

PCA Checkup

YOUR CUSTOMIZED ANALYSIS OF THE NCUA PROMPT CORRECTIVE ACTION REGULATION,
FINAL RISK-BASED NET WORTH REQUIREMENT, AND NET WORTH SCENARIO ANALYSIS

Prepared for:

XYZ Credit Union
First Quarter 2004

By:

CUNA's Economics & Statistics Department

Prompt Corrective Action (PCA) Overview

What is PCA?

PCA is a regulation that requires supervisory authorities to address safety and soundness concerns stemming from declining net worth ratios in a timely, predetermined manner. Credit union PCA contains three key provisions.

- 1) Basic PCA contains mandatory actions prescribed by statute and discretionary actions developed by the Agency. PCA defines net worth as reserves and undivided earnings and establishes net worth-to-asset ratio trigger points that require your regulator to take progressively more severe actions against your credit union should its net worth ratio fail to meet predetermined guidelines (See Appendix for a more detailed overview).
- 2) PCA for “new” credit unions – defined as those in operation less than ten years and with \$10 million or less in total assets.
- 3) A risk-based net worth requirement that applies to all credit unions that are determined by NCUA rule to be complex. The risk-based net worth requirement supplements prompt corrective action by identifying credit unions that have above normal balance sheet risk and imposing higher net worth requirements on these institutions. Complex credit unions are those that:
 - (a) Have more than \$10 million in assets; and
 - (b) Have a risk-based net worth requirement exceeding 6%

Why do we have PCA?

The PCA regulation was adopted to implement provisions in HR1151- the Credit Union Membership Access Act. Its inclusion in the bill ensured Treasury Department support for the bill and put credit unions under a system similar to that faced by other financial institutions since 1991. The purpose of PCA is to remove the possibility that regulatory forbearance will expose the insurance fund to additional losses when resolving problems at institutions under financial stress.

Who will the PCA regulation affect?

PCA is a major rule that applies to all federally insured credit unions. It moved federally insured credit unions to a system focused on minimum capital or “net worth” requirements.

When does the PCA regulation become effective?

The new rule became effective August 7, 2000. However, the first application of the basic rule occurred when credit unions reported their net worth ratio in the Call Report that was due January 22, 2001. The first quarter to which the risk-based net worth requirement for complex credit unions applied was the first quarter of 2001, based on data reflected in the Call Report filed in April 2001.

More information:

For more detailed information on the PCA regulation or the risk-based net worth requirement visit the CUNA web site at: <http://buy.cuna.org/detail.php?sku=refer006> or the NCUA site at: <http://www.ncua.gov>.

PCA Checkup Introduction

CUNA's economics and statistics department prepared the attached Prompt Corrective Action (PCA) Checkup for your credit union. The PCA Checkup summarizes your credit union's estimated position under the National Credit Union Administration (NCUA) Board's final rule on PCA. Your PCA Checkup also details what your credit union's status would be under NCUA's rule on risk-based net worth requirements.

The PCA Checkup uses a series of tables and graphs to summarize the PCA rule and the risk-based net worth requirement.

Pages 1-2

These pages summarize the risk-based net worth requirement and complex credit union calculations

- **Page 1** of your PCA checkup summarizes the results of your basic PCA analysis and your current position under the risk-based net worth requirement. It highlights your credit union's current net worth ratio. Your net worth ratio is calculated using either period-end assets or average assets over the previous four quarters (depending on which measure produces the higher net worth ratio).

If your credit union has not filed quarterly call reports we may estimate average assets to compute your net worth ratio.

Page 1 also shows your credit union's complexity status, risk-based net worth applicability, and net worth category.

- **Page 2** of the analysis summarizes the calculations we used to determine if a risk based net worth requirement is applicable to your credit union.

Note that the NCUA rule allows credit unions to use one or more alternative calculations to determine risk-based net worth requirements. Use of the alternative calculations may result in a requirement that is lower than that indicated in your PCA Checkup.

Your PCA Checkup does not evaluate the alternative calculations because the information required to do so is not available on the Call Report. It must be generated using your credit union's internal records.

PCA Checkup Introduction (continued)

Pages 3-6

These pages summarize how your credit union's growth rate and earnings capacity will influence its Basic PCA status over time.

- **Page 3** of the analysis highlights your credit union's earnings (net income as a percent of average assets) and asset growth rates over the past five years. The five-year median of each measure is presented as the "typical" value for each. The median is the middle value of the respective measures when each is ranked high-to-low.
- **Page 4** of your PCA Checkup shows your current net worth ratio as well as several forecasts of your net worth ratio at the end of five years. PCA's 7% "well capitalized" level of capitalization and your risk-based net worth requirement are included as a point of reference. Each forecast uses a combination of assumed asset growth and earnings (selected from your historical data on page 3) to project your net worth ratio. For a given level of earnings, faster asset growth will result in a lower future net worth ratio. Similarly, for a given asset growth rate, lower earnings will result in a lower future net worth ratio.
- **Page 5** shows how various asset growth rates affect your credit union's net worth ratio over time. These forecasts assume your credit union earns at its "typical" rate over the next five years – the median rate from the previous five years. As a point of reference, your credit union's current net worth ratio is included.

PCA's 7% "well capitalized" level of capitalization also is shown. For the sake of clarity, we have not included a line for PCA's 6% "adequate" category, but this can be easily visualized.

Note, if applicable, your credit union's current risk-based net worth requirement is included on the graph. However, since your credit union's balance sheet will change over time, your RBNW requirement five years in the future may differ from that shown on page 5.

This information will help you answer questions such as: "If we earn at our typical rate, how fast can we grow while maintaining our current net worth ratio?" Or: "If we earn at our typical rate, what asset growth rate must we not exceed to reach our risk-based net worth requirement?"

- **Page 6** shows how various earnings rates affect your credit union's net worth ratio over time. These forecasts assume your credit union asset growth stays at its "typical" rate over the next five years – the median rate from the previous five years. As a point of reference, your credit union's current net worth ratio is included.

PCA's 7% "well capitalized" level of capitalization also is shown. For the sake of clarity, we have not included a line for PCA's 6% "adequate" category, but this can be easily visualized.

Note, if applicable, your credit union's current risk-based net worth requirement is included on the graph. Since your credit union's balance sheet will change over time, your RBNW requirement five years in the future may differ from that shown on page 6.

This information will help you answer questions such as: "If we grow at our typical rate, how much must we earn to maintain our current net worth ratio?" Or: "If we grow at our typical rate, what level of earnings must we not exceed to reach our risk-based net worth requirement?"

Current Situation and Action Steps

The current situation:

The vast majority of credit unions are very well capitalized today. In fact, credit unions have average net worth equal to 10.7% of period-end assets as of March 2004. And most credit unions – roughly 97% -- are well capitalized, with net worth above 7%.

At the other end of the spectrum, about 0.7% of all credit unions have net worth below 5%. That's an important number because although credit unions with 5% to 5.99% are undercapitalized, PCA's harsher consequences kick in only when a credit union's net worth-to-assets ratio dips below 5%.

Roughly 9.4% of all credit unions are now complex (the movement's 4,444 credit unions with 1st quarter 2004 assets of \$10 million or less are exempt from the risk-based net worth provisions.) Less than 1% of complex credit unions have a risk-based net worth requirement that is higher than their actual net worth ratio, though some of these credit unions may meet their requirement after evaluating alternative components or by obtaining an offsetting risk mitigation credit.

Action steps to consider:

- The mere fact that your credit union is now “well capitalized” does not mean you can ignore PCA. Several years of poor earnings and/or fast asset growth could significantly change your PCA profile. Examine what will happen to your net worth ratio under various growth and earnings scenarios. Pay particular attention to PCA Checkup's extreme case, in which your credit union is assumed to have five years of high growth and low ROA (see the second-to-last bar in the graph on page 4).
- If your credit union has net worth pressure (e.g., undercapitalized or nearly undercapitalized), consider strategies that will change your asset growth rate and/or earnings rate to increase your capital buffer.
- Discuss establishing “comfort zones” or “buffers” to ensure your credit union doesn't run into trouble in the future. For example, a non-complex credit union may wish to have a board-approved 9% net worth ratio long-run target. This 2% buffer over the 7% “well capitalized” net worth designation would be used to give your credit union operational flexibility and would help ensure PCA's trip wires are not inadvertently crossed.
- The PCA Checkup provides a comprehensive overview for your credit union using recent operating results. You may wish to consider other scenarios and should model any specific plans or goals expressed in your most recent planning session. You are encouraged to visit the CUNA web site at <http://buy.cuna.org/detail.php?sku=refer006> to use our free PCA calculator to assist in these what-if analyses. Since the scenarios you examine today may be obsolete soon after they've been analyzed, it's important to view this as an analytical process, to be repeated with the passage of time.
- Review NCUA's risk-based net worth standard calculation on Page 2. Your PCA Checkup uses the final rule to determine if your credit union is complex, and if so, to calculate your credit union's risk-based net worth requirement. Begin to consider contingency plans in the event your credit union's current (or future) designation imposes higher requirements than the basic PCA guidelines.

XYZ Credit Union

Current PCA Profile

Basic PCA

<u>Your credit union's net worth components:</u>	<u>Account code</u>	<u>Dollar balance</u>
Regular reserves	931	\$5,380,161
Other reserves	658	\$0
Undivided earnings	940	\$21,675,263
Net Income	602	\$581,689
Uninsured secondary capital (low-income designated credit unions only)	925	\$0
Net worth		\$27,637,113
Period-end assets		\$292,657,628
Average assets		\$288,224,016
<u>Net worth ratios:</u>		
Net worth as a percent of period-end assets	9.44%	
Net worth as a percent of average assets	9.59%	

Your credit union is well capitalized under Basic PCA

Risk-Based Net Worth Requirement

Is a RBNW requirement applicable?	No	(See Page 2 for details)
Your credit union's risk-based net worth requirement	None	(See Page 2 for details)

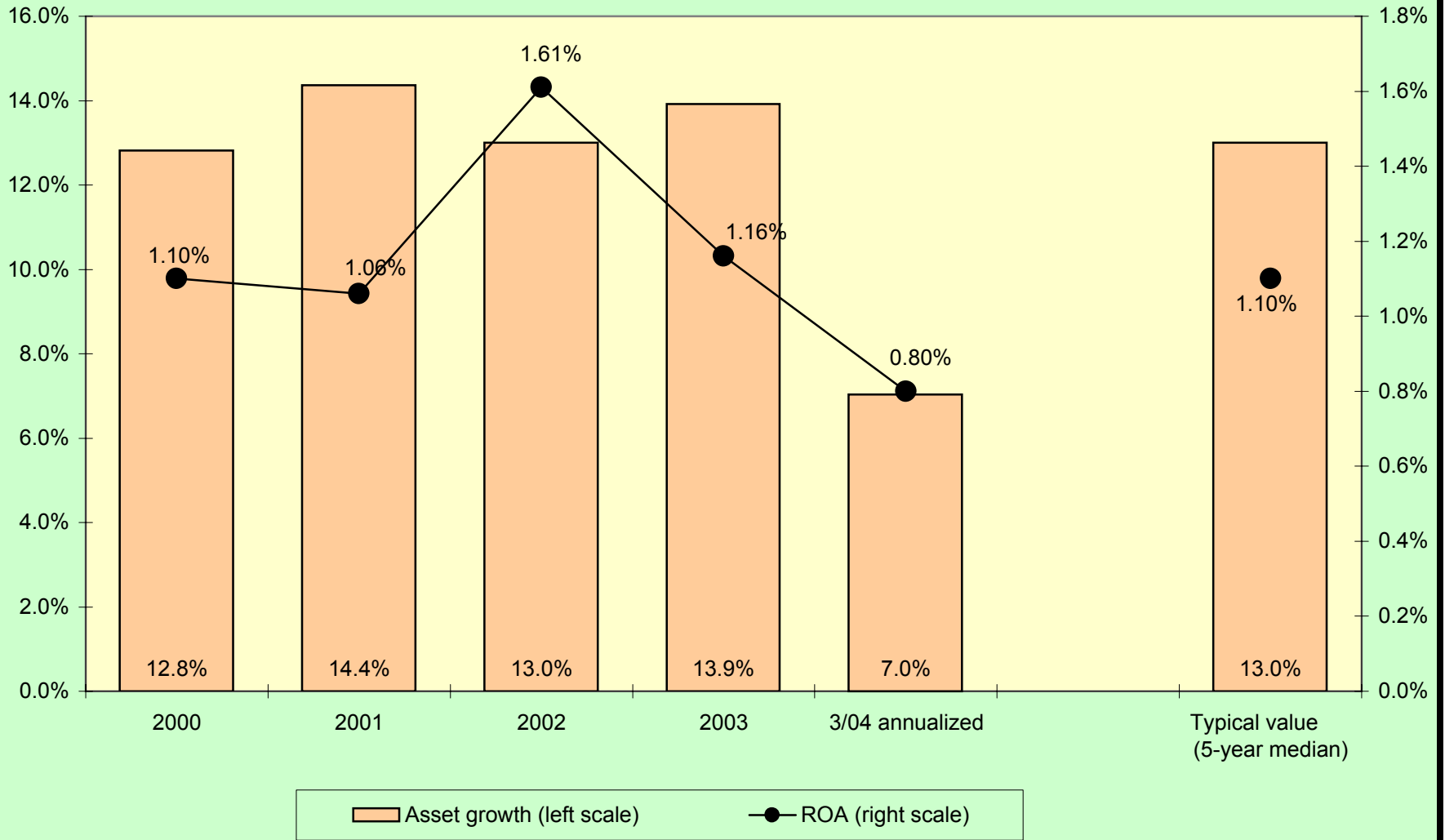
Standard Components of Risk Based Net Worth (RBNW) Requirement

XYZ Credit Union

Credit Union ID#:

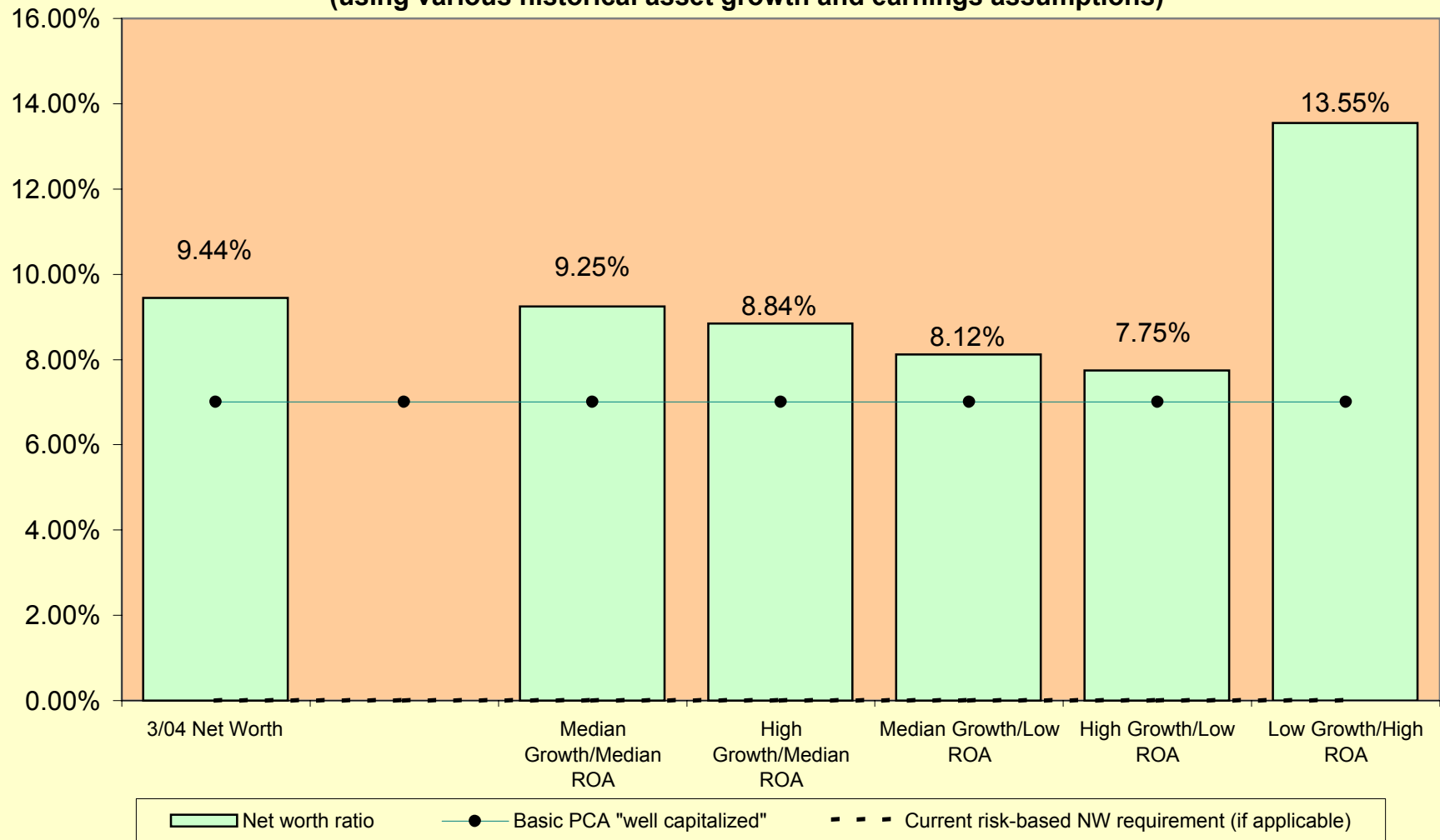
Risk Portfolio	Dollar Balance	Amount as percent of quarter-end total assets	Risk Weighting	Amount times risk weighting	Standard component
Quarter-end total assets					
Assets (acct.code 010)	292,657,628	100%			
(a) Long-term real estate loans					
(Acct. Code 710) less:	128,008,719				
(Acct Code. 718)	4,353,820				
(Acct. Code 712)	100,921,025				
Total (710 minus 718 and 712)	22,733,874	7.77%			
Threshold amount: 0 to 25%		7.77%	0.06	1,364,032	0.47%
Excess amount: over 25%		0.00%	0.14	0	0.00%
(b) MBLs outstanding					
(Acct. code 400)	6,755,381	2.31%			
Threshold amount: 0 to 15.00%		2.31%	0.06	405,323	0.14%
Threshold amount: 15.00 to 25.00%		0.00%	0.08	0	
Excess amount: over 25.00%		0.00%	0.14	0	0.00%
(c) Investments					
<i>Weighted-average life:</i>					
0 to 1 year (Acct. code 799A)	21,407,181	7.31%	0.03	642,215	0.22%
>1 yr. to 3 yrs. (Acct. code 799B)	32,447,455	11.09%	0.06	1,946,847	0.67%
>3yr. To 10 yrs. (Acct. code 799C)	0	0.00%	0.12	0	0.00%
>10 yrs. (Acct. code 799D)	60,000	0.02%	0.20	12,000	0.00%
(d) Low-risk assets					
(Acct. code 730A) plus:	2,065,501				
(Acct. code 794)	2,251,343				
Total (Acct. Code 730A plus 794)	4,316,844	1.48%	0.00	0	0.00%
Sum of risk portfolios (a) through (d) above	87,720,735				
(e) Average-risk assets					
Assets (Acct. code 010) less:	292,657,628				
Risk portfolio items (a) through (d) above	204,936,893	70.03%	0.06	12,296,214	4.20%
(f) Loans sold with recourse					
(Acct. code 819)	0	0.00%	0.06	0	0.00%
(g) Unused MBL Commitments					
(Acct. code 814B)	538,883	0.18%	0.06	32,333	0.01%
(h) Allowance (Credit limited to 1.5% of loans)					
(Acct. code 719)	1,975,316	0.67%	-1.00	-1,975,316	-0.67%
Sum of standard components:					
RBNW requirement (Acct. code 999)					5.03%

XYZ Credit Union Historical Results



XYZ Credit Union

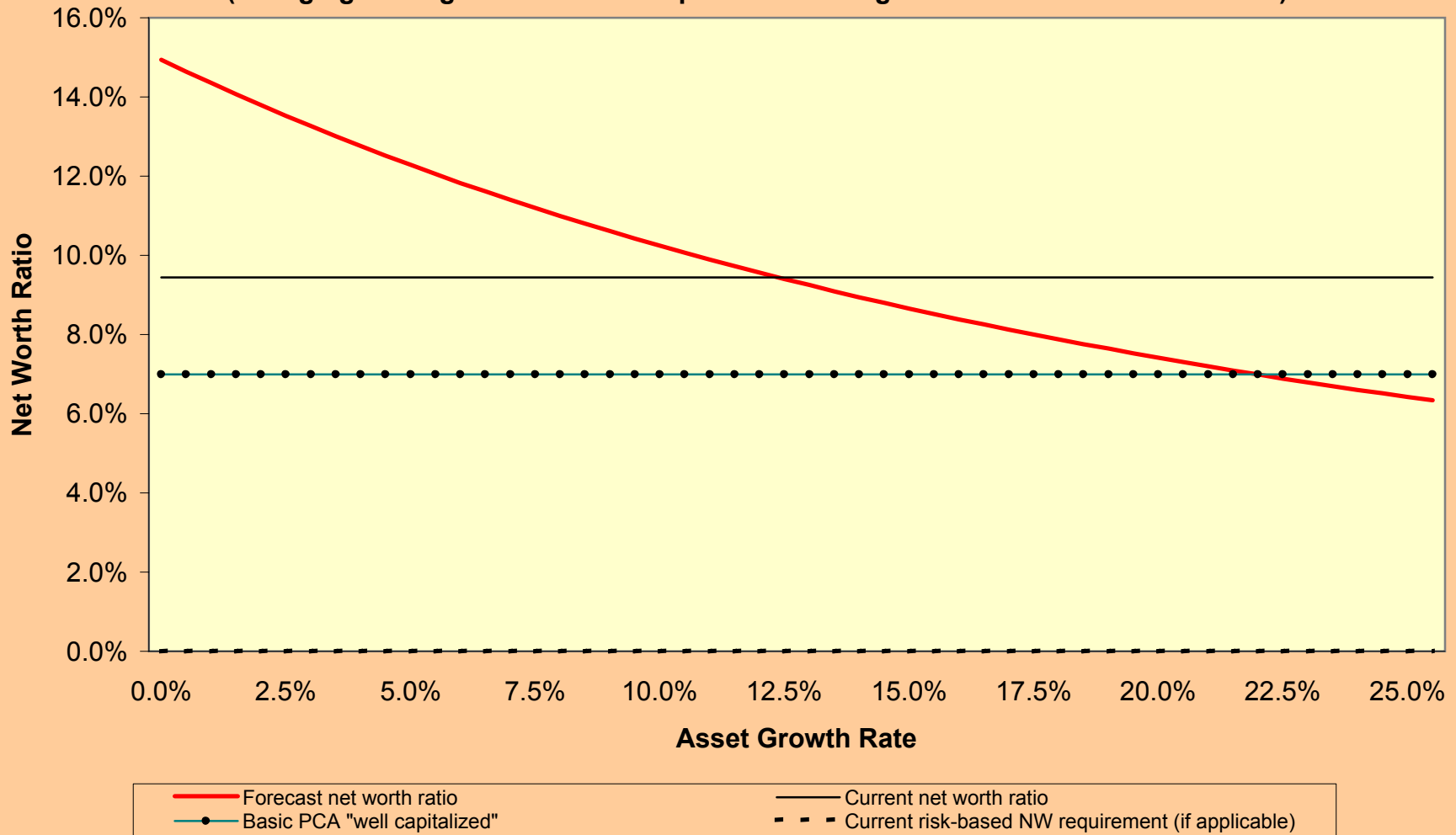
Estimated Net Worth Ratio at End of Fifth Year (using various historical asset growth and earnings assumptions)



Note: Basic PCA net worth to be "adequately capitalized" is 6%.

XYZ Credit Union

Estimated Net Worth Ratio at End of Fifth Year (changing asset growth rate assumptions & holding ROA constant at median level)

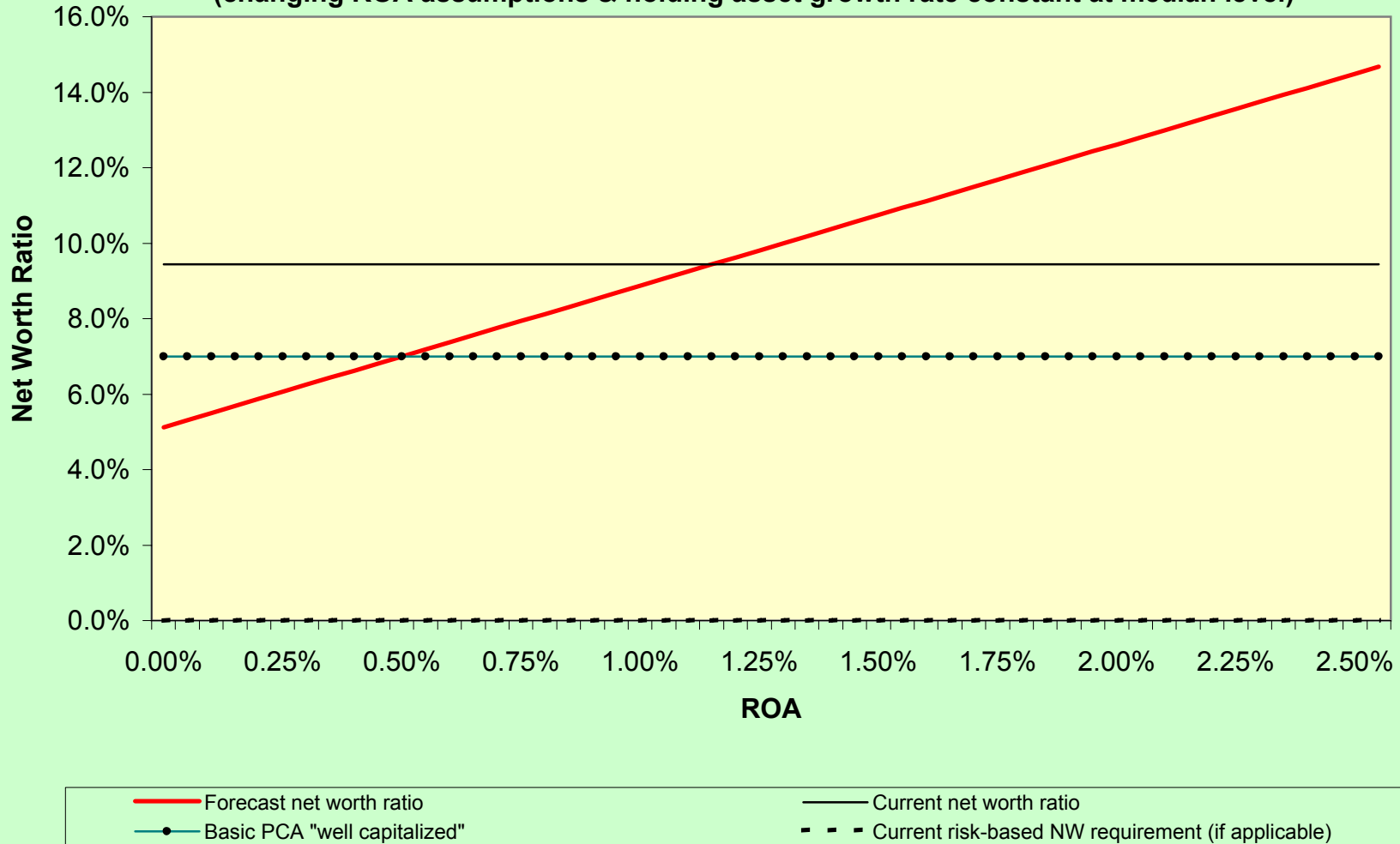


Note: Basic PCA net worth to be "adequately capitalized" is 6%.

XYZ Credit Union

Estimated Net Worth Ratio at End of Fifth Year

(changing ROA assumptions & holding asset growth rate constant at median level)



Note: Basic PCA net worth to be "adequately capitalized" is 6%.

Your Projected Net Worth Ratio At the End of 5 Years

Using Various Combinations of 5-Year Asset Growth and Earnings Assumptions

XYZ Credit Union

Your current net worth ratio as a percent of period-end assets = 9.4%

Return on Assets (ROA) in Each of the Next 5 Years

	0.00%	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%
-20.0%	28.8%	31.1%	33.4%	35.7%	38.1%	40.4%	42.7%	45.0%	47.3%	49.6%	51.9%
-17.5%	24.7%	26.8%	28.9%	31.0%	33.1%	35.2%	37.4%	39.5%	41.6%	43.7%	45.8%
-15.0%	21.3%	23.2%	25.1%	27.1%	29.0%	30.9%	32.9%	34.8%	36.7%	38.7%	40.6%
-12.5%	18.4%	20.2%	22.0%	23.8%	25.5%	27.3%	29.1%	30.9%	32.7%	34.4%	36.2%
-10.0%	16.0%	17.6%	19.3%	20.9%	22.6%	24.2%	25.9%	27.5%	29.2%	30.8%	32.5%
-7.5%	13.9%	15.5%	17.0%	18.5%	20.1%	21.6%	23.1%	24.7%	26.2%	27.7%	29.2%
-5.0%	12.2%	13.6%	15.1%	16.5%	17.9%	19.3%	20.8%	22.2%	23.6%	25.0%	26.5%
-2.5%	10.7%	12.1%	13.4%	14.7%	16.0%	17.4%	18.7%	20.0%	21.4%	22.7%	24.0%
0.0%	9.4%	10.7%	11.9%	13.2%	14.4%	15.7%	16.9%	18.2%	19.4%	20.7%	21.9%
2.5%	8.3%	9.5%	10.7%	11.9%	13.1%	14.2%	15.4%	16.6%	17.8%	18.9%	20.1%
5.0%	7.4%	8.5%	9.6%	10.7%	11.8%	12.9%	14.1%	15.2%	16.3%	17.4%	18.5%
7.5%	6.6%	7.6%	8.7%	9.7%	10.8%	11.8%	12.9%	13.9%	15.0%	16.0%	17.1%
10.0%	5.9%	6.9%	7.9%	8.8%	9.8%	10.8%	11.8%	12.8%	13.8%	14.8%	15.8%
12.5%	5.2%	6.2%	7.1%	8.1%	9.0%	10.0%	10.9%	11.9%	12.8%	13.8%	14.7%
15.0%	4.7%	5.6%	6.5%	7.4%	8.3%	9.2%	10.1%	11.0%	11.9%	12.8%	13.7%
17.5%	4.2%	5.1%	5.9%	6.8%	7.7%	8.5%	9.4%	10.2%	11.1%	12.0%	12.8%
20.0%	3.8%	4.6%	5.4%	6.3%	7.1%	7.9%	8.7%	9.6%	10.4%	11.2%	12.0%
22.5%	3.4%	4.2%	5.0%	5.8%	6.6%	7.4%	8.2%	8.9%	9.7%	10.5%	11.3%
25.0%	3.1%	3.9%	4.6%	5.4%	6.1%	6.9%	7.6%	8.4%	9.1%	9.9%	10.7%
27.5%	2.8%	3.5%	4.3%	5.0%	5.7%	6.4%	7.2%	7.9%	8.6%	9.3%	10.1%
30.0%	2.5%	3.2%	3.9%	4.6%	5.3%	6.0%	6.7%	7.4%	8.1%	8.8%	9.5%
32.5%	2.3%	3.0%	3.7%	4.3%	5.0%	5.7%	6.4%	7.0%	7.7%	8.4%	9.1%
35.0%	2.1%	2.8%	3.4%	4.1%	4.7%	5.4%	6.0%	6.7%	7.3%	8.0%	8.6%
37.5%	1.9%	2.6%	3.2%	3.8%	4.4%	5.1%	5.7%	6.3%	7.0%	7.6%	8.2%
40.0%	1.8%	2.4%	3.0%	3.6%	4.2%	4.8%	5.4%	6.0%	6.6%	7.3%	7.9%

RBNW Standard Component Definitions

Risk portfolio (a): Long-term real estate loans

Long-term real estate loan definition:

Long-term real estate loans and real estate lines of credit outstanding, exclusive of those outstanding that will contractually refinance, reprice or mature within the next five (5) years, and exclusive of all member business loans (as defined in 12 C.F.R. 723.1 or as approved under 12 C.F.R. 723.20)

Risk portfolio (b): Member business loans

Member business loan definition:

All member business loans as defined in 12 C.F.R. 723.20

Risk portfolio (c): Investments

Investments definition:

Investments as defined by 12 C.F.R. 703.150 or applicable State law, including investments in CUSOs.

Weighted average life of investments:

- a) Registered investment companies and collective investment funds: as disclosed in prospectus or trust instrument, but if not disclosed, greater than five (5) years, but less than or equal to seven (7) years. Money market funds and STIFs: One (1) year or less.
 - b) Callable fixed-rate debt obligations and deposits: Period remaining to maturity date.
 - c) Variable-rate debt obligations and deposits: Period remaining to next rate adjustment date.
- FINAL RISK-BASED NET WORTH REQUIREMENT, AND CREDIT UNION CALCULATION
- e) Investment in CUSOs: Greater than one (1) year, but less than or equal to three (3) years.
 - f) Other equity securities: Greater than ten (10) years.
 - g) Cash equivalents: One (1) year or less.

Risk portfolio (d): low-risk assets

Low risk assets definition:

Cash on hand (e.g., coin and currency, including vault, ATM and teller cash) and the NCUSIF deposit

Risk portfolio (e): average-risk assets

Average risk assets definition:

One hundred percent (100%) of total assets minus the sum of the risk portfolios (a) to (d).

Risk portfolio (f): loans sold with recourse

Loans sold with recourse definition:

Outstanding balance of loans sold or swapped with recourse, excluding loans sold to the secondary mortgage market that have representations and warranties consistent with those customarily required by the U.S. Government and government sponsored enterprises.

Risk portfolio (g): Unused MBL commitments

Unused MBL commitment definition

Unfunded commitments for loans and participation interested qualifying for RBNW as defined in 12 C.F.R. 723.1 or as approved under 12 C.F.R. 723.20

Risk portfolio (h): Allowance

Allowance definition

The allowance for Loan and Lease Losses not to exceed the equivalent of one and one-half percent (1.5%) of total loans outstanding

Alternative components

The risk-based net worth requirement stipulates that higher net worth must be held against assets in various risk portfolios.

Longer-term risk portfolio assets are considered riskier than short-term risk portfolio assets. However, the call report does not contain detailed information on your risk portfolio assets. If your internal records allow you to identify the detail of these risk portfolios you should fill out the alternative component worksheet. Your risk-based net worth requirement may be lower if one or more of the alternative component calculations show that a substantial portions of your risk portfolios contain shorter-term assets.

The final NCUA rule allows you to choose the calculation (standard vs alternative) which produces the lowest component. It also allows you to use "standard" calculations for some components and "alternative" calculations for others. This report does not account for these provisions.

Risk mitigation credit

The risk-based net worth requirement stipulates that credit unions failing to meet their risk-based net worth requirement under the standard component calculation or under the alternative component calculation can apply for a risk mitigation credit. The risk mitigation credit can lower the risk-based net worth requirement if the credit union can demonstrate that it mitigates credit or interest rate risk exposures.

Appendix: Detailed PCA Overview

A CU's net worth category is...	If its net worth ratio is...	And subject to the following condition(s)...	Regulatory actions
"Well capitalized"	7% or above	And if "complex", meets applicable risk-based net worth requirement (RBNW)	None
"Adequately capitalized"	6% to 6.99%	And if "complex", meets applicable RBNW	Increase net worth quarterly by 0.1% of assets for current quarter & continue until net worth ratio is 7%
"Undercapitalized" Tier 1 Tier 2	5% to 5.99% 4% to 4.99%	Or if "complex", fails applicable RBNW	<p><u>Mandatory actions:</u></p> <ol style="list-style-type: none"> 1) Earnings transfer requirement 2) Net worth restoration plan (NWRP) 3) Potential restrictions on growth & lending <p><u>Discretionary actions:</u> (Can apply to all tier 2 CUs & to tier 1 CUs that fail to comply with mandatory actions or fail to implement NWRP.)</p> <ol style="list-style-type: none"> 1) Prior approval of new branches/lines of business 2) Restrict certain transactions 3) Prohibit growth and/or prohibit certain other activities 4) Potential dismissal of director(s) and/or officer(s)
"Significantly undercapitalized"	2% to 3.99%	Or if "undercapitalized" at less than 5% net worth ratio, fails to timely submit or materially implement a net worth restoration plan	<p>Same mandatory actions that apply to undercapitalized CUs.</p> <p>Same discretionary actions that apply to undercapitalized CUs plus several additional (dividend restrictions, new board elections, compensation restrictions on senior officials, mergers required, conservatorship/ liquidation if no prospect of becoming adequately capitalized)</p>
"Critically undercapitalized"	Less than 2%	None	<p>Same mandatory actions that apply to undercapitalized CUs</p> <p>Same discretionary actions that apply to undercapitalized CUs plus several additional (dividend restrictions, new board elections, compensation restrictions on senior officials, mergers required, conservatorship/ liquidation if no prospect of becoming adequately capitalized)</p>

Appendix: Detailed PCA Overview for New CUs (Less than 10 years old & total assets not more than \$10 million)

A CU's net worth category is...	If its net worth ratio is...	And subject to the following condition(s)...	Regulatory actions
"Well capitalized"	7% or above	And if "complex", meets applicable risk-based net worth requirement (RBNW)	None
"Adequately capitalized"	6% to 6.99%	And if "complex", meets applicable RBNW	Increase net worth quarterly by 0.1% of assets for current quarter & continue until net worth ratio is 7%
"Moderately capitalized"	3.5% to 5.99%	Or if "complex", fails applicable RBNW	<p><u>Mandatory actions:</u></p> <ol style="list-style-type: none"> 1) Earnings transfer requirement 2) Revised business plan 3) Restrictions on member business loan growth <p><u>Discretionary actions:</u> Can apply if net worth has not increased according to business plan or CU fails to comply with mandatory actions</p> <ol style="list-style-type: none"> 1) Prior approval of new branches/lines of business 2) Restrict certain transactions 3) Prohibit growth and/or prohibit certain other activities 4) Potential dismissal of director(s) and/or officer(s) <p>Plus several additional (dividend restrictions, new board elections, compensation restrictions on senior officials, mergers required, conservatorship/ liquidation if no prospect of becoming adequately capitalized)</p>
"Marginally capitalized"	2% to 3.49%	None	Same mandatory and discretionary actions that apply to moderately capitalized new CUs.
"Minimally capitalized"	0% to 1.99%	None	Same mandatory and discretionary actions that apply to moderately capitalized new CUs.
"Undercapitalized"	Less than 0%	None	<p>Same mandatory and discretionary actions that apply to moderately capitalized new CUs</p> <p>Conservatorship/ liquidation in specific cases.</p>