NWRP that permits asset growth linked with increasing net worth. This concern is well taken in view of the relief from the MSA that CUMAA gives to credit unions operating under an approved NWRP that allows assets to increase in tandem with net worth. § 1790d(g)(1). NCUA will not permit this DSA to be used to effectively reinstate the MSA. Moreover, NCUA does not anticipate imposing this DSA when assets are growing pursuant to an NWRP which NCUA approved. A possible exception would be to limit or reduce a particular category of assets that poses an obstacle to restoring net worth.

Two commenters contend that this DSA is unnecessary because it duplicates the MSA restricting asset growth, § 702.202(a)(3). The MSA and this DSA are not comparable, however, because they serve different purposes. The MSA imposes a ceiling on asset growth to compel the credit union to develop a strategy for increasing its net worth ratio to 6% or more. Uncontrolled asset growth without attention to building net worth simply erodes the net worth ratio. This DSA, in contrast, is available to selectively limit or reduce growth in one or more specific asset categories, if needed to "fine tune" the asset growth that an approved NWRP allows. § 702.202(b)(4).

In lieu of limiting a credit union's asset growth, one commenter suggested limiting the risk on the investment of those assets by establishing minimum spreads, tightening lending procedures, and restricting investment options. NCUA prefers to retain this DSA as proposed because the suggested approach would necessitate an unworkable and intolerable level of micromanagement.

Restricting dividends or interest paid. As proposed, this DSA permits NCUA to prospectively restrict the dividend or interest rates a credit union pays to the prevailing rates paid on comparable accounts and maturities in its vicinity. 64 FR at 27096, line 2. One commenter urged excluding this DSA altogether, condemning it as an overreaction to a specific problem—paying high rates to

attract deposits—that plagued troubled thrift institutions in the 1980s, but does not affect credit unions now. In addition, this commenter claimed that this DSA adversely impacts members—depriving them of dividend and interest income—but would not have a disciplinary impact on management. NCUA disagrees because this DSA does not eliminate dividends and interest altogether; it merely establishes a reasonable ceiling on dividend and interest rates. This would prevent management from imprudently offering higher than prevailing rates to attract deposits that would inflate assets.

As proposed, the ceiling on rates was set at ''prevailing rates * * * in the region where the credit union is located.'' 64 FR at 27109. In response to a commenter's suggestion, the final rule sets the ceiling at ''prevailing rates'' in the credit union's ''relevant market area.'' § 702.202(b)(3). In addition, the scope of this DSA has been expanded to include interest rates because some State-chartered credit unions accept interest-bearing deposits not denominated as shares. *See* § 702.2(i). The final rule otherwise retains this DSA as proposed.

Alter, reduce or terminate activity of credit union or CUSO. The proposed rule authorized NCUA to ''[r]equire the credit union or its CUSO to reduce, alter or terminate any activity.'' 64 FR at 27097, line 5. Two commenters pointed out that this DSA omits the prerequisite built in to the corresponding ''discretionary safeguard''—that the activity in question must ''pose[] excessive risk'' to the credit union. 12 U.S.C. 1831o(f)(2)(E). Accordingly, the final rule has been revised to make ''excessive risk'' a prerequisite to imposing this DSA. § 702.202(b)(5).

Two other commenters urged that NCUA consider, as a factor in imposing this DSA, the ownership structure of the CUSO. When a CUSO is owned by multiple credit unions, a restriction on its activities could have an adverse impact on credit unions which are not subject to PCA. NCUA declines to make this an explicit criterion for imposing this DSA, but acknowledges that it is a valid mitigating factor when multiple-credit union ownership of a CUSO is involved.

Prohibiting nonmember deposits. The proposed rule authorized NCUA to ''prohibit [a] credit union from accepting nonmember deposits'' as otherwise permitted under federal or state law. 64 FR at 27097, line 6. Two commenters criticized this DSA for permitting an outright ban on nonmember deposits, suggesting instead that nonmember deposits be subject to a rate ceiling, as in section 702.202(b)(3). The final rule retains this DSA as proposed to ensure that credit unions are operated by and for their members as they build net worth. § 702.202(b)(6). This DSA is an important tool for preventing undue influence on a credit union by nonmembers, and overreliance on nonmembers by the credit union.

New election of directors; dismissal of directors or senior executive officers. As a means of improving management, the proposed DSAs authorized NCUA ''to order a new election of the credit union's board of directors'' or to ''dismiss [individual] directors or senior executive officers.'' 64 FR at 27097, lines 8 and 9. Commenters overwhelmingly opposed this DSA primarily because it strikes at a sacred and distinctive characteristic of credit unions—the member-elected board of directors which serves without compensation.

On the one hand, ordering a new election of directors does not compel a credit union to replace its board of directors with an NCUA-designated slate; it simply requires the membership to reconsider its choice of directors. On the other hand, wholesale election of the board of directors may be an overreaction when a credit union's net worth is marginally below 6%. Thus, for the ''undercapitalized'' category only (in both tiers), the final rule deletes the authority to order a new election of the board of directors; however, the unconditional discretion to dismiss individual directors or senior executive officers is retained. § 702.202(b)(7). In the ''significantly undercapitalized'' and ''critically undercapitalized'' categories, the discretion to order a new election of directors, and to dismiss a director or senior officer, remains unrestricted. §§ 702.203(b)(8), 702.204(b)(8).

In the ''undercapitalized'' category, the proposed rule allowed NCUA to dismiss directors or senior executive officers, and to order a credit union to employ qualified senior officers, only if NCUA ''first [took] one or more of the [DSAs prescribed for that category] or determined that none of those [DSAs] would further the purpose of [part 702].'' 64 FR at 27110. One commenter criticized this prerequisite as depriving NCUA of tools for ''improving management'' which it may need above all other DSAs to target the source of net worth problems at the outset. NCUA concurs and has deleted this prerequisite from the final rule, thus permitting directors and officers of an ''undercapitalized'' credit union to be dismissed without regard to the other DSAs available in that category. § 702.202(b)(7).

Restricting senior executive officers' compensation. For ''significantly undercapitalized'' or ''critically undercapitalized'' credit unions, the proposed rule gave NCUA an additional means of improving management—the discretion to limit or reduce compensation to a senior executive officer; to limit or proscribe a bonus to such officer; or to condition payment of compensation or a bonus upon NCUA approval. 64 FR at 27097, line 10. Four commenters objected that this DSA does not square with the parameters built in to the corresponding ''discretionary safeguard.'' While the corresponding provision requires prior approval to pay a bonus of any amount, it requires prior approval to pay compensation only when it exceeds the officer's ''average rate of compensation * * * during the 12 calendar months preceding the calendar month in which the institution became undercapitalized.'' 12 U.S.C. 1831o(f)(4)(A). In addition, the corresponding provision does not permit a reduction of compensation already set above the ceiling before that safeguard was imposed. Accordingly, this DSA has been modified in two ways. First, to require NCUA approval only to pay a bonus of any amount, or to compensate an officer in an amount exceeding his or her ''rate of compensation * * * during the four (4) calendar quarters preceding the effective date of classification of the credit union as 'significantly undercapitalized.''' Second, to exclude the authority to reduce compensation already set above the ceiling before the DSA is imposed. § 702.203(b)(10).

Restricting payments on uninsured secondary capital. For ''critically undercapitalized'' credit unions only, the proposed rule gave NCUA the discretion, beginning 60 days after a credit union becomes ''critically undercapitalized,'' to prohibit payment of principal or dividends on uninsured secondary capital accounts (although unpaid dividends would continue to accrue). 64 FR at 27098, line 13. The sole commenter protested that this DSA would change the terms of existing secondary capital account agreements, require new disclosures, and make these already high-risk, limited-reward investments (available only from low-income designated credit unions) unattractive to potential investors. To protect existing secondary capital accounts, this DSA is revised to apply only to those accounts established after August 7, 2000 (the effective date of the final rule). § 702.204(b)(11). The disclosure requirements for those

accounts (*see* appendix to 12 CFR 701.34), will be modified to reflect the prospective application of section 702.204(b)(11). In addition, since uninsured secondary capital accounts of low income-designated credit unions are structured as interest-paying debt, the final rule expands this DSA to include ''interest.''

Requiring NCUA prior approval for certain operations. For ''critically undercapitalized'' credit unions only, the proposed rule gave NCUA discretion to require its prior approval before a credit could undertake certain routine activities. 64 FR at 27098, line 13. One such activity is ''[e]ntering into any material transaction other than in the usual course of business'' or any similar action requiring prior notice to NCUA. *Id.* The sole commenter on this DSA sought a definition of a ''material'' transaction. NCUA declines to define ''material'' because it is best judged on a case-by-case basis. Instead, however, the final rule replaces the examples of material transactions enumerated in the proposed DSA with a blanket exemption for material transactions that fall within the scope of an approved NWRP. § 702.204(b)(12)(i).

Other action to carry out PCA. The proposed rule gave NCUA the discretion to ''restrict or require such other action * * * as [it] determines will carry out the purposes of [part 702] better than any of the [DSAs expressly] prescribed,'' respectively, in the ''undercapitalized'' or lower categories. 64 FR at 27097, line 7. For the ''undercapitalized'' category, however, the proposed rule imposed a prerequisite—that ''such other action'' could be imposed only if it were ''no more severe'' than the other DSAs available in that category. *Id.* No comments addressed the conditional or unconditional version of this provision. Nonetheless, NCUA has decided that the ''no more severe'' limitation on this DSA would be unworkable in practice because it is too subjective a standard of comparison. Hence, in the final rule, all three categories contain the identical DSA allowing ''such other action'' provided only that it ''carr[ies] out the purposes of PCA better than any of the actions prescribed'' for the ''undercapitalized'' category. §§ 702.202(b)(9), 702.203(b)(11), 702.204(b)(13).

Other DSAs. NCUA received no comments addressing two of the proposed DSAs: ''Restricting transactions with and ownership of a CUSO,'' 64 FR at 27096, line 2, and ''Requiring merger if grounds exist for conservatorship or liquidation.'' 64 FR at 27098, line 11. They are retained as proposed. §§ 702.202(b)(2), 702.203(b)(12).

3. Conservatorship and Liquidation

Discretionary conservatorship or liquidation. Reflecting the terms of CUMAA, the proposed rule gave NCUA discretion to place a ''significantly undercapitalized'' or ''critically undercapitalized'' credit union into conservatorship or liquidation if that credit union ''has no reasonable prospect of becoming 'adequately capitalized.' '' 64 FR at 27110, 27111; 12 U.S.C. 1786(h)(1)(F), 1787(a)(3)(A)(i). One commenter addressing this provision insisted that a credit union in either of these categories be permitted the option of merging with another credit union to avoid conservatorship or liquidation. This is precisely the purpose of the DSA entitled ''Requiring merger if grounds exist for conservatorship or liquidation'' (line 11, Table 2 above), available in both categories. §§ 702.203(b)(12), 702.204(b)(14). As explained in the preamble to the proposed rule, ''[t]his action is appropriate * * * because NCUA's insistence on merger with another financial institution gives credit union management the opportunity to consummate a merger to avoid inevitable conservatorship or liquidation, thereby permitting the credit union to survive in merged form.'' 64 FR at 27908. *See* 12 U.S.C. 1831o(f)(2)(A)(iii) (requiring institution to be acquired by holding company or to combine with another institution if grounds exist for conservatorship or receivership). Because the DSA requiring merger is available as an option for a credit union to preempt conservatorship or liquidation, the discretionary liquidation and conservatorship authority is retained as proposed. §§ 702.203(c).

Mandatory conservatorship and liquidation. Following the mandate of CUMAA, § 1790d(i)(1), the proposed rule required NCUA to place a ''critically undercapitalized'' credit union into conservatorship or liquidation within 90 days, unless NCUA determines that ''other corrective action'' in lieu of conservatorship or liquidation would better achieve the purposes of PCA. 64 FR at 27111. That determination, which must be documented, expires at the end of a period of no more than 180 days. If the determination is not affirmed before the period ends, NCUA must conserve or liquidate the credit union. The determination that ''other corrective action'' would better achieve the purpose of PCA may be renewed for additional periods of up to 180 days.[18] However, renewals which extend the full 180-day period will be limited to two and part of a third because of a statutory 18-month maximum period for ''other corrective action'' to succeed.

Under the proposed rule, NCUA must conserve or liquidate a surviving ''critically undercapitalized'' credit union, regardless of the impact of ''other corrective action,'' if that credit union is ''critically undercapitalized'' (2% net worth ratio) on average for a full calendar quarter beginning 18 months from the date it first was classified as such. 64 FR at 27111. This is the case even if the credit union manages to exceed a 2 percent net worth ratio on any of the preceding effective dates of classification during the 18 month period. A credit union may evade mandatory liquidation at this point only if NCUA certifies that the credit union (1) has, since the date of approval, substantially complied with an NWRP requiring improvement in net worth; (2) has positive net income or a sustainable upward trend in earnings; and (3) is viable and not expected to fail. § 1790d(i)(3)(B).[19]

The effective date when a credit union first became ''critically undercapitalized'' typically will fall one month after the end of a calendar quarter. Thus, the last possible day for ''other corrective action'' will be no more than 23 months from the effective date (18 calendar months from the effective date, plus two months to the end of the calendar quarter, plus the subsequent 3 months of the next calendar quarter), absent NCUA certification that the criteria for an exception to liquidation have been met.

NCUA received no comments on this mandatory liquidation procedure. It is retained as proposed, § 702.204(c), with

[18] Neither the original effective period of a determination to take ''other corrective action,'' nor an extension of that period, need extend for the maximum duration of 180 days. The NCUA Board has the discretion to establish a shorter original or renewed effective period; to reconsider any determination periodically; and to reverse and discontinue the ''other corrective action'' altogether. To renew a prior effective period, the NCUA Board must make and document a new finding prior to expiration of the present effective period that its ''other corrective action'' still furthers the purpose of PCA. § 702.204(c)(1)(iii).

[19] The authority to elect among conservatorship, liquidation, or other action concerning a ''critically undercapitalized'' credit union cannot be delegated unless the credit union has less than $5,000,000 in assets. § 1790d(i)(4)(A). if made by delegation, the decision is directly appealable to the NCUA Board. § 1790d(i)(4)(B); § 702.204(c)(4). Finally, a ''significantly undercapitalized'' or ''critically undercapitalized'' credit union which is placed into conservatorship or liquidation under part 702 retains the right to challenge NCUA Board's decision in court within 10 days. 12 U.S.C. 1786(h)(3), 1787(a)(1)(b).

two exceptions. First, both the statute and the proposed rule were silent regarding the method for calculating whether a credit union ''is 'critically undercapitalized' on average for a full calendar quarter'' beginning 18 months after the effective date of classification as such. The final rule now designates ''a monthly average basis'' over the calendar quarter as the required method. § 702.204(c)(3)(i). Second, the statute and proposed rule are silent regarding how to treat a ''critically undercapitalized'' credit union once it is certified as meeting the criteria for an exception to mandatory liquidation. § 702.204(c)(3)(ii). The final rule now requires NCUA to review that certification ''at least quarterly'' and to then either recertify the credit union or ''promptly place [it] into liquidation * * *'' § 702.204(c)(3)(iii).

4. Consultation With State Officials

CUMAA requires NCUA to consult with the appropriate State official when imposing PCA against a FISCU. § 1790d(l). Under the proposed rule, before conserving or liquidating a FISCU, NCUA must ''seek the views'' of the appropriate State official, provide reasons for the proposed action, give the official an opportunity to respond, and allow the official to implement the conservatorship or liquidation. 64 FR at 27111. If the State official disagrees with NCUA's determination to conserve or liquidate, NCUA can proceed only if it makes findings of risk of loss to the NCUSIF. 64 FR at 27112; *see also* 12 U.S.C. 1786(h)(2)(C), 1787(a)(3)(B).

Similarly, when imposing a DSA upon a FISCU, the proposed rule required NCUA to first ''seek the views'' of the appropriate State official, and to allow the official to impose the DSA independently or jointly with NCUA. 64 FR at 27112. Once these prerequisites are met, NCUA may proceed to impose the DSA.

NCUA received no comments regarding consultation in advance of conservatorship or liquidation of a FISCU. With respect to consultation regarding proposed DSAs, however, two commenters asked NCUA to replace the phrase ''seek the views of the appropriate State official'' with the phrase ''consult and seek to work cooperatively'' with that official, to conform to the specific language of § 1790d(l)(1). That provision of the final rule has been revised accordingly, and also has been modified to require NCUA to ''provide prompt notice of its decision [whether to impose a DSA on a FISCU] to the appropriate State official.''. § 702.205(c).

E. Subpart C—Alternative Prompt Corrective Action for New Credit Unions

1. Section 702.301—Scope and Definition

This provision of the proposed rule applied subpart C in lieu of subpart B to ''new'' credit unions; restates the statutory definition of a ''new'' credit union; explained how ''spun-off'' groups can meet the definition; and authorized NCUA to treat as not ''new'' under subpart B credit unions or groups which attempt to qualify as ''new'' for the purpose of evading subpart B. 64 FR at 27113. Four commenters generally addressed the separate system of PCA for ''new'' credit unions—two supporting it, one claiming that it equates low capital with impending failure, and one concerned that it could have unintended adverse consequences for a healthy, growing credit union.

Contrary to equating low capital with impending failure, subpart C establishes an ''uncapitalized'' net worth category which permits a ''new'' credit union to continue operating while it has no net worth so long as it is making efforts to build net worth. § 702.305. The concern that subpart C will restrict asset growth ignores a crucial distinction between ''new'' and non- ''new'' credit unions—that ''new'' credit unions are not subject to an MSA restricting asset growth. *See, e.g.,* § 702.202(a)(3). Rather, ''new'' credit unions are subject only to a DSA allowing NCUA to limit or reduce assets. § 702.304(b).

Accordingly, the final rule retains the scope and definition provisions as proposed. § 702.301.

2. Section 702.302—Net Worth Categories for ''New Credit Unions''

Proposed subpart C separately established six net worth categories for ''new'' credit unions, notably including an ''uncapitalized'' category for credit unions having no net worth. 64 FR at 27113. To facilitate the credit union's eventual transition from subpart C to subpart B, the net worth ratios for the ''well capitalized'' and ''adequately capitalized'' net worth categories are the same as those of the corresponding categories in subpart B. §§ 702.302(c)(1)–(2). The net worth ratios for the ''moderately capitalized,'' ''marginally capitalized'' and ''minimally capitalized'' categories differ somewhat from those of the corresponding categories in subpart B to allow gradual, if not steady, accumulation of net worth over a ten-year period, in contrast to restoration of net worth over a shorter term. This reflects field experience and historical data indicating that newly-chartered credit unions generally take up to 3 years to develop positive net worth and may take up to 5 years to attain a 2% net worth ratio.

Like the proposed rule, the preamble of the final rule suggests reasonable time frames (''benchmarks'') for attaining each ''new'' net worth category, which a ''new'' credit union should aspire to meet. *See* Table 5 below. These benchmarks are not mandatory and neither the proposed nor the final rule imposes them as a requirement. As first explained in the preamble to the proposed rule, the benchmarks represent only a guide as to how long it is ''reasonably expected'' to take a ''new'' credit union to reach a given net worth category. 64 FR at 27099. *The benchmarks in Table 5 below do not establish mandatory deadlines and do not trigger any supervisory action.*

TABLE 5 -- BENCHMARKS TO ACHIEVE NET WORTH CATEGORIES FOR "NEW" CREDIT UNIONS

"New" net worth category	*Net worth ratio*	*Anticipated by year-end of operation*
"Well Capitalized"	7% or greater	N/A
"Adequately Capitalized"	6% to 6.99%	10th
"Moderately Capitalized"	3.5% to 5.99%	7th
"Marginally Capitalized"	2% to 3.49%	5th
"Minimally Capitalized"	0% to1.99%	3rd
"Uncapitalized"	Less than 0%	N/A

In addition to the "new" net worth categories and corresponding net worth ratios, section 702.302 also incorporates from subpart A the "effective date" provision (§ 702.101(b)); the requirement to notify NCUA of a change in category classification in limited circumstances (§ 702.101(c)); and the authority to reclassify a credit union to a lower category on grounds of an unsafe or unsound practice or condition (§ 702.102(b)).

Benchmarks. NCUA received 4 comments on specific net worth benchmarks even though Table 4 is not a part of the final rule itself. To simplify subpart C, one commenter suggested pro-rating the benchmarks equally over the 10-year period subpart C covers. This would defeat the purpose of the benchmarks, which accommodate the need for greater regulatory forbearance in the early years when a "new" credit union is developing its operations and asset base. For this reason, NCUA declines to pro-rate the benchmarks equally to achieve simplicity.

A second commenter supported the concept of benchmarks, but indicated that "new" credit unions would need capital "subsidies" to meet them. NCUA disagrees, believing that the alternative system of PCA is designed, with relaxed standards and incentives, to help "new" credit unions build capital gradually on their own, instead of relying on capital subsidies.

A third commenter urged an 8-year benchmark, instead of 7 years, for requiring "new" credit union to reach a 3.5% net worth ratio and become "moderately capitalized." In fact, none of the benchmarks *requires* reaching a particular net worth category within a particular period of time; the benchmarks are simply guides based on past experience.

PCA criteria other than net worth. NCUA received 3 comments suggesting PCA criteria instead of, or in addition to, net worth for "new" credit unions. One commenter advocated abandoning "restrictive capital requirements" in favor of a more flexible approach—requiring an approved budget and plan to guide operations, apparently resembling a revised business plan. While revised business plans are an essential element of PCA for "new" credit unions, § 702.306, it would be contrary to CUMAA's intent to adopt an alternative system of PCA for "new" credit unions that entirely lacks fixed net worth standards. Instead, NCUA has chosen to adopt relaxed net worth ratios, and even to permit "new" credit unions to operate temporarily and periodically without net worth.

A second commenter suggested that a credit union's CAMEL rating is an appropriate measure of a "new" credit union's viability, and urged giving it as much weight in implementing PCA as net worth. However, to equate the CAMEL rating with net worth would dilute the focus of PCA because only one of the five CAMEL components is directly related to net worth.

A third commenter contended that the potential short-term negative effect of low cost, nonmember deposits on the net worth ratio of "new" low income-designated credit unions should not be grounds for prohibiting acceptance of such deposits. To minimize that effect, the commenter recommended either risk-weighting non-member deposits or excluding them from the net worth ratio calculation. NCUA does not support this proposal because there is no statutory basis for minimizing the impact of nonmember deposits as the commenter suggests.

3. "Uncapitalized" Net Worth Category

The "uncapitalized" net worth category, unique to PCA for "new" credit unions, permits a "new" credit union which has no net worth to continue operating under certain constraints. 64 FR at 27114. The final rule, like the proposed rule, permits a "new" credit union to operate with no net worth for the time period provided in its initial business plan (approved at the time the credit union's charter is granted) without being subject to MSAs and DSAs. § 702.305(a). A credit union which remains "uncapitalized" after expiration of the period approved for operating with no net worth will become subject to the MSAs and DSAs applicable to "new" credit unions. *Id.* A credit union which, after reaching a net worth above 0%, subsequently declines to the "uncapitalized" category from any higher net worth category would either begin (if it had declined directly from the "adequately capitalized" or "well capitalized" categories) or continue to comply with those MSAs and DSAs. *Id.*

In the "new" net worth categories which require submission of a revised business plan, the plan generally must be submitted when a credit union's net worth ratio has not increased consistent with the quarterly net worth targets prescribed in its then present business plan. § 702.304(a)(1)(i). In contrast, a credit union in the "uncapitalized" category must submit a revised business plan, regardless of its net worth targets, within 90 days of the effective date of classification as "uncapitalized" as a result of either expiration of the period allowed in its approved initial business plan, or a decline from a higher net worth category. § 702.305(a)(2).

Under the proposed rule, NCUA had the discretion to liquidate an "uncapitalized" credit union if it failed to submit a revised business plan within a specified period not to exceed 90 days from the effective date of classification as "uncapitalized." 64 FR at 27112. The final rule expands this discretion to include the option of conservatorship. § 702.305(c)(1). Under the proposed rule, NCUA was *required* to liquidate an

''uncapitalized'' credit union which remained ''uncapitalized'' 90 days after NCUA approved its revised business plan unless the credit union documented ''why it is viable and has a reasonable prospect of becoming 'adequately capitalized.''' The final rule makes liquidation discretionary instead of mandatory. § 702.305(c)(2). Both of these modifications are intended to increase flexibility in dealing with ''uncapitalized'' credit unions.

NCUA received two comments regarding the ''uncapitalized'' category for ''new'' credit unions. The first recommended allowing an ''uncapitalized'' credit union to avoid liquidation as long as capital trends are positive. The second suggested that new credit unions should be required to be profitable within three years, but should be allowed to operate while insolvent during that period, within certain limits. The final rule follows a middle course, establishing no fixed time frames to achieve profitability, but also not forbearing simply because a ''positive trend'' in net worth develops. Rather, the final rule adheres to an approach which allows ''new'' credit unions to build net worth gradually and to achieve profitability on an individualized timetable.

4. Section 702.306—Revised Business Plans for ''New'' Credit Unions

Under the proposed rule, ''new'' credit unions in the ''moderately capitalized'' and lower net worth categories (*i.e.,* net worth ratio of less than 6%) must file a revised business plan (''RBP'') whenever they timely fail to meet net worth targets in their original or present business plan. 64 FR at 27114.

Whereas an NWRP under subpart B is designed to restore net worth, the purpose of an RBP is to *build* net worth. An RBP is broader in scope than an NWRP, essentially calling for a ''new'' credit union to progressively update the business plan elements originally required for charter approval, as well as its quarterly targets for increasing net worth in each year in which the RBP is in effect. Approval of an RBP is effectively a charter to operate for the period covered by the plan. The proposed rule set forth deadlines for submitting an RBP, and for NCUA to approve it, as well as content requirements and criteria for approval. 64 FR at 27114, 27115.

NCUA received four comments regarding section 702.306. Two of these alluded to the time period for filing an RBP—one urging 90 days to file an RBP, and the other insisting that the extra 15-day period is too short to file an RBP once a credit union has failed to timely file one. In the final rule, the filing period for an RBP (as with an NWRP) is effectively extended because it now commences on the ''effective date'' of a quarterly net worth measurement—the last day of the calendar month following the quarter end—rather than on the last day of the quarter itself. § 702.306(a). This adds approximately 30 days to the initial filing period, in addition to the extra 15-day period that already is available. § 702.306(a)(1).

A third commenter urged NCUA to refrain from approving an RBP which prohibits a ''new'' low income credit union from making dividend or principal payments on secondary capital accounts because it would discourage non-member deposits. Regardless whether imposed in an approved RBP or through a DSA, the authority to prohibit dividend and principal payments on uninsured secondary capital accounts is always discretionary under part 702. § 702.204(b)(11). Thus, there is no reason to demand that prohibition as a prerequisite for approval of an RBP.

Finally, a fourth commenter discouraged NCUA from intervening in management of a credit union once NCUA has approved the credit union's RBP, thus ensuring that management has the flexibility to respond to ''changes in the marketplace.'' It would be inconsistent with the purpose of PCA for NCUA to approve an RBP which gives itself management responsibility over the credit union. On the contrary, NCUA's post-approval role in most cases will be limited to imposing DSAs when warranted.

Under the proposed rule, the requirement to file an RBP (other than in the ''uncapitalized'' category) was triggered when a ''new'' credit union's net worth ratio did not increase consistent with its then-present approved business plan. 64 FR at 27113–27114. The proposed rule overlooked two instances that should trigger the requirement to file an RBP. First, where a ''new'' credit union has no ''then-present approved business plan'' to follow, which would be the case if the credit union declined from the ''adequately capitalized'' or ''well capitalized'' categories. Second, where the credit union has, and is operating under, a then-present business plan, but is not complying with other applicable MSAs. The final rule corrects these oversights accordingly. § 702.304(a)(2)(ii)–(iii).

5. Mandatory and Discretionary Supervisory Actions for ''New'' Credit Unions.

Mandatory. The final rule imposes on ''new'' credit unions classified ''moderately capitalized'' and below a modified version of three of the corresponding MSAs that CUMAA imposes in subpart B. Whereas subpart B required submission of an NWRP by a credit union classified ''undercapitalized'' or below, subpart C requires submission of an RBP when a ''new'' credit union classified ''moderately capitalized,'' ''marginally capitalized'' or ''minimally capitalized'' fails to meet its quarterly net worth goals. §§ 702.304(a)(2), 702.305(a)(2). Subpart C requires the same quarterly increase to net worth, and transfer from undivided earnings to the regular reserve, as subpart B requires, § 702.303, except that subpart C imposes no minimum increase for ''new'' credit unions classified ''moderately capitalized'' or lower. §§ 702.304(a)(1), 702.305(a)(1). The member business loan restriction in subpart C is identical to that in subpart B. §§ 702.304(a)(3), 702.305(a)(3).

NCUA received a single comment on the MSAs, suggesting that no earnings transfer whatsoever be required of a ''new'' credit union less than five years in operation. As explained above, below the ''adequately capitalized'' category, subpart C sets no minimum amount for an increase to net worth. Thus, it is entirely possible, if warranted by the credit union's individual circumstances, to receive approval of an RBP requiring a minimal increase to net worth or no increase at all.

Discretionary. The proposed rule prescribed for ''new'' credit unions the same fourteen DSAs as those prescribed in subpart B, and allocated them among the ''new'' net worth categories by corresponding category in subpart B.[20]

NCUA received three comments regarding the appropriateness of the DSAs for ''new'' credit unions. One commenter found it ''counterproductive'' for ''new'' credit unions to share the same DSAs that apply to other credit unions. In view of the fact that ''new'' and non-''new'' credit unions alike share common

[20] Under the proposed rule, the DSAs available in the ''undercapitalized'' category in subpart B were available in the ''moderately capitalized'' category in subpart C; the DSAs available in the ''significantly undercapitalized'' category in subpart B were available in the ''marginally capitalized'' category in subpart C; and the DSAs available in the ''critically undercapitalized'' category in subpart B were available in the ''minimally capitalized'' and ''uncapitalized'' categories in subpart C. 64 FR at 27113.

attributes regardless of asset size or years in operation, as well as the goal of becoming ''adequately capitalized'' or better, NCUA declines to adopt separate DSAs for ''new'' credit unions solely to differentiate them.

As previously noted, the proposed rule allocated DSAs among the ''new'' net worth categories to parallel the allocation among the corresponding categories in subpart B. To achieve comparability with FDIA § 38, the DSAs were allocated among the net worth categories in subpart B to correspond approximately to the allocation of ''discretionary safeguards'' among the capital categories in FDIA § 38. This approach is appropriate because the discretion to impose a DSA in subpart B is triggered when a credit union falls to a lower net worth category. In contrast, the discretion to impose a DSA under subpart C is triggered when a ''new'' credit union fails to meet the quarterly net worth targets in its then-current RBP *regardless of net worth category.* §§ 702.304(b), 702.305(b). In view of this distinction, NCUA prefers a more flexible approach for ''new'' credit unions. Instead of allocating slightly different sets of DSAs among the different ''new'' net worth categories, the final rule makes all fourteen DSAs (enumerated in Table 1 above) available in each of the ''moderately capitalized,'' ''marginally capitalized,'' ''minimally capitalized'' and ''uncapitalized'' net worth categories. *Id.*

Two commenters agreed that NCUA should apply the same DSAs to all ''new'' credit unions. One of these urged exempting from DSAs altogether those ''new'' credit unions which meet the net worth benchmarks which NCUA has established as a guide for building net worth. *See* Table 5 above. This would be contrary to the role of the benchmarks as simply a guide, rather than as a mandatory trigger for PCA. Just as NCUA cannot use the benchmarks as a sword to impose MSAs or DSAs, so should ''new'' credit unions not be able to rely on them as a shield against such actions.

6. Incentives for ''New'' Credit Unions

CUMAA required NCUA to develop ''adequate incentives'' for new credit unions to become ''adequately capitalized'' before they either are in operation for more than 10 years or reach $10 million in total assets. § 1790d(b)(2)(B).[21] The proposed rule offered three such incentives: (1) classroom training in management, lending and product development for ''new'' credit union directors, officers and employees; (2) non-classroom individualized guidance and training in the preparation and revision of business plans; (3) eligibility to join and receive the benefits of NCUA's Small Credit Union Program. 64 FR at 27115.

NCUA received three comments generally supporting these incentives. One advocated making management training available to all less than ''adequately capitalized'' credit unions rather than only to ''new'' credit unions. Management training is offered for a maximum of ten years as an incentive for ''new'' credit unions to build net worth. Educating all less than ''adequately capitalized'' credit unions in management, regardless of how long they have been in operation, simply because their net worth is less than 6 percent, is well beyond the role of PCA.

Another commenter recommended that management training be provided by outside sources to avoid a perceived conflict of interest that may arise when NCUA actively participates in the training. For this and other reasons, NCUA has decided to reconsider the proposed sources for management training—NCUA itself and non-profit organizations—and the proposed means of funding them—grants and contracts pursuant to 12 U.S.C. 1766(f)(2)(A) and (i)(3). *See* 64 FR at 27101. Thus, while the final rule continues to prescribe ''management training and other assistance'' as an incentive for ''new'' credit unions, it will be provided in accordance with policies to be developed and approved by NCUA. § 702.307(b).

The proposed rule offered ''new'' credit unions assistance in revising business plans. 64 FR at 27115. CUMAA required NCUA to provide assistance in preparing an NWRP to credit unions having less than $10 million in assets. § 1790d(f)(2). To provide such assistance as a further incentive to ''new'' credit unions, NCUA equated an RBP required of ''new'' credit unions with an NWRP. NCUA now recognizes, however, that CUMAA's mandate to provide such assistance is broader than its definition of a ''new'' credit union, extending assistance to those credit unions having assets of less than $10 million regardless how long they have been in operation. § 1790d(f)(2). The final rule extends assistance in preparing RBPs accordingly, to credit unions having assets of less than $10 million, but which have been in operation for 10 years or more.[22] § 702.307(a). *See also* § 702.206(b).

The final rule also retains as an incentive a ''new'' credit union's eligibility to join NCUA's ''Small Credit Union Program.'' § 702.307(c). *See* NCUA Instruction no. 6052.00 (March 24, 1999).

F. Subpart D—Reserves

This subpart of the proposed rule retained much of the substance of NCUA's current reserve transfer and dividend payment requirements, modified to reflect the repeal of 12 U.S.C. 1762, and to conform with CUMAA. 64 FR at 27115. The proposed rule eliminated the ''statutory reserve''; retained the regular reserve, in which reserve transfers will be reflected; retained the requirement to maintain an allowance for loan losses, but decoupled it from the regular reserve; barred subsequent reversing of the current period provision; retained full and fair disclosure provisions in revised form; and retained restrictions on the payment of dividends when there is a deficit in undivided earnings.[23] 64 FR27101.

Two commenters contend that there is no longer a need for a regular reserve because fear of a decline in net worth classification alone is sufficient to deter an outflow of capital through dividends. Because part 702 now imposes a quarterly earnings transfer requirement on credit unions having a net worth of less than 7%, maintaining the regular reserve is necessary to facilitate and measure earnings retention. § 702.401(b). Credit unions are accustomed to relying on the regular reserve account as an appropriation of undivided earnings.

The final rule imports from the former part 702 conditions for charging losses to the regular reserve, modified to conform to CUMAA. § 702.401(c). Under that provision, credit unions may charge losses to the regular reserve, provided that the charge will not cause the credit union's net worth classification to fall below ''well capitalized.'' Otherwise, the credit union must receive the approval of NCUA or the appropriate State Official before charging losses to the regular reserve.

Under the proposed rule, ''a dual declaration by the treasurer and

[21] Once chartered and in operation, a new credit union is eligible to receive special assistance under FCUA § 208, 12 U.S.C. 1788, ''to prevent the closing of an insured credit union which the [NCUA] Board has determined is in danger of closing.''

[22] NCUA currently provides guidance indirectly, as needed by any credit union in preparing its initial business plan for charter approval under Interpretive Ruling and Policy Statement 99–1, 63 FR 71998, 72019 (December 30, 1998).

[23] As commenters have suggested, NCUA plans to explain the new reserve requirements, citing specific examples, in future NCUA Letters to Credit Unions.

president'' was required to support the credit union's Statement of Financial Condition. 64 FR at 27115. One commenter was confused as to whether ''president'' refers to the person who, at some credit unions, serves as president of the board, or to the person who is the credit union's chief executive officer. This is clarified in the final rule by requiring ''a dual declaration by the treasurer and chief executive officer'' of the credit union. § 702.402(c).

Ten commenters objected to the provision regarding payment of dividends when undivided earnings are depleted because it effectively permits only ''well capitalized'' credit unions to transfer earnings from the regular reserve to pay dividends. 64 FR at 27115. Less than ''well capitalized'' credit unions may do so only with approval of NCUA or the appropriate State official. § 702.403(b). The commenters insist that the rule be modified to allow ''adequately capitalized'' credit unions to pay dividends from the regular reserve. Allowing less than ''well capitalized'' credit unions to pay dividends from the regular reserve would defeat the purpose of the earnings retention requirement which applies to credit unions having a net worth ratio of less than 7%.

In reference to the source from which dividends must be paid, the final rule is amended to exclude the words ''post-closing, post-transfer '' modifying ''undivided earnings.'' § 702.403(a). Permitting dividends to be paid from post-closing undivided earnings would preclude accurate computation of net income for the period.

Part 702 generally applies to both federally-chartered credit unions and FISCUs. As proposed, however, this subpart applied to federally-chartered credit unions expressly, but to FISCUs only through incorporation by reference in general terms in 12 CFR 741.3(a)(1). For purposes of clarity and consistency with the other subparts of part 702, subpart C is revised in the final rule to expressly cover ''federally-insured credit unions,'' thus combining both federally-chartered credit unions and FISCUs. As discussed immediately below, 12 CFR 741.3. confirms that all of part 702 (and subpart L of part 747) applies to FISCUs.

G. Section 741.3—Application to FISCUs

The proposed rule failed to revise part 741.3 of chapter VII to indicate that FISCUs are subject to PCA as a prerequisite for insurance. Current section 741.3(a)(1) requires FISCUs to ''meet, at a minimum, the statutory reserve and full and fair disclosure requirements imposed on federal credit unions by [former 12 U.S.C. 1762 and current part 702].'' Section 1762 of Title 12 was repealed by CUMAA and current part 702 survives pending the effective date of this final rule; both addressed only reserves and associated matters. To ensure that FISCUs, as a prerequisite of insurance, will meet the requirements imposed under all components of PCA, the final rule revises section 741.3(a)(1) to read: ''State-chartered credit unions are subject to section 216 of the Act, 12 U.S.C. 1790d, and to part 702 and subpart L of part 747 of this chapter.''

In addition, the final rule modifies the conditions in section 741.3(a)(2) for charging losses to the regular reserve. Currently, that section allows losses other than loan losses to be charged without the approval of NCUA and the appropriate State official if the FISCU's net worth ratio is at least 6 percent and the charge will not cause the ratio to decline by more than 50 basis points. To conform to the requirements of CUMAA, part 702 permits loss charges without approval only if the credit union's net worth ratio is at least 7 percent and the charge will not cause the ratio to decline below 7 percent. § 702.401(c). To ensure that FISCUs, as a prerequisite of insurance, will comply with the new conditions imposed in part 702 for charging losses to the regular reserve, the final rule revises section 741.3(a)(2) to reflect the 7 percent minimum and to otherwise require the approval of the appropriate State official.

H. Subpart L of Part 747—Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action

1. Section 747.2001—Scope

CUMMA provides that ''material supervisory determinations, including decisions to require prompt corrective action, made * * * by [NCUA] officials other than the [NCUA] Board may be appealed to the [NCUA] Board'' through an independent appellate process * * * pursuant to separate procedures prescribed by regulation.'' § 1790d(k). Section 747.2001 establishes an independent process for appealing ''material supervisory decisions'' to impose PCA under part 702 (Table 5). For purposes of subpart L, NCUA staff decisions to impose a DSA (including dismissal of a director or senior executive officer) are considered ''material supervisory decisions.'' § 747.2001(a). In the case of FISCUs seeking independent review under subpart L, this section provides that the parties (*i.e.,* NCUA and credit union and/or a dismissed director or officer) shall serve upon the appropriate State official the documents filed or issued in connection with a proceeding under subpart L. NCUA received no comments on this section.

TABLE 6 -- PROCEDURES FOR REVIEW OF PROMPT CORRECTIVE ACTION UNDER SUBPART L OF PART 747

PCA imposed	*Procedures for review*
Discretionary supervisory action, §747.2002	• Prior notice of proposed DSA and grounds therefor. • 14 days to respond in writing, oppose or seek to modify DSA. • Failure to respond is deemed consent to DSA • May seek NCUA ombudsman's recommendation. • No right to hearing. • Final decision by independent person appointed by NCUA Board. • Once imposed, may later seek to modify or rescind.
Reclassification to next lower category on safety and soundness grounds, §747.2003	• Prior notice of proposed reclassification and grounds therefor. • At least 14 days to respond in writing, seek informal hearing, seek to present witnesses. • Must explain why CU is not in unsafe or unsound condition, or has corrected unsafe or unsound practice. • Failure to respond is deemed consent to reclassification. • Hearing held within 30 days before presiding officer appointed by NCUA Board. • Right to be represented by counsel at hearing. • Presiding officer makes recommended decision. • Final decision by NCUA Board. • Once reclassified, may later seek to rescind.
Dismissal of director or senior executive officer, §747.2004	• Notice of right to seek reinstatement given when credit union is served with order to dismiss. • 14 days to respond in writing, justify reinstatement, seek informal hearing, seek to present witnesses. • Failure to respond is deemed consent to dismissal. • Hearing held within 30 days before presiding officer appointed by NCUA Board. • Right to be represented by counsel at hearing. • Respondent bears burden of proof. • Presiding officer makes recommended decision. • Final decision by NCUA Board, must included reasons if reinstatement denied. • Dismissal effective pending final decision.

2. Section 747.2002—Discretionary Supervisory Actions

Section 747.2002 provides for prior notice and an opportunity to be heard before a DSA is imposed. The NCUA Board must give advance notice of its intention to impose a DSA , § 747.2002(a)(1), except when necessary to further the purpose of PCA. § 747.2002(a)(2). The credit union may then challenge the proposed action in writing and request that the DSA not be imposed or be modified. § 747.2002(c). However, the credit union is not entitled to a hearing. The NCUA Board, or an independent person designated by the NCUA Board, may then decide not to issue the directive or to issue it as proposed or as modified, § 747.2002(d); that decision is final. A credit union which already is subject to a DSA may request reconsideration and rescission due to changed circumstances. § 747.2002(f).

NCUA received 17 comments recommending modifications to § 747.2002. These include expanding

the opportunity to be heard into a full evidentiary hearing; establishing a panel of credit union industry officials to review specific challenges to DSAs and make recommendations to NCUA; establishing an independent council to periodically review PCA implementation and recommend revisions to part 702. Nine commenters urged involving either a mediator or an ombudsman in the appeal process for DSAs. Another contended that an already-existing DSA should be deemed modified or withdrawn if NCUA fails to decide a request for modification or rescission within 60 days.

NCUA received two comments advocating substitute alternative procedures. One alternative was a three-level appeal process commencing with a full evidentiary hearing before the appropriate Regional Director, followed by another full hearing before an NCUA-appointed presiding officer, with direct appeal of that decision to U.S. District Court, bypassing the NCUA Board altogether. The other alternative was a full evidentiary hearing in which NCUA would have the burden of justifying the proposed DSA, and the DSA would not take effect until all appeals were exhausted.

In general, involving panels and councils in the appeal process, and expanding it beyond an opportunity to be heard in writing, would undermine the overall objective of PCA—to act promptly. On the other hand, involving NCUA's ombudsman in the appeal process, and setting a time limit for NCUA to decide requests to modify, to not issue, or to rescind DSAs is appropriate. Accordingly, the final rule revises section 747.2002(f) to provide that if NCUA fails to decide a request to modify or rescind an existing DSA within 60 days, that DSA shall be deemed modified or rescinded. In addition, a new subsection 747.2002(g) is introduced to permit a credit union to request the recommendation of NCUA's ombudsman to not issue or to modify a proposed DSA, or to rescind an existing DSA, as the case may be.

3. Section 747.2003—Reclassification to Lower Net Worth Category

The NCUA Board is authorized to reclassify a credit union to the next lower net worth category on grounds of an unsafe or unsound practice or condition, provided the credit union is first given notice and an opportunity for a hearing. §§ 702.102(b), 702.302(d). In such cases, therefore, section 747.2003 requires the NCUA Board to give notice of its intention to reclassify a credit union, § 747.2003(a), and describe the practice(s) and/or condition(s) justifying reclassification. § 747.2003(b). The credit union may then challenge the reclassification, provide evidence supporting its position, and request an informal hearing and the opportunity to present witnesses. § 747.2003(c).

If requested, an informal hearing is conducted by a presiding officer designated by the NCUA Board. § 747.2003(d). At the hearing, the credit union may introduce relevant documents, present oral argument, and if authorized, present witnesses. § 747.2003(e). The presiding officer then makes a recommended decision to the NCUA Board, § 747.2003(e)(4), which then issues a final decision whether to reclassify the credit union. § 747.2003(f). The NCUA Board may not delegate the authority to make the final decision to reclassify. §§ 702.102(c), 747.2003(h); § 1790d(h)(2).

NCUA received seven comments on this section. Five sought to allow credit unions to be represented by counsel at an informal hearing challenging reclassification. NCUA concurs and has revised section 747.2003(e)(1) accordingly. Another commenter insisted upon a formal evidentiary hearing instead of an informal hearing. NCUA believes that the length of time that a formal hearing entails would undermine the promptness objective of PCA. The final commenter advocated that NCUA delegate its authority to reclassify on safety and soundness grounds to an independent person outside NCUA. As mentioned earlier, however, this is among the few actions NCUA is forbidden to delegate. § 702.102(c).

4. Section 747.2004—Dismissal of Director or Senior Executive Officer

The NCUA Board is authorized to issue a DSA directing a credit union to dismiss a director or senior executive officer. § 702.202(b)(7). In such cases, § 747.2004 requires the NCUA Board to serve the dismissed person with a copy of the directive issued to the credit union, accompanied by a notice of the right to seek reinstatement by the NCUA Board. § 747.2004(a)–(b). That person may then challenge the dismissal and request for reinstatement,[24] and may request an informal hearing and the opportunity to present witness testimony. § 747.2004(c). The dismissal remains in effect while the request for reinstatement is pending. § 747.2004(g).

If requested, a hearing is conducted by an NCUA Board-designated presiding officer under procedures identical to those which section 747.2003 prescribes in cases of reclassification, with two exceptions. First, the dismissed person bears the burden of proving that his or her continued employment would materially strengthen the credit union's ability to become "adequately capitalized" or to correct an unsafe or unsound condition, as the case may be. § 747.2004(e)(4). Second, if the NCUA Board's final decision is to deny reinstatement, it must provide reasons for its decision. § 747.2004(f).

NCUA received two comments in response to this section. The first urged reversal of the burden of proof, thus requiring NCUA to prove that the dismissed person's continued employment would not materially strengthen the credit union's ability to become "adequately capitalized" or to correct an unsafe or unsound condition. NCUA declines to reverse the burden of proof because section 747.2004(e)(4) emulates FDIA § 38, which imposes the burden of justifying reinstatement on the dismissed person. *E.g.,* 12 CFR 308.203.

5. Section 747.2005—Enforcement of Orders Imposing Prompt Corrective Action

CUMAA amended the FCUA to ensure that supervisory actions imposed under part 702 are enforceable. 12 U.S.C. §§ 1786(k)(1) and (2)(A). When a credit union fails to comply with an MSA or DSA, NCUA may apply to the appropriate U.S. District Court to enforce that action. § 747.2005(a). Alternatively, the NCUA Board may assess a civil money penalty against a credit union (and any institution-affiliated party acting in concert with it) which violates or fails to comply with an MSA or DSA, or fails to implement an approved NWRP under subpart B or revised business plan under subpart C. § 747.2005(b). Finally, subpart L allows the NCUA Board to enforce an MSA or DSA under part 702 "through any other judicial or administrative proceeding authorized by law." § 747.2005(c). NCUA received no comments on this section. It is retained without modification in the final rule.

I. Banking Industry Trade Association Comments

The three principal banking industry trade associations generally supported the proposed rule, agreeing that much of it is comparable to FDIA § 38, but nonetheless recommended as follows:

1. Incorporate benchmarks or a mandatory timetable for determining whether or not a new credit union is making reasonable, steady progress in

[24] The credit union which was directed to dismiss a director or officer may not seek reinstatement of the dismissed director or officer under section 747.2004, but that credit union may challenge the directive under section 747.2002.

accumulating net worth. The preamble of the final rule retains the proposed non-mandatory benchmarks established to guide ''new'' credit unions in building net worth (*see* Table 4 above);

2. Commence the additional 15-day period given to file an NWRP on the date NCUA issues its notice that the credit union has not timely filed its NWRP, rather than on the date the credit union receives that notice. NCUA continues in the final rule to use the date of receipt to measure the additional period because the time consumed by mailing or delivery could unreasonably shorten the period by several days. § 702.206(a)(4);

3. Decide whether to compel the sale of assets on a case-by-case basis as part of an NWRP. Consistent with this suggestion, part 702 contemplates case-by-case approval of an NWRP that may provide for reduction in assets, and case-by-case imposition of the DSA to reduce assets generally or a specific category of assets (line 5, Table 1 above);

4. Expand the DSA requiring ''other actions to carry out PCA'' (line 10, Table 1 above) to enumerate examples of such ''other actions,'' such as limiting management fees. The final rule deliberately articulates this DSA in general terms to maximize flexibility and to avoid suggesting that the ''other actions'' available under this DSA are limited to the enumerated examples. *E.g.* § 702.202(b)(9);

5. Eliminate as unwarranted the ''other actions no more severe'' limitation on the scope of the DSA requiring ''other actions to carry out PCA'' (line 10, Table 1 above) in the ''undercapitalized'' category. NCUA concurs and the final rule abandons that limitation. *Id.;*

6. Either eliminate the ''adjustment to net worth'' proposed to reflect items of ''other comprehensive income'' such as accumulated unrealized gains and losses on AFS securities (Call Report account no. 945), or modify it to reflect the adjustment that applies to banks. For the reasons explained in section II.B. above, the ''adjustment to net worth'' has been deleted from the final rule;

7. In measuring total assets, use average total assets over the preceding Call Report period, rather than the average of total assets over the preceding four quarterly Call Report periods. For all purposes except calculating the risk-based net worth requirement for ''complex'' credit unions, the final rule gives credit unions a choice of four methods to calculate ''total assets,'' including the average of month-end balances over the quarter. § 702.2(j);

8. Implement two additional MSAs: prohibit payments to third parties which would leave the credit union ''undercapitalized''; and require prior approval of acquisitions, new branches, new lines of business until the NWRP has been approved. NCUA lacks the authority to implement MSAs beyond the four expressly prescribed by CUMAA, § 702.202(a), nor to impose MSAs on ''well capitalized'' or ''adequately capitalized'' credit unions beyond the single MSA (earnings transfer to net worth) CUMAA imposes on the latter. § 702.201;

9. Eliminate ''prerequisite for improving management'' requiring NCUA to resort to all other DSAs before ordering a new election of the board of directors, or dismissing directors or senior executive officers, or requiring qualified senior officers to be hired (lines 7, 8 and 9, Table 2). NCUA concurs and has deleted this prerequisite from the ''undercapitalized'' category. §§ 702.202(b)(7)–(8); and

10. Restore to three of the DSAs (lines 5, 8 and 11, Table 2 above) the criterion built into the corresponding ''discretionary safeguard,'' to achieve comparability with FDIA § 38. With regard to two of these DSAs, the final rule is revised accordingly. §§ 702.202(b)(5), 702.203(b)(10). With regard to the last DSA (line 8, Table 1), however, the 180-day period protecting directors and officers from dismissal remains omitted from the final rule because a credit union official who is responsible for declining net worth, or who is incapable of reversing the decline, is not entitled to a ''safe harbor'' from dismissal. § 702.202(b)(7).

III. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis describing any significant economic impact a final regulation may have on a substantial number of small credit unions (primarily those under $1 million in assets). The final rule implements the statutory requirements of prompt corrective action, including net worth parameters, expressly mandated by CUMAA.

For the purpose of this analysis, credit unions under $1 million in assets will be considered small entities. As of June 30, 1999, there were 1,690 such entities, with a total of $807.3 million in assets, with an average asset size of $0.5 million. These small entities make up 15.6 percent of all credit unions, but only 0.2 percent of all credit union assets.

The final rule requires all federally-insured credit unions to determine their net worth ratio (primarily using Call Report data). The rule sets forth additional requirements, including development of an NWRP or an RBP if the credit union's net worth ratio falls below established thresholds.

The NCUA Board does not believe that the proposed regulation would impose reporting or recordkeeping burdens that require specialized professional skills not available to them. Further, NCUA estimates fewer than 100 of these small entities will meet the net worth ratios which trigger the requirements of the regulation.

Paperwork Reduction Act

The reporting requirements in part 702 have been submitted to the Office of Management and Budget. Under the Paperwork Reduction Act of 1995, no person is required to respond to a collection of information unless it displays a valid OMB number. The control number will be displayed in the table at 12 CFR part 795.

Executive Order 13132

NCUA Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily adheres to the fundamental federalism principles addressed by the executive order. This final rule will apply to all federally-insured credit unions, including federally-insured, state-chartered credit unions. Accordingly, it may have a direct effect on the States, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. This impact is an unavoidable consequence of carrying out the statutory mandate to adopt a system of PCA to apply to all federally-insured credit unions. Throughout the rulemaking process, NCUA staff has consulted with a committee of representative of state regulators regarding the impact of PCA on state-chartered credit unions. The committee's comments and suggestions are reflected in the final rule.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final

rule as defined by section 551 of the Administrative Procedure Act, 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule.

List of Subjects

12 CFR Part 702 and 741

Credit unions, Reporting and recordkeeping requirements.

12 CFR Part 747

Administrative practices and procedures, Credit unions.

By the National Credit Union Administration Board on February 3, 2000.

Becky Baker,

Secretary of the Board.

Accordingly, 12 CFR parts 702, 741 and 747 are amended as set forth below:

Part 702 is revised to read as follows:

PART 702—PROMPT CORRECTIVE ACTION

Sec.

702.1 Authority, purpose, scope and other supervisory authority.
702.2 Definitions.

Subpart A—Net Worth Classification

702.101 Measure and effective date of net worth classification.
702.102 Statutory net worth categories.
702.103 Risk portfolios defined. [Reserved]
702.104 Thresholds to define complex credit unions. [Reserved]
702.105 RBNW components to calculate risk-based net worth requirement. [Reserved]
702.106 Alternative components to calculate risk-based net worth requirement. [Reserved]

Subpart B—Mandatory and Discretionary Supervisory Actions

702.201 Prompt corrective action for ''adequately capitalized'' credit unions.
702.202 Prompt corrective action for ''undercapitalized'' credit unions.
702.203 Prompt corrective action for ''significantly undercapitalized'' credit unions.
702.204 Prompt corrective action for ''critically undercapitalized'' credit unions.
702.205 Consultation with State officials on proposed prompt corrective action.
702.206 Net worth restoration plans.

Subpart C—Alternative Prompt Corrective Action for New Credit Unions

702.301 Scope and definition.
702.302 Net worth categories for new credit unions.
702.303 Prompt corrective action for ''adequately capitalized'' new credit unions.
702.304 Prompt corrective action for ''moderately capitalized,'' ''marginally capitalized'' and ''minimally capitalized'' new credit unions.
702.305 Prompt corrective action for ''uncapitalized'' new credit unions.
702.306 Revised business plans for new credit unions.
702.307 Incentives for new credit unions.

Subpart D—Reserves

702.401 Reserves.
702.402 Full and fair disclosure of financial condition.
702.403 Payment of dividends.

Authority: 12 U.S.C. 1766(a), 1790d.

§ 702.1 Authority, purpose, scope and other supervisory authority.

(a) *Authority.* Subparts A, B and C of this part and subpart L of part 747 of this chapter are issued by the National Credit Union Administration pursuant to section 216 of the Federal Credit Union Act (FCUA), 12 U.S.C. 1790d (section 1790d), as added by section 301 of the Credit Union Membership Access Act, Pub. L. No. 105–219, 112 Stat. 913 (1998). Subpart D of this part is issued pursuant to FCUA section 120, 12 U.S.C. 1766.

(b) *Purpose.* The express purpose of prompt corrective action under section 1790d is to resolve the problems of federally-insured credit unions at the least possible long-term loss to the National Credit Union Share Insurance Fund. This part carries out the purpose of prompt corrective action by establishing a framework of mandatory and discretionary supervisory actions, applicable according to a credit union's net worth ratio, designed primarily to restore and improve the net worth of federally-insured credit unions.

(c) *Scope.* This part implements the provisions of section 1790d as they apply to federally-insured credit unions, whether federally- or state-chartered; to such credit unions defined as ''new'' pursuant to section 1790d(b)(2); and to such credit unions defined as ''complex'' pursuant to section 1790d(d). Certain of these provisions also apply to officers and directors of federally-insured credit unions. This part does not apply to corporate credit unions. Procedures for issuing, reviewing and enforcing orders and directives issued under this part are set forth in subpart L of part 747 of this chapter, 12 CFR 747.2001 *et seq.*

(d) *Other supervisory authority.* Neither § 1790d nor this part in any way limits the authority of the NCUA Board or appropriate State official under any other provision of law to take additional supervisory actions to address unsafe or unsound practices or conditions, or violations of applicable law or regulations. Action taken under this part may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA Board or appropriate State official, including issuance of cease and desist orders, orders of prohibition, suspension and removal, or assessment of civil money penalties, or any other actions authorized by law.

§ 702.2 Definitions

Except as provided below, the terms used in this part have the same meanings as set forth in FCUA sections 101 and 216, 12 U.S.C. 1752, 1790d.

(a) *Appropriate regional director* means the director of the NCUA regional office having jurisdiction over federally-insured credit unions in the state where the affected credit union is principally located.

(b) *Appropriate State official* means the commission, board or other supervisory authority having jurisdiction over credit unions chartered by the State which chartered the affected credit union.

(c) *Credit union* means a federally-insured, natural person credit union, whether federally- or State-chartered, as defined by 12 U.S.C. 1752(6).

(d) *CUSO* means a credit union service organization as described in 12 CFR 712 *et seq.* for federally-chartered credit unions, and as defined under State law for State-chartered credit unions.

(e) *NCUSIF* means the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783.

(f) *Net worth* means the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles. Retained earnings consists of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities. This means that only undivided earnings and appropriations of undivided earnings are included in net worth. For low income-designated credit unions, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders and the NCUSIF. For any credit union, net worth does not include the allowance for loan and lease losses account.

(g) *Net worth ratio* means the ratio of the net worth of the credit union (as defined in paragraph (f) of this section to the total assets of the credit union (as defined by a measure chosen under paragraph (j) of this section.

(h) *New credit union* means a federally-insured credit union which both has been in operation for less than ten (10) years and has $10,000,000 or less in total assets.

(i) *Shares* means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

(j) *Total assets*

(1) Total assets means a credit union's total assets as measured by either—

(i) *Average quarterly balance.* The average of quarter-end balances of the four most recent calendar quarters; or

(ii) *Average monthly balance.* The average of month-end balances over the three calendar months of the calendar quarter; or

(iii) *Average daily balance.* The average daily balance over the calendar quarter; or

(iv) *Quarter-end balance.* The quarter-end balance of the calendar quarter as reported on the credit union's Call Report, and for semi-annual filers as calculated for the quarters ending March 31 and September 30.

(2) For each quarter, a credit union must elect a measure of total assets from paragraph (j)(1) of this section to apply for all purposes under this part except §§ 702.103 through 702.106 [risk-based net worth requirement].

Subpart A—Net Worth Classification

§ 702.101 Measures and effective date of net worth classification

(a) *Net worth measures.* For purposes of this part, a credit union must determine its net worth category classification at the end of each calendar quarter using two measures:

(1) The net worth ratio as defined in § 702.2(g); and

(2) If defined as ''complex'' under § 702.104, the applicable risk-based net worth requirement.

(b) *Effective date of net worth classification.* For purposes of this part, the effective date of a federally-insured credit union's net worth category classification shall be the most recent to occur of:

(1) The last day of the calendar month following the end of the calendar quarter; or

(2) The date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination; or

(3) The date the credit union received written notice from NCUA or, if State-chartered, the appropriate State official, of reclassification on safety and soundness grounds as provided under §§ 702.102(b) or 702.302(d).

(c) *Notice by credit union of change in net worth category.*

(1) When filing a quarterly or semi-annual Call Report, a federally-insured credit union need not otherwise notify the NCUA Board of a change in its net worth ratio that places the credit union in a lower net worth category;

(2) A federally-insured credit union which files its Call Reports semi-annually shall give written notice to the NCUA Board and, if State-chartered, to the appropriate State official, of a change in its net worth ratio for the quarters ending March 31 and September 30, if that change places the credit union in a lower net worth category, *provided however,* that this paragraph does not apply when a credit union has been notified by NCUA or, if State-chartered, by the appropriate State official, of a change in its net worth ratio that places the credit union in a lower net worth category;

(3) Written notice as required under paragraph (c)(2) of this section shall be given no later than 15 calendar days after the effective date of the change in net worth category, and shall be deemed given upon receipt by the appropriate Regional Director and, if State-chartered, by the appropriate State official.

(4) Failure to timely file a Call Report or to timely provide notice as required under this section in no way alters the effective date of a change in net worth classification under this subparagraph, or the affected credit union's corresponding legal obligations under this part.

§ 702.102 Statutory net worth categories.

(a) *Net worth categories.* Except for credit unions defined as ''new'' under subpart B of this part, a federally-insured credit union shall be classified (Table 1)—

(1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater and also meets any applicable risk-based net worth requirement under §§ 702.105 and 702.106; or

(2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%), and also meets any applicable risk-based net worth requirement under §§ 702.105 and 702.106 below; or

(3) *Undercapitalized* if it has a net worth ratio of four percent (4%) or more but less than six percent (6%), or fails to meet any applicable risk-based net worth requirement under §§ 702.105 and 702.106; or

(4) *Significantly undercapitalized* if it

(i) Has a net worth ratio of two percent (2%) or more but less than four percent (4%); or

(ii) Has a net worth ratio of four percent (4%) or more but less than five percent (5%), and either—

(A) Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.206; or

(B) Materially fails to implement a net worth restoration plan approved by the NCUA Board; or

(5) *Critically undercapitalized* if it has a net worth ratio of less than two percent (2%).

TABLE 1 -- STATUTORY NET WORTH CATEGORY CLASSIFICATION

A credit union's net worth category is . . .	*if its net worth ratio is . . .*	*and subject to the following condition(s) . . .*
"Well Capitalized"	7% or above	And if "complex," meets applicable risk-based net worth requirement (RBNW)
"Adequately Capitalized"	6% to 6.99%	And if "complex," meets applicable RBNW
"Undercapitalized"	4% to 5.99%	Or if "complex," fails applicable RBNW
"Significantly Undercapitalized"	2% to 3.99%	Or if "undercapitalized" at less than 5% net worth ratio, fails to timely submit or materially implement a net worth restoration plan
"Critically Undercapitalized"	Less than 2%	None

(b) *Reclassification based on supervisory criteria other than net worth.* The NCUA Board may reclassify a ''well capitalized'' credit union as ''adequately capitalized'' and may require an ''adequately capitalized'' or ''undercapitalized'' credit union to comply with certain mandatory or discretionary supervisory actions as if it were in the next lower net worth category (each of such actions hereinafter referred to generally as ''reclassification'') in the following circumstances:

(1) *Unsafe or unsound condition.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union is in an unsafe or unsound condition; or

(2) *Unsafe or unsound practice.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union has not corrected a material unsafe or unsound practice of which it was, or should have been, aware.

(c) *Non-delegation.* The NCUA Board may not delegate its authority to reclassify a credit union under paragraph (b) of this section.

(d) *Consultation with State officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before reclassifying a federally-insured State-chartered credit union under paragraph (b) of this section, and shall promptly notify the appropriate State official of its decision to reclassify.

§ 702.103 Risk portfolios defined. [Reserved]

§ 702.104 Thresholds to define complex credit unions. [Reserved]

§ 702.105 RBNW components to calculate risk-based net worth requirement. [Reserved]

§ 702.106 Alternative components to calculate risk-based net worth requirement. [Reserved]

Subpart B—Mandatory and Discretionary Supervisory Actions

§ 702.201 Prompt corrective action for ''adequately capitalized'' credit unions

(a) *Earnings transfer.* Beginning the effective date of classification as ''adequately capitalized'' or lower, a federally-insured credit union must increase its net worth quarterly by an amount equivalent to at least 1/10th percent (0.1%) of its total assets for the current quarter, and must quarterly transfer that amount (or more by choice) from undivided earnings to its regular reserve account, until it is ''well capitalized.''

(b) *Reduction in earnings transfer.* On a case-by-case basis and subject to review and revocation no less frequently than quarterly, the NCUA Board may permit the credit union to quarterly transfer an amount that is less than the equivalent of 1/10th percent (0.1%) of its total assets, to the extent the NCUA Board determines that such lesser amount—

(1) Is necessary to avoid a significant redemption of shares; and

(2) Would further the purpose of this part.

§ 702.202 Prompt corrective action for ''undercapitalized'' credit unions

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is ''undercapitalized'' must—

(1) *Earnings transfer.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206, *provided however,* that a credit union in this category having a net worth ratio of less than five percent (5%) which fails to timely submit such a plan, or which materially fails to implement an approved plan, is classified ''significantly undercapitalized'' pursuant to § 702.102(a)(4)(ii) above;

(3) *Restrict increase in assets.* Beginning the effective date of classification as ''undercapitalized'' or lower, not permit the credit union's assets to increase beyond its total assets (per § 702.2(j)) for the preceding quarter unless—

(i) *Plan approved.* The NCUA Board has approved a net worth restoration plan which provides for an increase in total assets and—

(A) The assets of the credit union are increasing consistent with the approved plan; and

(B) The credit union is implementing steps to increase the net worth ratio consistent with the approved plan;

(ii) *Plan not approved.* The NCUA Board has not approved a net worth restoration plan and total assets of the credit union are increasing because of increases since quarter-end in balances of:

(A) Total accounts receivable and accrued income on loans and investments; or

(B) Total cash and cash equivalents; or

(C) Total loans outstanding, not to exceed the sum of total assets (per § 702.2(j)) plus the quarter-end balance of unused commitments to lend and unused lines of credit provided however that a credit union which increases a balance as permitted under paragraphs (A), (B) or (C) cannot offer rates on shares in excess of prevailing rates on shares in its relevant market area, and cannot open new branches;

(4) *Restrict member business loans.* Beginning the effective date of classification as ''undercapitalized'' or lower, not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *''Second tier'' discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to an ''undercapitalized'' credit union having a net worth ratio of less than five percent (5%), or a director, officer or employee of such a credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, unless the NCUA Board has approved the credit union's net worth restoration plan, the credit union is implementing its plan, and the NCUA Board determines that the proposed action is consistent with and will further the objectives of that plan;

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to reduce or divest its ownership interest in a CUSO;

(3) *Restricting dividends or interest paid.* Restrict the dividend or interest rates the credit union pays on shares to the prevailing rates paid on comparable accounts and maturities in the relevant market area, as determined by the NCUA Board, except that dividend rates already declared on shares acquired before imposing a restriction under this paragraph may not be retroactively restricted;

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce its assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(8) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval); and

(9) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (8) of this section.

(c) *''First tier'' application of discretionary supervisory actions.* An ''undercapitalized'' credit union having a net worth ratio of five percent (5%) or more, or which is classified ''undercapitalized'' by reason of failing to satisfy a risk-based net worth requirement under § 702.105 or 702.106, is subject to the discretionary supervisory actions in paragraph (b) of this section if it fails to comply with any mandatory supervisory action in paragraph (a) of this section or fails to timely implement an approved net worth restoration plan under § 702.206, including meeting its prescribed steps to increase its net worth ratio.

§ 702.203 Prompt corrective action for ''significantly undercapitalized'' credit unions.

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is ''significantly undercapitalized'' must—

(1) *Earnings transfer.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.202(a)(3) and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any ''significantly undercapitalized'' credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided in § 702.202(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends or interest paid.* Restrict the dividend or interest rates that the credit union pays on shares as provided in § 702.202(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Except with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as ''significantly undercapitalized,'' and prohibit payment of a bonus or profit share to such officer;

(11) *Other actions to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (10) of this section; and

(12) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Discretionary conservatorship or liquidation if no prospect of becoming ''adequately capitalized.''* Notwithstanding any other actions required or permitted to be taken under this section, when a credit union becomes ''significantly undercapitalized'' (including by reclassification under section 702.102(b) above), the NCUA Board may place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming ''adequately capitalized.''

§ 702.204 Prompt corrective action for ''critically undercapitalized'' credit unions

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is ''critically undercapitalized'' must—

(1) *Earnings transfer.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.202(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any ''critically undercapitalized'' credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided by § 702.202(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends or interest paid.* Restrict the dividend or interest rates that the credit union pays on shares as provided in § 702.202(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Reduce or, with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as ''critically undercapitalized,'' and prohibit payment of a bonus or profit share to such officer;

(11) *Restrictions on payments on uninsured secondary capital.* Beginning 60 days after the effective date of classification of a credit union as ''critically undercapitalized,'' prohibit payments of principal, dividends or interest on the credit union's uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law;

(12) *Requiring prior approval.* Require a ''critically undercapitalized'' credit union to obtain the NCUA Board's prior written approval before doing any of the following:

(i) Entering into any material transaction not within the scope of an approved net worth restoration plan (or approved revised business plan under subpart C of this part);

(ii) Extending credit for transactions deemed highly leveraged by the NCUA Board or, if State-chartered, by the appropriate State official;

(iii) Amending the credit union's charter or bylaws, except to the extent necessary to comply with any law, regulation, or order;

(iv) Making any material change in accounting methods; and

(v) Paying dividends or interest on new share accounts at a rate exceeding the prevailing rates of interest on insured deposits in its relevant market area;

(13) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (12) of this section; and

(14) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Mandatory conservatorship, liquidation or action in lieu thereof*—(1) *Action within 90 days.* Notwithstanding

any other actions required or permitted to be taken under this section (and regardless of a credit union's prospect of becoming ''adequately capitalized''), the NCUA Board must, within 90 calendar days after the effective date of classification of a credit union as ''critically undercapitalized''—

(i) *Conservatorship.* Place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(G); or

(ii) *Liquidation.* Liquidate the credit union pursuant to 12 U.S.C. 1787(a)(3)(A)(ii); or

(iii) *Other corrective action.* Take other corrective action, in lieu of conservatorship or liquidation, to better achieve the purpose of this part, provided that the NCUA Board documents why such action in lieu of conservatorship or liquidation would do so.

(2) *Renewal of other corrective action.* A determination by the NCUA Board to take other corrective action in lieu of conservatorship or liquidation under paragraph (c)(1)(iii) of this section shall expire after an effective period ending no later than 180 calendar days after the determination is made, and the credit union shall be immediately placed into conservatorship or liquidation under paragraphs (c)(1)(i) and (ii), unless the NCUA Board makes a new determination under paragraph (c)(1)(iii) of this section before the end of the effective period of the prior determination;

(3) *Mandatory liquidation after 18 months*—(i) *Generally.* Notwithstanding paragraphs (c)(1) and (2) of this section, the NCUA Board must place a credit union into liquidation if it remains ''critically undercapitalized'' for a full calendar quarter, on a monthly average basis, following a period of 18 months from the effective date the credit union was first classified ''critically undercapitalized.''

(ii) *Exception.* Notwithstanding paragraph (c)(3)(i) of this section, the NCUA Board may continue to take other corrective action in lieu of liquidation if it certifies that the credit union—

(A) Has been in substantial compliance with an approved net worth restoration plan requiring consistent improvement in net worth since the date the net worth restoration plan was approved;

(B) Has positive net income or has an upward trend in earnings that the NCUA Board projects as sustainable; and

(C) Is viable and not expected to fail.

(iii) *Review of exception.* The NCUA Board shall, at least quarterly, review the certification of an exception to liquidation under paragraph (c)(3)(ii) of this section and shall either—

(A) Recertify the credit union if it continues to satisfy the criteria of paragraph (c)(3)(ii) of this section; or

(B) Promptly place the credit union into liquidation, pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), if it fails to satisfy the criteria of paragraph (c)(3)(ii) of this section.

(4) *Nondelegation.* The NCUA Board may not delegate its authority under paragraph (c) of this section, unless the credit union has less than $5,000,000 in total assets. A credit union shall have a right of direct appeal to the NCUA Board of any decision made by delegated authority under this section.

§ 702.205 Consultation with State officials on proposed prompt corrective action.

(a) *Consultation on proposed conservatorship or liquidation.* Before placing a federally-insured State-chartered credit union into conservatorship (pursuant to 12 U.S.C. 1786(h)(1)(F) or (G)) or liquidation (pursuant to 12 U.S.C. 1787(a)(3)) as permitted or required under subparts B or C of this part to facilitate prompt corrective action—

(1) The NCUA Board shall seek the views of the appropriate State official (as defined in § 702.2(b), and give him or her an opportunity to place the credit union into conservatorship or liquidation;

(2) The NCUA Board shall, upon timely request of the appropriate State official, promptly provide him or her with a written statement of the reasons for the proposed conservatorship or liquidation, and reasonable time to respond to that statement; and

(3) If the appropriate State official makes a timely written response that disagrees with the proposed conservatorship or liquidation and gives reasons for that disagreement, the NCUA Board shall not place the credit union into conservatorship or liquidation unless it first considers the views of the appropriate State official and determines that—

(i) The NCUSIF faces a significant risk of loss if the credit union is not placed into conservatorship or liquidation; and

(ii) Conservatorship or liquidation is necessary either to reduce the risk of loss, or to reduce the expected loss, to the NCUSIF with respect to the credit union.

(b) *Nondelegation.* The NCUA Board may not delegate any determination under paragraph (a)(3) of this section.

(c) *Consultation on proposed discretionary action.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before taking any discretionary supervisory action under §§ 702.201(b), 702.202(b), 702.203(b), 702.204(b), 702.304(b) and 702.305(b) with respect to a federally-insured State-chartered credit union; shall provide prompt notice of its decision to the appropriate State official; and shall allow the appropriate State official to take the proposed action independently or jointly with NCUA.

§ 702.206 Net worth restoration plans.

(a) *Schedule for filing*—(1) *Generally.* A federally-insured credit union shall file a written net worth restoration plan (NWRP) with the appropriate Regional Director and, if State-chartered, the appropriate State official, within 45 calendar days of the effective date of classification as either ''undercapitalized,'' ''significantly undercapitalized'' or ''critically undercapitalized,'' unless the NCUA Board notifies the credit union in writing that its NWRP is to be filed within a different period.

(2) *Exception.* An otherwise ''adequately capitalized'' credit union that is reclassified ''undercapitalized'' on safety and soundness grounds under § 702.102(b) is not required to submit a NWRP solely due to the reclassification, unless the NCUA Board notifies the credit union that it must submit an NWRP.

(3) *Filing of additional plan.* Notwithstanding paragraph (a)(1) of this section, a credit union that has already submitted and is operating under a NWRP approved under this section is not required to submit an additional NWRP due to a change in net worth category (including by reclassification under § 702.102(b)), unless the NCUA Board notifies the credit union that it must submit a new NWRP. A credit union that is notified to submit a new or revised NWRP shall file the NWRP in writing with the appropriate Regional Director within 30 calendar days of receiving such notice, unless the NCUA Board notifies the credit union in writing that the NWRP is to be filed within a different period.

(4) *Failure to timely file plan.* When a credit union fails to timely file an NWRP pursuant to this paragraph, the NCUA Board shall promptly notify the credit union that it has failed to file an NWRP and that it has 15 calendar days from receipt of that notice within which to file an NWRP.

(b) *Assistance to small credit unions.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing an

NWRP required to be filed under paragraph (a) of this section.

(c) *Contents of NWRP.* An NWRP must—

(1) Specify—

(i) A quarterly timetable of steps the credit union will take to increase its net worth ratio so that it becomes ''adequately capitalized'' by the end of the term of the NWRP, and to remain so for four (4) consecutive calendar quarters. If ''complex,'' the credit union is subject to a risk-based net worth requirement that may require a net worth ratio higher than six percent (6%) to become ''adequately capitalized'';

(ii) The projected amount of earnings to be transferred to the regular reserve in each quarter of the term of the NWRP equivalent to not less than 1/10 percent (0.1%) of its total assets under § 702.201(a), or such lesser amount as the NCUA Board may permit under § 702.201(b);

(iii) How the credit union will comply with the mandatory and discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(iv) The types and levels of activities in which the credit union will engage; and

(v) If reclassified to a lower category under § 702.102(b), the steps the credit union will take to correct the unsafe or unsound practice(s) or condition(s);

(2) Include pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years; and

(3) Contain such other information as the NCUA Board has required.

(d) *Criteria for approval of NWRP.* The NCUA Board shall not accept a NWRP plan unless it—

(1) Complies with paragraph (c) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the credit union's net worth; and (3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(e) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become ''adequately capitalized,'' the NCUA Board shall, in evaluating an NWRP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by State law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(f) *Review of NWRP*—(1) *Notice of decision.* Within 45 calendar days after receiving an NWRP under this part, the NCUA Board shall notify the credit union in writing whether the NWRP has been approved, and shall provide reasons for its decision in the event of disapproval.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (f)(1) of this section, the NWRP is deemed approved.

(3) *Consultation with State officials.* In the case of an NWRP submitted by a federally-insured State-chartered credit union (whether an original, new, additional, revised or amended NWRP), the NCUA Board shall, when evaluating the NWRP, seek and consider the views of the appropriate State official, and provide prompt notice of its decision to the appropriate State official.

(g) *NWRP not approved* (1) *Submission of revised NWRP.* If an NWRP is rejected by the NCUA Board, the credit union shall submit a revised NWRP within 30 calendar days of receiving notice of disapproval, unless it is notified in writing by the NCUA Board that the revised NWRP is to be filed within a different period.

(2) *Notice of decision on revised NWRP.* Within 30 calendar days after receiving a revised NWRP under paragraph (g)(1) of this section, the NCUA Board shall notify the credit union in writing whether the revised NWRP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Disapproval of reclassified credit union's NWRP.* A credit union which has been classified ''significantly undercapitalized'' under § 702.102(a)(4)(ii) shall remain so classified pending NCUA Board approval of a new or revised NWRP.

(h) *Amendment of NWRP.* A credit union that is operating under an approved NWRP may, after prior written notice to, and approval by the NCUA Board, amend its NWRP to reflect a change in circumstance. Pending approval of an amended NWRP, the credit union shall implement the NWRP as originally approved.

Subpart C—Alternative Prompt Corrective Action for New Credit Unions

§ 702.301 Scope and definition.

(a) *Scope.* This subpart C applies in lieu of subpart B of this part exclusively to credit unions defined in paragraph (b) of this section as ''new'' pursuant to 12 U.S.C. 1790d(b)(2).

(b) *New credit union defined.* A ''new'' credit union for purposes of this subpart is a federally-insured credit union that both has been in operation for less than ten (10) years and has total assets of not more than $10 million. A credit union which exceeds $10 million in total assets may become ''new'' if its total assets subsequently decline below $10 million while it is still in operation for less than 10 years.

(c) *Effect of spin-offs.* A credit union formed as the result of a ''spin-off'' of a group from the field of membership of an existing credit union is deemed to be in operation since the effective date of the ''spin-off.'' A credit union whose total assets decline below $10 million because a group within its field of membership has been ''spun-off'' is deemed ''new'' if it has been in operation less than 10 years.

(d) *Actions to evade prompt corrective action.* If the NCUA Board determines that a credit union was formed, or was reduced in asset size as a result of a ''spin-off,'' or was merged, primarily to qualify as ''new'' under this subpart, the credit union shall be deemed subject to prompt corrective action under subpart A of this part.

§ 702.302 Net worth categories for new credit unions.

(a) *Net worth measures.* For purposes of this part, a new credit union must determine its net worth category classification quarterly according to its net worth ratio as defined in § 702.2(g), and any risk-based net worth requirement applicable to a new credit union defined as ''complex'' under §§ 702.103 through 702.106.

(b) *Effective date of net worth classification of new credit union.* For purposes of subpart C, the effective date of a new federally-insured credit union's classification within a net worth category in paragraph (c) of this section shall be determined as provided in § 702.101(b); and written notice to the NCUA Board of a decline in net worth category in paragraph (c) of this section shall be given as required by section 702.101(c).

(c) *Net worth categories.* A federally-insured credit union defined as ''new'' under this section shall be classified (Table 2)—

(1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater and also meets any applicable risk-based net worth requirement under §§ 702.105 and 702.106;

(2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%), and also meets any applicable risk-based net worth requirement under §§ 702.105 and 702.106;

(3) *Moderately capitalized* if it has a net worth ratio of three and one-half percent (3.5%) or more but less than six percent (6%), or fails to meet any

applicable risk-based net worth requirement under §§ 702.105 and 702.106;

(4) *Marginally capitalized* if it has a net worth ratio of two percent (2%) or more but less than three and one-half percent (3.5%);

(5) *Minimally capitalized* if it has a net worth ratio of zero percent (0%) or greater but less than two percent (2%); and

(6) *Uncapitalized* if it has a net worth ratio of less than zero percent (0%) (*e.g.,* a deficit in retained earnings).

TABLE 2 -- NET WORTH CATEGORY CLASSIFICATION FOR "NEW" CREDIT UNIONS

A "new" credit union's net worth category is . . .	*if its net worth ratio is . . .*	*and subject to the following condition(s) . . .*
"Well Capitalized"	7% or above	And if "complex," meets applicable risk-based net worth requirement (RBNW)
"Adequately Capitalized"	6% to 6.99%	And if "complex," meets applicable RBNW
"Moderately Capitalized"	3.5% to 5.99%	Or if "complex," fails applicable RBNW
"Marginally Capitalized"	2% to 3.49%	None.
"Minimally Capitalized"	0% to 1.99%	None.
"Uncapitalized"	Less than 0%	None.

(d) *Reclassification based on supervisory criteria other than net worth.* Subject to § 702.102(b) and (c), the NCUA Board may reclassify a ''well capitalized,'' ''moderately capitalized'' or ''marginally capitalized'' new credit union to the next lower net worth category (each of such actions is hereinafter referred to generally as ''reclassification'') in either of the circumstances prescribed in § 702.102(b).

(e) *Consultation with State officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before reclassifying a federally-insured State-chartered credit union under paragraph (d) of this section, and shall promptly notify the appropriate State official of its decision to reclassify.

§ 702.303 Prompt corrective action for ''adequately capitalized'' new credit unions.

Beginning on the effective date of classification as ''adequately capitalized'' or lower, an ''adequately capitalized'' new credit union must increase its net worth and transfer earnings to its regular reserve account in accordance with § 702.201, until it is ''well capitalized.''

§ 702.304 Prompt corrective action for ''moderately capitalized,'' ''marginally capitalized'' or ''minimally capitalized'' new credit unions.

(a) *Mandatory supervisory actions by new credit union.* A new credit union which is ''moderately capitalized,'' ''marginally capitalized,'' or ''minimally capitalized'' (including by reclassification under § 702.302(d) must—

(1) *Earnings transfer.* Beginning on the effective date of classification as ''moderately capitalized'' or lower, increase net worth and quarterly transfer earnings to the credit union's regular reserve account in an amount reflected in the credit union's approved initial or revised business plan;

(2) *Submit revised business plan.* Submit a revised business plan pursuant to § 702.306 if either—

(i) The credit union's net worth ratio has not increased consistent with its then-present approved business plan; or

(ii) The credit union has no then-present approved business plan; or

(iii) The credit union has failed to undertake any mandatory supervisory action prescribed in this paragraph; and

(3) *Restrict member business loans.* Beginning the effective date of classification as ''moderately capitalized'' or lower, not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.204(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Discretionary conservatorship or liquidation.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board may place a new credit union which is ''moderately capitalized,'' ''marginally capitalized'' or ''minimally capitalized'' (including by reclassification under § 702.302(d)) into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming ''adequately capitalized.''

§ 702.305 Prompt corrective action for ''uncapitalized'' new credit unions.

(a) *Mandatory supervisory actions by new credit union.* If a federally-insured new credit union either remains ''uncapitalized'' beyond the time period provided in its initial business plan (approved at the time the credit union's charter was granted), or subsequently declines to that category from a higher category after the expiration of that period, it must—

(1) *Earnings transfer.* Increase net worth and quarterly transfer earnings to the credit union's regular reserve account in an amount reflected in the credit union's approved initial or revised business plan;

(2) *Submit revised business plan.* Within 90 days of the effective date of

classification as ''uncapitalized'' as provided in paragraph (a) of this section, or such shorter period as the NCUA Board specifies, submit a revised business plan pursuant to § 702.306 providing for alternative means of funding the credit union's earnings deficit; and (3) *Restrict member business loans.* Not increase the total amount of member business loans (defined as loans outstanding and unfunded commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.204(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Mandatory liquidation or conservatorship.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board—

(1) *Plan not submitted.* May place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an ''uncapitalized'' new credit union which fails to submit a revised business plan within the time provided under paragraph (a)(2) of this section; or

(2) *''Uncapitalized'' after 90 days.* Must place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an ''uncapitalized'' new credit union which remains ''uncapitalized'' ninety (90) calendar days after the date the NCUA Board approved the revised business plan submitted by the credit union pursuant to paragraph (a)(2) of this section, unless the credit union documents to the NCUA Board why it is viable and has a reasonable prospect of becoming ''adequately capitalized.''

§ 702.306 Revised business plans for new credit unions.

(a) *Schedule for filing*—(1) *Generally.* A ''moderately capitalized,'' ''marginally capitalized'' or ''minimally capitalized'' new credit union must file a written revised business plan (RBP) with the appropriate Regional Director and, if State-chartered, with the appropriate State official within 30 calendar days following the effective date (per § 702.101(b)) of the credit union's failure to meet a quarterly net worth target prescribed in its then-present business plan, unless the NCUA Board notifies the credit union in writing that its RBP is to be filed within a different period, or that the NCUA Board is waiving the requirement that the credit union file an RBP. An ''uncapitalized'' new credit union must file an RBP within the time provided under § 702.305(a)(2).

(2) *Failure to timely file plan.* When a new credit union fails to file an RBP as provided under paragraph (a)(1) of this section, the NCUA Board shall promptly notify the credit union that it has failed to file an RBP and that it has 15 calendar days from receipt of that notice within which to do so.

(b) *Contents of revised business plan.* A new credit union's RBP must, at a minimum—

(1) Address changes, since the new credit union's current business plan was approved, in any of the business plan elements required for charter approval under Chapter 1, section IV.D. of NCUA's *Chartering and Field of Membership Manual* (IRPS 99–1), 63 FR 71998, 72019 (Dec. 30, 1998), or its successor(s), or for State-chartered credit unions under applicable State law;

(2) Establish a timetable of quarterly targets for net worth during each year in which the RBP is in effect so that the credit union becomes ''adequately capitalized'' and remains so for four (4) consecutive calendar quarters. If ''complex,'' the credit union is subject to a risk-based net worth requirement that may require a net worth ratio higher than six percent (6%) to become ''adequately capitalized'';

(3) Specify the projected amount of earnings to be transferred quarterly to its regular reserve as provided under § 702.304(a)(1) or 702.305(a)(1);

(4) Explain how the new credit union will comply with the mandatory and discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(5) Specify the types and levels of activities in which the new credit union will engage;

(6) In the case of a new credit union reclassified to a lower category under § 702.302(d), specify the steps the credit union will take to correct the unsafe or unsound condition or practice; and

(7) Include such other information as the NCUA Board may require.

(c) *Criteria for approval.* The NCUA Board shall not approve a new credit union's RBP unless it—

(1) Addresses the items enumerated in paragraph (b) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in building the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(d) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become ''adequately capitalized,'' the NCUA Board shall, in evaluating an RBP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by State law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(e) *Review of revised business plan*—(1) *Notice of decision.* Within 30 calendar days after receiving an RBP under this section, the NCUA Board shall notify the credit union in writing whether its RBP is approved, and shall provide reasons for its decision in the event of disapproval. The NCUA Board may extend the time within which notice of its decision shall be provided.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (e)(1) of this section, the RBP is deemed approved.

(3) *Consultation with State officials.* When evaluating an RBP submitted by a federally-insured State-chartered new credit union (whether an original, new or additional RBP), the NCUA Board shall seek and consider the views of the appropriate State official, and provide prompt notice of its decision to the appropriate State official.

(f) *Plan not approved*—(1) *Submission of new revised plan.* If an RBP is rejected by the NCUA Board, the new credit union shall submit a new RBP within 30 calendar days of receiving notice of disapproval of its initial RBP, unless it is notified in writing by the NCUA Board that the new RBP is to be filed within a different period.

(2) *Notice of decision on revised plan.* Within 30 calendar days after receiving an RBP under paragraph (f)(1) of this section, the NCUA Board shall notify the credit union in writing whether the new RBP is approved. The Board may extend the time within which notice of its decision shall be provided.

(g) *Amendment of plan.* A credit union that has filed an approved RBP may, after prior written notice to and approval by the NCUA Board, amend it to reflect a change in circumstance. Pending approval of an amended RBP, the new credit union shall implement its existing RBP as originally approved.

§ 702.307 Incentives for new credit unions.

(a) *Assistance in revising business plans.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing a revised business plan required to be filed under § 702.306.

(b) *Assistance.* Management training and other assistance to new credit unions will be provided in accordance with policies approved by the NCUA Board.

(c) *Small credit union program.* A new credit union is eligible to join and receive comprehensive benefits and assistance under NCUA's Small Credit Union Program.

Subpart D—Reserves

§ 702.401 Reserves.

(a) *Special reserve.* Each federally-insured credit union shall establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate State official.

(b) *Regular reserve.* Each federally-insured credit union shall establish and maintain a regular reserve account for the purpose of absorbing losses that exceed undivided earnings and other appropriations of undivided earnings, subject to paragraph (c) of this section. Earnings required to be transferred annually to a credit union's regular reserve under subparts B or C of this part shall be held in this account.

(c) *Charges to regular reserve.* The board of directors of a federally-insured credit union may authorize charges to the regular reserve for losses, provided that the authorization states the amount and provides an explanation of the need for the charge, and either—

(1) The charge will not cause the credit union's net worth classification to fall below ''well capitalized'' under subparts B or C of this part; or

(2) The appropriate Regional Director or, if State-chartered, the appropriate State official, has given written approval for the charge.

(d) *Transfers to regular reserve.* The transfer of earnings to a federally-insured credit union's regular reserve account when required under subparts B or C of this part must occur after charges for loan or other losses are addressed as provided in paragraph (c) of this section and § 702.402(d), but before payment of any dividends to members.

§ 702.402 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* ''Full and fair disclosure'' is the level of disclosure which a prudent person would provide to a member of a federally-insured credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a federally-insured credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when presented to members, to creditors or to the NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with generally accepted accounting principles (GAAP);

(2) The allowance for loan and lease losses (ALL) established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALL will be recorded in the expense account ''Provision for Loan and Lease Losses'';

(4) The maintenance of an ALL shall not affect the requirement to transfer earnings to a credit union's regular reserve when required under subparts B or C of this part; and

(5) At a minimum, adjustments to the ALL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.403 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from undivided earnings, if any.

(b) *Payment of dividends if undivided earnings depleted.* The board of directors of a federally-insured credit union which has depleted the balance of its undivided earnings account may authorize a transfer of funds from the credit union's regular reserve account to undivided earnings to pay dividends, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below ''well capitalized'' under subpart B or C; or

(2) The appropriate Regional Director or, if State-chartered, the appropriate State official, has given prior written approval for the transfer.

PART 741—REQUIREMENTS FOR INSURANCE

1. The authority citation for part 741 is revised to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1781–1790, and 1790d. Section 741.4 is also authorized by 31 U.S.C. 3717.

2. Section 741.3 is amended by revising paragraphs (a)(1) and (a)(2) to read as follows:

§ 741.3 Criteria

* * * * *

(a) *Adequacy of reserves*—(1) *General rule.* State-chartered credit unions are subject to section 216 of the Act, 12 U.S.C. 1790d, and to part 702 and subpart L of part 747 of this chapter.

(2) *Charges against reserves.* State-chartered credit unions may charge losses, including losses other than loan losses, against the regular reserve in accordance with either state law or procedures established by the appropriate State official. The board of directors of a credit union may authorize charges to the regular reserve for losses, provided that the authorization states the amount and provides an explanation of the need for the charge, and either—

(i) The charge will not cause the credit union's net worth classification to fall below ''well capitalized'' under subparts B or C of part 702; or

(ii) The appropriate State official has given written approval for the charge.

* * * * *

PART 747—ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS

1. The authority citation for part 747 is revised to read as follows:

Authority: 12 U.S.C. 1766, 1786, 1784, 1787, 1790d and 4806(a); and 42 U.S.C. 4012a.

2. Part 747 is amended by adding a new subpart L to read as follows:

Subpart L—Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action

Sec.
747.2001 Scope.
747.2002 Review of order imposing discretionary supervisory action.
747.2003 Review of order reclassifying a credit union on safety and soundness criteria.
747.2004 Review of order to dismiss a director or senior executive officer.
747.2005 Enforcement of orders.

Subpart L—Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action

§ 747.2001 Scope.

(a) *Independent review process.* The rules and procedures set forth in this subpart apply to federally-insured credit unions, whether federally- or state-chartered (other than corporate credit unions), which are subject to discretionary supervisory actions under part 702 of this chapter, and to reclassification under §§ 702.102(b) and 702.302(d) of this chapter, to facilitate prompt corrective action under section 216 of the Federal Credit Union Act, 12 U.S.C. 1790d; and to senior executive officers and directors of such credit unions who are dismissed pursuant to a discretionary supervisory action imposed under part 702. NCUA staff decisions to impose discretionary supervisory actions under part 702 shall be considered material supervisory determinations for purposes of 12 U.S.C. 1790d(k). Section 747.2002 of this subpart provides an independent appellate process to challenge such decisions.

(b) *Notice to State officials.* With respect to a federally-insured State-chartered credit union under §§ 747.2002, 747.2003 and 747.2004 of this subpart, notices, directives and decisions on appeal served upon a credit union, or a dismissed director or officer thereof, by the NCUA Board shall also be served upon the appropriate State official. Responses, requests for a hearing and to present witnesses, requests to modify or rescind a discretionary supervisory action and requests for reinstatement served upon the NCUA Board by a credit union, or dismissed director or officer thereof, shall also be served upon the appropriate State official.

§ 747.2002 Review of orders imposing discretionary supervisory action.

(a) *Notice of intent to issue directive.*—

(1) *Generally.* Whenever the NCUA Board intends to issue a directive imposing a discretionary supervisory action under §§ 702.202(b), 702.203(b) and 702.204(b) of this chapter on a credit union classified ''undercapitalized'' or lower, or under §§ 702.304(b) or 702.305(b) of this chapter on a new credit union classified ''moderately capitalized'' or lower, it must give the credit union prior notice of the proposed action and an opportunity to respond.

(2) *Immediate issuance of directive without notice.* The NCUA Board may issue a directive to take effect immediately under paragraph (a)(1) of this section without notice to the credit union if the NCUA Board finds it necessary in order to carry out the purposes of part 702 of this chapter. A credit union that is subject to a directive which takes effect immediately may appeal the directive in writing to the NCUA Board. Such an appeal must be received by the NCUA Board within 14 calendar days after the directive was issued, unless the NCUA Board permits a longer period. Unless ordered by the NCUA Board, the directive shall remain in effect pending a decision on the appeal. The NCUA Board shall consider any such appeal, if timely filed, within 60 calendar days of receiving it.

(b) *Contents of notice.* The NCUA Board's notice to a credit union of its intention to issue a directive imposing a discretionary supervisory action must state:

(1) The credit union's net worth ratio and net worth category classification;

(2) The specific restrictions or requirements that the NCUA Board intends to impose, and the reasons therefor;

(3) The proposed date when the discretionary supervisory action would take effect and the proposed date for completing the required action or terminating the action; and

(4) That a credit union must file a written response to a notice within 14 calendar days from the date of the notice, or within such shorter period as the NCUA Board determines is appropriate in light of the financial condition of the credit union or other relevant circumstances.

(c) *Contents of response to notice.* A credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the proposed discretionary supervisory action is not an appropriate exercise of discretion under this part;

(2) Request the NCUA Board to modify or to not issue the proposed directive;

(3) Include other relevant information, mitigating circumstances, documentation, or other evidence in support of the credit union's position regarding the proposed directive; and

(4) If desired, request the recommendation of NCUA's ombudsman pursuant to paragraph (g) of this section.

(d) *NCUA Board consideration of response.* The NCUA Board, or an independent person designated by the NCUA Board to act on its behalf, after considering a response under paragraph (c) of this section, may:

(1) Issue the directive as originally proposed or as modified;

(2) Determine not to issue the directive and to so notify the credit union; or

(3) Seek additional information or clarification from the credit union or any other relevant source.

(e) *Failure to file response.* A credit union which fails to file a written response to a notice of the NCUA Board's intention to issue a directive imposing a discretionary supervisory action, within the specified time period, shall be deemed to have waived the opportunity to respond, and to have consented to the issuance of the directive.

(f) *Request to modify or rescind directive.* A credit union that is subject to an existing directive imposing a discretionary supervisory action may request in writing that the NCUA Board reconsider the terms of the directive, or rescind or modify it, due to changed circumstances. Unless otherwise ordered by the NCUA Board, the directive shall remain in effect while such request is pending. A request under this paragraph which remains pending 60 days following receipt by the NCUA Board is deemed granted.

(g) *Ombudsman.* A credit union may request in writing the recommendation of NCUA's ombudsman to modify or to not issue a proposed directive under paragraph (b) of this section, or to modify or rescind an existing directive due to changed circumstances under paragraph (f) of this section. A credit union which fails to request the ombudsman's recommendation in a response under paragraph (c) of this section, or in a request under paragraph (f) of this section, shall be deemed to have waived the opportunity to do so. The ombudsman shall promptly notify the credit union and the NCUA Board of his or her recommendation.

§ 747.2003 Review of order reclassifying a credit union on safety and soundness criteria.

(a) *Notice of proposed reclassification based on unsafe or unsound condition or practice.* When the NCUA Board proposes to reclassify a credit union or subject it to the supervisory actions applicable to the next lower net worth category pursuant to §§ 702.102(b) and 702.302(d) of this chapter (each such action hereinafter referred to as ''reclassification''), the NCUA Board shall issue and serve on the credit union reasonable prior notice of the proposed reclassification.

(b) *Contents of notice.* A notice of intention to reclassify a credit union based on unsafe or unsound condition or practice shall state:

(1) The credit union's net worth ratio, current net worth category classification, and the net worth category to which the credit union would be reclassified;

(2) The unsafe or unsound practice(s) and/or condition(s) justifying reasons for reclassification of the credit union;

(3) The date by which the credit union must file a written response to the notice (including a request for a hearing), which date shall be no less than 14 calendar days from the date of service of the notice unless the NCUA Board determines that a shorter period is appropriate in light of the financial condition of the credit union or other relevant circumstances; and

(4) That a credit union which fails to—

(i) File a written response to the notice of reclassification, within the specified time period, shall be deemed to have waived the opportunity to respond, and to have consented to reclassification;

(ii) Request a hearing shall be deemed to have waived any right to a hearing; and

(iii) Request the opportunity to present witness testimony shall be deemed have waived any right to present such testimony.

(c) *Contents of response to notice.* A credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the credit union should not be reclassified;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the credit union's position;

(3) If desired, request an informal hearing before the NCUA Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the credit union wishes to present and the general nature of each witness's expected testimony.

(d) *Order to hold informal hearing.* Upon timely receipt of a written response that includes a request for a hearing, the NCUA Board shall issue an order commencing an informal hearing no later than 30 days after receipt of the request, unless the credit union requests a later date. The hearing shall be held in Alexandria, Virginia, or at such other place as may be designated by the NCUA Board, before a presiding officer designated by the NCUA Board to conduct the hearing and to recommend a decision.

(e) *Procedures for informal hearing.*—(1) The credit union may appear at the hearing through a representative or through counsel. The credit union shall have the right to introduce relevant documents and to present oral argument at the hearing. The credit union may introduce witness testimony only if expressly authorized by the NCUA Board or the presiding officer. Neither the provisions of the Administrative Procedure Act (5 U.S.C. 554–557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) shall apply to an informal hearing under this section unless the NCUA Board orders otherwise.

(2) The informal hearing shall be recorded, and a transcript shall be furnished to the credit union upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or by the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) Within 20 calendar days following the closing of the hearing and the record, the presiding officer shall make a recommendation to the NCUA Board on the proposed reclassification.

(f) *Time for final decision.* Not later than 60 calendar days after the date the record is closed, or the date of receipt of the credit union's response in a case where no hearing was requested, the NCUA Board will decide whether to reclassify the credit union, and will notify the credit union of its decision. The decision of the NCUA Board shall be final.

(g) *Request to rescind reclassification.* Any credit union that has been reclassified under this section may file a written request to the NCUA Board to reconsider or rescind the reclassification, or to modify, rescind or remove any directives issued as a result of the reclassification. Unless otherwise ordered by the NCUA Board, the credit union shall remain reclassified, and subject to any directives issued as a result, while such request is pending.

(h) *Non-delegation.* The NCUA Board may not delegate its authority to reclassify a credit union into a lower net worth category or to treat a credit union as if it were in a lower net worth category pursuant to §§ 702.102(b) or 702.302(d) of this chapter.

§ 747.2004 Review of order to dismiss a director or senior executive officer.

(a) *Service of directive to dismiss and notice.* When the NCUA Board issues and serves a directive on a credit union requiring it to dismiss from office any director or senior executive officer under §§ 702.202(b)(7), 702.203(b)(8), 702.204(b)(8), 702.304(b) or 702.305(b) of this chapter, the NCUA Board shall also serve upon the person the credit union is directed to dismiss (Respondent) a copy of the directive (or the relevant portions, where appropriate) and notice of the Respondent's right to seek reinstatement.

(b) *Contents of notice of right to seek reinstatement.* A notice of a Respondent's right to seek reinstatement shall state:

(1) That a request for reinstatement (including a request for a hearing) shall be filed with the NCUA Board within 14 calendar days after the Respondent receives the directive and notice under paragraph (a) of this section, unless the NCUA Board grants the Respondent's request for further time;

(2) The reasons for dismissal of the Respondent; and

(3) That the Respondent's failure to—

(i) Request reinstatement shall be deemed a waiver of any right to seek reinstatement;

(ii) Request a hearing shall be deemed a waiver of any right to a hearing; and

(iii) Request the opportunity to present witness testimony shall be deemed a waiver of the right to present such testimony.

(c) *Contents of request for reinstatement.* A request for reinstatement in response to a notice under paragraph (b) of this section must:

(1) Explain why the Respondent should be reinstated;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the Respondent's position;

(3) If desired, request an informal hearing before the NCUA Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the Respondent wishes to present and the general nature of each witness's expected testimony.

(d) *Order to hold informal hearing.* Upon receipt of a timely written request from a Respondent for an informal hearing on the portion of a directive requiring a credit union to dismiss from office any director or senior executive officer, the NCUA Board shall issue an order directing an informal hearing to commence no later than 30 days after receipt of the request, unless the Respondent requests a later date. The hearing shall be held in Alexandria, Virginia, or at such other place as may be designated by the NCUA Board, before a presiding officer designated by the NCUA Board to conduct the hearing and recommend a decision.

(e) *Procedures for informal hearing.*—(1) A Respondent may appear at the hearing personally or through counsel. A Respondent shall have the right to introduce relevant documents and to present oral argument at the hearing. A Respondent may introduce witness testimony only if expressly authorized by the NCUA Board or by the presiding officer. Neither the provisions of the Administrative Procedure Act (5 U.S.C. 554–557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) apply to an informal hearing under this section unless the NCUA Board orders otherwise.

(2) The informal hearing shall be recorded, and a transcript shall be furnished to the Respondent upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) A Respondent shall bear the burden of demonstrating that his or her continued employment by or service with the credit union would materially strengthen the credit union's ability to—

(i) Become ''adequately capitalized,'' to the extent that the directive was issued as a result of the credit union's net worth category classification or its failure to submit or implement a net worth restoration plan or revised business plan; and

(ii) Correct the unsafe or unsound condition or unsafe or unsound practice, to the extent that the directive was issued as a result of reclassification of the credit union pursuant to §§702.102(b) and 702.302(d) of this chapter.

(5) Within 20 calendar days following the date of closing of the hearing and the record, the presiding officer shall make a recommendation to the NCUA Board concerning the Respondent's request for reinstatement with the credit union.

(f) *Time for final decision.* Not later than 60 calendar days after the date the record is closed, or the date of the response in a case where no hearing was requested, the NCUA Board shall grant or deny the request for reinstatement and shall notify the Respondent of its decision. If the NCUA Board denies the request for reinstatement, it shall set forth in the notification the reasons for its decision. The decision of the NCUA Board shall be final.

(g) *Effective date.* Unless otherwise ordered by the NCUA Board, the Respondent's dismissal shall take and remain in effect pending a final decision on the request for reinstatement.

§ 747.2005 Enforcement of orders.

(a) *Judicial remedies.* Whenever a credit union fails to comply with a directive imposing a discretionary supervisory action, or enforcing a mandatory supervisory action under part 702 of this chapter, the NCUA Board may seek enforcement of the directive in the appropriate United States District Court pursuant to 12 U.S.C. 1786(k)(1).

(b) *Administrative remedies*—(1) *Failure to comply with directive.* Pursuant to 12 U.S.C. 1786(k)(2)(A), the NCUA Board may assess a civil money penalty against any credit union that violates or otherwise fails to comply with any final directive issued under part 702 of this chapter, or against any institution-affiliated party of a credit union (per 12 U.S.C. 1786(r)) who participates in such violation or noncompliance.

(2) *Failure to implement plan.* Pursuant to 12 U.S.C. 1786(k)(2)(A), the NCUA Board may assess a civil money penalty against a credit union which fails to implement a net worth restoration plan under subpart B of part 702 or a revised business plan under subpart C of part 702.

(c) *Other enforcement action.* In addition to the actions described in paragraphs (a) and (b) of this section, the NCUA Board may seek enforcement of the directives issued under part 702 of this chapter through any other judicial or administrative proceeding authorized by law.

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