NATIONAL CREDIT UNION ADMINISTRATION

REVISIONS

PROMPT CORRECTIVE ACTION
REFORM PROPOSAL

April 2007

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FOREWORD

The Credit Union Membership Access Act of 1998 mandated a system of Prompt Corrective Action (PCA) for credit unions designed to ensure problems in federally insured credit unions are resolved at the least long-term cost to the NCUSIF. PCA, and the focus it creates on active management of capital levels, has proven very valuable to NCUA's management of the National Credit Union Share Insurance Fund (NCUSIF) and the overall health of the credit union system. NCUA continues to strongly support a robust, statutorily mandated PCA system that fosters healthy capitalization levels and effective capital management in federally insured credit unions. However, the current statutory requirements for credit unions are too rigid and establish a structure based primarily on a "one-size-fits all" approach, which:

- Creates inequities for credit unions with low-risk balance sheets,
- Limits NCUA's ability to have a more relevant risk-based requirement without requiring unduly high capital levels, and
- Fosters accumulation of capital levels in excess of what is needed for most credit unions' safety and soundness and strategic needs.

A PCA system that is more risk-based, coupled with a leverage ratio more closely aligned with the requirement for other federally insured financial institutions, provides credit unions with greater ability to manage compliance through adjustments to their assets and activities and is consistent with sound risk management principles.

Based on December 31, 2006 data, credit unions enjoy very strong capital levels with 98.5 percent of credit unions categorized as Well Capitalized under PCA. Credit unions' conservative nature and limited ability to manage compliance with capital standards has resulted in their accumulating a cushion of capital well in excess of PCA requirements, with the aggregate level of capital in excess of 11 percent of total assets. Though high capital levels afford the insurance fund with additional protection and credit unions with various benefits, it comes with a cost. Over 90 percent of credit unions maintain a leverage ratio (net worth to total assets) more than 200 basis points in excess of PCA requirements. If credit unions had more flexibility to manage their compliance with PCA, they could still maintain a good cushion above regulatory requirements while safely returning more earnings to the members and/or expanding member services and other outreach programs.

Further, as the federal bank and thrift regulators are in the process of implementing changes to the capital standards under which their regulated institutions operate, it becomes even more important that capital standards for credit unions be updated to remain comparable and incorporate relevant improvements in approaches to measuring risk and allocating capital. The proposed PCA reforms for credit unions are designed to achieve greater comparability with other federally insured financial institutions, specifically with non-BASEL II FDIC-insured institutions, be more forward looking, provide a good balance between sound protection for the insurance fund and reasonable constraints on insured institutions, and make credit union capital requirements more risk-sensitive.

There are inherent limitations in risk-based capital techniques, and thus the leverage ratio plays an important part in a good regulatory capital system. However, it is important to have the right interplay between the leverage and risk-based requirements to ensure the risk-based requirement is effective in influencing risk management decisions of institutions and more closely relates required capital levels to institution specific risk profiles. In order to achieve greater comparability and a more risk-based system, some reduction in the standard net worth (i.e., leverage) ratio requirement for credit unions is proposed. Adjustment of the leverage ratio for credit unions will enable it to effectively complement the risk-based requirement, not overshadow it. This shift in emphasis to the risk-based requirement will promote more active management of risk in relation to capital levels. It will also reduce any competitive disadvantage that results from being held to a higher capital standard than other federally insured institutions when the higher standard is not warranted.

Of course, there are some differences between the types of federally insured financial institutions that need to be taken into account. For example, credit unions have limitations on their ability to raise capital. In addition, there is the need to account for the 1 percent deposit method of capitalizing the NCUSIF given its effect on the overall capital in the share insurance fund and the credit union system. Thus, the reform proposal incorporates a revised method for calculating the net worth ratio for PCA purposes by adjusting for the deposit credit unions maintain in the share insurance fund. However, the proposed treatment of the NCUSIF deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles, or NCUA's steadfast support of the mutual, deposit-based nature of the NCUSIF.

There are limitations in any regulatory capital scheme. No regulatory capital system can encompass all of the possible risks, nor factor in all relevant variables (both qualitative and quantitative), to be able to stand on its own. Also, PCA does not address capital management relative to the strategic needs of an institution. PCA merely sets *minimum* levels of capital that work in tandem, not isolation, with a robust supervisory review process (i.e., an examination and supervision program). Thus, NCUA's examination and supervision process will continue to involve an analysis of each credit union's capital position in relation to the complete, unique risk profile and strategic needs of the institution. This analysis can result in a need for capital levels higher than regulatory minimums. As such, this reform proposal also includes recommendations to improve NCUA's ability to address capital related risk management concerns.

The proposed new PCA system is rigorous in that it is much more effective at relating risk to capital levels, is more aggressive in respect to thinly capitalized institutions, and provides NCUA with additional supervisory tools to address capital weaknesses in institutions. The proposal also effectively balances the need for healthy credit unions to utilize capital more efficiently to best serve their members with maintaining safety and soundness and protecting the share insurance fund.

SUMMARY OF CHANGES

The March 2005 *Prompt Corrective Action Proposal for Reform* has been revised to reflect input by the Department of the Treasury and other suggested revisions. In addition, adjustments were made to the risk-based proposal impact model based on the direction the risk-based standards for non-BASEL II FDIC-insured institutions have taken (i.e., BASEL I-A).[1] This document covers all the proposed changes, as well as includes all of the statutory changes recommended. However, for the sake of brevity, all of the still relevant background information contained in the March 2005 proposal is not repeated, such as the discussion of credit unions' loss history and the treatment of membership interests.

A. Summary of Key Changes from Original Proposal

- The original proposal based the leverage ratio thresholds for each PCA category on the FDIC's levels (e.g., 5% for Well Capitalized). This revised proposal adds 25 basis points to the PCA categories for the leverage ratio to account for credit unions' limitations in raising capital relative to FDIC-insured institutions. (see Section B below)

- The original proposal set an 8 percent threshold for the risk-based requirement's Well Capitalized level, though the FDIC's threshold is set at 10 percent. NCUA did not make a distinction in the original proposal between Adequately and Well Capitalized for the risk-based requirement given credit unions are subject to an earnings retention requirement when less than Well Capitalized, whereas the FDIC's PCA system mandates corrective action for only less than Adequately Capitalized institutions. However, NCUA is proposing to eliminate the earnings retention requirement (see next item). Thus, the risk-based threshold for Well Capitalized was increased to 10 percent. This provides greater comparability and increases the emphasis on the risk-based requirement.

- NCUA proposes elimination of the earnings retention requirement in favor of a discretionary requirement to submit a net worth restoration plan. By increasing the leverage requirement to account for credit unions' inability to raise capital, there is no need for a mandatory requirement. Further, the earnings retention requirement of 0.4% is an arbitrary earnings goal with no relationship to an increase in the net worth ratio itself or the credit union's circumstances, and results in difficulties in its practical application. Specifically, a decline in the net worth ratio typically occurs due to financial problems resulting in a net operating loss for the institution. Resolution of the case involves proper recognition of losses (e.g., accounting adjustments, loan loss funding), making achievement of an arbitrary profitability goal inconsistent with proper problem resolution and accounting procedures. Thus, it is best to address any decline in net worth by empowering the Board to require submission of a comprehensive net worth restoration plan when the supervisory review determines one is needed. This increases

[1] See the Joint Notice of Proposed Rulemaking regarding Risk-Based Capital Guidelines published in the Federal Register on December 26, 2006.

NCUA's authority in addressing situations of declining net worth. This also eliminates the need for one of the technical corrections in the first proposal.

- The original proposal provided the NCUA Board with the authority to waive submission of a net worth restoration plan in cases involving short-term, marginal declines in net worth. Given the lower leverage requirement relative to current standards, this proposed authority was narrowed to apply only to instances involving major disasters.

B. Leverage Ratio

As Table 1 shows, the proposed leverage ratio thresholds reflect an additional 25 basis points for all but one PCA category[2] to account for credit unions' limitations in raising capital. The additional 25 basis points represents a cushion of one-year's worth of earnings given modest growth levels. For example, if a credit union operated with no profit in a given year and had asset growth of 5 percent,[3] the leverage ratio would decline from 5.25 percent to 5 percent. Conversely, if the leverage ratio declined to 5 percent, it would take one-year's worth of a modest return on assets level of 0.50 percent, again assuming 5 percent asset growth, to restore the leverage ratio to 5.25 percent.

Table 1 – Proposed PCA Thresholds for Credit Unions Compared to Bank PCA Thresholds

	Credit Unions		FDIC Insured**		
PCA Category*	**Leverage Ratio**	**Risk-Based Ratio**	**Tier 1 Capital to Total Assets (Leverage)**	**Tier 1 Capital to Risk Assets**	**Total Capital to Risk Assets**
Well Capitalized	5.25% or greater	10% or greater	5% or greater	6% or greater	10% or greater
Adequately Capitalized	4.25% to < 5.25%	8% or greater	4% to < 5% > 3% for CAMEL 1	4% to < 5%	8% to < 10%
Undercapitalized	3.25% to < 4.25%	6% to < 8%	3% to < 4% or < 3% for CAMEL 1	3% to < 4%	6% to < 8%
Significantly Undercapitalized	2% to < 3.25%	< 6%	2% to < 3%	< 3%	< 6%
Critically Undercapitalized	< 2%	NA	< 2% (tangible equity)	NA	NA

* The lowest category an institution falls into governs
** Source: FDIC Rules and Regulations §325.103

[2] Given that the proposed new method for calculating the leverage ratio raises the standard for Critically Undercapitalized, the proposal does not increase it an additional 25 basis points as this would further compress the Significantly Undercapitalized category.
[3] The median and mean levels of annual asset growth for credit unions over the last 10 years are 4.53% and 5.33% respectively.

As illustrated in Table 2, the proposed leverage ratio standard will result in maintaining the capital requirement for Significantly Undercapitalized and raising the capital requirement for Critically Undercapitalized. For the remaining categories, the actual reduction from the old to the new leverage ratio requirement is considerably less than the *prima facie* 175 basis point change in the threshold. This is due to the impact of the change in the method for calculating the net worth ratio whereby the NCUSIF deposit is subtracted from both net worth and total assets (see Appendix 3). As Column C shows, the required average net worth level would only decline by 104 basis points in the top three PCA categories. The new calculation method will actually require 74 basis points more in net worth in the Critically Undercapitalized category than the existing standard. (See Appendix 2 for additional explanation.)

Table 2 – Current vs. Proposed Leverage Ratio Standard

PCA Category	Column A Current Requirement Net Worth / Total Assets	Column B Proposed Requirement (Net Worth – NCUSIF) / (Total Assets – NCUSIF)	Column C Net Worth Required by Column B to Total Assets[4] [Range]	Change Column A- Column C [Range]
Well Capitalized	> 7%	> 5.25%	5.96%* [5.25% - 6.14%]	-104 bp [-175 bp to -86 bp]
Adequately Capitalized	< 7%	< 5.25%	5.96%* [5.25% - 6.14%]	-104 bp [-175 bp to -86bp]
Undercapitalized	< 6%	< 4.25%	4.96%* [4.25% - 5.16%]	-104 bp [-175 bp to -84 bp]
Significantly Undercapitalized	< 4%	< 3.25%	3.97%* [3.25% - 4.18%]	-3 bp [-75 bp to +18 bp]
Critically Undercapitalized	< 2%	< 2%	2.74%* [2% - 2.95%]	+74 bp [0 bp to +95 bp]
* Calculation based upon the average insured share to asset ratio of 75%.				

[4] The amount of change in a credit union's leverage ratio between the current and proposed calculations is dependent upon the level of insured shares. The new calculation would result in the same leverage ratio threshold if a credit union had no insured shares. The largest reduction from the current leverage ratio to the calculated leverage ratio would occur when a credit union has all insured shares. These two extremes are for illustration purposes to show the potential impact of the calculation change. Application of the proposed calculation disclosed that over 92 percent of credit unions realize a reduction in the leverage ratio from 50 basis points to 90 basis points with an average reduction of 70 basis points (see chart 2 on page 16).

C. Risk-Based Ratio

Given NCUA's intention that the credit union PCA system remain comparable with other federally insured financial institutions, including the risk-based requirement, NCUA will continue to closely monitor developments in risk-based capital standards. The results of the impact of the risk-based requirement are contained in the Impact Analysis section of this report. The risk portfolios and weights in Appendix 1 broadly illustrate application of the most recent proposal for BASEL 1-A[5] and how the impact of this proposal was modeled using December 31, 2006 call report data. The information in Appendix 1 is an outline of the proposed risk portfolios and weights, as well as some noteworthy detail, but is not a comprehensive list of all of the specific regulatory provisions that would be needed for full implementation. The proposed risk-based net worth requirement would be implemented via regulation, which will provide all parties with opportunity to provide input via the standard rulemaking process.

D. Tandem System

As Table 2 reflects, the adjustment for the NCUSIF deposit combined with an additional 25 basis points added to the PCA category thresholds has the effect of maintaining or raising the leverage standards for the most thinly capitalized credit unions. Also, unlike the current risk-based system which can only result in a credit union being classified as Undercapitalized, the proposed new risk-based requirement can result in a credit union being classified as Significantly Undercapitalized. Further, the new risked-based requirement results in a more risk-based system overall, which is more forward looking. The proposed risk-based requirement will govern (i.e., require more net worth in relation to total assets than the leverage requirement does) in over 60 percent of credit unions, with an average net worth requirement of 6.4 percent compared to 6 percent (on average) for the leverage ratio (see the Impact Analysis section).

[5] See the Joint Notice of Proposed Rulemaking regarding Risk-Based Capital Guidelines published in the Federal Register on December 26, 2006.

REVISED STATUTORY CHANGES RECOMMENDED

Additions are presented in italics, strikethroughs are used for deletions.

NET WORTH CATEGORIES - § 1790d(c)(1)

Change
(A) **Well capitalized.** - An insured credit union is 'well capitalized' if - (i) it has a net worth ratio of not less than ~~7~~ *5.25* percent; and (ii) ~~it meets any applicable risk-based net worth requirement under subsection (d)~~ *it has a risk-based net worth ratio of not less than 10 percent.*
(B) **Adequately capitalized.** - An insured credit union is 'adequately capitalized' if - (i) it has a net worth ratio of not less than ~~6~~ *4.25* percent; and (ii) ~~it meets any applicable risk-based net worth requirement under subsection (d)~~ *it has a risk-based net worth ratio of not less than 8 percent*.
(C) **Undercapitalized.** - An insured credit union is 'undercapitalized' if - (i) it has a net worth ratio of less than ~~6~~ *4.25* percent; or (ii) ~~it meets any applicable risk-based net worth requirement under subsection (d)~~ *it has a risk-based net worth ratio of less than 8 percent.*
(D) **Significantly undercapitalized.** - An insured credit union is 'significantly undercapitalized' if - (i) it has a net worth ratio of less than 3.25 percent; (ii) the credit union has a net worth ratio of less than 4.25 percent and either— (I) fails to submit an acceptable net worth restoration plan within the time allowed under subsection (f); or (II) materially fails to implement a net worth restoration plan approved by the Board; or (iii) the credit union has a risk-based net worth ratio of less than 6 percent.

Comment

These changes reset the benchmarks for the net worth categories. The leverage requirement begins with the Well Capitalized threshold at 5.25%. Though this is lower than the current 7% requirement, it is equivalent to a 6% level relative to how the net worth ratio is currently calculated. The adjustment for credit unions' limitations in raising capital and the NCUSIF deposit makes this level comparable to the leverage ratio requirement for FDIC-insured institutions.

The changes also set a statutory threshold for the risk-based net worth ratio comparable to that used for the total risk-based capital requirement of FDIC-insured institutions. In addition, it adds a risk-based standard to the Significantly Undercapitalized requirement.

The threshold for Critically Undercapitalized (not shown here since no change is recommended) remains at 2%.

ADJUSTING NET WORTH LEVELS - § 1790d(c)(2)

Change	Comment
(A) **In general.**—If, for purposes of section 38(c) of the Federal Deposit Insurance Act, the ~~Federal banking agencies~~ *Federal Deposit Insurance Corporation* increase*s* or decrease*s* *one of* the required minimum level*s* for the ~~leverage limit~~ *relevant capital measures* (as those terms are used in section 38), the Board may, by regulation, and subject to subparagraph (B) of this paragraph, correspondingly increase or decrease one or more of the net worth ratios specified in subparagraphs (A) through (D) of paragraph (1) of this subsection in an amount equal to ~~not more than the difference between the required minimum level most recently established by the Federal banking agencies and 4 percent of total assets (with respect to institutions regulated by those agencies)~~ *the increase or decrease made by the Federal Deposit Insurance Corporation*. (B) **Determinations required.**—The Board may increase or decrease net worth ratios under subparagraph (A) only if the Board— (i) determines, in consultation with the ~~Federal banking agencies~~ *Federal Deposit Insurance Corporation*, that the reason for the increase or decrease in the required minimum level for the ~~leverage limit~~ *relevant capital measures* also justifies the adjustment in the net worth ratios; and	This change provides the Board with the ability to adjust the leverage ratio and the risk-based net worth requirement in proportion to changes made by the FDIC to corresponding capital measures. NCUA would have to consult with the FDIC prior to implementing any changes to the capital measures.

RISK-BASED NET WORTH REQUIREMENT - § 1790d(d)

Change	Comment
(d) Risk-Based Net Worth Requirement ~~for Complex Credit Unions~~. –	To remove the word “complex” from the title. All federally insured credit union will be subject to the risk-based net worth requirement.

(1) **In general. -** The regulations required under subsection (b)(1) shall include a risk-based net worth requirement for insured credit unions ~~that are complex~~, ~~as defined by the Board~~ based on the portfolios of assets and liabilities of credit unions *as defined by the Board.*	As the risk-based net worth requirement applies to all insured credit unions based on the portfolios of risk assets they hold, there is no need to limit this to "complex" credit unions. Further, this maintains the Board's ability to design almost all aspects of the risk-based requirement via regulation.
(2) **Standard.** - The Board shall design the risk-based net worth requirement to take account of any material risks *as defined by the Board applicable to credit unions that are taken account of by comparable standards applicable to institutions insured by the Federal Deposit Insurance Corporation* ~~against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection~~.	This change requires NCUA to design its risk-based requirement to address the risks addressed under the FDIC system.[6] Currently FDIC's PCA system does not explicitly incorporate some forms of risk, such as interest rate risk. These risks are addressed under authorities related to reclassification of the PCA category and as part of the safety and soundness examination program. As the BASEL Committee explains, a balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental."[7] Until such time as advancements are made to capital standards to better incorporate interest rate risk, the best approach for NCUA is to address this as part of reclassification authority and the examination program (see recommendation below related to more stringent treatment based on other supervisory criteria). This change also removes the reference to the adequately capitalized category, which is no longer necessary given the change to the net worth category definitions.

[6] The FDIC PCA system primarily addresses credit risk. It also includes market risk for institutions with large trading portfolios (over 10% of assets or $1B), which has negligible application to credit unions.
[7] Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, para. 8.

EARNINGS RETENTION REQUIREMENT - § 1790d(e)

Change
(e) ~~Earnings-Retention~~ *Net Worth Restoration Plan* Requirement Applicable to Credit Unions That Are Not Well Capitalized.–*The Board may require an insured credit union to submit a net worth restoration plan, as required under subsection (f), if--*
(1) ~~In general.– an insured credit union that is not well capitalized shall annually set aside as net worth an amount equal to not less than 0.4 percent of its total assets~~ *material safety and soundness concerns caused the credit union to become less than well capitalized; and* *(2) the safety and soundness concerns remain unresolved.*
~~(2)~~ ~~**Board's authority to decrease earnings-retention requirement.**—~~ ~~(A)~~ ~~**In general.**—The Board may, by order, decrease the 0.4 percent requirement in paragraph (1) with respect to a credit union to the extent that the Board determines that the decrease—~~ ~~(i) is necessary to avoid a significant redemption of shares; and~~ ~~(ii) would further the purpose of this section.~~ ~~(B)~~ ~~**Periodic review required.**—The Board shall periodically review any order issued under subparagraph (A).~~

Comment

The earnings retention requirement is not appropriate in most cases involving a decline in the net worth ratio. Most declines typically occur due to financial problems resulting in a net operating loss for the institution. Resolution of the case involves further recognition of losses (e.g., accounting adjustments, loan loss funding) in the short-term, making achievement of an arbitrary profitability goal inconsistent with proper problem resolution and accounting procedures. Further, the 0.4 percent retention requirement is arbitrary. In some cases, this may be more than an adequate level of profitability to address the situation, and in others inadequate. Thus, in lieu of the arbitrary and impractical nature of this requirement, and the specific recognition of the limitation on credit unions' ability to raise capital through a higher leverage requirement, it is best to address any decline in net worth by empowering the Board to require submission of a more comprehensive net worth restoration plan when the supervisory review determines one is needed. This also increases NCUA's authority in addressing situations of declining net worth given the somewhat lower leverage requirement in this proposal. Any delegation of this authority by the Board would include procedures regarding the Regional Directors' use of this authority, such as requiring concurrence from the appropriate central office(s). Any such delegation by the board would remain subject to appeal to respective review committees and ultimately the NCUA Board.

NET WORTH RESTORATION PLAN REQUIRED. - § 1790d(f)

Change	Comment
(1) **In general.**— *Except as determined by the Board in the case of a credit union that becomes or remains no less than undercapitalized due to the impact of a major natural or man-made disaster,* each insured credit union that is undercapitalized shall submit an acceptable net worth restoration plan to the Board within the time allowed under this subsection.	The authority to waive the requirement to submit a NWRP for credit unions that have a decline in their net worth ratio below Adequately Capitalized, but no lower than Undercapitalized, beyond their control due to a natural or man-made disaster would help credit unions to continue to serve and assist members and the affected communities in resolution and restoration efforts.

MORE STRINGENT TREATMENT BASED ON OTHER SUPERVISORY CRITERIA. - § 1790d(h)

Change	Comment
(2) the Board may not delegate its authority to reclassify an insured credit union into a lower net worth category*, except to reclassify an insured credit union into the next lower net worth category, based on interest rate risk, to the extent any such reclassification by a delegatee may be reviewed by the Board,* or to treat an insured credit union as if it were in a lower net worth category.	The regulation of this authority by the Board would also include procedures regarding the Regional Directors' use of this authority, such as requiring concurrence from the appropriate central office(s). Any such delegation by the Board would remain subject to appeal to respective review committees and ultimately the NCUA Board.

DEFINITIONS. - § 1790d(o)

Change	Comment
(2) **Net worth.**—The term 'net worth'— (B) with respect to a low-income credit union, includes secondary capital accounts*, subject to limitations set by the Board to address the safe and sound use of secondary capital to carry out the*	For safety and soundness purposes, this revision clarifies that the Board may through regulation provide limitations on the types and characteristics of secondary capital permitted for low-income credit unions, and the extent to which these count as net worth. Comparable hybrid equity instruments in FDIC insured institutions are subject to limitations in terms of how much may be used to meet capital requirements (50 percent of Tier 1 for subordinated

purpose of this section, that are – (i) uninsured; and (ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.	debt and 100 percent of Tier 1 for all hybrid equity instruments), as well as reducing pro-rata the amount that counts toward capital as they approach maturity (decline below 5 years). The legislative record for this change should reflect that it is not the intent that the Board be able to preclude the safe and sound use of secondary capital by low-income credit unions in meeting net worth standards, and that any such limitations established by the Board must be well grounded on safety and soundness concerns.
(3) **Net worth ratio.** - The term 'net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union *minus its deposit in the Fund* to the total assets of the credit union *minus its deposit in the Fund.*	"*If Congress does not require that the 1-percent deposit be expensed, NCUA should require credit unions to exclude the amount from both sides of their balance sheet when assessing capital adequacy.*" – 1991 GAO Report Credit Unions Reforms for Ensuring Future Soundness - page 174. The 1997 Treasury study of credit unions reached a slightly different conclusion. This report suggested the net worth category thresholds be increased by 1 percent to address the "double-counting" of equity (both credit union net worth and the Fund) within the credit union system. The report admits this would *"more than"* compensate for the double-counting effect of the insurance fund deposit. In fact, since the deposit is based on insured shares and not total assets, this results in requiring on average an extra 25 basis points of net worth in relation to assets. Using the recommended approach of deducting the Fund deposit from both net worth (numerator) and total assets (denominator) results in an accurate capital charge to each insured credit union and places the equity within the credit union system on a comparable basis to that of FDIC-insured institutions. It is not NCUA's intention to alter the treatment of the NCUSIF deposit as an asset on credit union financial statements. Expensing the deposit would be inconsistent with its statutory treatment and with GAAP, which the FCU Act mandates credit unions follow.

(5) ***Risk-based net worth ratio****. - The term 'risk-based net worth ratio' means, with respect to any credit union, the ratio of the net worth of the credit union plus any loan loss reserves (subject to limit by the Board), and minus the credit union's deposit in the Fund, to risk assets of the credit union, as defined by the Board.*	This incorporates similar treatment of the insurance fund deposit, as well as allows the Board through regulation to define risk assets. This proposal incorporates the FDIC limit on inclusion of loan loss reserves of 1.25 percent of risk-weighted assets.

H. OTHER TECHNICAL CORRECTIONS

Change	Comment
§ 1790d(i)(1) (B) *order the credit union to* take such other action as the Board, *in the discretion of the Board,* determines would better achieve the purpose of this section, after documenting why the action would better achieve that purpose.	This clarifies that "other corrective action" (OCA) is not action the Board itself undertakes, but action it orders a Critically Undercapitalized credit union to take. Also, it makes clear that the Board determines the appropriate OCA, not the credit union.
§ 1790d(i)(3) **(A) In general. –** Notwithstanding paragraphs (1) and (2), the Board shall appoint a liquidating agent for an insured credit union if the credit union is critically undercapitalized on average during the ~~calendar quarter~~ *90 calendar days* beginning 18 months after the date on which the credit union *first* became critically undercapitalized.	This replaces the reference to calendar quarter with a 3-month period. The calendar quarter reference delays measurement and subsequent action until a calendar quarter has elapsed. For situations where the 18 month period ends a month into a calendar quarter, this adds an additional 2 months to the timeframe upon which measurement and subsequent action occur.
§ 1790d(l)(3)(A) (ii) give that official an opportunity to take the proposed action, *if the Board determines that such action by the official will carry out the purpose of this section*;	This clarifies that for PCA based concerns, the Board need only allow a State official to take a conservatorship or liquidation action in lieu of action by the Board if it will carry out the purposes of PCA.

IMPACT ANALYSIS

All statistics presented are based on December 31, 2006, data and included 8,349 active federally insured credit unions.

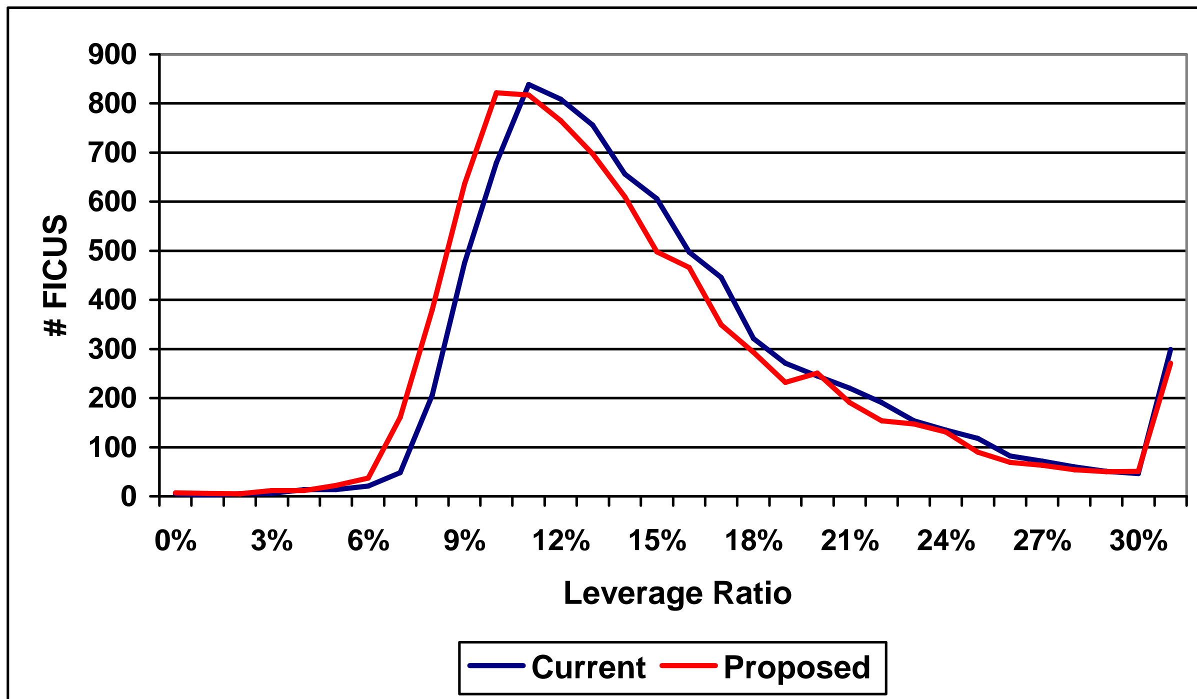
A. Leverage Ratio Comparison[8]

Aggregate Net Worth to Total Assets = 11.54%

Net Worth (Leverage) Ratio	Current Method	Proposed Method	Average Impact of NCUSIF Deduction
Mean	15.12%	14.42%	0.70%
Median	13.42%	12.69%	0.73%

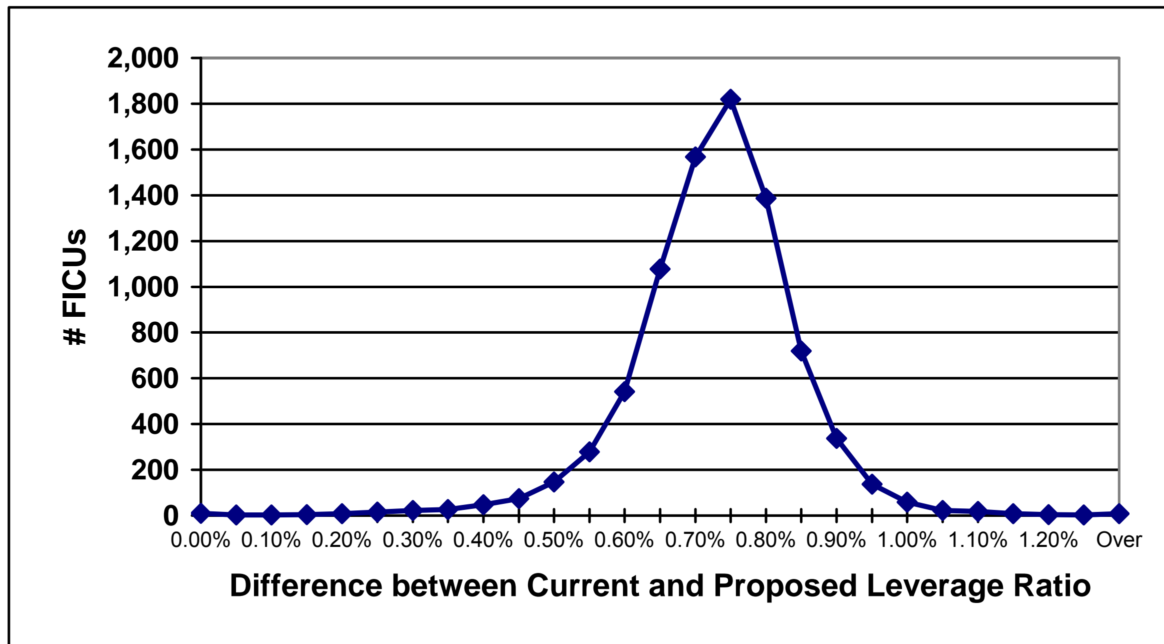
Range – FICU # and %	Current Method	Proposed Method
Very Well Capitalized (well +2%)	7,521 (90.6%)	8,017 (96.0%)
Well Capitalized	8,234 (98.6%)	8,282 (99.2%)
Adequately Capitalized	49 (0.6%)	19 (0.2%)
Under Capitalized	35 (0.4%)	13 (0.2%)
Significantly Undercapitalized	19 (0.2%)	17 (0.2%)
Critically Undercapitalized	10 (0.1%)	18 (0.2%)

Chart 1 – Leverage Ratio Distribution



[8] Statistics include credit unions that are defined as new, though new credit unions will continue to have separate requirements reflecting they begin with no capital and need to build capital over time.

Chart 2 – Impact of NCUSIF Deposit Adjustment on Leverage Ratio



B. Risk-Based Ratio Comparison

Risk-Based Requirement	Current Method	Proposed Method
FICUs Subject to Risk-Based Requirement	517 (6.2%)	8,349 (100%)
Mean Risk-Based Ratio	NA	26.2%
Aggregate Risk-Based Ratio	NA	19.0%
Mean Risk Assets to Total Assets	NA	61.7%
Aggregate Risk Assets to Total Assets	NA	59.1%
Average Risk-Based Net Worth Requirement (at 10%) to Total Assets		6.42%
Aggregate Risk-Based Net Worth Requirement (at 10%) to Total Assets	NA	6.21%
# FICUs with Risk-Based Net Worth Requirement > Current Leverage Requirement (7%)	125	2,824 (33.8%)
# FICUs with Risk-Based Net Worth Requirement > Proposed Leverage Requirement (5.25%)	NA	5,170 (61.9%)
Range – FICU # and %		
Well Capitalized	517 (6.2%)	8,137 (97.35%)
Adequately Capitalized	0	132 (1.6%)
Undercapitalized	0	45 (0.5%)
Significantly Undercapitalized	NA	35 (0.4%)
Critically Undercapitalized	NA	NA

Chart 3 – Distribution of Proposed Risk-Based Ratio

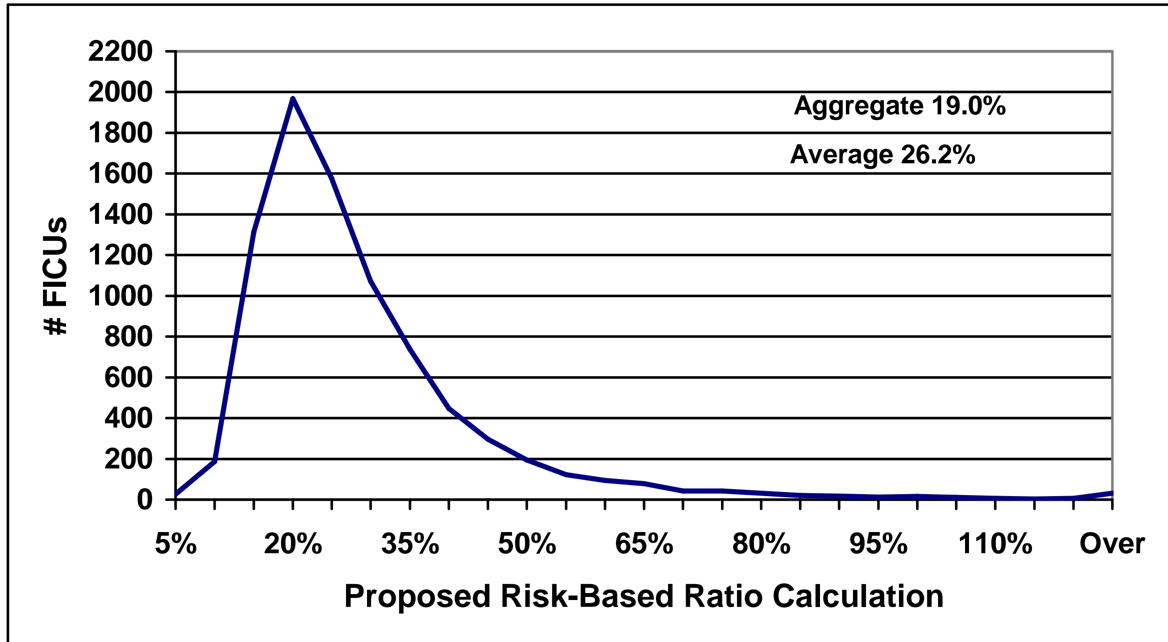


Chart 4 – Distribution of Proposed Risk Assets to Total Assets

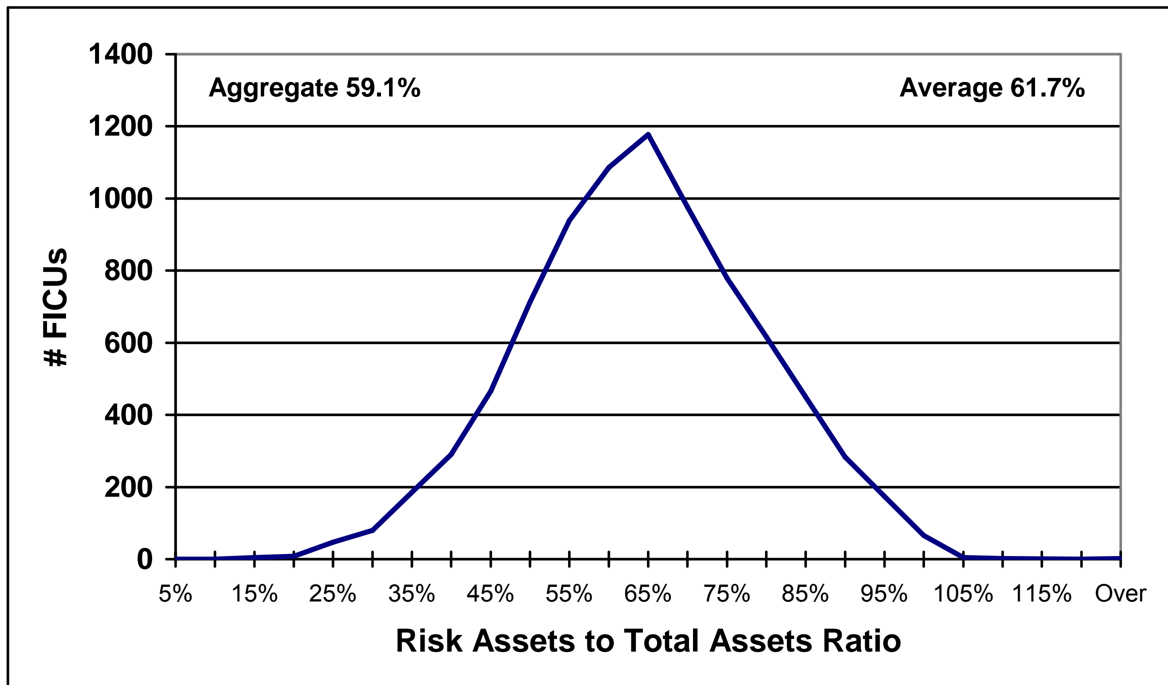
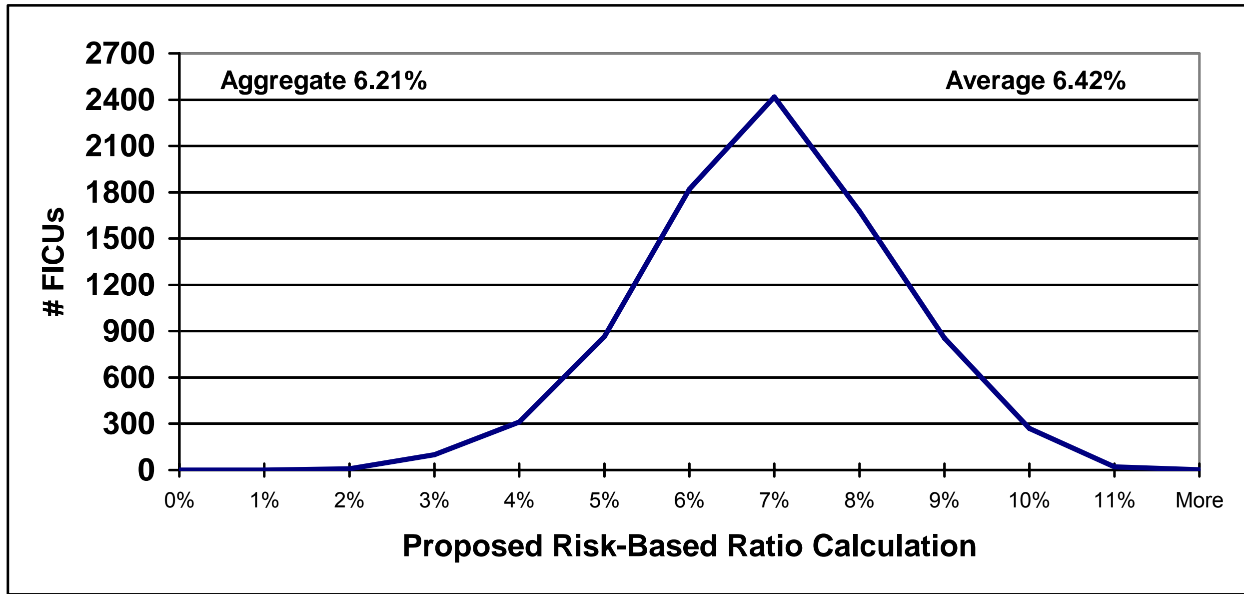


Chart 5 – Net Worth Required Under Proposed Risk-Based to Total Assets



C. Tandem Requirements Comparison

Net Worth Category Comparison - Current vs. Proposed PCA System
Number of Federally Insured Credit Unions
December 31, 2006 Data

		Proposed System					
	PCA Classification	Well Capitalized	Adequately Capitalized	Under Capitalized	Significantly Under-capitalized	Critically Under-capitalized	Total
Current System	Well Capitalized	8,119	101	14	0	0	8,234
	Adequately Capitalized	11	25	13	0	0	49
	Under Capitalized	0	7	19	9	0	35
	Significantly Undercapitalized	0	0	1	12	6	19
	Critically Undercapitalized	0	0	0	0	12	12
	Total	8,130	133	47	21	18	8,349

The red fields represent a reduction in PCA category, the yellow fields represent no change in PCA category, and the green fields represent an increase in PCA category.

APPENDIX 1 – RISK-BASED REQUIREMENT MODEL

A. Risk Weight Categories

Risk Weight	Risk Portfolios
0%	• Cash on hand • Securities, loans, leases unconditionally guaranteed by the United States and U.S. Government agencies (GNMA, VA, FHA, SBA)[9]
20%	• Claims on U.S. Government-sponsored agencies (FHLMC, FNMA, Farm Credit, FHLB, SLMA) • AAA or AA rated and A-1 (short-term) rated Investments[10] • Claims on federally insured financial institutions • Residential real estate LTV ≤ 60%
35%	• A rated and A-2 (short-term) rated investments • Residential real estate LTV > 60% and ≤ 80%
50%	• BBB+ rated investments • Residential real estate LTV > 80% and ≤ 85%
75%	• BBB and A-3 (short-term) rated investments • Residential real estate LTV > 85% and ≤ 90% • Stand-alone junior liens for residential real estate LTV ≤ 60%
100%	• BBB- rated investments • Consumer loans • Commercial loans[11] • Investment in fixed assets • Residential real estate LTV > 90% and ≤ 95%, and stand-alone junior liens for residential real estate LTV > 60% and ≤ 90% • Membership interests and equity interests in federally-insured financial institution • All other assets

[9] For assets partially guaranteed by the government, includes only the guaranteed portion.
[10] With only a few minor exceptions (like mortgage related securities), federal credit unions are not permitted to invest in instruments with any noteworthy credit risk (mostly government, federal agency, and GSE debt instruments). However, state-chartered credit unions in some states are authorized to invest in corporate debt instruments.
[11] The most recent BASEL 1-A proposal contemplates using a 75% risk weight for business loans < $1 million with a 7-year or less amortization, personal guarantees, and full collateralization.

150%	• BB+ and BB rated investments • Residential real estate LTV > 95%, and stand-alone junior liens for residential real estate LTV > 90%
200%	• < BB- rated investments and unrated investments

B. Other Considerations

Allowance for Loan and Lease Losses (ALLL). This contra account is an offset to assets. Because the ALLL has already been expensed through the income statement, the account represents a cushion against losses and, therefore, is recognized as an additional source of protection for the NCUSIF in calculating the risk-based net worth ratio. The amount of the ALLL that may be added back to Net Worth is limited to 1.25% of risk assets.

Membership and Equity Interests. Must be a non-significant minority interest (less than 20%) and non-reciprocal holding, otherwise deducted from Net Worth.[12]

Mutual Funds. Treatment consistent with the FDIC's current rule (App. A to Part 325, Section II.B.1.). Indirect holdings (e.g., mutual funds and common trusts) are assigned an unrated risk weight or, if identifiable, to the risk category for the highest risk-weighted asset the fund is permitted to hold, with a minimum 20% risk weight.

NCUSIF Deposit. This balance sheet asset is deducted from net worth for PCA purposes only. Because this account is dollar for dollar deducted from net worth, the account is excluded from risk assets. If the system were to incur losses in excess of retained earnings in the fund, the NCUSIF deposit would be reduced, then replenished by charges to credit unions, resulting in credit unions expensing the deposit.

Real Estate Loans. LTV incorporates private mortgage insurance. When an institution holds both the first and second lien, the combined LTV is used to determine the risk-weight category. Past due residential real estate loans with a risk-weight based on LTV of less than 100% are weighted at 100%.

[12] Bank equity instruments are not permissible for federal credit unions. However, state-chartered credit unions in some states are authorized to invest in bank equity instruments. Current FDIC treatment is 0% for Federal Reserve bank stock (App. A to Part 325, Section II.C, Category 1.b), 20% for FHLB stock (App. A to Part 325, Section II.C, Category 2.b), and 100% for bank capital instruments (App. A to Part 325, Section II.C, Category 4(c)).

Off-balance Sheet Items. Cancelable commitments are not included in risk assets. Cancelable means unconditionally cancelable at any time by the institution without prior notice to the full extent allowable under consumer protection legislation, or automatic cancellation due to deterioration in a borrower's creditworthiness. Non-cancelable commitments are converted to a credit equivalent amount at a rate of 10% for less than one year commitments and 50% for all other commitments. Recourse obligations and direct credit substitutes will be subject to the low level recourse rule limiting the credit charge to the maximum contractual exposure less any recourse liability established under GAAP.

C. Details of Model Used for Impact Analysis

Account codes are based on the December 31, 2006, Call Report.

1. Leverage Ratio Calculation

Formula = (997-794) / (if(010A>0,010A-794,if(010B>0,010B-794,if(010C>0,010C-794,010-794]))))

2. Risk-Based Ratio Calculation

Numerator	**Formula (5300 Account Codes)**	**Comments**
Net Worth	997+ALLL-794	
ALLL	ALLL=If(719<(Risk Assets*0.0125),719,(Risk Assets*0.0125))	ALLL formula adjusts for 1.25% limit.

Denominator for Risk-Based Ratio - Total Risk Assets equals the sum of the following:

Asset Categories	**Formula (5300 Account Codes)**	**Risk Weight**	**Comments**
Cash on Hand	730A	0	
Government Obligations	741C	0	
Federal Agency Securities	742C	0.2	May include some GNMA or SBA obligations
Claims on Federally-Insured Financial Institutions	730B+730C+744C+652C+672C	0.2	
Rated Investments	743C	.5	Assumption of BBB+ rating
Membership Interests	769A+769B	1	

Other Investments	799I-(741C+742C+744C+652C+672C+743C+769A+769B)	1	Capture investments not assigned risk weight. May capture stock in FHLB (20% risk weight)
Residential Real Estate Loans	710+003-718A	Varies	Assumption loans held for sale are residential real estate. Assumption weights used:[13] LTV / Risk Weight / % Applied < 60% / .2 / 30% 60-80% / .35 / 58% 80-85% / .5 / 4% 85-90% / .75 / 4% 90-95% / 1.0 / 2% > 95% / 1.5 / 2% CUs unable to produce this data would use a risk weight of 1.
All Other Loans	396+397+385+370+002+698	1	Will include some small business loans that may be eligible for 75% risk weight
All Other Assets	798A+007+008+009+718A	1	
Commitments – Business Loans	814+814A	.5*1	Assumes all non-cancelable, over 1 year in original maturity, and apply to loans with a risk weight of 100% with at 50% credit conversion factor
Commitments – Home Equity Loans	811	.5*.35	Assumption is LTV 60-80% of .35 and with a 50% credit conversion factor
Commitments – Letters of Credit	813	.5*1	50% credit conversion factor for performance-based standby letters of credit with a risk weight of 1
Loans Transferred with Recourse	819	0.35	Assumption related to real estate loans. Lowest RE weight given limited recourse by definition. Will not account for any recourse liability established.

[13] Percentage applied based upon results of the survey of 23 banks conducted by the New York State Banking Department, dated May 1, 2006.

APPENDIX 2 - Statutory Constraints Precluding Regulatory Design of a Well Balanced, Comparable Risk-Based System

The prompt corrective action statute for federally insured credit unions does provide NCUA with some authority to design the risk-based net worth requirement. (§1790d(d)). However, there are several statutory constraints that limit NCUA's ability to design a risk-based system that is (1) comparable to PCA standards for other federally insured institutions and (2) that places more emphasis on the risk-based requirement without being onerous in the overall level of capital required. As NCUA must design the system of prompt corrective action consistent with the statute (§1790d(b)(1)(A)(i)), the following statutory limitations prohibit design of a comparable PCA system that is more risk-based:

- The statute (§1790d(d)(1)) limits the imposition of a risk-based net worth requirement to "complex" credit unions, indicating narrow application and creating a class distinction, and requiring a two-step process to determine if a credit union is complex and then what its risk-based net worth requirement is. NCUA is proposing the risk-based requirement apply to all credit unions given that the risk profile of each institution will be taken into account automatically by the design of a risk-based system comparable to the FDIC's.

- The statute (§1790d(d)(2)) requires NCUA to "design the risk-based net worth requirement to take account of <u>any material risk</u> against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." This statutory requirement necessitates NCUA design the risk-based net worth requirement to address all material risks. One example of a material risk facing financial institutions is interest rate risk. However, neither BASEL I nor BASEL II addresses interest rate risk. It is particularly noteworthy that even under BASEL II's sophisticated internal ratings based approach for the largest and most complex financial institutions the material risk of interest rate risk is not taken into account.[14] This statutory requirement precludes NCUA from modeling a risk-based requirement after the advancements made by the other federal banking agencies in use of a BASEL approach. Rather, it requires NCUA to develop a risk-based capital system that exceeds the capabilities of all existing and proposed capital measurement systems, and to impose this on a subset of credit unions that overall are relatively small and less sophisticated institutions by comparison.

- The statute (§1790d(d)(2)) requires NCUA to "design the risk-based net worth requirement to take account of any material risk against which the net worth ratio required for an insured credit union <u>to be adequately capitalized</u> may not provide adequate protection." In relation to the risk-based net worth requirement, the statute precludes a distinction between Well Capitalized and Adequately Capitalized, and a credit union failing the risk-based net worth requirement is classified no lower than Undercapitalized. (§1790d(c)(1)). For the risk-based requirement under the FDIC system, and our reform proposal, the minimum level for Well Capitalized is higher than for Adequately Capitalized, and an institution with a very low risk-based capital ratio is classified as Significantly Undercapitalized.

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[14] BASEL takes this approach because a balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental." Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, paragraph 8.

- The statute requires credit unions to have a net worth ratio (leverage ratio for FDIC insured institutions) of 7% or greater to be Well Capitalized. (§1790d(c)(1)). This is 1.25% higher on average than the leverage ratio requirement for other federally insured financial institutions (adjusted for the NCUSIF deposit). This higher leverage ratio, combined with the fact credit unions' risk-based requirement is tied by statute to the lower Adequately Capitalized level of 6%, makes the net worth ratio the major determinate for minimum capital. This imbalanced interplay undermines development of a meaningful risk-based requirement that isn't unduly onerous in the level of capital it requires. As a result, only 517 FICUs (6.2%) are subject to the current risk-based net worth requirement (i.e., over 6% net worth). Assuming NCUA could adopt the BASEL 1-A risk portfolios and weights with the current statutory leverage requirement of 7%, the risk-based capital requirement would only be the major capital determinate in 2,824 credit unions (33.8%). Under a BASEL 1-A system, the risk-based capital requirement would be the major capital determinate in 5,170 (62%) of credit unions if the leverage ratio were lowered to the equivalent of 6% (5.25% adjusted for credit unions' deposits in the insurance fund). Also, for these 62% of credit unions, the risk-based requirement necessitates on average net worth equivalent to 6.4% of total assets.

APPENDIX 3 – Calculation of Net Worth Based on New Formula

The proposed new formula for the calculation of the net worth ratio is:

$$\text{(Net Worth – NCUSIF Deposit)} \div \text{(Total Assets – NCUSIF Deposit)} = \frac{(NW - Dep)}{(TA - Dep)}$$

The minimum decline in the leverage ratio this proposal allows is calculated in the formula below, which reflects (1) the minimum net worth ratio to be well capitalized of 5.25% and (2) all liabilities are insured.

$$(1)\quad 5.25\% = \frac{(NW - Dep)}{(TA - Dep)}$$

Since the credit union must hold a minimum level of net worth to be well capitalized, and the remaining portion of the liability and equity side of the balance sheet is assumed to be insured, the NCUSIF Deposit is:

$$\text{NCUSIF Deposit} = 1\%(\text{Total Assets – Net Worth}) = 1\%TA - 1\%NW$$

Substituting this into formula 1 for the NCUSIF Deposit, you get:

$$\frac{NW - (1\%TA - 1\%NW)}{TA - (1\%TA - 1\%NW)} = \frac{NW - 1\%TA + 1\%NW}{TA - 1\%TA + 1\%NW} = \frac{101\%NW - 1\%TA}{99\%TA + 1\%NW}$$

$$(2)\quad 5.25\% = \frac{101\%NW - 1\%TA}{99\%TA + 1\%NW}$$

$5.25\%(99\%TA + 1\%NW) = 101\%NW - 1\%TA$ [formula from cross multiplying]

$5.20\%TA + 0.05\%NW = 101\%NW - 1\%TA$ [multiplication on left side]

$6.20\%TA = 100.95\%NW$ [addition and subtraction of like elements]

$6.14\%TA = NW$ [divide both sides by 100.95% to isolate NW]

Thus, under the new 5.25% standard, the requirement relative to total assets would be for a level of net worth equal to 6.14% of total assets. Given the current standard is 7% of total assets, this represents a decline of 0.86% of total assets. The maximum potential decline is calculated the same way. However, since all liabilities are assumed to be uninsured, the NCUSIF Deposit would be 0. Thus, the level of net worth would equal 5.25% of total assets, representing a decline of 1.75% of total assets from the current 7% level.