REFORMING CREDIT UNION NET WORTH REQUIREMENTS

SUMMARY: This white paper discusses suggestions for revising the system of credit union net worth requirements. The appendix provides a comparison of credit union and bank capital requirements.

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 CUMAA stipulates both a basic net worth requirement and a risk-based net worth requirement for credit unions. This document suggests some possible modifications to credit union net worth requirements. It is followed by an Appendix providing additional information on the current system of net worth requirements for credit unions, comparing it to the system in place for banks.

REFORMING 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. 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. 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:

- 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. Further, credit union net worth requirements can only be changed by law, as opposed to being established by the relevant regulatory authority in the case of banks.
- Credit unions may only use retained earnings to build net worth. They are currently not permitted any form of secondary capital.
- The risk-based net worth requirements on some assets are so high that they effectively require a credit union to be overcapitalized if they have significant concentrations in those assets.

Taken together, these problems can create an unnecessary restraint on growth and member service by healthy, well-managed credit unions. 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% or total capital of purposes of meeting net worth requirements.

The other direction for reform would be some modification in PCA requirements. This could be done in a number of ways. One might be replacing the current two-phased PCA system with a single system of risk-based capital. The new risk-based approach could 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 the weights should be 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 appropriately defined risk-based system that captures the two major sources of balance sheet risk (interest-rate and credit risk) could well suffice as a net worth requirement for credit unions, without the need for a separate leverage ratio or basic net worth requirement. If that were not deemed to be sufficient, the law could be changed to require NCUA to set a basic leverage ratio for credit unions. However, because varying levels of risk would be more appropriately accounted for in a risk-based system, the basic leverage requirement for credit unions would no longer need to be higher than the bank requirement.

Indeed, without even significant changes in the treatment of risk in credit union PCA, a good case can be made that the basic net worth requirements of CUMAA should be lowered. CUNA believes the following points should be considered:

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 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 net worth is completely depleted. In either event, losses to the Share Insurance Fund are minimized. 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 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.
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 poorly capitalized institutions can easily access the capital markets. If an institution’s net worth ratio falls substantially due to losses, investors may 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. 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 almost 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. One could in fact argue that credit unions require less net worth than do for-profit financial institutions. Credit unions by 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.

Appendix

COMPARING CREDIT UNION AND BANK CAPITAL REQUIREMENTS

Credit union PCA differs from bank capital requirements in two ways: first, credit unions’ basic net worth requirements are hard-coded into the statute as opposed to being set at the discretion of the federal regulator. The net worth ratio required to be adequately capitalized for credit unions (6%) is specified in the CUMAA. The minimum required capital level for a bank (known as the leverage requirement) is technically 3%, but that level applies only to a bank that meets a number of conditions such as not expecting significant growth and having a CAMELS code of 1. It is very difficult to maintain a CAMELS code of 1 with only a 3% core capital ratio. For all other banks, the required minimum capital level or leverage requirement, set by FDIC, is 4%. That is 2 percentage points below the statutorily mandated 6% level for credit unions. (We have heard from bank officials that regulators effectively require 5% as a minimum, but that is not part of the
regulation). Savings institutions operate under similar ratios set by the Office of Thrift Supervision.

At the time of the passage of CUMAA, the two-percentage point additional requirement for credit unions was based on the following two considerations:

1. Credit unions’ deposits in the National Credit Union Share Insurance Fund (NCUSIF) of 1% of insured shares had been questioned by some as a double counting of assets because the asset is counted both on the books of credit unions and of the NCUSIF. Requiring an extra 1% of capital was said to address this issue.

2. As cooperatives without access to capital other than retained earnings, it takes longer for credit unions to accumulate capital; therefore, some policy makers felt they should hold more to start with.

The second difference between credit union and bank net worth requirements is in the treatment of risk. The credit union risk-based net worth requirement (RBNW) differs substantially from the Basel-based risk weighted assets used by the banking regulators. Under the Basel-based system used by banks, each asset is assigned a risk weight of 0%, 20%, 50%, or 100% depending on the credit risk of the asset. (There are also factors to account for some off balance sheet risks.) To the extent a bank has assets in the 0%, 20%, and 50% categories, its risk-weighted assets will be less than its total assets. Such a bank will have a higher ratio of capital to risks assets than capital to total assets. The risk-based capital ratio must exceed 8% in order for the bank to be adequately capitalized (in addition to meeting the leverage requirement).

The weighting categories are quite complex, but in summary form for retail focused domestic institutions and assets they are:

- 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
  - some securities with ratings not high enough to qualify for the 20% group

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

This risk weighting system is entirely based on credit risk. It takes no account of interest rate risk. For example, a long-term fixed rate mortgage is treated as being half as risky as a secured, adjustable rate auto loan. NCUA’s reading of the CUMAA is that PCA’s risk-based system must explicitly account for interest rate risk. It is for this reason that NCUA did not adopt the Basel system for the risk-based component of PCA.

The credit union risk based net worth (RBNW) system uses a completely different technique to account for risk. Instead of assigning risk weights of up to 100% to various types of assets, the RBNW system applies varying net worth requirements against different types of assets, with higher-risk assets requiring more net worth. “Standard” credit union assets are assigned a net worth requirement of 6% (the same as the average requirement to be considered adequately capitalized.) Some lower-risk assets have net worth requirements of less than 6% (0% or 3%), while other higher-risk assets have requirements of 8%, 12%, 14% and in one case even 20%. The weighted average of these risk-based net worth requirements is the credit union’s overall RBNW or “risk based net worth requirement”.

The following table summarizes the current risk-based net worth requirements of the PCA system. (The PCA risk based system is currently undergoing some revision to the member business loan component. The table shows the proposed treatment of MBLs. There are also requirements for some off-balance sheet items.)

**STANDARD RBNW REQUIREMENTS**

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Subcategory</th>
<th>Net Worth Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Long-term Real Estate Loans</td>
<td>Up to 25% of assets</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>Over 25% of assets</td>
<td>14%</td>
</tr>
<tr>
<td>2. Member Business Loans</td>
<td>Up to 15% of assets</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>15% to 25% of assets</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>Over 25% of assets</td>
<td>14%</td>
</tr>
<tr>
<td>3. Investments</td>
<td>Up to 1 year WAL*</td>
<td>3%</td>
</tr>
<tr>
<td></td>
<td>1 to 3 years WAL</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>3 to 10 years WAL</td>
<td>12%</td>
</tr>
<tr>
<td></td>
<td>Over 10 year WAL</td>
<td>20%</td>
</tr>
<tr>
<td>4. Cash on hand and NCUSIF Deposit</td>
<td></td>
<td>0%</td>
</tr>
<tr>
<td>5. All other assets**</td>
<td></td>
<td>6%</td>
</tr>
</tbody>
</table>

*WAL is Weighted Average Life. In this context, the term to the next repricing or maturity of the investment.
**In addition, the allowance for loan losses up to 1.5% of loans can be deducted from the RBNW.

COMPARING BASEL TO RBNW.

In addition to meeting its leverage requirement, under the Basel risk based capital system a bank is adequately capitalized if its ratio of capital to risk assets is more than 8%. Under PCA, in addition to meeting its basic 6% net worth requirement, a credit union is adequately capitalized if its net worth ratio exceeds its risk based net worth requirement. To better understand how the two systems operate, consider two types of institutions with the same pure leverage ratio (net worth to total assets) but with different levels of risk in the balance sheet. Further assume that each institution has enough capital to meet its leverage requirement. The “low-risk” institution under Basel would have much of its balance sheet in low weight assets (0%, 20% and 50%). Therefore, its risk-weighted assets would be considerably below its total assets. As a result, the ratio of its net worth to risk assets would be substantially above its leverage ratio. Such a bank would likely have very little difficulty meeting its risk-based capital requirement.

Consider now a low-risk institution under PCA. It would have few if any assets in the categories with high net worth requirements (8%, 12% or 14%) and a preponderance of assets in average or low requirement categories (6%, 3%, 0%). Such a credit union is likely to have an RBNW that is substantially less than 6%. It too would have no difficulty complying with its RBNW. In other words, a low-risk institution under Basel will have a high ratio of capital to risk assets. A low-risk institution under PCA will have a low risk-based net worth requirement. (As described below, a “low-risk” institution under Basel may not be a “low-risk” institution under PCA.)

Turning to the opposite type of case, consider institutions that meet their leverage ratios but have relatively risky balance sheets under either the Basel or PCA rules. Under Basel, if most of the assets are in 100% assets, the ratio of capital to risk assets will be only slightly higher than the ratio of capital to total assets. The bank might meet its pure leverage requirement (4% or 5% in practice) but not meet its 8% risk-based capital requirement. A similar type of institution under PCA would have many assets in the high-requirement categories. Therefore its RBNW could be considerably higher than 6% (the pure leverage requirement.) The credit union could meet its leverage requirement, but not its risk-based net worth requirement. In other words, a high-risk institution under Basel will have a lower ratio of capital to risk assets. A high-risk institution under PCA will have a higher risk-based net worth requirement. (As described below, a “high-risk” institution under Basel will probably not be a “high-risk” institution under PCA because of the different treatment of credit and interest-rate risk.)

The two systems are very different, both in their construction and in the types of risk they account for. Nevertheless, empirically, application of a Basel system or the PCA’s RBNW system give fairly similar results overall. Under both systems, the vast majority of credit unions hold far more capital than they need for the risk-based requirements. (For the analysis that follows, we compare the Basel and PCA systems when applied to all credit unions. In reality, under PCA the RBNW requirement only applies to credit unions with over $10 million in assets.)

Applying standard bank Basel weights to credit union data as of December 2002 shows that only 59 out of 9,654 credit unions have a ratio of net worth to risk assets of less than 8%. That is, only 59 credit unions would be undercapitalized under the Basel risk-based capital standard. Similarly, only 48 credit unions had a RNBW greater than their actual net worth ratio, i.e., only
48 credit unions were undercapitalized due to the PCA risk-based net worth requirement. However, most of these credit unions’ problems derived more from a shortage of net worth than from an over abundance of risk. If we limit the analysis to only those 9,572 credit unions with leverage ratios (net worth to assets) over 6%, only 8 credit unions would fail to meet the Basel standard, and the same number would not meet PCA’s RBNW standard.

Although the number of credit unions classified as undercapitalized by the two risk-based systems is similar, there are likely to be very few credit unions on both lists. (Indeed, the two lists of eight otherwise adequately capitalized credit unions that don’t meet the Basel or PCA risk-based requirements have no credit unions in common.) This is because the Basel system comes down heavily on credit risk, ignoring interest rate risk, while PCA is much more concerned about interest rate risk. This can perhaps best be seen by the following table, which shows the percentage capital requirements for various types of assets under the two systems. The capital requirements for PCA are taken directly from the RBNW requirements. For Basel, the risk weighting is applied to the 8% risk-based capital requirement (weight times 8%). For example, if an asset is in the 50% risk category, that asset has a capital requirement of 4%.

**COMPARISON OF CAPITAL REQUIREMENTS FOR SELECTED ASSETS UNDER BASEL AND PCA**

<table>
<thead>
<tr>
<th></th>
<th>Basel</th>
<th>PCA</th>
</tr>
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<tbody>
<tr>
<td>Commercial Paper</td>
<td>8%</td>
<td>3%</td>
</tr>
<tr>
<td>Short term bank deposits</td>
<td>1.6%</td>
<td>3%</td>
</tr>
<tr>
<td>1 Year Treasury</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>30 Year Treasury</td>
<td>0%</td>
<td>20%</td>
</tr>
<tr>
<td>Commercial loan (up to 15% of assets)</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>Commercial loan (over 25% of assets)</td>
<td>8%</td>
<td>14%</td>
</tr>
<tr>
<td>Consumer loan</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>Mortgage Loan (up to 25% of assets)</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Mortgage Loan (over 25% of assets)</td>
<td>4%</td>
<td>14%</td>
</tr>
</tbody>
</table>

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