

August 2004

CREDIT UNIONS

Available Information Indicates No Compelling Need for Secondary Capital



G A O

Accountability * Integrity * Reliability



Highlights of [GAO-04-849](#), a report to congressional requesters

Why GAO Did This Study

Since the passage of the Credit Union Membership Access Act of 1998 (CUMAA), many in the credit union industry have sought legislative changes to the net worth ratio central to prompt corrective action (PCA). The current debate centers on the issue of allowing federally insured credit unions to include additional forms of capital within the definition of net worth. In light of the issues surrounding the debate, GAO reviewed (1) the underlying concerns that have prompted the credit union industry's interest in making changes to the current capital requirements, (2) the issues associated with the potential use of secondary capital in all federally insured credit unions, and (3) the issues associated with the potential use of risk-based capital in all federally insured credit unions.

What GAO Recommends

GAO observes that the general favorable economic climate for credit unions experienced during the relatively short time that PCA has been in place for credit unions precluded sufficient testing of the current system of PCA and that additional time and greater experience are needed to determine what, if any, changes to PCA are warranted. In comments on this report, the National Credit Union Administration (NCUA) concurred that a case for introducing secondary capital has not been made but believed that adjustments to PCA were needed to make it more fully risk based.

www.gao.gov/cgi-bin/getrpt?GAO-04-849.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

CREDIT UNIONS

Available Information Indicates No Compelling Need for Secondary Capital

What GAO Found

The credit union industry's interest in making changes to the current capital requirements for credit unions appears to be driven by three primary concerns: (1) that restricting the definition of net worth solely to retained earnings could trigger PCA actions due to conditions beyond credit unions' control; (2) that PCA in its present form acts as a restraint on credit union growth; and (3) that PCA tripwires, or triggers for corrective action, are too high given the conservative risk profile of most credit unions. Despite these concerns, available indicators suggest that the credit union industry has not been overly constrained as a result of the implementation of PCA. As a group, credit unions have maintained capital levels well above the level needed to be considered well-capitalized and have grown at rates exceeding those of other depository institutions during the three calendar years that PCA has been in place for credit unions.

Allowing credit unions to use secondary capital instruments to meet their regulatory net worth requirements would raise a number of issues and concerns, with perhaps the most important issue centering on who would purchase the secondary capital instruments. While outside investors would provide market discipline, this would raise concerns about the potential impact on the member-owned, cooperative structure of credit unions. Inside investors, however, could impose less discipline and raise systemic risk concerns if it resulted in a situation where weaker credit unions could bring down stronger credit unions due to secondary capital investments. Other issues relate to the specific form of the capital instruments for credit unions. The credit union industry itself appeared divided on the desirability or appropriate structure of secondary capital instruments.

Conceptually, the use of risk-based capital to address the concerns some in the credit union industry expressed about PCA is less controversial. Though two risk-based capital proposals were put forward, neither has garnered industry consensus and both lacked details of key components upon which to base any assessment of their merits. Risk-based capital is intended to reflect the unique risk profile of individual financial institutions; however, there are other factors that can affect an institution's financial condition that are not easily quantified. In recognition of the limitations of risk-based capital systems, bank and thrift regulators use leverage and risk-based capital requirements in tandem. GAO is aware that NCUA is constructing a more detailed risk-based capital proposal that incorporates both risk-based and leverage requirements; however due to the lack of formalized details, GAO could not perform a meaningful assessment of the proposal.

Contents

Letter

Results in Brief	1
Background	3
Concerns about PCA Appear to Drive Industry Interest in Secondary Capital	6
Potential Use of Secondary Capital in the Credit Union Industry	10
Poses Many Unanswered Questions	17
While Many View Risk-Based Capital as an Enhancement to PCA for Credit Unions, Key Structural Issues Remain Unresolved	25
Observations	34
Agency Comments and Our Evaluation	35

Appendixes

Appendix I: Objectives, Scope, and Methodology	40
Appendix II: Definitions of Risk Portfolios and Weighted-Average Life of an Investment, and a Risk-Based Standard Calculation Example	41
Appendix III: Items in Use by NCUA in Developing Its Risk-Based Capital Proposal	43
Appendix IV: Comments from the National Credit Union Administration	45
Appendix V: GAO Contacts and Staff Acknowledgments	49
GAO Contacts	49
Acknowledgments	49

Tables

Table 1: Summary of PCA Capital Requirements for Credit Unions	8
Table 2: NAFCU Board's Seven Principles for a Viable Alternative Capital Model	24
Table 3: Risk Portfolios Defined	41
Table 4: Weighted-Average Life of Investments	41
Table 5: Example of the Standard Calculation of the Risk-Based Net Worth Requirement	42

Figures

Figure 1: Federally Insured Credit Unions' Total Shares, Total Assets, and Capital Ratios, 1994–2003	13
Figure 2: Asset Growth of Other Depository Institutions Compared with Credit Unions, 1994–2003	15

Figure 3: Summary of FDICIA Capital Categories and Ratio Requirements

Abbreviations

CEO	chief executive officer
CRA	Community Reinvestment Act
CUMAA	Credit Union Membership Access Act of 1998
CUNA	Credit Union National Association
FCUA	Federal Credit Union Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
GAAP	generally accepted accounting principles
NAFCU	National Association of Federal Credit Unions
NASCUS	National Association of State Credit Union Supervisors
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NWRP	Net Worth Restoration Plan
PCA	prompt corrective action
RBNW	risk-based net worth
ROAA	return on average assets
Treasury	Department of the Treasury

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



United States Government Accountability Office
Washington, D.C. 20548

August 6, 2004

The Honorable Michael G. Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

The Honorable Brad Sherman
House of Representatives

Credit unions, which have approximately 82 million members across the United States, historically have occupied a unique niche among depository institutions.¹ Credit unions are member-owned cooperatives that are exempt from federal income taxes. They do not issue capital stock; rather, they are not-for-profit entities that build capital by retaining earnings. Recent debate about and support for changes to the existing capital requirements for credit unions—which establishes the percentage of net worth to total assets that they must maintain—has raised concerns about potential safety and soundness implications. These implications derive from the many important purposes a depository institution’s capital serves. From a regulatory perspective, capital acts as a buffer against unexpected operating losses or other adverse financial results. From a depository institution’s perspective, capital serves as a basis to generate long-term growth. Capital is also commonly viewed as a measure of financial strength.

¹In this report, we use “credit union” to refer to federally insured, natural person credit unions—those institutions with a membership consisting of individuals. As of December 2003, there were 9,369 federally insured, natural person credit unions. In contrast, corporate credit unions have a membership consisting of other credit unions. As of December 2003, there were 31 corporate credit unions.

Prior to 1998, the National Credit Union Administration (NCUA), which regulates federally chartered credit unions and certain aspects of federally insured state-chartered credit unions, did not impose any net worth requirement on federally insured credit unions.² Instead, as noted by NCUA, Section 116 of the Federal Credit Union Act (FCUA) required credit unions to make a periodic reserve transfer until reserves reached 6 percent of risk-assets (10 percent for credit unions with under \$5 million in assets). Then in 1998, the Credit Union Membership Access Act (CUMAA) established a capital-based supervisory framework called prompt corrective action (PCA) that requires NCUA to classify federally insured credit unions into five categories—well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized—based on net-worth-to-total-assets ratios. Under PCA, credit unions that are less than well-capitalized must take actions prescribed by statute and discretionary actions developed by NCUA based on the institutions' capitalization category.³

Since the implementation of PCA for credit unions, some sectors of the credit union industry have been calling for changes to the capital requirements for credit unions. The changes called for generally include (1) amending the definition of net worth to include alternative forms of capital, such as unsecured subordinated debt instruments—known as secondary capital instruments; (2) moving to risk-based capital standards; and (3) some combination of the changes discussed above.⁴

As agreed, you asked us to describe (1) the underlying concerns that have prompted the credit union industry's interest in making changes to the current capital requirements, (2) the issues associated with the potential use of secondary capital in all federally insured credit unions, and (3) the

²Like banks, federally insured credit unions can be federally chartered or state chartered. NCUA has oversight authority for federally chartered credit unions and requires its credit unions to obtain federal share (deposit) insurance, through the National Credit Union Share Insurance Fund (NCUSIF), which it administers. Additionally, most state-chartered credit unions also have federal insurance. Approximately 98 percent of credit unions are federally insured.

³See Pub. L. No. 105-219 §301 (1998), as amended, 12 U.S.C. §1790d (2000 & Supp. 2004). These actions are set forth in NCUA's regulations 12 C.F.R. Part 702, Subpart B (2004).

⁴Subordinated debt is debt that is either unsecured or has a lower priority than that of another debt claim on the same asset. Subordinated debt instruments are not backed or guaranteed by the federal deposit or share insurance funds.

issues associated with the potential use of risk-based capital in all federally insured credit unions.

To identify and describe concerns regarding the current capital requirements for credit unions, we interviewed credit union industry groups, several credit union chief executive officers, credit union regulators and two banking regulators. Additionally, in these interviews we gathered information on the issues and concerns associated with the potential use of secondary capital and risk-based capital by credit unions. We also conducted a literature search to identify studies on the potential use of secondary capital by credit unions and spoke with academics and other industry observers. Appendix I provides additional details on our scope and methodology. We are aware that NCUA is constructing a more detailed risk-based capital proposal that incorporates both risk-based and leverage requirements; however due to the lack of formalized details, we could not perform a meaningful assessment of the proposal. We conducted our work in Washington, D.C., from November 2003 through July 2004 in accordance with generally accepted government auditing standards.

Results in Brief

The credit union industry's interest in making changes to the current capital requirements for credit unions appears to be driven by three primary concerns: (1) that restricting the definition of net worth solely to retained earnings could trigger PCA actions due to conditions beyond credit unions' control; (2) that PCA in its present form acts as a restraint on credit union growth; and (3) that PCA tripwires, or triggers for corrective action, are too high given the conservative risk profile of most credit unions. First, the argument most often advanced for allowing all federally insured credit unions to use additional forms of capital is that events such as a rapid inflow of funds, as occurred in recent years because of adverse conditions in investment markets, might result in otherwise well-managed credit unions experiencing a rate of share (deposit) growth that exceeds their ability to accumulate retained earnings. Consequently, this would decrease credit unions' net worth ratio and trigger PCA actions. However, we did not find evidence that the inflow of member share deposits resulted in widespread net worth problems for federally insured credit unions during the period that PCA has been in place. Second, some industry representatives have argued that PCA acts as a restraint on growth because credit unions are not able to retain earnings quickly enough to avoid a decline in net worth ratios during periods of sustained growth. While PCA is intended to curb aggressive growth, our analysis of credit union and bank data indicates that credit unions have been able to grow at a higher

rate than banks during the 3 years that PCA has been in place for credit unions. Third, some industry representatives have also contended that PCA trigger points for credit unions are higher than for banks and thrifts despite the generally more conservative risk profile of credit unions. It should be noted that Congress established the capital standards to take into account that credit unions do not issue capital stock and must rely on retained earnings to build net worth, which necessarily takes time. Moreover, the Department of the Treasury (Treasury) stated that Congress established the leverage capital level 2 percentage points higher than banks and thrifts because 1 percent of a credit union's capital is deposited in the National Credit Union Share Insurance Fund (NCUSIF) and another 1 percent of the typical credit union's capital is invested in a corporate credit union.

The credit union industry itself has expressed widely divergent viewpoints on the desirability of additional forms of capital for all federally insured credit unions, with perhaps the most important issue centering on who would purchase the secondary capital instruments. Allowing investors outside of the credit union industry to hold the instruments would bring increased market discipline, but there are concerns that this would be more costly than the usual sources of funds and change the member-owned, cooperative nature of the credit union industry. Alternatively, allowing investors from within the industry may alleviate these concerns; however, in-system investors could impose less discipline than out-of-system investors, raising concerns about investor protection—adequacy of disclosure regarding the uninsured, subordinated status of the investment—and the potential that a weaker credit union could pull down a stronger one (systemic risk) because the investment of one credit union would be treated as the capital of another. Other concerns relate to the specific form of the capital instruments, and how they would be incorporated into the regulatory net worth requirement for credit unions. We could not identify proposals on the use of secondary capital by credit unions that were specific enough to facilitate our assessment of these key issues. While two types of specialized credit unions—low income and corporate—can currently use alternative capital instruments to meet their regulatory capital requirements, their experiences are too limited or unique for application to the bulk of the industry. One industry group, however, has developed a list of principles, or minimum set of criteria, to consider for any proposal.

A number of key structural issues regarding the potential use of risk-based capital for all credit unions remain unresolved, including (1) the extent to which risk-based ratios would be used to augment, versus replace, the

current PCA net worth (leverage) requirements; and (2) how key risk components and weights that are appropriate to the unique characteristics of credit unions would be defined. In contrast to most credit unions, all banks and thrifts are required to meet both a leverage ratio and a risk-based capital ratio in order to be “adequately capitalized.” Bank and thrift regulators recognized the limitations of a solely risk-based capital requirement and continued the leverage requirements to address factors a risk-based ratio does not address but that can affect an institution’s financial condition, such as liquidity and operational risks. Under CUMAA, the few credit unions that must meet risk-based net worth requirements are called “complex” credit unions, generally those with total assets at the end of a quarter exceeding \$10 million and with a risk-based net worth calculation exceeding 6 percent; they represent approximately 8 percent of all federally insured credit unions as of December 2003. Though a credit union trade association has put forward two risk-based capital proposals, neither has garnered industry consensus. Moreover, each proposal lacked key components such as a clear definition of risk assets, risk weights, and asset classifications appropriate for credit unions. As a result, these proposals did not contain sufficient details upon which to assess their merits. In addition, NCUA officials told us they are developing, but have not yet finalized, a risk-based capital proposal to augment the current PCA for all credit unions that they believe acknowledges the unique nature of credit unions and incorporates the relevant and material risks credit unions face.

We provided a draft of this report to the Chairman of the National Credit Union Administration and the Secretary of the Treasury for review and comment. We received written comments from NCUA that are reprinted in appendix IV. NCUA agreed with this report’s assessment that a case for secondary capital has not been made due to key unresolved issues and the lack of industry consensus on the need for and appropriate structure of secondary capital instruments. However, NCUA stated that its experience gained to date with the PCA system for federally insured credit unions indicates a need to make adjustments to better achieve its overall objectives. Specifically, NCUA stated that these adjustments should move PCA to a more fully risk-based system, with a lower leverage ratio (ratio of net worth to total assets). However, we believe that the generally favorable economic climate for credit unions experienced during the relatively short time that PCA has been in place for credit unions precluded sufficient testing of the current system of PCA for credit unions to determine if significant changes, such as that proposed by NCUA, are warranted. In addition, GAO believes that any proposal to move to a more risk-based

system should provide for both risk-based and meaningful leverage capital requirements to work in tandem.

Background

The current U.S. bank risk-based capital regulations implement the 1988 Basel Accord on risk-based capital.⁵ The Basel Accord established the widespread use of capital ratios that bank and thrift regulators could use as a starting point for assessing the financial condition—that is, safety and soundness—of internationally active banks and thrifts. In the United States, U.S. bank regulators applied the Basel Accord to all banks, rather than just internationally active ones. In 1991, GAO recommended a tripwire approach—incorporating capital and safety and soundness standards, or levels at which supervisory actions would be triggered—based on our findings that regulatory discretion and a common philosophy of trying to resolve the problems of troubled institutions informally and cooperatively resulted in enforcement actions that were neither timely nor forceful enough to prevent or minimize losses to the deposit insurance fund.⁶ Moreover, acting in response to the large number of bank and thrift failures in the late 1980s and early 1990s, Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which included a capital-based regulatory structure known as PCA.⁷ Specifically, FDICIA categorizes depository institutions into five classifications on the basis of their capital levels and imposes increasingly more severe restrictions and supervisory actions as an institution’s capital level deteriorates.

⁵The document referred to as the Basel Accord is entitled “International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision” (Basel, Switzerland: July 1988).

⁶U.S. General Accounting Office, *Bank Supervision: Prompt and Forceful Regulatory Actions Needed*, GAO/GGD-91-69 (Washington, D.C.: Apr. 15, 1991).

⁷Pub. L. No. 102-242 §131(a), 12 U.S.C. §1831o, as amended.

CUMAA required NCUA to adopt a system of PCA comparable with that of FDICIA for use on federally insured credit unions, which NCUA initially implemented in 2000.⁸ CUMAA defined the net worth ratio for PCA purposes as net worth to total assets.⁹ Under CUMAA, net worth is defined as the retained earnings balance of the credit union at quarter end, as determined under generally accepted accounting principles (GAAP).¹⁰ NCUA regulations provide four alternative methods that credit unions can use to calculate total assets for use in the net worth ratio: (1) average of quarter-end balances of the current and three preceding calendar quarters, (2) average of month-end balances over the three calendar months of the calendar quarter, (3) average daily balance over the calendar quarter, or (4) quarter-end balance of the calendar quarter as reported on the credit union's call report.¹¹ NCUA regulations state that for each quarter, a credit union must elect a measure of total assets from these four alternatives to apply for all PCA purposes, except for the risk-based net worth requirement.¹²

⁸Pub. L. No. 105-219, Title III (1998), codified at 12 U.S.C. §1790d (2000 & 2003 Supp.). The NCUA's initial implementing regulations were published at 65 Fed. Reg. 8560 (Feb. 18, 2000).

⁹12 U.S.C. §1790d(o)(3).

¹⁰Retained 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. As discussed elsewhere in this report, CUMAA defines "net worth" for low income credit unions to include uninsured, subordinate capital accounts. 12 U.S.C. §1790d(o)(2)(B).

¹¹12 C.F.R. §702.2(k)(1) (2004). Call reports are submitted by credit unions to NCUA and contain data on a credit union's financial condition and other operating statistics.

¹²12 C.F.R. §702.2(k)(2).

CUMAA prescribes three principal components of the PCA system for credit unions: (1) a comprehensive framework of actions, including actions prescribed by statute and discretionary actions to be developed by NCUA, for credit unions that are less than well-capitalized; (2) an alternative system of PCA to be developed for credit unions that NCUA defines as “new”; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as “complex.”¹³ Table 1 summarizes the PCA capital requirements for regular and complex credit unions.

Table 1: Summary of PCA Capital Requirements for Credit Unions

PCA category	Net worth ratio for all credit unions (percent)	Risk-based ratio for “complex” credit unions
Well-capitalized	≥ 7	And, ≥ applicable risk-based net worth (RBNW) requirement
Adequately capitalized	6 to 6.99	And, ≥ applicable RBNW requirement
Undercapitalized	4 to 5.99	Or, < applicable RBNW requirement
Significantly undercapitalized	2 to 3.99, or less than 5 and fails to submit or implement a net worth restoration plan	Not applicable
Critically undercapitalized	< 2	Not applicable

Source: NCUA Rules and Regulations, 12 C.F.R. §702.102.

CUMAA imposes up to four mandatory supervisory actions—an earnings transfer, submission of an acceptable net worth restoration plan, a restriction on asset growth, and a restriction on member business lending—depending on a credit union’s capital classification, as determined by net worth ratios. Credit unions that are not well-capitalized are required to take an earnings transfer.¹⁴ Credit unions that are

¹³NCUA regulations define a “new” credit union as one that has been in operation for less than 10 years and has less than \$10 million in total assets. 12 C.F.R. §702.301 (2004). Because of the relatively small number of “new” credit unions, this report does not focus on them. NCUA defines a credit union as “complex” when its total assets at the end of a quarter exceed \$10 million and its risk-based net worth calculation exceeds 6 percent net worth. 12 C.F.R. §702.103 (2004).

¹⁴An earnings transfer means that a federally insured credit union must increase the dollar amount of its net worth quarterly either in the current quarter, or on average over the current and three preceding quarters, by an amount equivalent to at least 0.1 percent of its total assets, and must quarterly transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is “well-capitalized.” See 12 C.F.R. §702.201(a) (2004).

undercapitalized, significantly undercapitalized, or critically undercapitalized are subject to all four actions. In addition, CUMAA requires NCUA to appoint a conservator or liquidation agent within 90 days of a credit union becoming critically undercapitalized unless the NCUA Board of Directors determines that other action would better achieve PCA's purpose. Pursuant to CUMAA, NCUA also developed discretionary supervisory actions, such as the dismissal of officers or directors of an undercapitalized credit union, to complement the prescribed actions under the PCA program.

While CUMAA required NCUA to implement a system of capital-based tripwires, capital-based safeguards of insurance funds are inherently limited because capital does not typically show a decline until an institution has experienced substantial deterioration in other components of its operations and finances. Deterioration in an institution's internal controls, asset quality, and earnings can occur years before capital is adversely affected. Financial regulators recognize that, though essential, a capital requirement is only one of a larger set of prudential tools used to protect customers and ensure the stability of financial markets they regulate. For depository institutions, the key or critical tool that financial regulators use to ensure the adequacy of an institution's capital levels and its safety and soundness is the on-site examination process.

Concerns about PCA Appear to Drive Industry Interest in Secondary Capital

The credit union industry's recent interest in using alternative forms of capital appears to be associated primarily with three concerns about PCA for credit unions. First, several credit union officials argued that secondary capital or other alternatives were needed, given concerns that credit unions might trigger PCA restrictions because of rapid inflows of deposits due to investors' "flight to safety"; however, we have not found widespread evidence to support these concerns. To assist credit unions that fall marginally below "adequately capitalized" primarily because asset growth has outstripped income growth, NCUA proposed the use of an abbreviated net worth restoration (NWRP) plan. According to an NCUA official, the proposed rule was not pursued further because it was considered too complicated, would only benefit a very small number of credit unions, and did not appear to provide material relief. Second, other credit union officials contended that PCA acts as a restraint on credit union growth. Our analysis of credit union and bank data indicates that credit unions have been growing faster than banks in the 3 years credit union PCA has been in effect. Finally, several credit union officials are concerned that the PCA tripwires for credit unions are too high, given the conservative risk profile of most credit unions. It should be noted that, according to Treasury, Congress established the capital level 2 percentage points higher because 1 percent of a credit union's capital is deposited in NCUSIF and another 1 percent of the typical credit union's capital is invested in a corporate credit union.¹⁵

"Flight to Safety" Raised Concerns about PCA, Although Net Worth Ratios Generally Remained above Well-Capitalized Levels

As investors sought high-quality (that is, safe) investments due to weak performance by the stock and other investment markets in the early 2000s, credit unions experienced significant growth in member share deposits. Several credit union industry officials expressed concern that this inflow of new shares into credit unions might dilute net worth ratios, thus triggering net worth restoration plans and other supervisory actions under PCA.

To assist credit unions that fall marginally below "adequately capitalized" primarily because asset growth outstrips income growth, NCUA introduced the concept of an abbreviated NWRP in June 2002.¹⁶ While no specific

¹⁵Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions* (Washington, D.C., January 2001).

¹⁶See 67 Fed. Reg. 38431 (June 4 2002).

proposal was introduced, the NCUA board invited public comment on the concept of what was then referred to as “safe harbor” approval of a NWRP—that is, notice of certain criteria established by regulation that, when met, will ensure approval.

In November 2002, NCUA put forth a proposed rule and request for public comment on allowing the use of abbreviated NWRP—which NCUA referred to as a first-tier NWRP—by qualifying federally insured credit unions whose net worth ratio declined marginally below the adequately capitalized threshold (6 percent) because growth in assets outpaced growth in net worth.¹⁷ Under the proposal, a credit union would have been eligible to file an abbreviated NWRP if it satisfied three criteria: historical net worth, performance, and growth.¹⁸

There were three principal differences between the content requirement of a standard NWRP and the abbreviated NWRP proposed by NCUA. First, the proposed abbreviated NWRP would require only 4 quarters of pro forma projections of total assets, shares and deposits, and return on average assets, while the standard NWRP required complete pro forma financial statements covering a minimum of 2 years. Second, the abbreviated NWRP would not require a credit union to specify what steps it would take to meet its schedule of quarterly net worth targets, which is required for a standard NWRP. Finally, a standard NWRP requires those steps to extend beyond the term of the plan to ensure that the credit union remains at least adequately capitalized for 4 consecutive quarters thereafter. In contrast, the proposed abbreviated NWRP did not address the credit union’s net worth after the

¹⁷See 67 Fed. Reg. 71113 (Nov. 29, 2002).

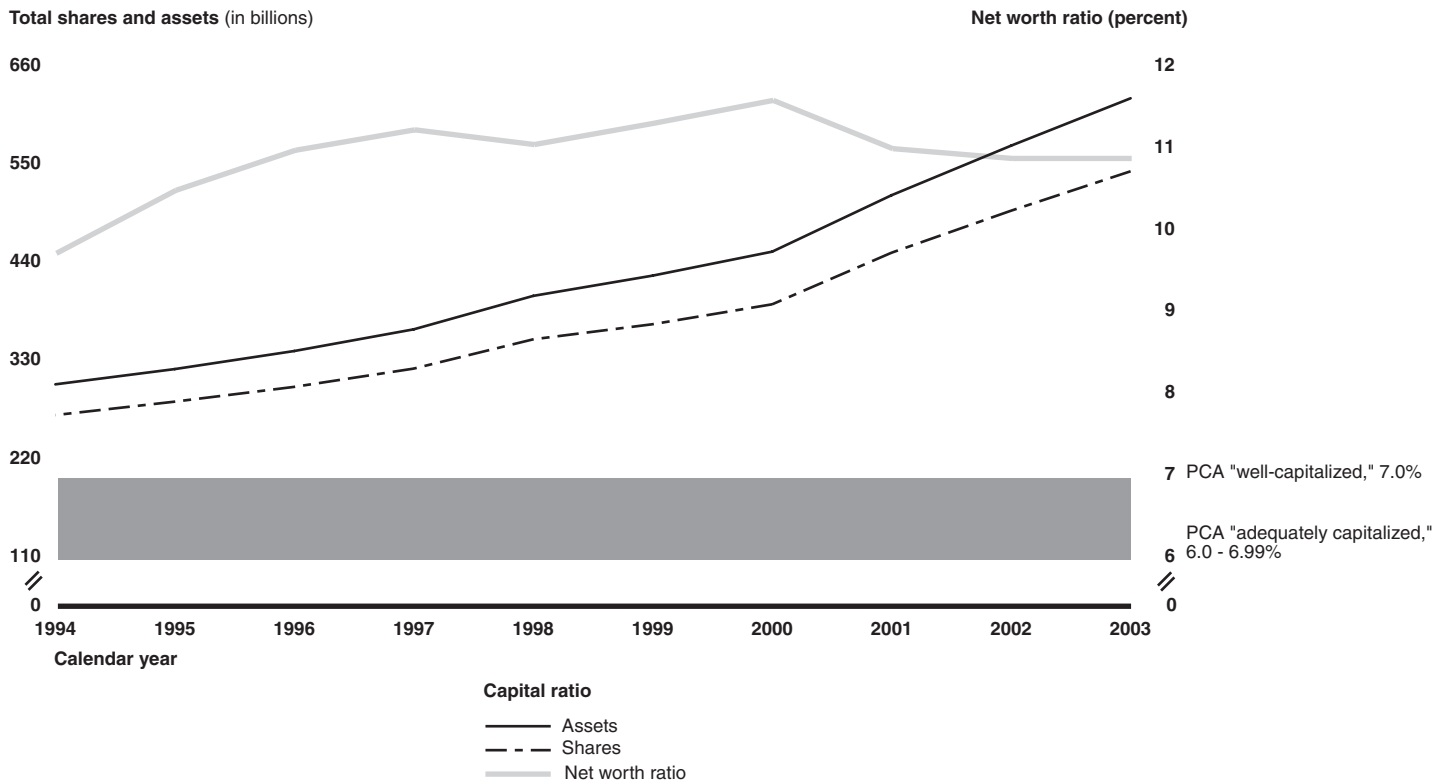
¹⁸The historical net worth criterion had two parts: (1) a credit union would need a minimum net worth ratio of 5.50 percent as measured using the quarter-end balance of total assets. If there was an applicable RBNW requirement, the credit union’s net worth ratio could not be more than 50 basis points (0.50 percent) below the RBNW requirement; and (2) for each of the 3 prior quarters, a credit union would need to have achieved a net worth ratio of at least 6 percent. In contrast to measuring current quarter net worth by quarter-end total assets in (1) above, for each of the three prior quarters a credit union could elect among any of the four methods of calculating the total assets denominator of the net worth ratio. If that credit union were subject to a RBNW requirement, it would also need to have met that requirement in each of the 3 prior quarters. For the performance criterion, NCUA proposed that for the current and each of the 3 preceding quarters, a credit union would need to have increased the dollar amount of its net worth by a 60 basis point (0.60 percent) annual return on average assets (ROAA). Finally, the proposed growth criterion required that for the period combining the current and 3 preceding quarters, the credit union’s ending total asset growth could not exceed 110 percent of the growth in net worth plus shares and deposits. See 67 Fed. Reg. 71113 (Nov. 29, 2002).

end of the term of the plan. NCUA's proposed rule also detailed the criteria for approval of the abbreviated NWRP and the circumstances in which a credit union that would otherwise be eligible to file an abbreviated NWRP would have been required to file a standard NWRP instead.

According to an NCUA official, the proposed rule was not pursued further because it was considered too complicated, would benefit only a very small number of credit unions, and did not appear it would provide material relief since some form of NWRP (albeit somewhat abbreviated) was still required by statute. NCUA officials stated that the credit union industry supported the proposal for an abbreviated NWRP but the credit union industry was advocating a proposal that would be automatically approved if it met a fixed set of objective criteria. However, NCUA officials explained that CUMAA requires a case-by-case determination by NCUA that a plan "is based on realistic assumptions and is likely to succeed in restoring the net worth of the credit union."

Although NCUA's proposal to assist certain credit unions that fall marginally below "adequately capitalized" was not pursued further, we found that despite a recent inflow of member share deposits, the credit union industry as a whole has been able to maintain net worth ratios well above the PCA threshold for well-capitalized credit unions. Moreover, current data suggest that the "flight to safety" may be over, as investors appear to be returning to the investment markets. Figure 1 illustrates that during the period that PCA has been in place for credit unions (2001–2003), the net worth ratios for federally insured credit unions dropped somewhat initially but stabilized at the close of 2003.

Figure 1: Federally Insured Credit Unions' Total Shares, Total Assets, and Capital Ratios, 1994–2003



Source: GAO analysis of NCUA data.

Note: We analyzed the NCUA Form 5300 database, found at <http://www.ncua.gov/data/FOIA/foia.html>.

Groups such as the National Association of State Credit Union Supervisors (NASCUS) and several credit union chief executive officers (CEO) told us that that the combination of PCA requirements and members' flight to safety from the markets could force both fast-growing credit unions and small to midsize credit unions to choose between (1) refusing deposits, (2) reducing services to members in order to retard the growth of assets, (3) converting to a savings and loan or community bank, or (4) merging with another credit union. While some of the larger credit union CEOs with whom we spoke stated that PCA is not causing capital constraints currently, they told us the potential exists for share growth to outstrip their ability to retain earnings, thus triggering net worth restoration plans and other supervisory actions under PCA. On the other hand, according to some CEOs of small and midsize credit unions, these constraints are

affecting them currently. While the constraints noted above may have occurred to some extent in a limited number of credit unions, we did not find evidence of widespread net worth problems for federally insured credit unions during the period PCA has been in place. Moreover, as of December 2003, less than 3 percent of federally insured credit unions have reported a net worth ratio below the well-capitalized threshold.

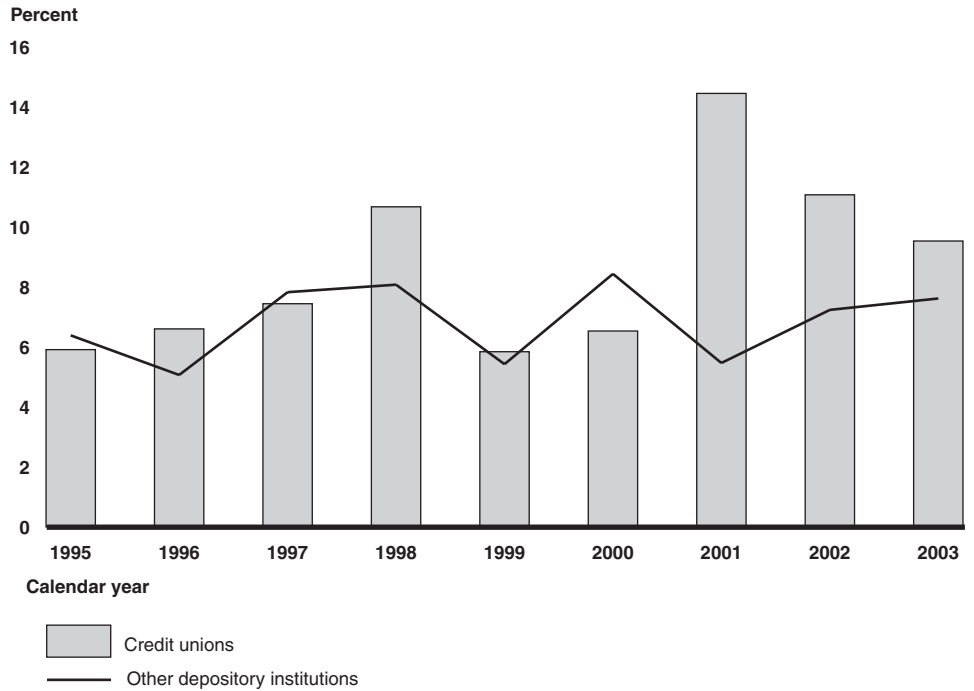
PCA Cited as a Restraint on Growth, Although Credit Unions Have Had Stronger Growth Rates Than Banks and Thrifts

Some credit union industry officials have indicated that the current credit union PCA system acts as a restraint on credit union growth, because any additional new member shares (deposits) would increase their assets and correspondingly reduce their net worth ratios. While most credit unions have been well-capitalized during the period that PCA has been in place, some industry officials have suggested that the capital constraints it imposes will become increasingly difficult to manage, forcing credit unions to turn away deposits so as not to dilute or decrease their net worth ratios. It should be noted that PCA was intended to curb aggressive growth, since uncontrolled growth was one of the common attributes of thrifts and banks that failed during the banking crisis of the late 1980s and early 1990s.

Credit union industry officials, including NCUA, have stated that some credit unions have had to reduce their services to members in an effort to satisfy PCA requirements. NCUA officials told us credit unions that have decreased services to their members have done so as part of net worth restoration plans. However, NCUA officials told us they would have no way of determining the number of credit unions considering decreasing services in an effort to prevent being subject to regulatory actions by NCUA. We have not found any evidence that federally insured credit unions are limiting their services to accommodate a rapidly growing deposit base. Moreover, active asset management is a major component of the operations of any financial institution. Credit union managers are expected to manage the growth of their institutions so that an influx of member deposits would not cause the credit union to become subject to PCA.

Despite the concerns about PCA acting as a constraint against asset growth, credit unions have grown at a higher rate than banks and thrifts during the period that PCA has been in place for credit unions (see fig. 2). This was particularly the case in 2001, the first full calendar year in which PCA was in place for credit unions. In that year, credit unions achieved an asset growth rate of more than 14 percent, compared with an approximate growth rate of 6 percent for other depository institutions. The disparity in growth rates narrowed in 2002 and 2003.

Figure 2: Asset Growth of Other Depository Institutions Compared with Credit Unions, 1994–2003



Source: GAO analysis of NCUA and FDIC data.

Industry Has Contended That PCA Triggers Are Too High

The credit union industry has consistently criticized PCA triggers (that is, capital thresholds) as being too high. Some credit union officials have noted that PCA encourages credit union managers to hold more capital than is necessary, which does not allow them to maximize shareholder value. In addition, they said that PCA tripwires for credit unions are higher than those of banks and thrifts despite the more conservative risk profile of credit unions.

Banks and thrifts are required to meet two capital requirements in order to be adequately capitalized: (1) a minimum tier 1 leverage ratio—that is a minimum ratio of total capital to total assets, which is generally 4 percent of tier 1 capital; and (2) a risk-based capital ratio of 8 percent capital to risk-weighted assets.¹⁹ Under CUMAA's net worth requirements, federally insured credit unions must maintain at least 6 percent net worth to total assets to be considered adequately capitalized. This exceeds the 4 percent tier 1 leverage ratio applicable for banks and thrifts (and is statutory, as opposed to regulatory). In its 2001 report, Treasury stated that Congress determined that a higher ratio was appropriate because credit unions cannot quickly issue capital stock to raise their net worth as soon as a financial need arises. Instead, credit unions must rely on retained earnings to build net worth, which necessarily takes time. Moreover, Treasury stated that Congress established the capital level 2 percentage points higher, a level recommended by Treasury in its 1997 report on credit unions, because 1 percent of a credit union's capital is deposited in NCUSIF and another 1 percent of the typical credit union's capital is invested in a corporate credit union.²⁰ Effective July 3, 2003, a federally insured credit union is allowed to invest up to 2 percent of its assets in any one corporate credit union and, in the aggregate, up to 4 percent of its assets in multiple corporate credit unions.²¹

¹⁹The total risk based capital ratio is the sum of tier 1 capital (core) and tier 2 capital (supplementary) divided by risk-weighted assets. Tier 1 includes common stockholder's equity, retained earnings, and noncumulative and limited amounts of cumulative perpetual preferred stock. Tier 2 includes, among other supplementary capital elements, the nontier 1 portion of cumulative perpetual preferred stock, limited-life preferred stock and subordinated debt, and loan loss reserves up to certain limits. See Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions* (Washington, D.C., January 2001). See also Department of the Treasury, *Credit Unions* (Washington, D.C., December 1997).

²⁰Id.

²¹See 68 Fed. Reg. 32958 (June 3, 2003); see also 12 C.F.R. §703.14(b) (2004).

Potential Use of Secondary Capital in the Credit Union Industry Poses Many Unanswered Questions

Though some in the credit union industry seek use of alternative forms of capital, little information exists that would allow us to assess the implications of using these instruments. We found that the credit union industry lacks consensus on the desirability of these instruments, with one of the key issues in the current debate over secondary capital centered on who would purchase these instruments and their resulting impact on the unique nature of credit unions—member-owned, not-for-profit cooperatives. Also, we could not identify a definitive proposal that specifically addressed other critical issues relating to the use of secondary capital instruments, such as pricing and market demand. While low income credit unions are allowed to use secondary capital instruments and corporate credit unions are allowed to use secondary capital instruments and count it toward their net worth requirements, their experiences are too narrow to offer insight into the value of such an instrument for all federally insured credit unions.²² However, one industry group has developed a list of principles, or minimum set of criteria, to consider for any proposal.

Industry and Other Experts Disagree on the Merits of Using Secondary Capital

The credit union industry is divided on the merits and potential effects of using alternative capital. Credit union industry officials have expressed concerns that credit unions may find their rate of share (deposit) growth exceeding their ability to accumulate retained earnings, triggering net worth restoration plans and other supervisory actions under PCA. According to one trade association, the Credit Union National Association (CUNA), building net worth through earnings retention is a time-consuming process, and being able to use alternative capital instruments would allow a credit union to quickly build its capital levels. Additionally, some credit union officials believe that the current credit union capital system encourages managers to overcapitalize their credit unions (that is, hold excessive capital), which is not always the best alternative for financial institutions. Some officials have stated that secondary capital would allow credit union managers the flexibility to be more proactive in managing their capital.

One credit union CEO, whose institution is one of the largest federally insured credit unions, stated that three of the five largest federally chartered credit unions were against allowing credit unions to acquire

²²In this report, we refer to corporate credit unions' additional forms of capital as secondary capital per the NCUA description.

secondary capital. He countered arguments for changing PCA by citing his credit union's experience with a dramatic influx in shares 2 years ago. He noted the influx did not trigger PCA because his institution's capital was aggressively managed. The CEO added that the dividends paid to the credit union's members, along with other services, were not limited or reduced as a result of this aggressive management. He explained that the excess capital (which was built over time through returns on investments at higher interest rates) in concert with diligent capital management kept the credit union from triggering PCA.

Industry Debate Centers around Key Issue of Outside Versus In-System Investors

Debate over secondary capital centers around who should be allowed to purchase these instruments. Some in the credit union industry argue that allowing outsiders to invest in the credit union industry would increase market discipline, but there are concerns that outside investment would be more costly and change the structure of the credit union industry. Opponents of secondary capital suggest that allowing voting, or even nonvoting, secondary capital from investors outside of the credit union industry would dilute the ownership structure of credit unions—not-for-profit, member-owned cooperatives. For example, one credit union CEO asserts that secondary capital would allow outside investors “a place at the table,” whether the subordinated debt instruments carry voting or nonvoting rights. He explained that the outside investors could demand returns on investments through changes in interest rates or another form of return, or a right of first refusal if the credit union should ever adopt a for-profit model. Other credit union managers, including those in favor of secondary capital, told us that if done carelessly, secondary capital for credit unions could be disastrous; however, they will continue to promote the use of secondary capital provided it does not change the credit union's ownership rights.

To alleviate these concerns, others suggest allowing investors from within the industry (in-system investors). This approach, however, raises concerns about investor protection and other systemic risks. Moreover, in-system investors could impose less discipline than out-of-system investors. According to one academic expert, the credit union industry is divided on the topic of alternative capital; the academic stated that at least 55 percent of credit unions want to avoid the capital markets, while the remainder would be more open to entering the capital markets and become increasingly banklike. He cautioned that alternative capital should not be used to sustain credit unions that were not already solvent. He explained that secondary capital from investors within the credit union system—that

is, credit union members and other credit unions—might introduce systemic risk, wherein the risks of the issuing credit union were inherently spread to the credit union holding the debt instrument. For example, if Credit Union A purchased subordinated debt from Credit Union B and Credit Union B failed and was forced to liquidate its assets, Credit Union A would then be financially affected, possibly resulting in two failed credit unions.

Additionally, some officials in the credit union industry suggested that with appropriate disclosure, individual credit union members could invest in secondary capital instruments offered by credit unions. However, even with these disclosures (recognizing that alternative capital instruments are uninsured, nonvoting, and subordinated to other shares), it is possible that credit union members may not fully understand and appreciate the subordinated nature of their investments.

Industry Has Not Produced Detailed Proposals; Other Literature on Secondary Capital Also Limited

We identified one proposal and one academic study that suggest how secondary capital could be utilized by all federally insured credit unions; however, these lacked sufficient detail and did not address critical issues. Specifically, the proposal and academic study did not address the specific form of the capital instruments, criteria governing its issuance (including how it would be incorporated into the regulatory net worth requirement for credit unions), market viability and demand (including in-system or out-of-system investors), and pricing analysis to effectively discuss its potential benefits and implications. As a result of the lack of detail, we were unable to fully assess the issues associated with the potential use of secondary capital by all credit unions.

The secondary capital proposal—“Capital Notes”—was developed by the CUNA Mutual Group, a company that offers health insurance and financial services to credit unions. CUNA Mutual Group believes the Capital Notes program, slated for two phases, could help credit unions meet their capital needs. CUNA Mutual Group is piloting this secondary capital mechanism to low income credit unions, which are already permitted under NCUA regulations to count secondary capital toward their PCA requirements. The Capital Notes program allows low income credit unions to issue unrated subordinated debt in a private placement with flexible terms and rates.²³ CUNA Mutual Group purchases the notes issued by the low income credit unions to hold in its investment portfolio.

According to CUNA Mutual Group, if the PCA definition of net worth is changed to include secondary capital, the subsequent planned phase of the Capital Notes program will allow all federally insured credit unions to issue unrated, unsecured notes that would be purchased by a trust. The trust would then go through a ratings process and issue its own notes that institutional investors such as corporate credit unions, CUNA Mutual Group, and other insurance companies could purchase. CUNA Mutual Group representatives stated that corporate credit unions would then purchase the highest-rated notes and CUNA Mutual Group, or other insurance companies, would most likely hold the lower-rated or first-loss notes. According to CUNA Mutual Group, the advantages of its Capital Notes program are that it

- allows fast-growing and low-capitalized credit unions to secure additional needed capital;
- provides additional protection to NCUSIF, the share insurance fund;
- allows credit unions access to capital sources already available to other depository institutions, such as banks;
- maintains members’ governance rights; and
- avoids potential abuses in sales of the notes by restricting purchasers to qualified (institutional) investors.

²³Unrated subordinated debt has not been evaluated by a rating agency for risk—that is, probability of full repayment. Private placement is a sale directly to an institutional investor.

Because the Capital Notes program began its pilot phase in December 2003, insufficient time has passed to allow for an assessment of the effectiveness of the program for low income credit unions. In addition, the motivation of secondary capital investors in low income credit unions is likely significantly different from that of investors in other federally insured credit unions. Consequently, the pricing analysis, market viability, and demand (in-system as well as out-of-system) of the first phase of Capital Notes may not be applicable to the proposed second phase of the program.

We identified an academic study regarding the potential use of alternative capital instruments by credit unions.²⁴ This study, issued by the Filene Research Institute and the Center for Credit Union Research, concluded that allowing credit unions to sell subordinated debt to parties outside of the credit union industry to meet their capital requirements could provide the following advantages:

- In terms of market discipline, the higher interest costs associated with debt of riskier credit unions would reduce the temptation of excessive risk taking by credit union managers and would send a forward-looking signal to regulators if credit unions' risk taking increased.
- In terms of transparency and disclosure, marketing of subordinated debt, directly or via a pool arrangement, would require increased transparency and disclosure about the condition of credit unions.
- In terms of maintaining a larger cushion for the share insurance fund, the holders of subordinated debt would be compensated only after NCUSIF was fully compensated out of sales of existing assets, thereby reducing the risk to the insurance fund.
- In terms of increasing the incentives for prompt action by supervisors, holders of subordinated debt would encourage regulators to act promptly if credit unions became excessively risky or troubled.

However, while presenting a framework for using secondary capital, the authors of the study did not provide a specific proposal. In addition, they did not address market demand for secondary capital, pricing or the ultimate cost of these instruments to credit unions or assess the impact of

²⁴See James A. Wilcox, "Subordinated Debt for Credit Unions" (prepared for the Filene Research Institute and The Center for Credit Union Research, 2002).

the external subordinated debt holders on the member-owned and member-operated structure of credit unions.

Few Credit Unions Have Experience with Secondary Capital Instruments

NCUA first authorized the issuance of secondary capital instruments by low income credit unions in 1996.²⁵ According to NCUA, it granted the authority in recognition of the special needs of these credit unions to raise capital from sources outside of their low income communities. Under NCUA regulations, credit unions with a low income designation can (1) receive nonnatural person, nonmember deposits that are not NCUSIF-insured; (2) offer uninsured secondary capital accounts and include these accounts on the credit union's balance sheet for accounting purposes; and (3) include these secondary capital accounts in the credit union's net worth for PCA purposes.²⁶ However, investment in low income credit unions does not offer a template for the industry because the motivations of secondary capital investors in low income credit unions may be different from investors in other federally insured credit unions. For example, banks may obtain credit under the Community Reinvestment Act (CRA) for their investment in low income credit unions.²⁷ In addition, many foundations and philanthropic organizations also are involved in providing secondary capital to low income credit unions in an effort to ensure that the credit

²⁵A credit union may be designated by NCUA as a low income credit union if it serves predominantly low-income members, a category that includes members who either earn less than 80 percent of the average for all wage earners as established by the Bureau of Labor Statistics, or have annual household income that falls at or below 80 percent of the median household income for the nation. The term "low income" also includes members who are full-time or part-time students in a college, university, high school, or vocational school. See 12 C.F.R. §701.34 (2004).

²⁶NCUA regulations also specify the conditions under which low income credit unions can receive secondary capital accounts. For example, the maturity of the secondary capital account must be for a minimum of five years and must not be redeemable prior to maturity. See 12 C.F.R. §701.34(b).

²⁷The CRA requires all federal bank and thrift regulators to encourage depository institutions under their jurisdiction to help meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operations. See 12 U.S.C. §§2901, 2903, and 2906 (2000). CRA requires that the appropriate federal supervisory authority assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income areas. Federal bank and thrift regulators perform what are commonly known as CRA examinations to evaluate services to low- and moderate-income neighborhoods. Assessment areas, also called delineated areas, represent the communities for which the regulators are to evaluate an institution's CRA performance.

unions are able to provide needed financial services to areas traditionally underserved by mainstream financial institutions.

Moreover, as of December 31, 2003, less than 6 percent of all low income credit unions had secondary capital accounts. Additionally, low income credit unions that had secondary capital accounts represented less than 1 percent of all federally insured credit unions. Thus, in addition to the different incentives for investment, the limited experience of low income credit unions with secondary capital instruments also provides little insight into the potential market demand and pricing of secondary capital instruments for all federally insured credit unions.

Corporate credit unions—whose members are credit unions, not individuals—also can issue forms of secondary capital.²⁸ According to NCUA, corporate credit unions have been allowed to use secondary capital instruments to meet their regulatory capital requirements since 1992 in recognition that the ability of corporate credit unions to build capital is limited by the combined effects of (1) conservative investment standards imposed by NCUA and (2) the competitive markets in which corporate credit unions vie for credit unions' investment funds. Capital for corporate credit unions is defined as the sum of a corporate credit union's retained earnings, paid-in capital (both member and nonmember), and membership capital. NCUA refers to this paid-in capital and membership capital as corporate credit union secondary capital; among other things, these two types of capital are not insured by NCUSIF and are generally longer-term investments.²⁹ As of December 31, 2003, 18 out of all 31 corporate credit unions had member paid-in capital accounts, 30 out of 31 had membership capital accounts, and none had nonmember paid-in capital accounts. However, taking into account that (1) corporate credit unions and natural person credit unions are not comparable given their member base, and (2)

²⁸Corporate credit unions provide credit unions with services, investment opportunities, loans, and other forms of credit should the credit unions face liquidity problems. See 12 C.F.R. Part 704 (2004).

²⁹12 C.F.R. §704.2. Under this regulation, membership capital means funds contributed by members that (1) have an adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years, (2) are available to cover losses that exceed retained earnings and paid-in capital, (3) are not insured by NCUSIF or other share or deposit insurers, and (4) cannot be pledged against borrowings. Paid-in capital encompasses accounts or other interests of a corporate credit union that (1) are perpetual, noncumulative dividend accounts, (2) are available to cover losses that exceed retained earnings, (3) are not insured by NCUSIF or other share or deposit insurers, and (4) cannot be pledged against borrowings.

there are far fewer corporate credit unions compared with the total number of federally insured credit unions, those 18 corporate credit unions with member paid-in capital and 30 with membership capital do not provide a representative or sufficient sample that can be used as a model to demonstrate how secondary capital could be used for all federally insured credit unions. Thus, the limited experience of corporate credit unions with member paid-in capital, coupled with the lack of experience with nonmember capital sources, provides little insight into the potential demand and pricing of secondary capital instruments for all federally insured credit unions.

Although the Credit Union Industry Lacks Consensus on Proposals, One Industry Group Has Developed a Set of Principles

The credit union industry as a whole has neither endorsed secondary capital nor put forth a specific secondary capital proposal; however, several officials with whom we spoke referred to the principles of the National Association of Federal Credit Unions (NAFCU) board for the development of a secondary capital instrument as a set of criteria to consider. Listed in table 2 are the NAFCU board's principles recommended for any secondary capital instrument designed for use by all federally insured credit unions.

Table 2: NAFCU Board's Seven Principles for a Viable Alternative Capital Model

-
1. Preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions and ensure that ownership interest (including influence) remains with the members.

 2. Ensure that the capital structure of credit unions is not fundamentally changed and that the safety and soundness of the credit union community as a whole is preserved.

 3. Provide a degree of permanence such that a sudden outflow of capital will not occur.

 4. Allow for a feasible means to augment capital.

 5. Provide a solution with market viability.

 6. Ensure that any proposed solution applies for PCA purposes (to include risk-based capital as appropriate) or changes the definition of net worth to include other equity capital balances.

 7. Ensure that any proposed solution qualifies as equity capital balances under GAAP; and qualifies as an amendment redefining net worth.
-

Source: NAFCU.

While we believe that this list incorporates key factors that should be considered for an alternative capital proposal, it should be noted that this is not an exhaustive list of all the possible concerns that may develop as a result of allowing all federally insured credit unions the use of alternative capital instruments. NAFCU officials told us that they have not been able to

produce an alternative capital proposal that satisfies these seven principles because of some of the inherent tensions among the principles. For example, were alternative capital issued only within the credit union system, the number of investors would be more limited than if it were issued to the general public, suggesting that a viable alternative capital instrument should be issued in the markets—that is, outside of the credit union system. However, issuing alternative capital instruments outside of the credit union system may create another “class” of owners, thereby changing the nature of credit unions.

While Many View Risk-Based Capital as an Enhancement to PCA for Credit Unions, Key Structural Issues Remain Unresolved

The debate about the potential use of risk-based capital for all credit unions revolves around key structural issues, including (1) the extent to which risk-based ratios would be used to augment, versus replace, the current PCA net worth (leverage) requirements and (2) how key risk components and weights that are appropriate to the unique characteristics of credit unions would be defined. While all banks and thrifts are required to meet both a risk-based capital ratio and a leverage ratio to be classified as adequately capitalized, most credit unions are required to meet only one—a leverage ratio—to be classified as adequately capitalized. Bank and thrift regulators recognized the limitations of a solely risk-based capital requirement and continued the leverage requirements to address other factors that can affect a bank’s financial condition, which a risk-based ratio does not address. NCUA has adopted a risk-based component of PCA; however, it affects only a small percentage of credit unions—those that meet NCUA’s definition of “complex.” Though a credit union trade association has put forward two risk-based capital proposals, neither has garnered industry consensus. Moreover, each proposal lacked details of key components upon which to base any assessment of their merits. NCUA officials told us they are developing, but have not yet finalized, a risk-based capital proposal to augment current PCA for all credit unions that they believe acknowledges the unique nature of credit unions and incorporates the relevant and material risks credit unions face.

Leverage Ratio Requirements Used to Augment Risk-Based Capital for All Banks and Thrifts

FDICIA requires all banks and thrifts to meet both a risk-based and a leverage requirement.³⁰ Leverage ratios have been part of bank regulatory requirements since the 1980s. They were continued after the introduction of risk-based capital requirements as a cushion against risks not explicitly covered in the risk-based capital requirements. According to regulatory guidelines on capital adequacy, the final supervisory judgment of a bank's capital adequacy may differ from the conclusions that might be drawn solely from the risk-based capital ratio. Banking regulators recognized that the risk-based capital ratio does not incorporate other factors that can affect a bank's financial condition, such as interest-rate exposure, liquidity risks, the quality of loans and investments, and management's overall ability to monitor and control financial and operating risks.³¹ FDICIA also requires bank regulators to monitor other risks, such as interest-rate and concentration risks.³²

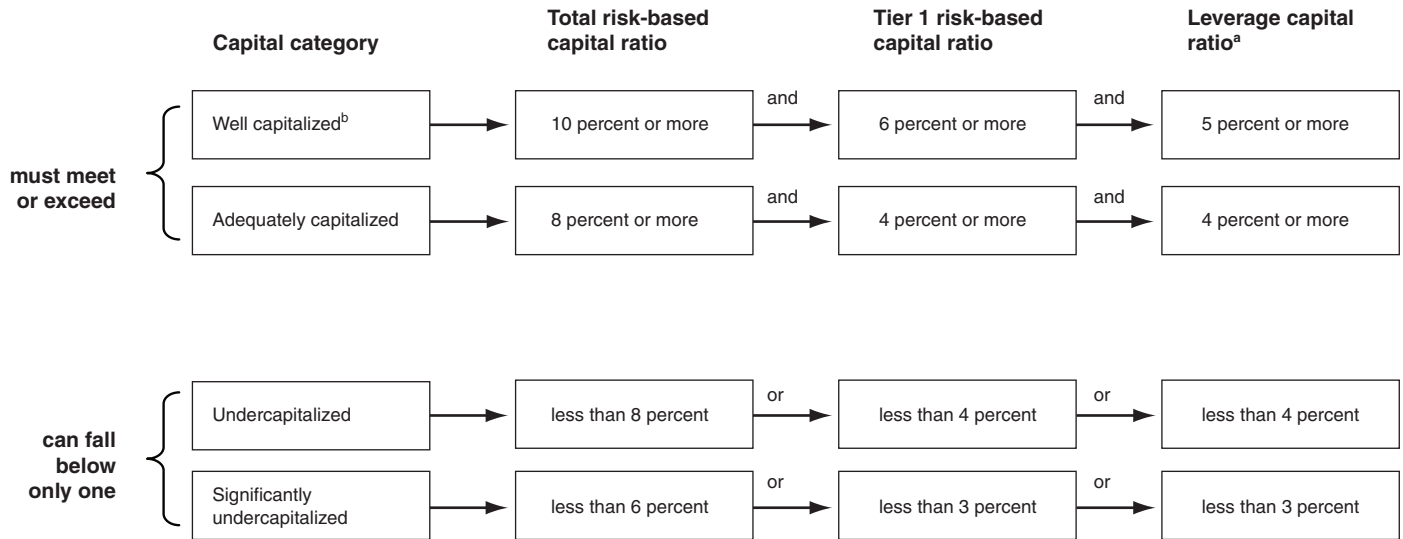
FDICIA requires the federal bank and thrift regulators to establish criteria for classifying depository institutions into five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Figure 3 illustrates four capital categories and ratio requirements of FDICIA's PCA provisions.

³⁰12 U.S.C. §1831o(c)(1). The minimum leverage ratio is a requirement that tier 1 capital be equal to a certain percentage of total assets, regardless of the type and riskiness of the assets.

³¹Liquidity risk is the potential for financial losses due to the inability of an institution to meet its obligations on time because of an inability to liquidate assets or obtain adequate funding, such as might occur if most depositors or other creditors were to withdraw their funds from an institution. Operational risk is the potential for unexpected financial losses due to inadequate information systems, operational problems, breaches in internal controls, or fraud.

³²Interest-rate risk is the risk of potential loss arising from changes in interest rates. It exists in traditional banking activities, such as deposit taking and loan provision, as well as in securities and derivatives activities. Concentration risk exists if a bank is heavily exposed to certain sectors or countries. It deals with the risks of not diversifying assets so that a problem in any one sector or country might financially affect the bank.

Figure 3: Summary of FDICIA Capital Categories and Ratio Requirements



Source: Interagency regulations issued on September 29, 1992 (Fed. Reg. 44866).

^aThe leverage ratio can be as low as 3 percent if the institution has a regulator-assigned composite rating of 1. Regulators are to assign a composite rating of 1 only to institutions considered to be sound in almost every respect of operations, condition, and performance.

^bAn institution cannot be considered to be well-capitalized if it is subject to a formal regulatory enforcement action that requires the institution to meet and maintain a specific capital level.

Although not shown in figure 3, a fourth ratio—tangible equity—is used to categorize an institution as critically undercapitalized.³³ Any institution that has a 2 percent or less tangible equity ratio is considered critically undercapitalized, regardless of its other capital ratios. The amount of capital held by a bank is to be greater than or equal to the leverage ratio. However, if the risk-based capital calculation yields a higher capital requirement, the higher amount is the minimum level required.³⁴

³³12 U.S.C. §1831o(c)3. The tangible equity ratio is the sum of common stock, surplus, and retained earnings, net of Treasury stock and currency translation adjustments, with intangible assets subtracted from both the numerator and denominator.

³⁴For additional information on bank capital components and bank risk-based capital regulations, see U.S. General Accounting Office, *Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk*, GAO/GGD-98-153 (Washington, D.C.: July 20, 1998).

Although U.S. bank risk-based capital guidelines address several types of risk, only credit and market risk are explicitly quantified.³⁵ The quantified risk-based capital standard is defined in terms of a ratio of qualifying capital divided by risk-weighted assets. All banks are required to calculate their credit risk for assets, such as loans and securities; and off-balance sheet items, such as derivatives or letters of credit.³⁶ There are two qualifying capital components in the risk-based credit risk computation—core capital (tier 1) and supplementary capital (tier 2). In addition to credit risk, banks with significant market risk exposures are required to calculate a risk-based capital ratio that takes into account market risk in positions such as securities and derivatives in an institution’s trading account and all foreign exchange and commodity positions, wherever they are located in the bank.³⁷ The market-risk capital ratio augments the definitions of qualifying capital in the credit risk requirement by adding an additional capital component (tier 3). Tier 3 capital is unsecured, subordinated debt that is fully paid up, has an original maturity of at least 2 years, and is redeemable before maturity only with approval by the regulator. To be included in the definition of tier 3 capital, the subordinated debt must include a lock-in clause precluding payment of either interest or principal (even at maturity) if the payment would cause the issuing bank’s risk-based capital ratio to fall or remain below the minimum requirement.

³⁵See e.g. Federal Reserve Board Regulation H, 12 C.F.R. Part 208, App. A, E; Office of the Comptroller of the Currency regulations, 12 C.F.R. Part 3, App. A, B; Federal Deposit Insurance Corporation (FDIC) regulations, 12 C.F.R. Part 325, App. A, C. Credit risk is the potential for financial loss resulting from the failure of a borrower or counterparty to perform on an obligation. Market risk is the potential for financial losses due to the increase or decrease in the value or price of an asset resulting from broad movements in prices, such as interest rates, commodity prices, stock prices, or the relative value of currencies (foreign exchange).

³⁶Derivatives are financial products that enable risk to be shifted from one entity to another. An off-balance sheet item is a financial contract that can create credit losses for the bank but that is not reported on the balance sheet under standard accounting practices. An example of such an off-balance sheet position is a letter of credit or an unused line of credit that commits the bank to making a loan in the future that would be on the balance sheet and thus create a credit risk.

³⁷To be considered a significant exposure, this gross market risk exposure must exceed 10 percent of total assets or exceed \$1 billion.

Current Risk-Based Component of PCA for Credit Unions Applies to Few Credit Unions

NCUA's PCA risk-based capital rule currently applies to relatively few credit unions—approximately 8 percent of all federally insured credit unions that were designated as “complex” as of December 31, 2003.³⁸ It should be noted that none of the five largest credit unions, and only one of the top 10 credit unions in terms of assets, met NCUA's definition of complex. CUMAA mandated a risk-based net worth requirement for “complex” credit unions, for which NCUA was required to formulate a definition according to the risk level of the credit union's portfolios of assets and liabilities.³⁹ These credit unions are subject to an additional risk-based net worth requirement to compensate for material risks, against which a 6 percent net worth ratio may not provide adequate protection. Specifically, the risk-based net worth calculation measures the risk level of on- and off-balance sheet items in the credit union's “risk portfolios.”⁴⁰

³⁸NCUA Form 5300. Available from www.ncua.gov.

³⁹NCUA defines a credit union as “complex” when its total assets at the end of a quarter exceed \$10 million and its risk-based net worth calculation exceeds 6 percent net worth. 12 C.F.R. § 702.103.

⁴⁰NCUA's November 2000 report notes that the “risk portfolios” of balance sheet assets consist of long-term real estate loans, member business loans outstanding, investments, low-risk assets, and average-risk assets. The “risk portfolios” of off-balance sheet assets are loans sold with recourse and unused member business loan commitments.

NCUA uses two methods to determine whether a complex credit union meets its risk-based net worth requirement: (1) a “standard calculation,” which uses specific standard component amounts; and (2) a calculation using alternative component amounts.⁴¹ A credit union’s risk-based net worth requirement is the sum of eight standard components, which include such items as unused member business loan commitments and allowance for loan and lease losses. Appendix II provides an example of the standard calculation of the risk-based net worth requirement, including the definitions of the risk portfolios and weighted average life for investments. Although not shown in appendix II, the alternative method of calculating the risk-based requirement involves weighting four of the risk portfolio components—long-term real estate loans, member business loans, investments, and loans sold with recourse—according to their remaining maturity, weighted average life, and weighted average recourse, respectively.⁴² In addition, the risk-based net worth requirement allows credit unions that succeed in demonstrating mitigation of interest-rate or credit risk to apply to NCUA for a risk mitigation credit. The credit, if approved, would reduce the risk-based net worth requirement a credit union must satisfy to remain classified as adequately capitalized or above. According to NCUA, between March 2002 and December 2003 there have been 38 credit unions that failed the standard risk-based net worth requirement, with two credit unions failing both the standard and alternative calculation requirements.⁴³ In addition, toward the end of 2003 two credit unions submitted applications for a risk mitigation credit.

⁴¹A credit union may substitute one or more alternative components, in place of the corresponding standard components in 12 C.F.R. §702.106, when any alternative component amount, expressed as a percentage of the credit union’s quarter-end total assets as reflected in its most recent call report, rounded to two decimal places, is smaller.

⁴²12 C.F.R. §702.107 (2004).

⁴³The majority of these failures have occurred during the latter part of 2003.

Existing Industry Proposals Lack Specificity and Consensus

The credit union officials with whom we spoke disagreed whether the current PCA system should be replaced or augmented by a risk-based PCA system. One credit union official—a recognized proponent of secondary capital—told us that risk-based capital should be used to augment, but not replace, the current leverage-based net worth capital requirements. Conversely, two industry groups told us that they see risk-based capital requirements serving as a complement to secondary capital, if it were allowed to be included as a component of net worth. Many credit union officials told us that current PCA is “one size fits all” but would not comment further on risk-based capital. In addition, NASCUS told us that it has recently endorsed the risk-based language in a House of Representatives bill, although it continues to support secondary capital for all credit unions.⁴⁴ However, it should be noted that for most credit unions, risk-based assets are less than total assets; therefore, a given amount of capital would have a higher net worth ratio if risk-based assets were used. And capital requirements would likely be reduced if risk-based capital were an alternative, rather than a complement, to leverage ratios.

CUNA put forward two risk-based capital proposals that they believe (1) would preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized and (2) would not encourage well-capitalized credit unions to establish such large buffers over minimum net worth requirements that they would become overcapitalized. However, both proposals lacked details of key components that would be needed in order to assess their merits. The first CUNA proposal does not provide a clear definition of risk assets. The second CUNA proposal does not provide specific risk weights and asset classifications appropriate for credit unions.

⁴⁴H.R. 3579—Credit Union Regulatory Improvements Act of 2003.

The first proposal would replace the current two-phased PCA system with a single system using risk-based and net worth ratio requirements for all credit unions.⁴⁵ This system would incorporate NCUA's pre-CUMAA definition of risk assets—all loans not guaranteed by the federal government, and all investments with maturities over 5 years—into the PCA system by modifying the current definition of net worth ratio.⁴⁶ Specifically, the first proposal would lower the current net worth ratios for each PCA category to parallel the leverage ratio requirement for banks and thrifts and add a risk-based net worth ratio requirement using the existing PCA threshold levels for credit unions. For example, an adequately capitalized credit union would be defined as having a risk-based net worth ratio of 6 percent or greater and a net worth ratio of 4 percent or greater. Under this proposal, if a credit union's net worth ratio falls into different categories by risk and total assets, the lower classification would apply. The proposal stated that risk assets could be defined as nonguaranteed loans and long-term investments, or NCUA could be instructed to define risk assets in a manner consistent with its pre-CUMAA requirements.

The second proposal would incorporate components of both the Basel capital framework currently in use by banks and thrifts in the United States and the risk-based portion of the current credit union PCA applicable to complex credit unions. Specifically, this proposal states that net worth requirements could be based on risk weights for assets as in place for banks, but with the weights established on the basis of both credit and interest-rate risk. Under this proposal, the risk weights could be set by NCUA based on the Basel system.⁴⁷ According to the second proposal, it is likely that NCUA could choose to adopt some credit-risk weights that are different from those currently in use by bank and thrift regulators under the Basel system because some of the weights would be assigned on the basis of interest-rate risk. The proposed risk-based ratio requirements for each PCA category would parallel the current total risk-based requirement for banks and thrifts. In addition, this proposal states that a credit union could also be required to maintain a net worth ratio equivalent to the leverage

⁴⁵Two-phased refers to the current PCA system of required net worth ratio for most credit unions and an additional risk-based computation required for complex credit unions.

⁴⁶Prior to CUMAA, although credit unions were not subject to an explicit net worth requirement, they were required to make transfers to a regular reserve account based on the current ratio of their regular reserves to risk assets.

⁴⁷The risk weights for the four categories in the Basel Accord assume all assets within each category have the same level of credit risk.

ratio required for banks and thrifts. Similar to the first proposal, if a credit union's net worth ratio falls into different categories by risk and total assets, the lower classification would apply. For example, in order to be adequately capitalized under the second proposal, a credit union would have to have a risk-based ratio of 8 percent or greater and a net worth ratio of 4 percent or greater.

NCUA Suggests Using Risk-Based Capital Requirements for All Credit Unions

According to NCUA officials, NCUA envisions a risk-based PCA system similar in structure to that currently employed in the banking system. However, they stated that NCUA would tailor the risk weights and the categories into which assets fall, to take into consideration the unique nature of credit unions and the loss histories of their asset portfolios. In addition, the NCUA officials told us that a risk-based credit union PCA system should be designed to address all relevant and material risks (for example, interest-rate risk). According to these NCUA officials, the credit union PCA system should be robust enough so as not to be "one-size-fits-all," but simple enough to facilitate administration of the system and be well understood by credit unions. NCUA officials told us that they are in the process of developing a risk-based PCA proposal that would be used for all credit unions, not just complex credit unions. See appendix III for items being used in the development of NCUA's risk-based PCA proposal.

NCUA officials emphasized that the CUMAA mandate to take prompt corrective action to resolve problems at the least long-term cost to NCUSIF is good public policy and consistent with NCUA's fiduciary responsibility to the share insurance fund. However, they stated that they believe additional flexibility is needed to enable NCUA to work with problem institutions. They explained that the additional flexibility could be structured to constrain any tendency toward regulatory forbearance and preserve the objective of PCA. NCUA officials told us that they believe a revised system would alleviate most concerns that credit unions have with PCA. They believe changing the system would provide credit union management with the ability to manage compliance by making adjustments to their asset portfolios, maintain ample protection for the system and individual credit unions, and preserve NCUA's ability to address net worth problems. NCUA officials told us that such a system would likely obviate the need or desire for secondary capital for the vast majority of credit unions.

Observations

Despite concerns raised by some in the credit union industry, available information indicates no compelling need for using secondary capital instruments to bolster the net worth of credit unions, or to make other significant changes to PCA as it has been implemented for credit unions. Available indicators suggest that the credit union industry as a whole has not been overly constrained as a result of the implementation of PCA. Notably, credit unions were able to maintain capital levels well in excess of the PCA requirements during a period of rapid share or deposit growth. One of the inherent weaknesses in PCA is its focus on capital, which typically is a lagging indicator of a financial institution's health. As such, it will be important for NCUA to distinguish between capital deterioration that occurs because of fundamental weaknesses in the institution's structure or management versus temporary capital shortfalls due to constraints beyond a credit union's control. While we do not find the arguments for using secondary capital instruments to be compelling, to the extent that well-managed and -operated credit unions do experience temporary capital constraints, NCUA may want to revisit the concept of an abbreviated net worth restoration plan for marginally undercapitalized credit unions. Consideration of changes such as this seem to be more consistent with the notion that the problems some credit unions may be facing are temporary and, therefore, best tackled with temporary, not more permanent, solutions, such as secondary capital instruments.

Allowing credit unions to use secondary capital instruments to meet their regulatory net worth requirements would raise a number of issues and concerns. One of the key issues is who would be allowed to invest in the secondary capital instruments of credit unions. While allowing credit unions to sell secondary capital instruments to investors outside of the credit union industry would provide market discipline, this would raise concerns about the potential impact on the member-owned, cooperative nature of credit unions. Some have proposed limiting potential investors to credit union members, other credit unions, and corporate credit unions; however, in-system investors could impose less discipline and raise systemic risk concerns if it were to create a situation where weaker credit unions brought down stronger credit unions due to secondary capital investments. Other issues relate to the specific form of the capital instruments, and how they would be incorporated into the regulatory net worth requirement for credit unions. The credit union industry itself appeared divided on the desirability or appropriate structure of secondary capital instruments.

Conceptually, the potential use of a risk-based capital system for all credit unions appears less controversial. Risk-based capital is intended to require institutions with riskier profiles to hold more capital than institutions with less risky profiles. However, not all of the risks that credit unions face, such as liquidity and operational risk, can be quantified. In recognition of the limitations of risk-based capital systems, the bank and thrift regulators use both risk-based and nonrisk weighted (leverage ratio) capital requirements for PCA purposes. The requirements are used in tandem to better ensure safety and soundness in banks and thrifts. Among the numerous issues that would need to be addressed in a risk-based capital proposal, given the unique nature of credit unions, would be the appropriate risk weights and categories into which assets fall and the appropriate risk-based and nonrisk-based capital ratios for each PCA category. We are aware that NCUA is constructing a more detailed risk-based capital proposal that includes both risk-based and leverage requirements for all credit unions and believe that any proposal should be based on the premise that risk-based capital be used to augment, but not replace, the current net worth requirement for credit unions.

We remain a strong supporter of PCA as a regulatory tool. The system of PCA implemented for credit unions is comparable with the PCA system that bank and thrift regulators have used for over a decade. The concerns raised by the credit union industry appear to reflect the inherent tension between credit union managers' desire to maintain the optimal amount of capital to efficiently fuel growth and returns to credit union members and Congress's desire to protect the federal share insurance funds from losses that could have been prevented by early and forceful supervisory action. As we stated in our October 2003 report, credit unions have been subject to PCA for a short time, and the advantages and disadvantages of the current program are not yet evident. Additional time and greater experience with the use of PCA in the credit union industry would provide greater insight into the need for any significant changes to PCA as well as the best options for any changes.

Agency Comments and Our Evaluation

We provided a draft of this report to the Chairman of the National Credit Union Administration and the Secretary of the Treasury for review and comment. We received written comments from NCUA that are reprinted in appendix IV. In addition, we received technical comments from NCUA and Treasury that we incorporated into this report, as appropriate.

NCUA concurred with this report's assessment that there is no compelling need for secondary capital. For example, NCUA concurred that there are key unresolved issues, such as whether secondary capital instruments would be commercially viable, to whom these instruments could and should be sold (e.g. inside versus outside investors), the effects on the member-owned, cooperative structure of credit unions, and any safety and soundness and systemic risk implications posed by this activity. NCUA also concurred that there is a lack of consensus within the credit union system on the need for and appropriate structure of secondary capital instruments. Finally, NCUA stated that the vast majority of insured credit unions maintain extremely strong capital positions, notwithstanding a recent prolonged period of rapid share growth.

NCUA stated that it concurred with views expressed by many within the credit union industry that the current PCA tripwires were too high. NCUA disagreed with Treasury's rationale for the higher limit—1 percent for the deposit in NCUSIF and another 1 percent for the typical credit union's capital invested in corporate credit unions—than that imposed on banks and thrifts. NCUA stated that under GAAP, which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on the financial statements of a credit union. Further, NCUA stated that the NCUSIF deposit is not related to a credit union's net worth from either an accounting or financial risk standpoint. In addition, NCUA noted that not all credit unions belong to corporate credit unions or hold this form of investment; therefore, using a "one size fits all" approach to trigger PCA supervisory actions based on this assumption is inherently unfair. Finally, NCUA stated that PCA tripwires are too high, penalizes institutions with conservative risk profiles, and allows higher risk earnings strategies without commensurate net worth levels. While we did not perform an evaluation of PCA, which would include a discussion of the thresholds, we note that the NCUSIF deposit is not liquid and, therefore, not immediately accessible for credit unions to use as a capital buffer. Though we agree that not all credit unions are engaged in corporate credit union investments, we believe that these investments are still relevant as a PCA consideration and any risk-based capital standards should appropriately recognize these investments.

NCUA stated that based on their experience gained to date with the PCA system for federally insured credit unions, adjustments are needed to better achieve PCA's overall objectives. Specifically, NCUA stated that the adjustments should move PCA to a more fully risk-based system, with a lower leverage ratio required of a credit union to meet the well-capitalized

levels. NCUA believes that a well-capitalized leverage requirement in the range of 5 percent would be more than sufficient to meet the safety and soundness goals of PCA. However, NCUA did not provide evidence that the current 7 percent net worth requirement has been a hardship to the credit union industry. As noted in this report, credit unions cannot quickly raise their capital through the issuance of capital stock when a financial need arises, they must rely on retained earnings to build sufficient capital—which necessarily takes time. Further, we believe that the generally favorable economic climate for credit unions coupled with the relatively short amount of time that PCA has been in place for credit unions do not provide a sufficient testing of the current system of PCA for credit unions to determine if changes are warranted.

NCUA stated that it recognized that, as our draft report indicated, the efficacy of a risk-based system is highly dependent on the details of the risk categories and weights, as well as the complementary relationship between the risk-based and leverage requirements. However, NCUA stated that the draft report suggested that a risk-based system would result in risk assets being lower than total assets for most credit unions, resulting in a given amount of capital producing a higher net worth ratio. NCUA stated that such a result was not a foregone conclusion. NCUA indicated that a proposal under consideration included risk categories with weights at and above 100 percent. The statement in the draft report was based on our discussion with representatives of the credit union industry. As we noted in our draft report, no detailed proposals regarding a risk-based system for all credit unions was available for our analysis, including that being developed by NCUA. In the absence of details, we cannot comment on the ultimate effect of a proposal that is in the process of being developed on the required capital levels for credit unions. However, we believe that, used in tandem with leverage capital requirements, any risk-based capital standards should appropriately recognize the risks credit unions face.


In response to the statement in our draft report that PCA was intended to act as a restraint on growth, NCUA stated that it was important to differentiate overly aggressive growth from robust growth, consistent with sound business strategy, experienced by healthy credit unions. While we agree that there are different types of growth, institutions still need to hold sufficient capital regardless of the type of growth experienced. As noted in this report, PCA was intended to curb aggressive growth, since uncontrolled growth was one of the common attributes of banks and thrifts that failed during the banking crisis of the late 1980s and early 1990s. Moreover, our analysis of aggregated credit union data indicated that credit

unions have been able to maintain a rate of growth that has exceeded that of banks and thrifts in the three full calendar years that PCA has been in place for credit unions.

NCUA noted that our draft report suggested that NCUA revisit the concept of an abbreviated NWRP for marginally undercapitalized credit unions for situations involving temporary capital shortfalls. It noted that the statutory language of CUMAA precluded NCUA from providing any significant regulatory relief in this regard. NCUA stated that it supported a statutory change to provide NCUA the regulatory authority to waive the requirement to submit a NWRP for credit unions that have a temporary, marginal drop in their net worth ratio below adequately capitalized, as determined on a case-by-case basis. While NCUA put forth a proposed rule on an abbreviated NWRP, NCUA did not pursue it further. We believe it is important that NCUA explore and use all of the available options and discretion provided by CUMAA. While an abbreviated NWRP may not be viewed by NCUA or the industry as granting significant regulatory relief, the experiences gained with an abbreviated NWRP would provide NCUA and Congress with additional information regarding the need for additional regulatory authorities. Moreover, it is important to note that none of the federal bank or thrift regulators have similar authority to that being sought by NCUA.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from its issuance date. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs. We also will send copies to the National Credit Union Administration and the Department of the Treasury and make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

This report was prepared under the direction of Harry Medina, Assistant Director. If you or your staffs have any further questions, please contact me at (202) 512-8678 or hillmanr@gao.gov, or Harry Medina, Assistant Director, at (415) 904-2220 or medinah@gao.gov. Key contributors are acknowledged in appendix V.

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman
Director, Financial Markets
and Community Investment

Objectives, Scope, and Methodology

To identify and describe concerns regarding the current capital requirements for credit unions, we interviewed credit union industry groups, several credit union chief executive officers, credit union regulators, and two banking regulators. Additionally, through these interviews we gathered information on the issues and concerns associated with the potential use of secondary capital and risk-based capital by credit unions, including any documented proposals. We also conducted a literature search to identify studies on the potential use of secondary capital by credit unions and spoke with academics and other industry observers.

To illustrate credit union prompt corrective action (PCA) capital levels over time, we conducted research on PCA regulations and reviewed the National Credit Union Administration's (NCUA) Form 5300 (call report) database for 1994-2003 for federally insured, natural person credit unions. We reviewed NCUA-established procedures for verifying the accuracy of the Form 5300 database and found that the data constituting this database are verified on an annual basis, either during each credit union's examination, or through off-site supervision. We determined that the data were sufficiently reliable for the purposes of this report. In addition, we reviewed capital requirements of banks and thrifts for comparison with credit union capital requirements.

Credit unions have been subject to PCA programs for a short time, and the advantages and disadvantages of the current programs are not yet evident. As a result, we did not perform an evaluation or assessment of credit union PCA. We are aware that NCUA is constructing a more detailed risk-based capital proposal that incorporates both risk-based and leverage requirements; however, due to the lack of formalized details, we could not perform a meaningful assessment of the proposal. Given that none of the secondary capital or risk-based PCA proposals provided to us have garnered credit union industry consensus or contain sufficient details on which to base an assessment, we did not perform an evaluation of these proposals or an analysis of their potential benefits and implications.

We conducted our work in Washington, D.C., from November 2003 through July 2004 in accordance with generally accepted government auditing standards.

Definitions of Risk Portfolios and Weighted-Average Life of an Investment, and a Risk-Based Standard Calculation Example

Table 3: Risk Portfolios Defined

Risk portfolio	Assets, liabilities or contingent liabilities
Long-term real estate loans	Total real estate loans and real estate lines of credit (excluding member business loans) with a maturity (and next rate adjustment period if variable rate) greater than 5 years
Member business loans outstanding	Member business loans outstanding
Investments	As defined by federal regulation or applicable state law
Low-risk assets	Cash on hand and National Credit Union Share Insurance Fund (NCUSIF) deposit
Average-risk assets	100 percent of total assets minus sum of risk portfolios above
Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less
Unused member business loan commitments	Unused commitments for member business loans
Allowance for loan and lease losses	Allowance for loan and lease losses limited to equivalent of 1.50 percent of total loans

Source: NCUA Rules and Regulations, 12 C.F.R. §702.104.

Table 4: Weighted-Average Life of Investments

Investment	Weighted-average life
Registered investment companies and collective investment funds	<ul style="list-style-type: none"> i. Registered investment companies and collective investment funds: As disclosed in prospectus or trust instrument, but if not disclosed, greater than 5 years, but less than or equal to 7 years ii. Money market funds and short-term investment funds: 1 year or less
Callable fixed-rate debt obligations and deposits	Period remaining to maturity date
Variable-rate debt obligations and deposits	Period remaining to next adjustment date
Capital in mixed-ownership government corporations and corporate credit unions	Greater than 1 year, but less than or equal to 3 years
Investments in credit union service organizations	Greater than 1 year, but less than or equal to 3 years
Other equity securities	Greater than 10 years

Source: NCUA Rules and Regulations, 12 C.F.R. §702.105.

**Appendix II
Definitions of Risk Portfolios and Weighted-
Average Life of an Investment, and a Risk-
Based Standard Calculation Example**

Table 5: Example of the Standard Calculation of the Risk-Based Net Worth Requirement

Risk portfolio	Dollar balance	Amount as a percentage of quarter-end total assets (percent)	Risk weighting	Amount times risk weighting (percent)	Standard component (percent)
Quarter-end total assets	200,000,000	100			
Long-term real estate loans	60,000,000	30 =			2.20
Threshold amount: 0 to 25 percent		25	.06	1.5	
Excess amount: over 25 percent		5	.14	0.7	
Member business loans outstanding	35,000,000	17.5 =			1.10
Threshold amount: 0 to 15 percent		15	.06	0.9	
Intermediate tier: > 15 to 25 percent		2.5	.08	0.2	
Excess amount: over 25 percent		0	.14	0	
Investments	50,000,000 =	25 =			1.51
Weighted-average life:					
0 to 1 year	24,000,000	12	.03	0.36	
> 1 year to 3 years	15,000,000	7.5	.06	0.45	
>3 years to 10 years	10,000,000	5	.12	0.6	
> 10 years	1,000,000	0.5	.20	0.1	
Low-risk assets	4,000,000	2	.00		0
Sum of risk portfolios above	149,000,000	74.5			
Average-risk assets	51,000,000	25.5	.06		1.53
Loans sold with recourse	40,000,000	20	.06		1.20
Unused member business loan commitments	5,000,000	2.5	.06		0.15
Allowance for loan and lease losses	2,040,000	1.02	(1.00)		(1.02)
Sum of standard components:					
Risk-based net worth requirement					6.67

Source: NCUA Rules and Regulations, 12 C.F.R. §702, App. A.

Items in Use by NCUA in Developing Its Risk-Based Capital Proposal

While NCUA has not finalized its risk-based PCA proposal for all credit unions, NCUA officials provided us items being used in the development of their risk-based PCA proposal:¹

- NCUA supports a statutorily mandated PCA system, with a minimum core leverage requirement (hard floor of 2 percent of total assets for critically undercapitalized); a statutory definition of net worth (with ability through regulation to reduce what qualifies as net worth, not increase it); and statutory thresholds based on risk assets defined by NCUA for the various net worth categories. NCUA also believes it should be provided with the authority to set the remaining elements of the risk-based PCA system by regulation.
- With the exception of being able to set by regulation a minimum level of net worth in relation to total assets (for example, 4 percent or 5 percent, tied to the credit union's CAMEL rating) to be considered adequately capitalized, NCUA believes the current thresholds (but in relation to risk assets) are acceptable and best left established by statute.² However, NCUA wants to keep the parity provision in the current statute, which provides the authority to change the thresholds by regulation, commensurate with any changes to the banks' PCA thresholds.³
- With regard to the net worth ratio numerator, NCUA also supports a statutory definition for net worth, but the current definition should be expanded beyond retained earnings under generally accepted accounting principles (GAAP). NCUA believes a better definition of net worth is equity of the credit union as determined under GAAP and as authorized by the NCUA board. NCUA believes this would provide the NCUA board with the authority through regulation to subtract from net worth balance sheet items (such as goodwill that have no value in the

¹We did not perform an evaluation or assessment of the items provided by NCUA. Appendix I provides additional details on our scope and methodology.

²Regulators use the CAMEL (capital adequacy, asset management, earnings, and liquidity) system to rate depository institutions on a scale of 1-5: 1 is strong, 2 is satisfactory, 3 is flawed, 4 is poor, and 5 is unsatisfactory.

³The parity provision in Credit Union Membership Access Act of 1998 (CUMAA) states that, in general, if the federal banking agencies increase or decrease the required minimum level for the leverage limit (as those terms are used in section 38 of Federal Deposit Insurance Corporation Improvement Act of 1991), the NCUA board may, by regulation, and subject to the determinations set forth in CUMAA section 301(c)(2), correspondingly increase or decrease one or more of the PCA net worth ratios. See 12 U.S.C. §1790d(c)(2).

event of a payout) the NCUA board deems appropriate. Additionally, NCUA believes that this definition preserves the requirement to comply with GAAP and limits statutorily what can be included in net worth, while providing NCUA with the flexibility to reduce assets that count toward net worth for PCA purposes but that do not have value to the insurance fund.

- With regard to the net worth ratio denominator, NCUA advocates having the regulatory flexibility to set the risk weights for assets and adjust them, as it deems appropriate.
- In cases where there is a marginal drop in net worth below adequately capitalized, NCUA advocates having the regulatory flexibility to temporarily waive a credit union's requirement to submit a net worth restoration plan if: (a) the credit union is CAMEL-rated 1 or 2 with a net worth ratio in the range of 5 percent to 7 percent, (b) the credit union's book of business does not present a safety and soundness issue, and (c) the credit union's assets are well managed. In addition, NCUA desires the regulatory flexibility to revisit the credit union after a specified time to determine if the temporary waiver is still appropriate and, if not, require the credit union to submit a net worth restoration plan. NCUA believes that this would reduce the burden placed on credit unions experiencing a small, temporary decline in the net worth ratio due to circumstances such as unsolicited, robust share growth that do not pose a safety and soundness concern. Further, NCUA believes such a provision would still provide NCUA with adequate authority to address any concerns on a case-by-case basis.

Comments from the National Credit Union Administration



National Credit Union Administration

Office of the Chairman

July 9, 2004

Richard J. Hillman, Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, D.C.

Re: Draft GAO Report 04-849

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on the General Accounting Office's (GAO) draft report entitled *Credit Unions – Available Information Indicates No Compelling Need for Secondary Capital* (the report). On behalf of the National Credit Union Administration (NCUA), I would like to express our appreciation for the professionalism exhibited by your staff and your careful consideration of this important matter.

As the report discusses, questions surrounding the appropriateness of authorizing all federally insured credit unions to use secondary capital to meet prompt corrective action (PCA) requirements are numerous and complex. We agree with your conclusion that there are key unresolved issues, such as whether or not secondary capital instruments would be commercially viable, to whom these instruments could and should be sold (e.g., inside versus outside investors), the effects on the member-owned cooperative structure of credit unions, and any safety and soundness and systemic risk implications posed by this activity. We also agree that there is a lack of consensus within the credit union system on the need for and appropriate structure of secondary capital instruments. In view of these considerations and the fact that the vast majority of insured credit unions maintain extremely strong capital positions notwithstanding a recent prolonged period of rapid share growth, at this time we accept your conclusion that a case for secondary capital has not been made. We fully expect that there will be continued debate and study of this issue within the credit union system.

The report does, however, discuss what we believe are valid concerns with the PCA system established by the Credit Union Membership Access Act (CUMAA). NCUA strongly believes the statutory mandate to take prompt corrective action to resolve problems at the least long-term cost to the National Credit Union Share Insurance Fund (NCUSIF) is sound public policy consistent with NCUA's fiduciary responsibility to the NCUSIF. However, now that we have gained experience with a PCA structure for federally insured credit unions we believe there is a need to make adjustments to better achieve its overall objectives.

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300

Richard J. Hillman
July 9, 2004
Page 2

These adjustments should move PCA to a more fully risk-based system, with a lower leverage ratio (ratio of net worth to total assets) required of a credit union to meet the "well-capitalized" level. In view of the conservative nature of credit unions (driven by their cooperative, member-owned structure), the comparatively low loss history of the credit union system, and the fact that our experience indicates that the great majority of credit unions manage their net worth to a level higher than the leverage requirement, we believe a "well-capitalized" leverage requirement in the range of 5% would be more than sufficient to meet the safety and soundness goals of PCA. Some additional details of the risk-based system that we envision are discussed below.

The report notes that PCA is intended to act as a restraint on growth that outpaces a credit union's ability to generate commensurate earnings, especially aggressive growth strategies that have a high correlation to problems in financial institutions. However, it is important to differentiate overly aggressive growth from robust growth, consistent with sound business strategy, experienced by healthy credit unions.

When a credit union experiences safe but strong growth that in the short term exceeds the ability of a prudent earnings strategy to fund net worth at the same pace, NCUA believes the key factor is how the credit union invests these funds. Page 17 of the report states "*credit union managers are expected to manage the growth of their institutions so that an influx of member deposits would not cause the credit union to become subject to PCA.*" However, the current "one-size-fits-all" PCA system does not permit this, short of turning away deposits after dividend rates have been reduced to below market rates. Under a risk-based system with a lower leverage requirement, credit unions would have greater ability to manage compliance by shifting investment strategies from longer-term, higher credit risk assets to shorter-term, lower credit risk assets resulting in the need to hold less capital on these safer assets with lower risk weights. This would provide credit unions with the ability to manage compliance with PCA by also managing the asset side of the balance sheet.

NCUA also believes that having the ability to waive the requirement for a net worth restoration plan (NWRP) under certain circumstances would help address the growth issue. The report suggests NCUA revisit the concept of an abbreviated NWRP for marginally undercapitalized credit unions for situations involving temporary capital shortfalls. We considered this initial proposal carefully. However, the statutory language of CUMAA precludes NCUA from providing any significant relief to credit unions in this regard. Thus, we support a statutory change to provide NCUA the regulatory authority to waive the requirement to submit a NWRP for credit unions that have a temporary, marginal drop in their net worth ratio below "adequately capitalized", as determined on a case-by-case basis.

NCUA concurs with the views expressed by many within the credit union industry that the PCA tripwires are too high. The current system's high leverage requirement, coupled with the underlying psychological factors driving credit union officials to have a cushion above the PCA requirements, creates a "one-size-fits-all" PCA system. This has the effect of penalizing institutions with conservative risk profiles. At the same time, it allows higher risk earnings

Richard J. Hillman
July 9, 2004
Page 3

strategies without commensurate net worth levels. A well designed risk-based system with lower leverage requirements would more closely relate required capital levels with the risk profile of the institution and allow for better utilization of capital.

The report repeats the Department of Treasury's contention that Congress determined that a 2% higher limit than that imposed on banks and thrifts was necessary due to the 1% deposit in the NCUSIF and another 1% of the typical credit union's capital invested in corporate credit unions. NCUA respectfully disagrees with this rationale.

Under GAAP, which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on the financial statements of a credit union. Further supporting its treatment as a credit union asset, it has been NCUA's long standing practice to return this deposit when a credit union exits federally insured status or converts to another form of financial institution. These funds are also available to absorb losses in the event of a liquidation or purchase and assumption of a failed credit union. The NCUSIF deposit is not related to a credit union's net worth from either an accounting or financial risk standpoint. It would take a highly improbable massive systemic event to trigger a write-off of the NCUSIF deposit and recapitalization of the insurance fund. Further, if the NCUSIF equity ratio declines below 1.2%, CUMAA mandates that NCUA charge an insurance premium to restore the fund to at least 1.2%.

Regarding natural person credit unions' investment in capital instruments of corporate credit unions, the report acknowledges that this was factored into the higher limit because the typical credit union holds this form of investment. We note that not all credit unions belong to corporate credit unions or hold this form of investment. Therefore, using a "one-size-fits-all" approach to trigger PCA supervisory actions based on this assumption is inherently unfair. We believe natural person credit unions' investments in capital instruments of corporate credit unions is best addressed by factoring any individual institution's at-risk investments in corporate credit unions into a risk-based PCA system.

We recognize, as the report indicates, the efficacy of a risk-based system is highly dependent on the details of the risk categories and weights, as well as the complementary relationship between the risk-based and leverage requirements. The report suggests a risk-based system will result in risk assets being lower than total assets for most credit unions, resulting in a given amount of capital producing a higher net worth ratio. In fact, a proposal under consideration includes risk categories with weights at and above 100%. Thus, it is not a foregone conclusion that the risk-based portion of the PCA system would result in significantly lower required capital levels.

We agree with the report's assertion that not all risks that credit unions face can be quantified. Thus, although we are still working on the details, we envision a risk-based capital structure that works in tandem with a leverage component. This can be illustrated as follows:

Appendix IV
Comments from the National Credit Union
Administration

Richard J. Hillman
July 9, 2004
Page 4

Figure 1: Example of Possible Parameters for a Risk-Based Capital Requirement in Tandem with a Leverage Requirement for Credit Unions

Capital Category*	Risk-Based Net Worth Ratio	Leverage Ratio
Well Capitalized	7% or greater	5% or greater
Adequately Capitalized	6% to 6.99%	4% to 4.99%
Undercapitalized	4% to 5.99%	3% to 3.99%
Significantly Undercapitalized	2% to 3.99%	2% to 2.99%
Critically Undercapitalized	< 2%	< 2%

* The lowest category a credit union falls into governs.

We appreciate the inability of GAO and others to comment further on NCUA's proposal for a more risk-based PCA system until it is fully developed. We look forward to the continued dialogue on this issue with all parties sharing our common interest in the continued safety and soundness of the credit union system. Thank you again for the opportunity to comment on the draft report. If you have any questions or need further information, please feel free to contact NCUA Executive Director J. Leonard Skiles at (703) 518-6321.

Sincerely,



JoAnn M. Johnson
Chairman

GAO Contacts and Staff Acknowledgments

GAO Contacts

Richard J. Hillman, (202) 512-8678
Harry Medina, (415) 904-2220

Acknowledgments

In addition to those named above, Heather T. Dignan, Landis L. Lindsey, Kimberly A. Mcgatlin, Carl M. Ramirez, Barbara M. Roesmann, Paul G. Thompson, John H. Treanor, and Richard J. Vagnoni made key contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

**United States
Government Accountability Office
Washington, D.C. 20548-0001**

**Official Business
Penalty for Private Use \$300**

Address Service Requested

**Presorted Standard
Postage & Fees Paid
GAO
Permit No. GI00**

