REFORMING PCA

Addendum to Submitted Statements of

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and

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to the

National Credit Union Administration’s

Summit on Credit Union Capital

Representing the

Credit Union National Association

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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” (then defined as 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 PCA

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 three 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 surprising 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:

- **HIGH BASIC CREDIT UNION CAPITAL REQUIREMENTS.** Credit unions have higher capital requirements than do banks, even though the National Credit Union Share Insurance Fund has an enviable performance record compared to other federal deposit insurance funds. Indeed, because credit unions’ cooperative structure creates a systemic incentive against excessive risk taking, it has been argued that credit unions actually require less capital to meet potential losses than to other depository institutions.

- **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 specified in the law. 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.

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1 The first NCUA Call Reports under PCA were those for December 2000. From December 2000 to December 2003, the number or credit unions classified as either critically or significantly undercapitalized fell from 60 to 40. As of December 2003, 0.43% of credit unions were so undercapitalized, and they represented just 0.01% of credit union assets. During 2001 and 2002 and 2003, insurance losses at the NCUSIF averaged 0.003% of insured shares.

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.
• LACK OF ACCESS TO CAPITAL MARKETS. Except for a small number of low-income and community development credit unions, 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 protecting the share insurance fund and meeting capital requirements.

• RISK BASED SYSTEM COULD BE IMPROVED. In one way, the risk-based net worth requirements for credit unions under PCA represent an 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.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that those credit unions with net worth ratios well below the adequately capitalized level 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 and sound manner, but that feel constrained by potential future reductions in their net worth ratios that can result from growth in member deposits.

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 that is the product of 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. This reduces the ability of credit unions to provide benefits to members and to grow.

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 section of the addendum 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.

CUNA believes that the best way to reform PCA consistent with these two requirements would be to transform the system into one which is much more explicitly based on risk measurement. Because of the variety of risk exposures a credit union could come under for a given level of assets, the riskiness of those assets should be given greater consideration in determining capital adequacy.

A CREDIT UNION VERSION OF BASEL II

CUNA believes that a good starting point for considering a revision to the risk-based component of PCA is the recently finalized Basel II Accords of the Bank for International Settlements. Basel II is the result of an intense, five-year review of risk-based capital standards for financial institutions around the world. The arithmetic of Basel II differs from that of the current credit union PCA risk-based net worth requirement, but the two approaches seek the same result, to quantify capital adequacy in light of risk considerations. Under PCA, various assets are assigned net worth requirements, from as low as 0% to as high as 20%. A credit union must hold enough net worth to capitalize all assets depending on their risk weights. Under Basel II, each asset is assigned a risk weight, from 0% to 150% (most weights are 100% or lower), and a risk weighted asset figure is calculated
adding up the product of each asset the financial institution holds times its risk weight. The institution’s net worth is then divided by the risk asset total. To the extent an institution has assets with risk weights of less than 100%, its risk weighted assets will be less than its total assets, and the ratio of net worth to risk assets will be greater than the ratio of net worth to total assets.

The Basel II Accords have a number of changes from the original Basel system (Basel I), two of which are relevant to our discussion here. First, the approach of Basel I, in which each institution calculates a risk asset total based on standard risk weights, has been termed the “standardized” approach in Basel II. There have then been significant changes to this standardized approach in Basel II. Certain assets will have lower risk weights under Basel II than under Basel I. In particular, the risk weight for residential mortgages has declined from 50% under Basel I to 35% under Basel II. Further, the risk weight for “consumer” portfolios has been lowered from 100% to 75%. “Consumer” credits include all non-mortgage consumer loans plus small business loans, those business loans with a total exposure to the borrower of less than $1 million. These reduced weights will lead to substantial reductions in the amount of capital banks will need to hold to be considered adequately capitalized under Basel II. The amount of capital necessary for mortgage, consumer and small business loans will decline by slightly over 20% at those institutions using the standardized approach.

The second significant change in Basel II is the creation of a new “Internal Ratings-Based Approach” (IRB) whereby a financial institution can use complicated (and expensive) risk measurement techniques to analyze its assets and determine a risk assets total that is unique to that institution, i.e., that does not rely on the standardized approach. Empirical analysis suggests that banks that use the IRB will see the amount of capital they need to hold against their mortgage, consumer and small business portfolios decline by around 50%, much more than in the standardized approach. In addition, use of the IRB for other components of the balance sheet will lead to other reductions in capital requirements compared to the standardized approach.

A controversial feature of Basel II is that because of the expense and infrastructural requirements of the IRB, only the very largest banks will be able to employ it. In the US, it has been estimated that only the largest dozen or so of the nations over 9,000 banking institutions will use the IRB.

CUNA believes it is crucial for NCUA and the Congress to realize, at a time when PCA reform is under consideration, that after several years of intense study and analysis, the international banking regulators have come to the conclusion that the very types of loans that credit union hold are less risky than they previously thought was the case. The relevance of this change goes far beyond the question of risk-based capital in credit unions. It provides further evidence that credit unions should not be required to meet higher leverage requirements than banks.
NCUA has said that a direct application of Basel to credit union risk-based net worth requirements would not be appropriate because the Agency believes that the Federal Credit Union Act requires it to include interest rate risk in the determination of quantitative capital requirements. Basel explicitly accounts only for credit risk in its risk weights. We therefore suggest a modified version of Basel II, which would include additional risk weights for certain assets based on their interest rate risk. A credit union that held such assets would have a lower ratio of net worth to risk assets than another credit union that held none of those assets, other things being equal. Also, such a credit union would have a lower ratio of net worth to risk assets than a bank with theoretically an identical balance sheet. Specifically, we suggest that long-term, fixed rate mortgages have a risk weight of 50% instead of 35%. Further, medium- and longer-term investments could have higher risk weights than short-term investments. Those with remaining maturities of 1 to 3 years could have an additional risk weight of 5%; those with remaining maturities of 3 to 10 years, 10%; and those beyond 10 years, 20%.

Under this system, the following risk weights would apply:

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

- **20% risk weights**
  - claims on or guaranteed by US depository institutions
  - claims conditionally guaranteed by the US government
  - claims on US sponsored agencies
  - other highly rated securities

- **35% risk weights**
  - residential real estate loans that are not long-term, fixed rate

- **50% risk weights**
  - long-term, fixed rate real estate loans

- **75% risk weights**
  - all consumer loans
  - member business loans where the total exposure to any one borrower is less than $1 million

- **100% risk weights**
  - member business loans where the total exposure to any one borrower is over $1 million
  - land, building and other fixed assets
  - investments in CUSOs
- 150% risk weights
  - delinquent loans

- Additional weights
  - 5% for investments between 1 and 3 years remaining maturity
  - 10% for investments between 3 and 10 years remaining maturity
  - 20% for investments with over 10 years remaining maturity

A conversion to a more 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. CUNA believes that Congress should grant NCUA the authority to set minimum leverage requirements equivalent to the authority that banking regulators have in setting leverage ratios for banks. Failing that, a lowering of the required net worth ratio from 7% to 5% for a well capitalized credit union and from 6% to 4% for an adequately capitalized credit union, retaining the language that these requirements could be changed by NCUA should the banking agencies change bank leverage requirements, would be appropriate.

This reform proposal involves improving the risk-based components of PCA and placing greater emphasis on the risk-based measures, while lowering the pure net worth ratio requirements (leverage ratio) 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. It does this in two ways. First, it creates a powerful incentive for individual credit unions to maintain net worth ratios above those required by the regulation. Second, it requires the NCUSIF to take mandatory supervisory corrective action whenever an individual credit union’s net worth ratio falls below certain levels. These corrective 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, reducing losses to the Share Insurance Fund. 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, or to the level of net worth that an individual credit union should aspire to so as to comply with the rule. The only time the 1% issue would come into play in the context of PCA 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 strong capitalization of credit unions that PCA itself incents, and the existence of PCA to force corrective action at individual credit unions before failure, such a systemic meltdown is extremely unlikely. Therefore, one might ask why does each credit union have to be overcapitalized compared to a similarly situated bank, 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. A problem with this logic is that is 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 creates the dual effects of retarding growth and boosting net income, both of which raise net worth ratios. A credit union should be allowed to protect a reasonable 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 (an earnings level consistent with the highest CAMEL rating of 1 and 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.\(^5\) Because credit union boards and management are not

\(^5\) 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
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 demonstrated by 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.\(^6\) 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.

4. As previously mentioned, the Bank for International Settlements, in promulgating the standardized approach of Basel II, provides further evidence that credit union balance sheets are concentrated in low-risk assets. As compared to Basel I, the risk weights for residential mortgages, consumer loans, and small business loans have all been decreased.

Reforming PCA along the lines of the risk-based approach suggested here would preserve and strengthen the essential share-insurance fund protection of PCA. It would more closely tie a credit union’s net worth requirements to its exposure to risk – the reason for holding net worth in the first place. It would also permit adequately and well-capitalized credit unions to operate in a manner devoted more to member service and less to unnecessary capital accumulation.

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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)  
\(^6\) See Appendix I
## Frequently Requested U.S. Credit Union/Bank Comparisons

<table>
<thead>
<tr>
<th>Year</th>
<th>NCUSIF</th>
<th>FDIC BIF</th>
<th>CUs</th>
<th>Banks</th>
<th>CUs</th>
<th>Banks</th>
<th>CUs (60+)</th>
<th>Banks (90+)</th>
<th>Total Assets (billions)</th>
<th>Average size (millions)</th>
<th>Asset Growth</th>
<th>New Charters</th>
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<td>5.80%</td>
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<td>$38.4</td>
<td>$668.4</td>
</tr>
<tr>
<td>2000</td>
<td>$1.33</td>
<td>-$1.35</td>
<td>1.02%</td>
<td>1.19%</td>
<td>11.14%</td>
<td>8.50%</td>
<td>0.74%</td>
<td>1.12%</td>
<td>$449.8</td>
<td>$6,238.7</td>
<td>$42.1</td>
<td>$750.3</td>
</tr>
<tr>
<td>2001</td>
<td>$1.27</td>
<td>-$1.26</td>
<td>0.95%</td>
<td>1.15%</td>
<td>10.93%</td>
<td>9.09%</td>
<td>0.85%</td>
<td>1.41%</td>
<td>$515.1</td>
<td>$6,552.0</td>
<td>$49.5</td>
<td>$810.9</td>
</tr>
<tr>
<td>2002</td>
<td>$1.27</td>
<td>-$1.27</td>
<td>1.07%</td>
<td>1.33%</td>
<td>10.85%</td>
<td>9.16%</td>
<td>0.79%</td>
<td>1.45%</td>
<td>$574.2</td>
<td>$7,075.0</td>
<td>$57.2</td>
<td>$897.0</td>
</tr>
<tr>
<td>2003</td>
<td>$1.27</td>
<td>-$1.32</td>
<td>0.98%</td>
<td>1.40%</td>
<td>10.77%</td>
<td>9.10%</td>
<td>0.77%</td>
<td>1.19%</td>
<td>$620.9</td>
<td>$7,602.5</td>
<td>$65.2</td>
<td>$978.6</td>
</tr>
</tbody>
</table>

### Notes:
- NCUSIF & FDIC fiscal years end in December. Prior to 1995, NCUSIF’s fiscal year ended in September.
- Insurance fund equity is expressed in dollars per $100 insured.
- Net income ratio is net income as a percent of average total assets (after tax).
- Capital ratio is capital (excluding loss allowances) as a percent of total assets.
- Loan delinquency expressed as ratio of dollars delinquent to dollar amount of total loans. (CUs 60 days or more delinquent, banks 90 days or more plus non-accrual loans.)
- Average size is average assets per institution.

### Sources:
- Insurance fund information from NCUSIF, FDIC.
- Credit union information from Credit Union National Association, Economics & Statistics Department.
- Bank information from FDIC.
Figure 1: Insurance Fund Ratios
Credit Union & Bank Insurance Funds

Source: FDIC & NCUSIF
Figure 2: Net Income Ratios
Credit Unions & Commercial Banks

Source: FDIC, NCUA, and CUNA E&S.
Figure 3: Equity Capital Ratios
Credit Unions & Commercial Banks

Source: FDIC, NCUA, and CUNA E&S.
Figure 4: Loan Delinquency Ratios
Credit Unions & Commercial Banks

Source: FDIC, NCUA & CUNA E&S
Figure 5: Total Assets
Credit Unions & Commercial Banks

Source: FDIC, NCUA & CUNA E&S
Figure 6: Average Institution Size as of December 2002
Credit Unions & Commercial Banks

Source: FDIC, NCUA, and CUNA E&S.
Figure 7: Asset Growth
Credit Unions & Commercial Banks

Source: FDIC, NCUA, and CUNA E&S.
Figure 8: New Charters
Credit Unions & Commercial Banks

Source: FDIC, NCUA, and CUNA E&S.