SUMMARY: This white paper describes, in more detail than REFORMING CREDIT UNION NET WORTH REQUIREMENTS two proposals for reforming PCA.

The Prompt Corrective Action (PCA) section of the Credit Union Membership Access Act of 1998 (CUMAA) established for the first time “capital” or “net worth” requirements for credit unions. Prior to that time, credit unions were subject only to a requirement to increase their regular reserves depending on the ratio of these reserves to “risk-assets” (loans and long-term investments). The purpose of Section 1790d. (Prompt Corrective Action) of the Act is “to resolve the problems of insured credit unions at the least possible long-term loss to the Fund.” The CUMAA instructs the National Credit Union Administration (NCUA) to implement regulations that establish a system of prompt corrective action for credit unions that is consistent with the PCA regime for banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) but that takes into account the unique cooperative nature of credit unions.

NEED FOR REFORM OF CREDIT UNION PROMPT CORRECTIVE ACTION

The legislative creation of credit union Prompt Corrective Action in 1998 was a significant first step in establishing capital requirements for credit unions. Indeed, during the first two full years of PCA’s existence, the number of seriously undercapitalized credit unions has declined substantially, while the costs of resolving failed credit unions have remained modest. However, capital requirements were not the original purpose of the CUMAA. The genesis of the Act was the Supreme Court’s field of membership decision of 1998 that prohibited the NCUA from approving credit union fields of membership comprising more than one group. Most of Congress’ attention at the time was necessarily devoted to resolving the field of membership issue. Therefore, it is not at all unusual that there should be a need for some modifications to PCA now that the NCUA and the credit union movement have some experience with it.

Basic problems with the current PCA system are:

1 The first NCUA Call Reports under PCA were those for December 2000. From December 2000 to December 2002, the number or credit unions classified as either critically or significantly undercapitalized fell from 60 to 32. As of December 2002, 0.33% of credit unions were so undercapitalized, and they represented just 0.07% of credit union assets. During 2001 and 2002, insurance losses at the NCUSIF averaged 0.003% of insured shares.
- **HIGH BASIC CREDIT UNION CAPITAL REQUIREMENTS.** Credit unions have higher capital requirements than do banks, even though the credit union share insurance fund has an enviable record compared to other federal deposit insurance funds.\(^2\) Indeed, because of the influence of credit unions’ cooperative structure on their operations, it has been argued that credit unions require less capital to meet potential losses than to other depository institutions.\(^3\)

- **NET WORTH REQUIREMENT HARD CODED INTO LAW.** Bank and thrift regulatory agencies are empowered to establish the capital ratios that place institutions into the various capitalization categories: well capitalized, adequately capitalized, inadequately capitalized, etc. In the case of credit unions, the actual numerical values for these ratios are written into the law.\(^4\) This denies the NCUA the opportunity to establish net worth ratios based on its informed understanding of potential threats to the National Credit Union Share Insurance Fund.

- **LACK OF ACCESS TO CAPITAL MARKETS.** Credit unions may only use retained earnings to build net worth. They are currently not permitted any form of secondary capital, which could be used to augment retained earnings in meeting capital requirements.

- **RISK BASED SYSTEM COULD BE IMPROVED.** The risk-based net worth requirements for credit unions under PCA incorporate a significant improvement over banks’ Basel-type risk based capital requirements. The credit union system explicitly accounts for both interest-rate and credit risk. The current Basel system considers only credit risk. However, the Basel system’s method of applying different risk weights to assets permits a more precise accounting for risk than does the credit union system, which focuses on concentrations of assets in the balance sheet.\(^5\)

Taken together, these problems can create an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that those credit unions with net worth ratios well below those required to be adequately capitalized should be subject to prompt and stringent corrective action. There is no desire to shield such credit unions from PCA. They are indeed the appropriate targets of PCA. However, the pernicious effects of PCA have been on those credit unions that have more than enough capital to operate in a safe

\(^2\) See Appendix I for a comparison of relevant bank and credit union data.

\(^3\) In Differences in Bank and Credit Union Capital Needs (Filene Research Institute, Madison, WI. 2001) David M. Smith and Stephen A. Woodbury find that credit unions have lower loan delinquencies and net-charge off rates than do banks, and that charge-offs at credit unions are only two-thirds as sensitive to macroeconomic shocks as they are at banks.

\(^4\) Legislated net worth categories for credit unions under PCA are as follows: net worth ratio under 2%, “critically undercapitalized”; 2% to 4%, “significantly undercapitalized”; 4% to 6%, “undercapitalized”; 6% to 7%, “adequately capitalized”; and over 7%, “well capitalized”. In addition, in order to be “adequately-“ or “well-“ capitalized, a credit union must meet a risk-based net worth requirement determined by regulation.

\(^5\) Appendix II provides a more in-depth comparison of bank and credit union capital requirements.
and sound manner, but that feel constrained by potential future reductions in their net worth ratios. The law stipulates that a credit union with a 6% net worth ratio is “adequately” capitalized. Considering the risk exposure of the vast majority of credit unions, 6% is indeed a completely adequate level of net worth. However, because of PCA, a very well run, very healthy, very safe and sound credit union cannot feel comfortable operating with just a 6% net worth ratio. This is because of the effect of potential growth on a credit union’s net worth ratio. Without access to capital markets, a spurt of growth brought on by members’ desire to save more at their credit union can quickly lower a credit union’s net worth ratio, even if the credit union maintains a healthy net income rate.

This effect goes far beyond those credit unions that are close to the 6% cutoff for being considered adequately capitalized. Again because of the conservative management style consistent with their cooperative structure, most credit unions wish to be always classified as “well” rather than “adequately” capitalized. In order to do that, they must maintain a significant cushion above the 7% level required to be “well” capitalized so as not to fall below 7% during a period of rapid growth. A typical target is to have a 200 basis point cushion above the 7% standard. Thus, in effect, the PCA regulation, which was intended to ensure that credit unions maintain a 6% capital ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50% higher than that level. The PCA regulation in its present form thus incents credit unions to operate at “overcapitalized” levels.

There are two ways to resolve these problems. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the share insurance fund and does not upset the unique cooperative ownership structure of credit unions. Secondary capital could come either from members in the form of uninsured shares, or from nonmembers in the form of subordinated debt or trust preferred securities. There would likely be limits on the extent to which a credit union could rely on secondary capital to meet net worth requirements. For example, secondary capital might be limited to no more than 50% of total capital for purposes of meeting net worth requirements. That said, the rest of this paper deals with reforming basic PCA requirements rather than with secondary capital.

The other solution would be a reform of PCA requirements themselves. Reform of prompt corrective action should have two primary goals. First, it should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized. This will maintain the very strong incentives for credit unions to avoid becoming seriously undercapitalized. This is essential to achieving the purpose of minimizing losses to the share insurance fund. Second, a reformed PCA should not induce well-capitalized credit unions to feel the need to establish such a large buffer over minimum net worth requirements that they feel required to become overcapitalized.
We present below two types of reform that meet both of these goals. The first would replace the current two-phased PCA system with a single system of risk-based capital. The second option would adopt a Basel-type risk-based system specific to credit unions, with concomitant adjustments to core net worth requirements.

TRADITIONAL CREDIT UNION RISK ASSET SYSTEM.

Prior to the CUMAA, although credit unions were not subject to an explicit net worth requirement, they were required to make transfers to a regular reserve account (a form of net worth) based on the current ratio of their regular reserves to risk assets. Risk assets at the time were defined as all loans not guaranteed by the federal government, and all investments with maturities over 5 years. That system was successful in incenting a well-capitalized credit union system, but did not include the specified sanctions for undercapitalized credit unions that are a hallmark of PCA. The first reform would incorporate that prior definition of risk assets into the PCA system by modifying the definition of “net worth ratio” for PCA as contained in the Act. Specifically, the current definition “the ratio of the net worth of the credit union to the total assets of the credit union” would be changed by inserting “risk” between “total” and “assets.” Risk assets could be defined in the Act as non-guaranteed loans and long-term investments, or NCUA could be instructed to define “risk assets” in a manner consistent with its previous regulation. In addition to amending the definition of the net worth ratio, a conversion to a traditional credit union risk based system would also need to incorporate a minimum core leverage requirement to ensure that an undercapitalized credit union that held primarily non-risk assets would not be inappropriately shielded from PCA. To that end, in addition to maintaining the stipulated level of net worth to total risk assets, a credit could be required to maintain a ratio of net worth to total assets of at least 4% to be considered adequately capitalized. Further, any credit union with a ratio of net worth to total assets of less than 3% or 2% would be considered significantly or critically undercapitalized respectively, regardless of its net worth ratio.

Under this proposal, a credit union’s PCA capitalization classification would be determined as follows:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Ratio of Net Worth to Risk Assets*</th>
<th>Ratio of Net Worth to Total Assets*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well Capitalized</td>
<td>Over 7%</td>
<td>&amp; 5% and above</td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>6% and above</td>
<td>&amp; 4% and above</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>4% and above</td>
<td>&amp; 3% and above</td>
</tr>
<tr>
<td>Significantly Undercapitalized</td>
<td>2% and above</td>
<td>&amp; 2% and above</td>
</tr>
<tr>
<td>Critically</td>
<td>Under 2%</td>
<td>or Under 2%</td>
</tr>
</tbody>
</table>
Undercapitalized *If a credit union’s net worth ratio falls into different categories by risk and total assets, the lower classification would apply.

A CREDIT UNION BASEL BASED SYSTEM.

This version of PCA reform would incorporate the best components of both the Basel system (credit risk based) in use by banks in the U.S. and the risk-based portion of the current PCA (primarily interest rate risk based). Specifically, net worth requirements could be based on risk weights for assets as under Basel, but with the weights established on the basis of both credit risk and interest rate risk. The risk weights could be set by NCUA based on the Basel system, and its knowledge and understanding of credit union operations. Because some of the weights would be assigned on the basis of interest rate risk, it is likely that the NCUA could choose to adopt some credit-risk weights that are different from those currently in use by bank regulators under the Basel system.

An outline of a possible way of creating credit union specific set of Basel weights follows. Unless an item is in bold type, its weight is the same as under the current bank Basel system.

- **0% risk weights:**
  - cash and direct claims on the US government
  - claims unconditionally guaranteed by the US government or US government agencies

- **20% risk weights:**
  - claims on or guaranteed by US depository institutions
  - claims conditionally guaranteed by the US government
  - claims on US government sponsored agencies
  - claims on other state and local governments
  - highly rated asset- and mortgage-backed securities
  - some other highly rated or collateralized securities

- **50% risk weights:**
  - single- and multi-family residential mortgage loans with adjustable rates, or less than 5 years to next repricing
  - some securities with ratings not high enough to qualify for the 20% group

- **75% risk weight:**
  - single- and multi-family residential mortgage loans with more than 5 years to next repricing (50% under bank Basel)
• consumer loans (100% under bank Basel)

• 100% risk weights:
  • all other claims on private obligors, which includes business loans and many private securities
  • land, building and other fixed assets
  • investments in subsidiaries

This approach has two differences from the standard, bank-type Basel system, and both involve the creation of a new 75% risk weight category. First, fixed-rate, long-term mortgage loans would be assigned a 75% weight under the credit union system rather than the 50% weight of the bank system. This is to account for the higher interest rate risk of fixed-rate first mortgages compared to other assets on the credit union balance sheet. This is despite the fact that foreclosure rates on credit union mortgages are believed to be lower than at banks. The second change is that consumer loans at credit unions would be assigned a 75% weight rather than the 100% weight for banks. This is to account for both the relatively lower interest rate risk of such loans compared to other assets on credit union balance sheets, and the fact that credit union loan delinquency and charge-off rates are substantially lower than those at banks. \(^6\) (Smith and Woodbury.)

To account for the possibility that a credit union with very little capital could achieve a sufficient ratio of net worth to risk assets by holding predominantly low-risk assets, in order to be classified as adequately capitalized, a credit union could also be required to maintain at a ratio of net worth to total assets of at least 4%.

Under this Basel-type proposal, a credit union’s PCA capitalization classification would be determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>Ratio of Net Worth To Risk Based Assets*</th>
<th>Ratio of Net Worth To Total Assets*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well Capitalized</td>
<td>Over 10%</td>
<td>&amp; 5% and above</td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>8% and above</td>
<td>&amp; 4% and above</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>6% and above</td>
<td>&amp; 3% and above</td>
</tr>
<tr>
<td>Significantly Undercapitalized</td>
<td>2% and above</td>
<td>&amp; 2% and above</td>
</tr>
<tr>
<td>Critically Undercapitalized</td>
<td>Under 2%</td>
<td>or Under 2%</td>
</tr>
</tbody>
</table>

*If a credit union’s net worth ratio falls into different categories by risk and total assets, the lower classification would apply.

\(^6\) A variation on this approach would assign a 75% risk weight to secured consumer loans, and a 100% weight to unsecured consumer loans.
BASIC CREDIT UNION NET WORTH REQUIREMENTS

Both of these reform proposals involve improving the risk-based components of PCA and placing greater emphasis on the risk-based measures, while lowering the pure net worth ratio requirements to be classified as adequately capitalized. Each also maintains a basic 4% net worth requirement regardless of risk (compared to the current 6% requirement) to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the net worth levels to be classified as well- or adequately-capitalized is justified for the following reasons:

1. One of the original justifications for higher credit union net worth requirements (higher than for banks) is the 1% NCUSIF deposit. However, the 1% NCUSIF deposit is a systemic, as opposed to an individual credit union issue. The purpose of PCA is to minimize losses to the Share Insurance Fund. As such, it works by requiring the NCUSIF to take mandatory supervisory corrective action whenever an individual credit union’s net worth ratio falls below certain levels. These actions are designed to restore the credit union to an adequately capitalized level, or to force liquidation before that individual credit union’s net worth is completely depleted. In either event, losses to the Share Insurance Fund are minimized. The loss minimization effects of PCA are achieved more by managing the resolution costs of troubled credit unions than by requiring all credit unions to have so much capital that it becomes virtually impossible for any credit union to fail. The systemic issue of the 1% deposit really has nothing to do with the level of net worth at which NCUSIF might need to take corrective action with respect to any individual credit union. The only time the 1% issue would come into play is if huge numbers of credit unions failed concurrently, so that individual credit unions were required to write-down part of their 1% deposits. Given the high capitalization of most credit unions, and the very existence of PCA to force corrective action at individual credit unions before failure, such a systemic meltdown is very unlikely. Therefore, one might ask why does each credit union have to be overcapitalized compared to a similarly situated bank, and subject to PCA at higher net worth ratios, to guard against the extremely unlikely event that huge numbers of credit unions fail simultaneously? The answer is they should not be.

2. Another reason given for credit unions’ higher net worth requirements is their lack of access to capital markets. Credit unions’ only source of net worth is the retention of earnings, which is a time consuming process. The idea is that since credit unions cannot access capital markets, they should hold more capital to begin with so that they have it available in time of need. There is some merit to this notion, but a problem with this logic is that it suggests that a poorly capitalized institution can easily access the
capital markets. However, if an institution’s net worth ratio falls substantially due to losses, investors are likely to be wary of providing additional capital. Thus lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from other depository institutions as much as it might appear. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. The other reason that a credit union’s net worth ratio might fall – rapid asset growth – also should not require a higher net worth requirement for credit unions. Asset growth (which comes from savings deposits) can be substantially influenced by a credit union’s dividend policies. Lowering dividend rates create the dual effects of retarding growth and boosting net income, both of which raise net worth ratios compared to not lowering dividend rates. A credit union should be allowed to protect its net worth ratio with aggressive dividend rate cutting rather than being required to hold additional capital. Also, a credit union could maintain a 4% net worth ratio earning 1% of assets (close to the credit union average net income ratio over the past two decades) and still grow by as much as 30% per year. Therefore, lack of access to net worth from sources other than retained earnings does not justify a higher net worth requirement for credit unions.

3. There is substantial evidence that credit unions require less net worth than do for-profit financial institutions for purposes of providing protection to the deposit insurance system. Credit unions, because of their very cooperative nature, take on less risk than do for-profit financial institutions. Because credit union boards and management are not incented by stock ownership and options, the moral hazard problem of deposit insurance has much less room for play in credit unions than in other insured depository institutions. Evidence of the effects of this conservative financial management by credit unions is found in the fact that average credit union ratios for net worth, net income and credit quality have shown dramatically less volatility over that past two decades than comparable statistics for banks and thrifts. Similarly, the equity ratio of the NCUSIF has been remarkably stable between 1.2% and 1.3% while other federal deposit funds have seen huge swings and even insolvency. This is hardly evidence supporting the need of more capital in credit unions than in banks and thrifts.

SUMMARY OF THE EFFECTS OF THE PROPOSALS

7 See The federal deposit insurance fund that didn’t put a bite on U.S. taxpayers, Edward J. Kane and Robert Hendershott, Journal of Banking and Finance, Volume 20, September 1996, pp.1305-1327. In the abstract of their paper Kane and Hendershott state “the paper analyzes how differences in incentive structure constrain the attractiveness of interest-rate speculation and other risk-taking opportunities to managers and regulators of credit unions.” Smith and Woodbury (footnote 3) also find that because of the governance structure in credit unions “economic theory predicts that credit unions would take less risk than banks.” (p 5)

8 See Appendix I
How these proposals would affect the net worth classifications of credit unions as of last December is shown in the following table. The two proposals would classify fewer credit unions as undercapitalized (43 in the traditional risk system, and 57 with the modified Basel system compared to the 92 under the current PCA system.) However, the traditional risk proposal would identify the same number of critically and significantly undercapitalized credit unions (24) as the current system. These are credit unions most in need of corrective action. The modified Basel would actually identify more such credit unions, 33. All three approaches would identify similar numbers of well-capitalized credit unions. However, both of the proposals would provide more of the well-capitalized credit unions with a cushion of at least 200 basis points above the well-capitalized levels.

### Distribution of Credit Unions by Net Worth Category

#### Current PCA and Two Proposals

<table>
<thead>
<tr>
<th>Net Worth Category</th>
<th>Current PCA</th>
<th>Traditional Risk System</th>
<th>Basel-Based System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Critically Undercapitalized</td>
<td>13</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>Significantly Undercapitalized</td>
<td>11</td>
<td>9</td>
<td>15</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>68</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>Subtotal</td>
<td>92</td>
<td>43</td>
<td>51</td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>163</td>
<td>29</td>
<td>45</td>
</tr>
<tr>
<td>Well Capitalized by less than 2%</td>
<td>1,297</td>
<td>271</td>
<td>240</td>
</tr>
<tr>
<td>Well Capitalized by more than 2%</td>
<td>8,093</td>
<td>9,331</td>
<td>9,343</td>
</tr>
<tr>
<td>Well Capitalized Subtotal</td>
<td>9,390</td>
<td>9,602</td>
<td>9,583</td>
</tr>
</tbody>
</table>

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