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2016 Capital Planning - Observed and Leading Practices

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TABLE OF CONTENTS

- 2016 Capital Planning: Observed and Leading Practices 2
 - Introduction..... 2
- Effective Capital Policy and Governance 2
 - Governance and Effective Challenge 2
 - Governing Framework Over Capital Planning and Analysis 3
 - Capital Policy - Goals and Limits..... 3
 - Capital Analysis Roles 3
 - Risk Culture..... 4
 - Capital Policy – Capital Contingency Plans..... 4
- Internal Capital Adequacy Assessment Process (ICAAP) 5
 - Board, Committee, Management, & Staff Responsibilities 5
 - Integration with Strategic Business Planning and Operations..... 5
 - Model Risk Management, Review and Validation 6
 - Operational Risk 7
 - Internal Audit and Capital Planning Controls..... 7
 - Sensitivity Analysis..... 8
 - Reverse Stress Testing..... 8
- Conclusion..... 9

2016 Capital Planning: Observed and Leading Practices

Introduction

NCUA places a high level of importance on capital planning at its largest credit unions. Capital planning requires each covered credit union to consider its own risk exposures and establish capital goals to support these risks, and develop a capital contingency plan. This document summarizes capital planning and analysis practices related to governance and the management of capital analysis as observed in capital plans provided to NCUA through the May 31, 2016, submission¹.

Observations in this document are intended to alert covered credit unions to these practices to assist them in enhancing their capital plans where appropriate. Practices identified as leading or sound represent views at the time of this publication. NCUA anticipates that leading practices will continue to evolve as new data become available, economic conditions change, new products and businesses introduce new risks, and estimation techniques advance further.

NCUA has communicated that capital planning is an iterative process. In similar fashion, NCUA designed its review of the capital plans in an iterative manner. In the rule's inaugural year, 2015, NCUA focused on the governance of the capital planning process. NCUA's 2016 review increased the scope of its capital planning reviews with additional emphasis on management of capital analysis. The qualitative aspects of governance and management practices surrounding capital analysis are essential elements to ensure effective board oversight and senior management participation in the overall capital planning process.

This guidance paper builds upon previously issued range of practice guidance by revisiting and identifying enhancements in observed practices in overall corporate governance over capital planning, as well as providing an emphasized focus on observed practices in management of the capital analysis functions.

Effective Capital Policy and Governance

Governance and Effective Challenge

Credit unions with stronger capital policy practices formulated distinct policies that addressed the key elements of the credit union's capital planning process, and defined the roles and responsibilities for capital governance decisions. Stated capital targets were clear and specific, and a risk awareness culture was evident in all aspects of governing policies and practices associated with the capital analysis. Capital contingency actions were also observed as both credible and actionable. Credit unions with stronger governance practices had either established

¹ Credit unions with \$10 billion or more in assets as of their March 31 Call Report (of a given calendar year) are covered by NCUA Rules and Regulations Part 702 Subpart E – Capital Planning and Stress Testing¹ in the following calendar year.

committees to govern the capital planning process or had clearly modified existing governance arrangements to incorporate new processes for the governance, execution, reporting and review of capital analysis results.

Governing Framework Over Capital Planning and Analysis

Review and assessment of 2016 capital plan submissions demonstrated incremental maturity in governing structures and practices. Credit unions that displayed leading practices made efforts to further identify and define the roles and responsibilities of the board of directors, senior management and middle level management with specificity to various aspects of the institution's risk management framework and capital analysis and planning processes. Similarly, leading practices demonstrated movement toward more formalized and defined segregation of senior management responsibilities for risk assessment and management from those responsible for risk taking activities. Credit unions that instituted clear lines between risk taking and risk oversight, are more transparent in their communication of material risks, demonstrate effective challenge of capital analysis, and exhibit stronger alignment of capital goals with stated risk tolerance levels.

Capital Policy - Goals and Limits

Covered credit unions continue to use "reactive" approaches to capital adequacy analysis. Static capital goals or limits are established, scenario analysis is conducted, and the residual remaining capital is compared to the static goals and limits. In some cases, capital limits were expressed in a graduated way to denote the corresponding level of concern and actions that would occur as risk to capital is elevated. These graduated limits with escalation triggers are considered an incremental improvement over capital analysis focused on compliance with a singular breach limit relative to various static net worth ratio goals.

Weaker practices in this area included establishing limits based primarily on regulatory capital minimums or without consideration of the credit union's capital needs as implied by its risk profile, business strategy, stress test analysis and/or sensitivity to changing market conditions.

Credit unions did not implement the stronger "proactive" approach to capital analysis. Proactive approaches assess capital adequacy with respect to material risks, assess capital adequacy with respect to current aggregate risk exposure, and attribute capital at risk to individual material risks.

Capital Analysis Roles

As a general observation, 2016 submissions did not differentiate between the governance of general capital planning and the management of capital analysis. Roles of capital analysis are often blurred with other board directives governing the capital planning process, while the tactical job of capital analysis remained primarily a middle office function of the finance department. As a result, weakness was observed in clearly and transparently identifying the roles and responsibilities for capital analysis itself, and challenge of that capital analysis by departments independent of risk taking activities.

An observed sound practice is to identify the governance and controls specific to capital analysis, transparently identify challenge functions and points of effective challenge. This practice is further improved when risk takers are identified and shown to be independent of those preparing capital analysis.

Stronger practices in this area provide well documented process flow charts and organizational charts that clearly assign specific responsibilities in the risk assessment, measurement, internal control, and financial forecasting aspect of capital planning and analysis, and identifying assigned “challenge” points over these various functions material to the capital adequacy assessment and planning process.

Capital analysis, and its corresponding governance, will continue to be a matter of supervisory attention for all covered institutions as part of both review of submitted plans as well as the supervisory examination process.

Risk Culture

Institutions demonstrating leading practices with respects to the fundamental elements of capital analysis and planning demonstrated a strong risk culture that fostered the understanding that there are differences between financial reporting and risk reporting, and expected and unexpected losses. Those deemed to have a strong corporate risk culture fairly and independently assessed and identified source risks, and demonstrated more realistic and actionable capital analysis and contingency actions. Similarly strong risk management cultures defined risk through key risk management data and risk indicators as opposed to historical reported financial performance data. For example, losses relevant to risk management may include measures of default frequency and loss severity; however, credit losses expressed as net charge-offs are relevant to reporting financial performance. The two different views of credit risk may provide different numbers, but should be derived from the same set of foundational data. This leads to more transparent, effective and wide ranging approaches to risk assessment and risk quantification techniques.

Capital Policy – Capital Contingency Plans

A capital policy should describe the credit union’s capital adequacy decision-making process, including the process for invoking capital contingency plans when established goals and targets are at risk of being breached. The policy, and capital plan, should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached.

The range of contingency plans proposed by credit unions to deal with shortfalls in their capital improved, but remained wide. Contingency plans are integral to credit union capital planning and need to show that a credit union has considered a slate of actions to bolster capital to absorb losses under stress, and also assess the efficacy of these actions under various conditions. Unlike business plans, capital plans must consider that severely unfavorable events can occur and may

erode capital in such a way as to materially threaten credit union viability. As a leading practice, NCUA observed credit unions adopting contingency plans that provided an extensive series of actions to be considered, provided context of feasibility, spoke to the timing and impact to capital of each action, and were tied to triggers rendered in policy. An additional leading practice is to incorporate the capital contingency plan under an unfavorable scenario and present contingency actions taken and present the potential results on capital.

Internal Capital Adequacy Assessment Process (ICAAP)

Board, Committee, Management, & Staff Responsibilities

During the first two years' submissions, each credit union established and enhanced its own structure for governing its capital planning process. Credit unions with stronger practices continue to enhance and train their boards' understanding of institutional activities and resulting risk exposures. They seek to raise the board's level of expertise and engagement through presentations throughout the plan development process to orient board members and facilitate the transfer of knowledge. This is essential to provide the means for effective challenge by the board. Some credit unions demonstrated a clear path by forming specific board and management level committees to support capital planning and testing for unfavorable circumstances which reported through to the board.

Another strong practice is to recognize the necessity for separation between business line activities and oversight functions, which includes capital analysis and capital adequacy reporting. NCUA observed incremental steps toward the separation of business activity, risk oversight and capital adequacy analysis, and internal control validation within only a couple capital plans. Creating a structure with three purely independent and equally capable functions requires time and overhead capacity. While credit unions are moving toward a more ideal structure, redundant layers of review at various levels have been observed as a short term solution to mitigate the lack of independence.

Integration with Strategic Business Planning and Operations

The effectiveness and utility of performing robust capital analysis is essential to effective ongoing business and strategic planning. Conversely, it is imperative to the effectiveness of a credit union's capital planning processes that anticipated strategic endeavors be considered within the analysis performed. Integration of key strategic initiatives planned by the credit unions board of directors is crucial to the effectiveness of ongoing capital analysis in informing key business and risk management decisions. Key points of integration between effective capital analysis, strategic business planning, and ongoing business operations include but are not limited to:

Integration of key strategic initiatives planned by the credit unions board of directors is crucial to the effectiveness of ongoing capital analysis in informing key business and risk management decisions.

- Institutional risk assessment and tolerance statements informing stress test scenario designs, comprehensive capital analysis performed, and the establishment of capital goals and business concentration limits;
- Incorporation of planned strategic initiatives into comprehensive capital analysis either through scenario analysis itself or through sensitivity analysis;
- Delineation and control of models used in business operations for parallel use in comprehensive capital analysis;
- Alignment of capital goals and limits arising out of capital planning with strategic plans and policy allowable product, service and risk concentrations.

Observations of submissions to date indicate evolving practices in this area. In most cases it was noted that baseline capital analysis was completed using the same modeling platforms, balance sheet growth assumptions and pricing forecasts as those used in the credit union's strategic planning and budgeting endeavors. Leading observed practices in capital planning include a detailed synopsis of planned strategic endeavors and transparent discussion as to how the anticipated risks, costs, and planned benefits of these endeavors would be encapsulated in the various scenario analysis presented in the plan.

It is desirable for capital analysis to share the same foundational basis as strategic planning and budgeting. However, leading practitioners do not view baseline stress test analysis as synonymous to the credit union's budget or strategic plan. Capital analysis is a risk management exercise that must include fundamental risk management perspectives while the strategic plan and budget are pro forma financial planning exercises with heavy accounting emphasis.

In our observations it was not always clear how the capital adequacy analysis was used to inform strategic planning, board policy, and concentration limits over risk outside of scenario testing. Moving forward, more transparent analysis and discussion as to how capital planning and analysis is integrated and informs ongoing strategic planning, board policy, and business operations will be a focus of NCUA review.

Model Risk Management, Review and Validation

Model risk management practices covering capital analysis and risk modeling, in general, continue to evolve at covered credit unions. Leading practice is this enterprise function is owned and operated by an independent risk management function. These model risk management programs implement an organization wide function that contains:

- model risk management policies and modeling standards,
- a process to inventory and prioritize models,
- requirements to ensure models are validated for all intended purposes,
- procedures to identify and document appropriate assumption and data parameters, and
- an evaluation of the model's conceptual soundness prior to implementation.

The leading practice is model risk management is owned and operated by an independent risk management function.

Sound model risk management will identify and/or review weaknesses in capital adequacy analysis to assess the needs for additional controls and added conservatism. Management overlays fall under the scope of model risk management. Credit unions that use, and document, management overlays to compensate for matters such as insufficient data, methodological weaknesses, and other considerations of conservatism are practicing sound modeling practices.

Several credit unions are in the process of creating the appropriate structure for robust model risk management. These credit unions have implemented controls to mitigate the lack of an independent function to own model risk management. NCUA has not adopted formal guidance in this area, but credit unions looking to enhance this area may look to the Federal Reserve and Office of the Comptroller of the Currency's authoritative guidance on model risk management in 2011 ([SR 11-7, Guidance on Model Risk Management](#) | [OCC Bulletin 2011-12, Supervisory Guidance on Model Risk Management](#)).

Lagging model risk management practices retain this functional responsibility and accountability in the hands of model owners. An additional lagging practice is to approach model risk management as a mere mathematical check of the model.

Operational Risk

Quantifying operational capital at risk can be a daunting capital analysis exercise. Admittedly, capital exposure to operational risk is difficult to assess and quantify. Techniques used by credit unions ranged from the use of overlapping qualitative assessments and the use of Basel II approaches, to designing scenarios with operational risk components and adding a qualitative operational risk charge, to the lagging practice of not addressing operational risk in capital adequacy analysis.

Internal Audit and Capital Planning Controls

The development of internal audit reviews of the capital planning processes were a frequently identified gap observed during the 2015 plan review cycle. Significant progress was noted in this key internal control aspect of the overall planning process during 2016. All covered credit unions have now completed at least one "end to end" audit engagement over their capital planning and analysis programs, although the approaches to planning and conducting first and second year audit activities varied. In all cases auditing procedures applied placed heavy focus on regulatory compliance with both NCUA Rules and Regulations and supervisory guidance issued in September of 2014.

Leading practices were observed where audit scope and procedures were expanded to specific governance and internal control processes related to the credit unions capital analysis. While "periodic" full "end to end" audits of each credit union's full range of capital planning practices are an expectation set forth in NCUA's September 2014 supervisory guidance, the sound practice is for a risk-focused process with specific audit procedures to be applied annually as various aspects of each credit unions' capital planning programs are implemented and mature.

Reviews of future audits work will focus on the manner in which credit union audit departments evaluate material aspects of the capital planning and analysis process.

The majority of audits were completed by in-house internal auditing staff, and in two cases audit activities over capital planning were co-sourced to outside auditing professionals. The leading practice is for the capital planning audit team to contain subject matter expertise of the various areas of operation and resulting risk positions at the institution.

Weaker observations included audits focused on strict compliance with regulatory requirements and lack of depth of review and effectiveness of the policies, processes and internal controls in place over those processes was acceptable for the size and complexity of the credit union. Moving forward NCUA will focus on the manner in which credit union audit departments assess and scope material aspects of the capital planning and analysis process, and the depth and effectiveness of audits completed.

Sensitivity Analysis

The techniques used by credit unions to assess sensitivity of variables in their analysis varied considerably. Some credit unions sought to focus on key variables, and increased these in structured ways focusing separately on credit risk variables and interest rate risk variables. In the case of credit risk, changes in gross charge-off losses and recoveries were adjusted directly, or were attributed based on macro-economic variables such as unemployment or the home price index. Interest rate risk variables were either attributed directly in terms of increased deposit rate sensitivity, or were attributed to shifts in deposit mix. Some credit unions analyzed the impact of sensitivity from changes in multiple variables. These included growth assumptions, changes in probabilities of default, yield curve changes, interest rate shocks, and changes in asset maturities or prepayments. NCUA recognizes that many different factors may affect each credit union's results, and encourages credit unions to assess, identify, and prioritize the set of variables to which credit union performance is most sensitive and capital may be most at risk. Sound sensitivity analysis should serve as input to strategic planning, policy making and limit setting, and risk reporting. It is also a natural step to performing reverse stress tests.

Reverse Stress Testing

The purpose of reverse stress testing is to alert credit union directors and executives to the magnitude and convergence of unfavorable events that may break defined capital limits. A majority of the credit unions appeared to approach reverse stress testing as an anecdotal exercise by layering loss events onto adverse scenarios.

While anecdotes help executives and directors conceptualize reverse stress testing, the story should make clear and concise links to the credit union's material risks, the amount of exposure necessary to breach limits, and how the material exposures may be related to each other during periods of stress. This story must accurately depict the magnitude of risk exposure, and an

understanding of how risk exposure relationships with each other, that can cause capital depletion that breaches board predefined levels.

Credit unions with better practices, which were more in line with the intent of reverse stress testing, posited adverse unlikely events with appropriate narrative and attributed consequences, to construct their reverse stress test scenarios.

Conclusion

NCUA sees capital planning as a prudent practice for covered credit unions. The evaluation of capital at risk is a rigorous and substantive expectation. Through the rule and the companion guidance, NCUA set increased expectations for covered credit unions to elevate the assessment of capital risk to an enterprise-wide level. As they gain more experience with the application of contemporary capital planning practices, NCUA will continue to communicate with credit unions to promote the evolution of the capital planning process.