CREDIT UNIONS

UNITED STATES DEPARTMENT OF THE TREASURY

December 1997

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1997

The Honorable Alfonse M. D'Amato
Chairman
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit unions.

As required by section 2606 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, this report evaluates: (1) the potential for, and the potential effects of, having some entity other than the National Credit Union Administration (NCUA) administer the National Credit Union Share Insurance Fund; (2) whether the 1 percent deposit that federally insured credit unions have made into the Share Insurance Fund should continue to be treated as an asset on credit unions' books or whether credit unions should, instead, expense that deposit; (3) the 10 largest corporate credit unions, including their investment practices and their financial stability, financial operations, and financial controls; (4) the NCUA's regulations; and (5) the NCUA's supervision of corporate credit unions.

In preparing this report, we consulted with the NCUA and its Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. We also met with all the major credit union, bank, and thrift trade associations, and with numerous credit union representatives. We published a request for comments in the *Federal Register* and received 181 responses. We visited eight credit unions and two corporate credit unions. In evaluating the 10 largest corporate credit unions, we assembled an interagency team of federal banking examiners to assist us, as required by the mandate.

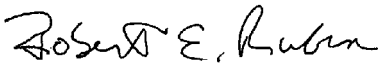
Credit unions intermediate only a small portion of the savings and credit in our financial system, but they serve some 70 million Americans. As a group, they appear to be in strong financial condition. Similarly, the Share Insurance Fund, which insures deposits at credit unions, is at its statutory maximum reserve level and has had few losses in recent years. Although we found credit unions and the Share Insurance Fund in good condition, we also identified several important aspects of the NCUA's safety and soundness regulations, the NCUA's administration of the Share Insurance Fund, and the statutes under which the NCUA operates that need strengthening.

In 1994, several corporate credit unions with investment portfolios heavily concentrated in collateralized mortgage obligations experienced financial difficulties. The NCUA closed one corporate credit union (Capital Corporate) and its member credit unions recorded $60 million in aggregate losses. These developments, coupled with a $225 million investment by U.S. Central Corporate Credit Union in a Spanish bank that failed in 1993, raised questions about the financial strength of the corporate system and the NCUA's oversight of that system. We found that both corporate credit unions and the NCUA have made significant improvements since 1994. However, we also found a need for further strengthening of the corporate credit union system and the NCUA's oversight of it.

An emerging trend among credit unions involves the consolidation of credit unions into fewer but larger institutions, some of which have become quite complex. Our report describes some of the safety and soundness issues raised by this trend. However, the current dispute regarding credit unions' fields of membership is beyond the scope of our report. We continue to monitor the issues involved and await a ruling by the Supreme Court.

If you would like to discuss the findings and recommendations in this report, please contact Assistant Secretary Richard Carnell.

Sincerely,



Robert E. Rubin

Enclosure

[Identical letter sent to the Honorable Paul S. Sarbanes]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1997

The Honorable James A. Leach
Chairman
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, D.C. 20515-6050

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit unions.

As required by section 2606 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, this report evaluates: (1) the potential for, and the potential effects of, having some entity other than the National Credit Union Administration (NCUA) administer the National Credit Union Share Insurance Fund; (2) whether the 1 percent deposit that federally insured credit unions have made into the Share Insurance Fund should continue to be treated as an asset on credit unions' books or whether credit unions should, instead, expense that deposit; (3) the 10 largest corporate credit unions, including their investment practices and their financial stability, financial operations, and financial controls; (4) the NCUA's regulations; and (5) the NCUA's supervision of corporate credit unions.

In preparing this report, we consulted with the NCUA and its Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. We also met with all the major credit union, bank, and thrift trade associations, and with numerous credit union representatives. We published a request for comments in the *Federal Register* and received 181 responses. We visited eight credit unions and two corporate credit unions. In evaluating the 10 largest corporate credit unions, we assembled an interagency team of federal banking examiners to assist us, as required by the mandate.

Credit unions intermediate only a small portion of the savings and credit in our financial system, but they serve some 70 million Americans. As a group, they appear to be in strong financial condition. Similarly, the Share Insurance Fund, which insures deposits at credit unions, is at its statutory maximum reserve level and has had few losses in recent years. Although we found credit unions and the Share Insurance Fund in good condition, we also identified several important aspects of the NCUA's safety and soundness regulations, the NCUA's administration of the Share Insurance Fund, and the statutes under which the NCUA operates that need strengthening.

In 1994, several corporate credit unions with investment portfolios heavily concentrated in

collateralized mortgage obligations experienced financial difficulties. The NCUA closed one corporate credit union (Capital Corporate) and its member credit unions recorded $60 million in aggregate losses. These developments, coupled with a $225 million investment by U.S. Central Corporate Credit Union in a Spanish bank that failed in 1993, raised questions about the financial strength of the corporate system and the NCUA's oversight of that system. We found that both corporate credit unions and the NCUA have made significant improvements since 1994. However, we also found a need for further strengthening of the corporate credit union system and the NCUA's oversight of it.

An emerging trend among credit unions involves the consolidation of credit unions into fewer but larger institutions, some of which have become quite complex. Our report describes some of the safety and soundness issues raised by this trend. However, the current dispute regarding credit unions' fields of membership is beyond the scope of our report. We continue to monitor the issues involved and await a ruling by the Supreme Court.

If you would like to discuss the findings and recommendations in this report, please contact Assistant Secretary Richard Carnell.

Sincerely,

Robert E. Rubin

Robert E. Rubin

Enclosure

[Identical letter sent to the Honorable Henry B. Gonzalez]

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS AND DEFINITIONS

Bank Board	Federal Home Loan Bank Board
CAMEL	Capital adequacy, asset quality, management, earnings, and asset/liability management; for banks and thrifts, the L component stands for liquidity
CAMELS	Capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk; part of the revised Uniform Financial Institution Rating System
Cap Corp	Capital Corporate Credit Union, Lanham, Maryland
C.F.R.	Code of Federal Regulations
CLF	Central Liquidity Facility
CUNA	Credit Union National Association
FDIC	Federal Deposit Insurance Corporation
Federal agency security	Primarily debt and mortgage-backed securities issued or guaranteed by such GSEs as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System; the federal government does not guarantee GSE securities; also includes federally guaranteed securities issued by the Government National Mortgage Association (Ginnie Mae)
Fed. Reg.	Federal Register
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
GSE	Government-sponsored enterprise
NAFCU	National Association of Federal Credit Unions
NASCUS	National Association of State Credit Union Supervisors
NCUA	National Credit Union Administration
NEV	Net economic value
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
Share Insurance Fund	National Credit Union Share Insurance Fund
U.S.C.	United States Code

ACKNOWLEDGMENTS

Richard S. Carnell, Assistant Secretary of the Treasury for Financial Institutions, directed this study. Edward J. DeMarco managed the study team, which consisted of W. Scott Frame, Margaret D. Nilson, Brian S. Tishuk, and Margaret Woolley. Other Treasury officials making significant contributions to the study included Victoria P. Rostow, Joan Affleck-Smith, David Icikson, and Patricia A. Milon.

The study mandate directed the Treasury to analyze the 10 largest corporate credit unions "in cooperation with appropriate employees of other Federal agencies with expertise in the examination of federally insured financial institutions." With assistance from the Office of the Comptroller of the Currency, we assembled an inter-agency team of examiners to work with us in this aspect of the study. The examiner team consisted of Anthony DiLorenzo (OCC), who was the team leader, Todd Bethany (Federal Reserve), Stan Crisp (OCC), Michael Finn (OTS), Roy Henson (FDIC), and Michael Sullivan (OCC). The Treasury acknowledges and deeply appreciates the examiners' outstanding professionalism and effort.

NOTE ON TERMINOLOGY

Over the years, credit unions and their regulators have developed a rich stock of specialized terminology. Some of this terminology involves different words for things that also exist, at least in some analogous form, at other depository institutions. In credit union parlance, deposits are "shares," savings accounts are "share accounts," checks are "share drafts," certificates of deposit are "share certificates," capital or net worth is "reserves," and deposit insurance is "share insurance." This terminology in part reflects credit unions' status as member-owned cooperatives in which deposits are legally equity capital.

Some credit union terminology refers to entities or distinctions that do not exist among depository institutions generally. Thus, for example, one can refer to regular credit unions -- the sort that individuals can join -- as "natural person credit unions" to distinguish them from "corporate credit unions," which are wholesale financial institutions that serve natural person credit unions' needs for transaction, investment, and liquidity services.

We have sought to make this study readily accessible to a wide range of people -- both those who are familiar with credit unions and those who are not. To this end, when we have faced a choice between using specialized credit union terminology and a plain-language, generic equivalent applicable to depository institutions generally, we have typically opted for the plain-language equivalent. Thus, for example, we refer to deposits, deposit insurance, checking and savings accounts, and net worth. We refer to natural person credit unions simply as "credit unions."

SUMMARY

Credit unions are depository institutions. Like banks and thrift institutions, they accept deposits and make loans. At this basic financial level, credit unions resemble banks and thrifts: by intermediating funds from savers to borrowers, credit unions take on credit risk (the risk that borrowers will not repay loans) and interest rate risk (the risk that changes in interest rates will alter the value of assets relative to liabilities). Managing these risks represents a key aspect of credit unions' financial operations.

The National Credit Union Administration (NCUA) -- credit unions' federal safety and soundness regulator -- supervises such risk-taking much as the federal banking agencies supervise the safety and soundness of banks and thrifts. The NCUA administers a deposit insurance fund -- the National Credit Union Share Insurance Fund -- that insures deposits at credit unions, just as the Federal Deposit Insurance Corporation (FDIC) insures deposits at banks and thrifts.

However, credit unions have several characteristics that, taken together, distinguish them from banks and thrifts. First, credit unions are member-owned, member-directed depository institutions. Credit unions do not issue capital stock. Instead, they derive their net worth from their accumulated retained earnings.

Second, credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each credit union's membership.

Third, credit unions do not operate for profit.

Fourth, credit unions have a public purpose. Congress intended credit unions "to make more available to people of small means credit for provident purposes." Of course, other depository institutions also operate under statutes that delineate public purposes, so any distinction here is one of degree.

Fifth, credit unions have certain limitations on their membership, limitations generally based on some affinity among members. The Federal Credit Union Act limits federal credit union membership to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district." Most state credit union statutes also impose some sort of common bond requirement. Thus, unlike other depository institutions, a federal credit union cannot serve just anyone from the general public. Current disputes about the terms of the federal common bond requirement are beyond the scope of this study.

At the end of 1996, 11,392 federally insured credit unions provided depository services to some 70 million Americans. Collectively, credit unions' $327 billion in assets pale compared to commercial banks' $4.6 trillion in assets.

Of the 11,392 credit unions, over 7,000 have less than $10 million in assets. These small credit unions offer a simple array of deposit accounts and a limited set of loan products, such as

automobile loans and unsecured personal loans. At the same time, a small, but growing number of credit unions are large, complex financial institutions. They offer a wide array of deposit and loan products, generally comparable to the consumer product offerings of mid-size and large commercial banks.

Moreover, all credit unions, large and small, operate in an ever more complex financial system. The NCUA can and should continue modernizing and improving its safety and soundness oversight of, and standards for, all credit unions.

The National Credit Union Share Insurance Fund

We examined the NCUA's oversight of the National Credit Union Share Insurance Fund, the advantages and disadvantages of having some entity other than the NCUA administer the Share Insurance Fund, and the strengths and weaknesses of the Fund's financial structure.

Condition of the Share Insurance Fund

The Share Insurance Fund is well capitalized, has had few losses in recent years, and appears capable of handling various types of stress. We found that the NCUA generally seeks to assist troubled credit unions by providing, for example, cash or noncash assistance through the Share Insurance Fund. We found no particular problems in how the NCUA administers the Share Insurance Fund, although we concluded that the broad discretion available to the NCUA should be channeled to ensure timely and consistent treatment of troubled credit unions.

The Share Insurance Fund's reserve ratio -- its ratio of total reserves to total insured deposits -- is the standard measure of the Fund's health. The reserve ratio has been at or near its statutory ceiling of 1.3 percent every year since 1985. We do, however, have two concerns about the reserve ratio.

The reserve ratio does not reflect the actual composition of the Share Insurance Fund's assets. When credit unions come under stress (e.g., during an economic recession), illiquid assets acquired from failed or troubled institutions will tend to increase at the expense of liquid assets -- leaving the Fund less able to provide cash assistance to other ailing credit unions. We recommend that Congress require the Share Insurance Fund to maintain an available assets ratio of 1.0 percent of insured deposits. Should the available assets ratio fall below this level, the NCUA would not be permitted to pay dividends even if the Fund's reserve ratio were to exceed 1.3 percent.

We are also concerned that the NCUA's method of measuring the Share Insurance Fund's reserve ratio generally overstates the reserves actually available. The NCUA calculates the reserve ratio each month by dividing the Fund's reserve balance for that month by the previous year-end total of insured deposits. Thus each year-end reserve ratio is calculated using a denominator that may be up to 12 months old, which tends to inflate the ratio. For example, at year-end 1996 the Share Insurance Fund had $3.4 billion in reserves and insured $275.5 billion in

deposits, which implied a reserve ratio of 1.24 percent. However, the NCUA calculated the Fund's year-end 1996 reserve ratio as 1.3 percent by dividing the year-end 1996 total Fund reserves by the year-end 1995 total insured deposits.

Because the NCUA must, by law, distribute dividends to member credit unions whenever the Share Insurance Fund's reserve ratio exceeds 1.3 percent, the NCUA's procedure has led it to pay dividends when the Fund's reserve ratio, measured contemporaneously, was actually less than 1.3 percent. Paying dividends under such circumstances dissipates the Fund's reserves without good reason. We accordingly recommend that the NCUA correct this non-contemporaneous measurement of the reserve ratio.

The NCUA's Administration of the Share Insurance Fund

Congress directed us to evaluate the potential costs and benefits of having some entity other than the NCUA administer the Share Insurance Fund. Neither the statutory language requiring this study nor its legislative history indicates what entity or entities Congress had in mind as possible candidates to administer the Fund. Nor do they indicate the policy objective of such a change. We identified two possible conflicts of mission in having the NCUA operate the Share Insurance Fund. The first involves the NCUA's role in chartering federal credit unions and in administering the Fund. The second involves the NCUA's role in supervising credit unions and administering the Fund. These two possible conflicts, although distinguishable, significantly overlap (e.g., a chartering entity also supervises the institutions it charters). They raise many of the same issues and invite many of the same arguments.

Based on our review, we found no compelling case for moving the Share Insurance Fund out of the NCUA. In our view, any potential for conflicts of mission is best handled by applying a system of prompt corrective action to credit unions. The tension between the incentives of the charterer and the goals of the regulator may be balanced by prompt corrective action rules that require the regulator to take certain corrective actions when a depository institution's condition deteriorates. For credit unions, charterer, examiner, and insurer are the same entity and, in a sense, make the decision together. The NCUA, with no statutory prompt corrective action requirements like those for the FDIC, has broad discretion about whether, when, and how to take corrective action. We believe that prompt corrective action rules for credit unions would impose an important and highly constructive discipline on both the NCUA's supervisory and insurance functions. That discipline should, to a significant degree, offset any incentive to permit the promotion of credit unions to interfere with the NCUA's responsibilities for the Fund.

The Share Insurance Fund's Financing Structure

Each insured credit union maintains on deposit in the Share Insurance Fund an amount equal to 1 percent of the credit union's insured deposits. The Fund's reserves consist of this 1 percent deposit plus any additional amounts accumulated through interest earnings and insurance premiums. Although the NCUA has no formal policy about when to assess premiums, it

considers charging a premium if the reserve ratio falls below 1.25 percent. The NCUA has assessed a premium only once since 1984. If the reserve ratio exceeds 1.3 percent, the NCUA must pay the excess as a dividend on credit unions' 1 percent deposit.

The Share Insurance Fund counts the 1 percent deposit as its reserves. At the same time, credit unions count the 1 percent deposit as an asset on their own books, which makes their reported net worth higher than it would be than if they had expensed the deposit. This treatment of the same dollars as reserves of the Fund and as an asset of credit unions results in double counting if one views the Fund and credit unions' net worth as the total buffer available to absorb credit union losses. If the Share Insurance Fund has losses large enough to dip into the 1 percent deposit, credit unions must then expense that portion of the cost and replenish the deposit. Incurring these expenses during a time of stress could further debilitate already weak credit unions.

Proponents of the 1 percent system, including virtually all credit union managers, argue that this funding structure appropriately treats the deposit as an asset because it is refundable (under certain conditions) and it may earn dividends. They also note that the structure provides a mechanism for promptly correcting any deficiencies in the Share Insurance Fund's reserves, and in effect gives the Fund a claim on the entire net worth of all credit unions.

Critics of the 1 percent system, including many bankers, argue that the accounting treatment of the 1 percent deposit overstates the resources available to offset losses to the Share Insurance Fund. During times of economic stress, they argue, credit unions are likely to have reduced income or even have losses, and credit union failures are likely to increase. If the Fund's reserve ratio falls below 1.25 percent, the NCUA may begin assessing premiums. If losses are large enough to impair the 1 percent deposit, then credit unions must write off and replenish the amount that was impaired. The critics point out that credit unions would thus have to pay premiums and write off and replenish the impaired deposit at a time when earnings are depressed and net worth may already be declining. By expensing the 1 percent deposit now, credit unions would not have to expense it during a time of economic stress. They would, however, still have to pay premiums to rebuild the Fund's reserves.

The overriding federal interest in the Share Insurance Fund's financial structure lies in protecting taxpayers from potential losses, while creating a healthy set of incentives for insured credit unions. Thus, whatever the accounting issues and their resolution, the ultimate policy concern must be the Share Insurance Fund's fiscal soundness.

The financing structure of the Share Insurance Fund fits the cooperative character of credit unions. Because credit unions must expense any losses to the Share Insurance Fund, they have an incentive to monitor each other and the Share Insurance Fund. This financing structure makes transparent the financial support that healthier credit unions give to the members of failing credit unions. Credit unions understand this aspect of the Share Insurance Fund and embrace it as a reflection of their cooperative character.

It would be feasible for credit unions to expense the 1 percent deposit now, when they are healthy and have strong earnings. However, expensing the deposit would add nothing to the Share Insurance Fund's reserves, and better ways of protecting the Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.

Instead, we recommend a strengthened reserving requirement. Under current law, credit unions set aside a small percentage of their gross earnings as reserves until their net worth reaches 6 percent. We recommend increasing the 6 percent threshold to 7 percent. Thus we would not require credit unions to write off part of their net worth but instead to add to it (if they did not already meet the 7 percent target). This additional net worth cushion would more than offset the double counting of the 1 percent deposit. And this approach should ultimately strengthen both individual credit unions and the Share Insurance Fund.

In addition, the NCUA should have some flexibility to let the Share Insurance Fund accumulate additional investment earnings in good times that would increase its resiliency during economic downturns. The Federal Credit Union Act currently imposes a rigid 1.3 percent ceiling on the Fund's reserve ratio. We recommend that Congress give the NCUA discretion to let investment earnings increase the Fund's reserve ratio to 1.5 percent.

Current law also permits the NCUA to assess insurance premiums only at a fixed rate of 1/12 of 1 percent of insured deposits. Here again, we believe that the NCUA should have more flexibility to ensure adequate, timely financing of the Share Insurance Fund. Specifically, we recommend that Congress give the NCUA flexibility to set premiums higher or lower than 1/12 of 1 percent, as needed. Similarly, it may be appropriate to consider authorizing the NCUA to assess risk-based premiums and perhaps to make risk-based adjustments in dividends from the Share Insurance Fund. Although this study does not recommend such changes, we see value in a broader debate over their possible advantages and disadvantages.

The NCUA's Safety and Soundness Regulations

The NCUA establishes and enforces safety and soundness regulations as charterer and supervisor of federal credit unions and deposit insurer of both federal and state credit unions. In view of the extensive statutory and administrative modernization of bank and thrift regulation over the past decade, we used the federal banking agencies' safety and soundness regulations as a starting point for our review of the NCUA's safety and soundness regulations. When we identified differences between the two sets of regulations, we evaluated them in light of credit unions' distinctive character and their size and complexity relative to banks and thrifts. We identified four key differences between the NCUA's regulations and those of the federal banking agencies that we believe warrant action by Congress or the NCUA.

Rulemaking

In formulating fundamental safety and soundness policies, the NCUA has often relied on such informal means as examiner manuals, policy statements, or bylaws. To some degree, this informal approach reflects the historical prevalence of small credit unions with relatively simple operations. Such informality has its benefits for the NCUA and for credit unions, but it may also have significant potential drawbacks. For example, reliance on unwritten or informal rules reduces or eliminates the opportunity for public comment. And a lack of clear public rules increases the risk of the NCUA treating or being perceived as treating similarly-situated credit unions differently without good reason. We recommend that the NCUA make important safety and soundness rules readily accessible to all interested parties. And, if it intends its rules to have the force of law and apply to credit unions generally, it should promulgate them as regulations and codify them in the *Code of Federal Regulations*. As part of this rulemaking process, the NCUA should publish proposed rules in the *Federal Register* and solicit comments from interested parties.

Net Worth Requirements

Credit unions are not subject to net worth requirements. Regulators of other federally insured depository institutions establish minimum net worth (capital) requirements to help ensure that such institutions have a sufficient buffer to absorb unforseen losses without in turn imposing losses on depositors or the deposit insurance fund. Requiring depository institutions to have adequate net worth also helps counteract the moral hazard of deposit insurance (i.e., the tendency of deposit insurance to permit or encourage insured depository institutions to take excessive risks -- risks that they would not take in a free market). Net worth is like the deductible on an insurance policy: the higher the deductible, the greater the incentive to avoid loss. Adequate net worth gives a depository institution's owners incentives compatible with the interests of the insurance fund because the fund absorbs losses only after the institution has exhausted its net worth and thus eliminated the economic value of the owners' investment.

A credit union's net worth represents the sum of the various reserve accounts on its balance sheet. These accumulated reserves form the buffer that protects the credit union and the Share Insurance Fund from possible losses. Yet the NCUA's regulations do not impose any net worth requirement on credit unions in the sense of requiring credit unions to have at least a given ratio of net worth to assets in order to be in good standing. We recommend the following changes that together should provide adequate, effective net worth requirements.

Most importantly, a credit union should have to meet a net worth requirement -- a requirement that the credit union maintain a specified ratio of net worth to total assets. We recommend that Congress require a credit union that has existed for a given number of years or has attained a certain asset size (whichever occurs first) to have at least a 6 percent ratio of net worth to total assets. (As described next, we would make such a requirement part of a system of prompt corrective action designed to ensure that credit unions correct any net worth deficiency

expeditiously.) Other credit unions should be required to build reserves in a manner that ensures that they will meet the 6 percent net worth target by the time they have existed for the specified number of years or reached the specified asset size.

Additionally, the existing statutory reserving requirement (i.e., the requirement that a federal credit union set aside as reserves a certain percentage of its gross income) should have a higher target reserve ratio. Specifically, we recommend that Congress raise the current reserving target from 6 percent of "risk assets" to 7 percent of total assets. A 1 percentage point increase in the reserving target would approximate credit unions' 1 percent deposit in the Share Insurance Fund. Furthermore, credit unions should deduct from their reserves, some portion of any member capital accounts at a corporate credit union and all paid-in capital issued by a corporate credit union.

Congress should also authorize the NCUA to develop an appropriate risk-based net worth requirement for larger, more complex credit unions. This risk-based requirement would supplement the simple 6 percent net worth to total assets requirement and permit the NCUA to take account of risks -- such as off-balance sheet risks or interest rate risk (from, for example, a large mortgage portfolio) -- that may be appreciable only for a small subset of credit unions. Most credit unions are well capitalized. At the end of 1996, 93 percent of all federally insured credit unions had at least 7 percent net worth total assets.

Prompt Corrective Action

Congress enacted a system of prompt corrective action for banks and thrifts in 1991. Prompt corrective action is a capital-based approach to safety and soundness supervision aiming to resolve net worth deficiencies before they grow into large problems. The goal of a prompt corrective action structure is to minimize -- and, if possible, avoid -- losses to the deposit insurance fund. Prompt corrective action lays clear markers for when regulatory action must occur and identifies a range of acceptable actions for a given degree of net worth deficiency.

The NCUA has some informal policies analogous to prompt corrective action. However, it has no regulations or even formal guidelines for taking corrective action regarding a troubled credit union.

We recommend that Congress adopt a system of prompt corrective action for federally insured credit unions. This system would be a streamlined version of that currently applicable to FDIC-insured institutions and would be specifically tailored to credit unions as not-for-profit, member-owned cooperatives. It would thus, for example, omit the various provisions keyed to the existence of capital stock since credit unions have no capital stock.

A prompt corrective action system for credit unions, like the system already in effect for other federally insured depository institutions, might have five net worth categories. A credit union with a ratio of net worth to total assets meeting the revised reserving target of 7 percent

would be "well capitalized." In keeping with our recommendation to generally require credit unions to maintain 6 percent net worth, credit unions with at least 6 percent net worth would be "adequately capitalized," and credit unions with less than 6 percent net worth would be "undercapitalized." A credit union with less than 4 percent net worth would be "significantly undercapitalized." A credit union with less than 2 percent net worth (or such higher level, not exceeding 3 percent, as the NCUA may prescribe by regulation) would be "critically undercapitalized."

We would not apply these prompt corrective action provisions to credit unions that have existed for less than a given number of years (the same as the phase-in period for meeting the 6 percent net worth requirement) or reached a given asset size. New credit unions should, however, be subject to prompt corrective action if they are not making sufficient progress towards meeting the 6 percent requirement.

Such a system of prompt corrective action would reinforce the commitment of credit unions and the NCUA to resolve net worth deficiencies promptly, before they worsen. Its clarity and predictability should promote fair, consistent treatment of similarly situated institutions. It should also ultimately reduce the number and cost of credit union failures. In so doing, it should conserve the resources of the Share Insurance Fund, make it even more resilient, and make more money available for lending to credit union members. And it would respect and complement the cooperative character of credit unions.

Audit Requirements

Although the NCUA requires each federal credit union to undergo an annual audit satisfying criteria prescribed by the NCUA, the NCUA does not generally require even large credit unions to obtain outside independent audits. Instead, a credit union's supervisory committee, which consists of volunteer members of the credit union appointed by the credit union's board of directors, has responsibility for conducting the audit itself or retaining an independent, licensed certified public accountant to do so. The NCUA requires an independent audit only if the supervisory committee has not conducted an annual audit, the supervisory committee's audit failed to meet the NCUA's requirements, or the credit union has had serious and persistent recordkeeping deficiencies.

With the rise of large, financially complex credit unions, the audit becomes increasingly more difficult for unpaid volunteers to carry out personally. The NCUA has noted the inadequacies of supervisory committee audits in general. Accordingly, we recommend that the NCUA require each large federally insured credit union to obtain an annual audit from an independent public accountant. The audit should be at least comparable to those required for banks and thrifts.

Corporate Credit Unions

Corporate credit unions are cooperatively owned by their member credit unions. They serve their members primarily by lending or otherwise investing excess funds deposited by member credit unions. At the end of 1996, corporate credit unions held 7 percent of all regular credit unions' assets. Corporate credit unions also provide services comparable to the correspondent services that large commercial banks have traditionally provided to smaller banks. U.S. Central Credit Union is a corporate credit union serving 38 of the 40 other corporate credit unions.

General Observations

Corporate credit unions invest in high-quality assets, and thus have limited exposure to credit risk. To maintain a liquid balance sheet, they keep their investments mostly short-term. At the same time, corporate credit unions tend to be thinly capitalized (that is, have relatively little net worth) and they operate with very narrow margins (that is, have only a small spread between their interest earnings and interest expenses). These narrow margins hinder corporate credit unions from increasing their capital quickly through retained earnings.

This combination of thin capitalization and narrow margins leaves little room for error and heightens the importance of proper internal controls and strong management. Corporate credit unions' asset size may also fluctuate greatly as member deposits rise and fall, and as member loan demand changes. This potential volatility, combined with the difficulty of building capital quickly through retained earnings, reinforces the need for sufficient capital.

In recent years the NCUA has encouraged corporate credit unions to increase their net worth, and corporate credit unions have done so. We believe that this trend is critically important and that further increases in net worth are essential. We anticipate that the NCUA's new corporate credit union regulation will encourage corporate credit unions to continue to build their net worth. In particular, we believe that the new regulation correctly bases permissible investment risk on core capital (retained earnings), and emphasizes the importance of corporate credit unions coming to rely on core capital rather than other forms of capital.

The three-tier cooperative structure of the credit union system -- regular credit unions, corporate credit unions, and U.S. Central -- creates an interdependence risk among and within the various levels. Specifically, a credit union's deposits at its corporate credit union, and its membership capital account, are assets on its books. At the same time, the credit union's corporate credit union carries these funds as (largely uninsured) deposits and secondary capital, respectively, on its balance sheet. The same relationship holds between corporate credit unions and U.S. Central. Thus, if U.S. Central were to fail, its member corporate credit unions could face losses on their deposits -- reducing their own net worth. Similarly, if a corporate credit union were to fail, its member credit unions could face losses on their deposits -- reducing their own net worth.

This interdependence raises at least two issues. First, each level of the credit union system must have sufficient net worth relative to the risks undertaken so as not to pose a risk of losses cascading to the level below it. Second, if a system-wide demand for liquidity arises, corporate credit unions have only limited ability to bring in liquidity from outside the system. Corporate credit unions would largely have to rely on liquidating their investments to meet their members' liquidity needs, but members' deposit withdrawals would tend to deplete those investments.

Corporate credit unions face increasing competitive pressure from each other (due largely but not entirely to their overlapping fields of membership) and from other market participants. The investment, liquidity, and transaction services that corporate credit unions offer to their members are by no means unique; viable market alternatives exist, although small credit unions may have access to a far more limited range of alternatives than large credit unions.

This competitive environment poses important safety and soundness issues for both the near-term and the long-term. Some consolidation among corporate credit unions has begun and we anticipate more in the future. It is unclear what the corporate system will look like in 5 to 10 years, but it is quite likely to look much different than today. How corporate credit unions, and their members, respond to competition among themselves and from other market participants -- whether through rapid growth, developing new activities, increased risk-taking, consolidation, shifting business strategy, or standing still -- will determine the sort of safety and soundness issues that will arise. The NCUA will clearly need to monitor these developments closely.

Financial Condition of the Largest Corporate Credit Unions

Having analyzed the investment portfolios of the 10 largest corporate credit unions and U.S. Central, we concluded that those portfolios generally have limited credit risk exposure, but that concentration risk is an issue and that some institutions' portfolios are vulnerable to changes in interest rates. In particular, we observed a concentration in certain classes of asset-backed securities.

We have several concerns about this concentration of corporate credit union investments in particular classes of assets. First, corporate credit unions' generally small net worth ratios leave little room for error. Second, although the NCUA limits the amount that a corporate credit union can invest in obligations of a single issuer, it does not limit the amount that a corporate credit union can invest in a class of assets. Third, the risks of concentrating investments in a single asset class are exacerbated by the interdependence risk among corporate credit unions and by the relative homogeneity of the different corporate credit unions' balance sheets.

We therefore recommend that the NCUA develop policy guidance or regulations governing asset concentration risks. The NCUA also needs to consider the implications of such concentration risk across all corporate credit unions. That is, although an examiner may conclude that any one corporate credit union's concentration in a particular asset class is within some

acceptable level of tolerance, the NCUA should also consider the corporate system's overall exposure to that particular asset class.

We reviewed the NCUA's examinations of U.S. Central and the 10 largest corporate credit unions. We found continued problems involving internal controls and management quality at some corporate credit unions -- although improvements have been made. We also found that, during the most recent examination cycle, the NCUA had various degrees of concern about 6 of the 11 institutions.

NCUA's Corporate Credit Union Regulations

Earlier this year, the NCUA completed a sweeping overhaul of its corporate credit union safety and soundness regulation. The new regulation strengthens minimum capital requirements, clarifies the responsibilities of a corporate credit union's management and board of directors, explicitly limits exposure to interest rate risk, implements strict credit review procedures, and requires corporate credit unions to formulate contingent liquidity plans.

These changes have significantly improved the regulation of corporate credit unions. With corporate credit unions operating in a highly dynamic market, the NCUA will, over time, need to reexamine various elements of the new regulation. In fact, when the NCUA published that regulation, it committed itself to issuing a report within 18 months on the issues involved.

NCUA's Supervision of Corporate Credit Unions

We evaluated the Office of Corporate Credit Union's approach to supervising corporate credit unions, including its staffing, its policies and procedures, its examiner guidance, and its safety and soundness standards. The Office is relatively new -- the NCUA created it in 1994 -- yet it represents a significant improvement over the NCUA's previous, less rigorous approach to supervising corporate credit unions. Based on our evaluation, we identified several areas for continued development.

First, we found that the Office of Corporate Credit Unions is understaffed. The resources currently devoted to supervising corporate credit unions fall short of reflecting the proportionate risk these institutions pose to both credit unions and the Share Insurance Fund.

Second, the NCUA's practices for regulating corporate credit unions diverge in some respects from the best-practice approaches developed cooperatively by other federal regulatory agencies. In particular, the bank and thrift regulators have been developing risk assessment techniques that focus examiner attention on high risk areas and overall portfolio risk. Our review of NCUA corporate examination reports found a more audit-oriented focus, rather than one keyed to the critical risk areas in a particular credit union. We also found that examination reports contained excessive detail about small deficiencies, which detracted from the major findings and prescriptions for corrective action. More generally, the NCUA could benefit from

more regular interaction with the federal banking agencies to learn about, and participate in developing best practices for approaching emerging financial market risks.

Third, the NCUA has not adequately developed written guidance for examiners and corporate credit unions. Moreover, the NCUA does not currently have sufficient capacity to review industry trends, assess potential systemic risks, and assess corporate credit unions as a group.

Fourth, the rating system used for corporate credit unions does not reflect the current risks and risk-taking in such institutions. In particular, the NCUA has not adopted the federal banking agencies' revised rating system, which includes a component rating for an institution's sensitivity to market risk.

Fifth, the NCUA's examination reports and work papers for the 11 corporate credit unions we reviewed did not always sufficiently support examiner ratings. We also have concerns about the Office of Corporate Credit Unions' policy of basing the overall rating on the lowest of the five component ratings.

In view of these findings, we recommend that the NCUA: commit greater resources to the Office of Corporate Credit Unions; interact more with the four federal banking agencies and make greater use of risk-based approaches to supervision; improve its written examiner guidance; add to its ratings of corporate credit unions a component rating for sensitivity of market risk; and provide better analysis and documentation in connection with its examinations.

Credit Union Liquidity and the Central Liquidity Facility

Liquidity refers to the relative ease with which one can convert assets into cash. One of the key functions of corporate credit unions is to provide liquidity to member credit unions. Corporate credit unions are currently well positioned to do so because their portfolios consist of investments of high credit quality with relatively short maturities. However, they are not equipped to deal with systemic liquidity demands by regular credit unions. For this purpose, Congress created the Central Liquidity Facility (CLF) in 1978, when credit unions had no access to emergency liquidity from a governmental lender of last resort. In 1980, however, Congress expanded access to the Federal Reserve's discount window to all depository institutions, including credit unions, offering accounts that are subject to reserve requirements.

The CLF is a mixed-ownership government corporation within the NCUA. CLF membership is voluntary and available to all credit unions. Most credit unions join the CLF through their corporate credit union, which acts as an agent for its members. Unlike credit unions, however, corporate credit unions do not actually pay cash for CLF shares. Through a complex series of accounting transactions involving corporate credit unions, U.S. Central, and the CLF, entries are recorded to show stock purchases, although no funds actually change hands. These transactions artificially inflate the parties' balance sheets.

The CLF creates a concentration of credit risk for itself by holding all of its investments at U.S. Central. If U.S. Central were ever to become impaired, the CLF's elaborate redeposit-based capital structure could collapse and its share accounts could suffer losses; the combined effect could largely eliminate the CLF's net worth.

The CLF has authority to lend to member credit unions and the Share Insurance Fund but actual CLF lending has been modest. The CLF currently has statutory authority to borrow $17 billion. Moreover, the Justice Department's Office of Legal Counsel has stated that full faith and credit of the United States backs such borrowing. Although the CLF may borrow from any source, it has long had a credit arrangement in place with the Federal Financing Bank, which is part of the Treasury. Various appropriations acts have limited to $600 million the amount that the CLF can lend directly to credit unions, yet they have not limited the CLF's ability to borrow the full $17 billion at any one time and lend it to the Share Insurance Fund. In a systemic crisis, the federal government could incur significant losses if such funds were advanced to shore up troubled credit unions or a troubled insurance fund.

We recommend that Congress discontinue the CLF. Credit unions, particularly larger ones, should apply to their Federal Reserve Bank for discount window access. Smaller credit unions should at least have firm lines of credit for emergency liquidity from their corporate credit unions or other depository institutions. In addition, we recommend that corporate credit unions and the NCUA each evaluate credit unions' potential liquidity needs and the options available for credit unions and corporate credit unions to meet those needs. A recent NCUA regulation directs corporate credit unions to do this.

CHAPTER I

CREDIT UNIONS

Credit unions are member-owned depository institutions that serve individuals belonging to a defined field of membership. The nation's 11,392 federally insured credit unions provide basic retail financial services to some 70 million Americans.[1] Most credit unions are relatively small institutions that rely, to a significant degree, on member-volunteers to help run them. Many small credit unions offer a relatively simple set of products, such as deposit accounts and consumer loans. Although they are numerous, small institutions hold a relatively small proportion of total credit union assets. Conversely, the largest 1,300 credit unions (11 percent of all credit unions) hold approximately 75 percent of total credit union assets. These large credit unions commonly offer a wide range of financial services, including mortgages, small business loans, and credit cards. Although most credit unions have federal deposit insurance, 462 credit unions do not.[2] This study deals with only federally insured credit unions.

Federal credit unions have traditionally had "fields of membership" defined by "common bonds" of association, occupation, or geographic location. Associational credit unions may include members of a religious congregation, a fraternal organization, or a civic group. Occupational credit unions may include individuals sharing a common employer or workplace. Community credit unions may include anyone who lives, works, or worships in a single neighborhood, city, county, or metropolitan area.

In this introductory chapter, we will first briefly sketch the history of credit unions and their federal regulator, the National Credit Union Administration (NCUA). Second, we will compare credit unions with other depository institutions. Third, we will discuss the current condition of credit unions. Finally, we will summarize the statutory requirements for this study, describe our methodology, and outline the structure of the study.

A. CREDIT UNIONS: AN HISTORICAL OVERVIEW

Modern-day credit unions trace their origins to credit organizations formed in Central Europe during the mid-1800s. In 1850, German craftsmen and farmers in need of credit services formed the first credit association by pooling their savings and offering loans to each other. Credit associations spread to North America in the late 1800s. In 1909, members of St. Mary's Parish in Manchester, New Hampshire, organized the first credit union in the United States,

---

[1] NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions* (Alexandria, VA: NCUA, 1997), 7. Because some people belong to more than 1 credit union, the 70 million figure reflects some double counting.

[2] Credit Union National Association, *Response to the Treasury's Data Request*, Nov. 6 (Washington, DC: CUNA, 1997).

known as the St. Mary's Cooperative Credit Association. Shortly thereafter, Massachusetts became the first state to create a credit union charter.[3]

Credit unions proliferated during the early decades of this century. By 1934, the United States had approximately 2,500 credit unions, with 38 states and the District of Columbia offering credit union charters.[4] In 1934, the Federal Credit Union Act created a federal credit union charter and established the Bureau of Federal Credit Unions as the regulator. The bureau began as part of the Farm Credit Administration and then moved to the Federal Deposit Insurance Corporation (1942), the Federal Security Agency (1948), and the Department of Health, Education, and Welfare (1953).[5]

In 1970, Congress created the NCUA and the National Credit Union Share Insurance Fund (Share Insurance Fund). The NCUA, an independent federal agency, is governed by the three-member NCUA Board, with members appointed by the President and confirmed by the Senate for six-year terms. In appointing the Board members, the President designates the Chairman. The NCUA also administers the Share Insurance Fund.[6]

Like banks and thrift institutions, credit unions have a dual chartering and supervisory system. The NCUA supervises federal credit unions, while states supervise the credit unions they charter. But the NCUA, as manager of the Share Insurance Fund, also has some supervisory authority over all federally insured state credit unions. The NCUA currently supervises and insures 7,152 federal credit unions and insures 4,240 state-chartered credit unions.[7]

In 1970, Congress directed the NCUA to certify eligible institutions as low-income credit unions.[8] As credit unions serving predominantly low-income persons could not meet their members' credit needs using only deposits from other members, Congress permitted low-income credit unions, or community development credit unions (CDCUs), to accept deposits from nonmembers.[9] CDCUs may have occupational or geographic fields of membership. CDCUs distinguish themselves from traditional credit unions by serving those who may have a difficult time obtaining credit, such as people who receive public assistance or reside in public housing. As

---

[3] J. Carroll Moody and Gilbert C. Fite, *The Credit Union Movement: Origins and Development, 1850-1980*, 2d ed. (Dubuque, IA: Credit Union National Association, 1984), 1-5, 23-27.

[4] Ibid., 123.

[5] NCUA, *1994 Annual Report* (Alexandria, VA: NCUA, 1995), 2.

[6] Like the Federal Deposit Insurance Corporation, which manages insurance funds for both banks and thrifts, the Share Insurance Fund insures credit union deposit accounts to $100,000.

[7] NCUA, *1996 Annual Report* (Alexandria, VA: NCUA, 1997), 17.

[8] Pub. L. No. 91-468, § 10(1), 84 Stat. 994, 1017 (1970).

[9] S. Rep. 1128, 91st Cong., 2d Sess. 9 (1970).

of year-end 1996, 346 CDCUs served over 800,000 people. CDCUs' assets total over $2 billion, with the average CDCU having under $7 million in assets.[10, 11]

B. CREDIT UNIONS AS DEPOSITORY INSTITUTIONS

Credit unions are depository institutions. Like banks and thrifts, they accept deposits and make loans. At this basic financial level, credit unions very much resemble banks and thrift institutions: by intermediating funds from savers to borrowers, credit unions take on credit risk (the risk that borrowers will not repay loans) and interest rate risk (the risk that changes in interest rates will alter the value of assets relative to liabilities). Managing these risks represents a key aspect of credit unions' financial operations. Supervising such risk-taking represents a key aspect of credit unions' federal oversight and makes the NCUA's responsibilities much like those of the federal banking agencies.[12]

However, credit unions have several characteristics that, taken together, distinguish them from banks and thrifts. As part of our research, we asked credit unions, credit union trade associations, and the NCUA to describe what makes a credit union different from a bank or thrift. The answers given pointed to five basic credit union characteristics. Although other financial institutions may also have one or more of these characteristics, it is the combination of them that defines credit unions as a distinct class of depository institutions.

First, credit unions are member-owned, member-directed depository institutions.[13] Each member has one vote in selecting board members and making certain other decisions. This voting structure (one member, one vote) differs from that of mutual savings associations and mutual savings banks in that a mutual institution, although also member-owned, allocates voting rights according to the size of a member's deposit (roughly equivalent to one vote per $100).

Like mutual savings institutions, credit unions do not issue capital stock. Credit union members' deposits are generally considered part of capital. But federal insurance protects virtually all of these deposits, and the deposits themselves do not represent the kind of capital available for absorbing losses and thereby protecting the Share Insurance Fund.[14] Credit unions

---

[10] NCUA, *1996 Annual Report* (Alexandria, VA: NCUA, 1997), 15.

[11] In 1996, CDCUs obtained the exclusive authority (among credit unions) to issue secondary capital with a maturity of at least five years. This secondary capital generally comes from philanthropic sources interested in strengthening CDCUs' capital base so that they can accept more deposits and make more loans.

[12] The federal banking agencies are the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

[13] Credit unions are structured as a cooperative. As a business form, the modern cooperative dates from the mid-1800s. Democratic participation in management by the cooperatives' members is a fundamental characteristic of cooperatives. Bankline, *Encyclopedia of Banking and Finance,* 10th ed. (Chicago: Bankline, 1994), 254.

[14] As of year-end 1996, uninsured deposits represented only 4 percent of all deposits at federally insured credit unions. Sheshunoff Information Services, Inc., *BankSearch* (Austin, TX: Sheshunoff, 1997).

derive that kind of capital (i.e., net worth) from their accumulated retained earnings. Most credit unions start their existence with no net worth, and then build it up over time. The absence of capital stock -- and the concomitant reliance on retained earnings -- reinforces the member-owned character of credit unions. It also means that credit unions, unlike most other depositories, do not have the option of increasing their net worth in times of stress by issuing stock.[15]

Second, credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each institution's membership. The board sets policy for the credit union and hires the senior management team. In small credit unions, member-volunteers may staff the institution. The board appoints member-volunteers to a supervisory committee, which has responsibility for auditing the credit union, reviewing its performance, and making recommendations to the board on these and other policy matters.

Third, credit unions do not operate for profit. They return any earnings to their members, typically as reduced fees or reduced interest rates on loans or as "dividends on shares" (which in substance resemble interest paid on deposits), or reinvest those earnings in the credit union as retained earnings.

Fourth, credit unions have a public purpose. According to the Federal Credit Union Act, Congress intended credit unions "to make more available to people of small means credit for provident purposes."[16] The Act declares that credit unions are established for "promoting thrift among [their] members and creating a source of credit for provident or productive purposes."[17] Of course, other depository institutions also operate under statutes that delineate public purposes, so any distinction here is one of degree.

Fifth, credit unions have certain limitations on their membership, generally based on some affinity among members. According to the International Credit Union Operating Principles of the World Council of Credit Unions, "[m]embership in a credit union is voluntary and open to all within the accepted common bond of association that can make use of its services and are willing to accept the corresponding responsibilities."[18] The Federal Credit Union Act embodies this principle by limiting federal credit union membership to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district."[19] Most state credit union statutes also impose some sort of common bond

---

[15] Although mutual savings banks and mutual savings associations also do not issue stock, such institutions have the option of converting to stock form without fundamentally altering their basic character. Credit unions cannot become stock institutions and still remain credit unions.

[16] Pub. L. No. 73-467, 48 Stat. 1216, 1216 (1934) (long title).

[17] 12 U.S.C. § 1752(1).

[18] World Council of Credit Unions Membership Council, *International Credit Union Operating Principles* (Madison, WI: World Council of Credit Unions, 1984), leaflet.

[19] 12 U.S.C. § 1759.

requirement.[20] Thus, unlike other depository institutions, a federal credit union cannot serve just anyone from the general public. Table I.1 displays the number of federal credit unions and their total assets in each type of membership category.

Table I.1: Federal Credit Unions by Type of Membership*
(Dollar figures in billions; data as of December 31, 1996)

Occupational CUs		Assocational CUs		Community CUs		Other CUs**	
Number	Total Assets	Number	Total Assets	Number	Total Assets	Number	Total Assets
5,283	$179	743	$3	469	$11	573	$19

Source: NCUA, *Response to the Treasury's Data Request*, Oct. 28.

*Data on state-chartered credit unions were not available.
**Most credit unions in this category have multiple groups with more than one type of membership.

C. CREDIT UNIONS RELATIVE TO OTHER DEPOSITORY INSTITUTIONS

As of year-end 1996, the Share Insurance Fund insured 11,392 credit unions, which together controlled $327 billion in assets. Thus each credit union averages $29 million in total assets. Moreover, some 65 percent of credit unions had less than $10 million in total assets. In contrast, commercial banks average $480 million in total assets.[21] However, these aggregate figures fail to capture two important facts about credit unions' size relative to other depositories.

First, as with other depositories, a significant concentration of credit union assets exists in the largest institutions. Table I.2 and Figure I.1 present the number of credit unions by asset size category and the percentage of total assets in each category. The 11 percent of credit unions with over $50 million in assets (1,284 institutions) hold 74 percent of credit unions' aggragate assets.

[20] According to the National Association of State Credit Union Supervisors, of the 47 states with credit union acts, all but 7 have some statutory reference to a common bond. However, common bond requirements vary widely among the states. National Association of State Credit Union Supervisors, *Letter to the Treasury*, Apr. 15 (Birmingham, AL: NASCUS, 1997), 1.

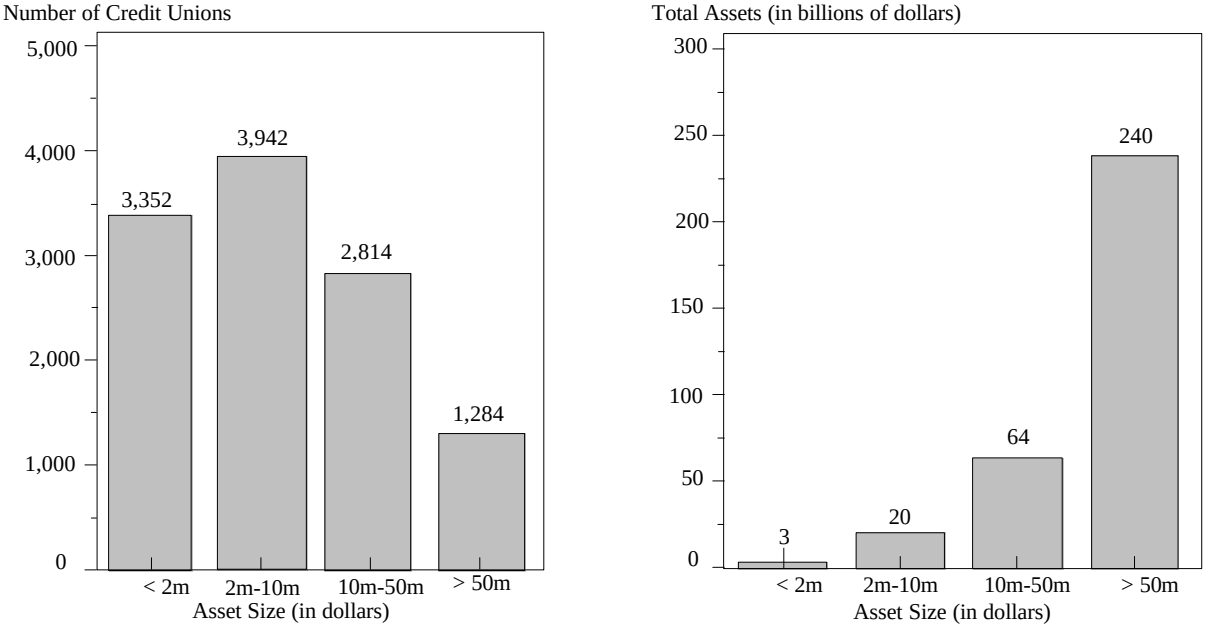
[21] Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile*, 4th qtr. (Washington, DC: FDIC, 1996), 5.

Table I.2: Number of Credit Unions and Total Assets by Size Category
(Dollar figures in billions; data as of December 31, 1996)

Asset Size Category	# of Institutions	Total Assets	% of Credit Union Assets
< $2 million	3,352	$3	1%
$2-10 million	3,942	$20	6%
$10-50 million	2,814	$64	19%
> $50 million	1,284	$240	74%
Total	11,392	$327	100%

Source: NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions.*

Figure I.1: Number of Credit Unions and Total Assets by Size Class
(Data as of December 31, 1996)



Source: NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions.*

Second, although both banks and thrifts collectively dwarf credit unions in asset size, credit unions may well (according to comments we received from banks) be significant competitors for individual community banks and thrifts in local markets. As Table I.3 indicates,

credit unions are comparable in number and aggregate assets to banks and thrifts that have less than $100 million in assets (community banks and thrifts). Indeed, the $324 billion in assets held by community banks and thrifts at the end of 1996 is almost identical to credit unions' $327 billion in assets.

Table I.3: Credit Unions Compared to Banks, Thrifts, and Community Banks and Thrifts
(Data as of December 31, 1996)

	Number of Institutions	Total Assets (in billions)	Average Assets (in millions)
Commercial Banks	9,528	$4,578	$481
Thrifts	1,924	$1,028	$534
Community Banks and Thrifts*	7,049	$324	$46
Credit Unions	11,392	$327	$29

Sources: Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile*, 4th qtr.; and NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions.*

*Defined as all federally insured banks and thrifts with less than $100 million in assets.

Large credit unions offer a range of products and services comparable to that of banks and thrifts. The Credit Union National Association (CUNA), the largest credit union trade association, describes how credit unions' products and services differ according to asset size:

> **$1 million to $2 million:** Credit unions with less than $2 million in assets comprise about 30 percent of all credit unions. They primarily offer their members shares [deposit accounts] and loans. Just over a third of credit unions with $1 million to $2 million in assets receive ACH [automated clearing house] payments. The average membership for these credit unions is 690, the average savings per member is $1,810 and the average size of a loan outstanding is $3,914.
>
> **$5 million to $10 million:** Credit unions that have reached this asset size have larger memberships that require and can support more extensive services. They probably offer share draft [checking] accounts, IRAs [individual retirement accounts] and larger consumer loans. Half of them offer credit cards and almost half offer ATM [automated teller machine] access. More than four fifths of these credit unions receive ACH payments. The average membership for these credit unions is 2,280, the average savings per member is $2,709 and the average size of a loan outstanding is $4,611.

> **$50 million to $100 million:** These credit unions are large full-service financial institutions. They receive ACH payments and two-thirds of them own at least one ATM. Over 80 percent have more than one office. The average membership for these credit unions is 16,001, the average savings per member is $3,839 and the average size of a loan outstanding is $5,379.[22]

Table I.4 presents data from CUNA's annual survey, which reflect this size-based differentiation. For example, only 10 percent of small credit unions offer first mortgage loans, while 97 percent of the largest institutions offer such loans. Moreover, few small credit unions offer telephone banking or ATM cards, but nearly all institutions with assets over $200 million offer these services.

As credit unions continue to grow in size and complexity, the range of their product offerings will almost certainly continue to expand. For example, the NCUA Board recently approved a pilot program that would permit up to 500 credit unions to offer IRAs with returns tied to the stock market.[23] In addition, whether to use risk-based pricing (i.e., charging members different rates based on their creditworthiness) is an emerging issue for credit unions. A recent report by CUNA showed that 13 percent of credit unions use such pricing and that another 17 percent are considering doing so within the next three years. The report also indicates that the larger the credit union, the more likely it is to practice or consider adopting risk-based pricing.[24]

---

[22] CUNA, *Credit Union Report 1996 Year-end* ([Madison, WI]: CUNA, 1997), 3.

[23] NCUA, *Board Action Bulletin*, Jul. 23 (Alexandria, VA: NCUA, 1997), <http://www.ncua.gov/news/board_reports/board_reports.html>.

[24] CUNA, *Credit Union Executive's 1997 Risk-Based Lending Survey Report* (Madison, WI: CUNA, 1997), vi. Risk-based pricing is controversial among credit unions. Some argue that such a pricing policy conflicts with credit union philosophy by treating members unequally. Others argue that risk-based pricing increases a credit union's total volume of lending, thereby helping all members, by making the credit union a more competitive source of credit for low-risk members while remaining the best source of credit for high risk members.

Table I.4: Federal Credit Union Products and Services by Asset Size
(Percent of credit unions; data as of December 31, 1996)

	Asset Size (in millions)				
	$1-2m	$5-10m	$50-100m	Over $200m	All Credit Unions
Loans:					
Unsecured	99%	100%	100%	100%	99%
First Mortgage	10%	35%	85%	97%	38%
Guaranteed Student	6%	17%	40%	52%	18%
Used Auto	96%	99%	100%	100%	95%
New Auto	96%	99%	100%	100%	95%
Auto Leasing	2%	8%	32%	38%	10%
Plane/Boat/RV	71%	86%	96%	96%	78%
Credit Cards	5%	50%	93%	98%	43%
Member Services:					
Stock/Bond Brokerage*	2%	4%	33%	55%	9%
Mutual Funds*	1%	2%	32%	57%	8%
Safe Deposit Boxes	1%	3%	50%	65%	12%
Audio Response	2%	22%	89%	97%	30%
PC-Based Banking	1%	1%	22%	47%	6%
ATM Cards	3%	47%	93%	99%	42%
Deposit Accounts/Services:					
CDs	38%	74%	96%	97%	63%
IRAs	22%	66%	94%	98%	54%
Business Checking	8%	38%	51%	45%	29%
Personal Checking	16%	71%	96%	98%	55%

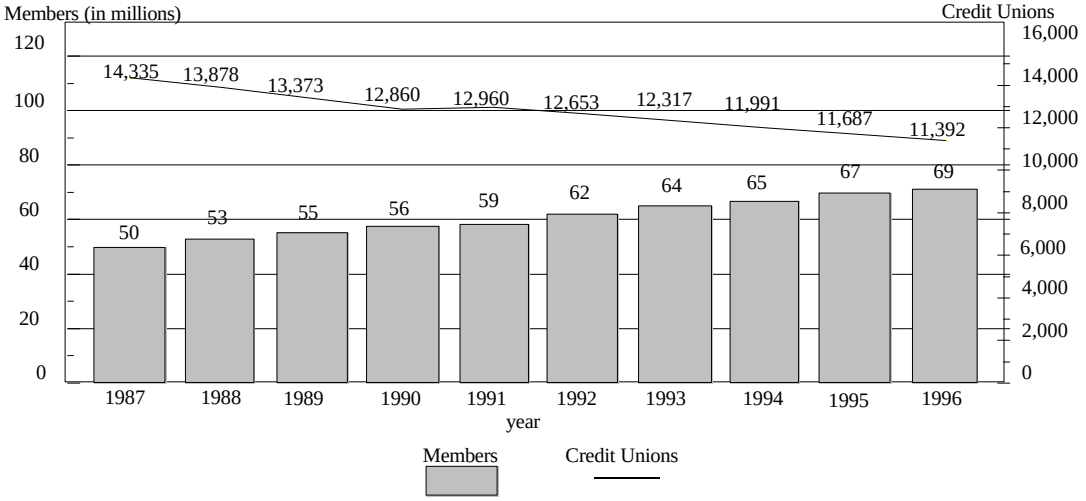
Source: CUNA, *Credit Union Services Profile 1996.*

*Institutions may not provide these services themselves, but may offer them if another entity actually provides the services.

In recent years, consolidation has accelerated among credit unions, as among other depository institutions. The number of credit unions has declined 21 percent since 1987, as shown in Figure I.2, even as the number of credit union members has grown 38 percent. Significant asset growth has accompanied consolidation, with credit unions' assets expanding

50 percent between 1991 and 1996.[25] The largest credit unions accounted for most of this growth. Credit unions with over $250 million in assets recorded growth over 64 percent, whereas institutions with less than $2 million in assets grew only 18 percent between 1991 and 1996.[26]

Figure I.2: Total Members and Credit Unions
(Data as of December 31, 1996)



Source: NCUA, *1996 Annual Report.*

1. Credit Union Assets

As of year-end 1996, loans comprised 65 percent of total credit union assets. The vast majority of these loans were automobile loans, first mortgage loans, and unsecured consumer loans.[27] Investments -- primarily U.S. Treasury and federal agency securities (primarily securities issued by government-sponsored enterprises (GSEs))[28] and deposits in corporate credit unions

[25] Over the same period, assets of FDIC-insured institutions grew 23 percent (to $6 trillion). Federal Deposit Insurance Corporation, *Statistics on Banking: 1996* (Washington, DC: FDIC, 1997), B-25; and FDIC, *Statistics on Banking: Historical, 1934-1994* (Washington, DC: FDIC, 1995), A-48, B-42.

[26] Sheshunoff Information Services, Inc., *BankSearch* (Austin, TX: Sheshunoff, 1997).

[27] NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions* (Alexandria, VA: NCUA, 1997), 1.

[28] Federal agency securities consist chiefly of debt and mortgage-backed securities issued or guaranteed by such GSEs as the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank System. The federal government does not guarantee GSE securities. This category also includes securities that are federally guaranteed such as those of the Government National Mortgage Association.

and commercial banks -- accounted for 30 percent of credit unions' total assets.[29] Table I.5 shows credit unions' consolidated assets by asset size.

Table I.5: Credit Unions' Consolidated Assets by Asset Size
(Percent of total assets; data as of December 31, 1996)

	Asset Size (in millions)			
	<$2m	$2-10m	$10-50m	>$50m
Cash	5%	3%	2%	2%
Total Loans Outstanding:	65%	65%	65%	65%
Unsecured Credit Card	1%	2%	5%	6%
All Other Unsecured	18%	13%	9%	7%
Vehicle	36%	36%	30%	24%
1st Mortgage Real Estate	1%	4%	9%	15%
Other Real Estate	1%	4%	8%	8%
All Other Loans	8%	6%	5%	4%
Allowance for Loan Losses	(2%)	(1%)	(1%)	(1%)
Total Investments:	31%	31%	30%	31%
U.S. Government Obligations	1%	1%	2%	5%
Federal Agency Securities	0%	2%	6%	15%
Mutual Fund & Common Trust	1%	1%	0%	1%
Corporate Credit Unions	16%	13%	10%	5%
Commercial Banks, S&Ls	11%	13%	10%	4%
Credit Unions	1%	1%	0%	0%
NCUSIF Capitalization Deposit	1%	1%	1%	1%
All Other Investments	0%	0%	0%	1%
Allowance for Investment Losses	N/A	N/A	N/A	N/A
All Other Assets	1%	2%	3%	3%

Source: NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions.*

[29] NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions* (Alexandria, VA: NCUA, 1997), 1.

Although loans comprise 65 percent of total assets, the prevalence of loan types varies over time and by institution size. Both small and large credit unions concentrate primarily on automobile and unsecured lending; however, larger institutions also devote a substantial portion of their portfolios to mortgage lending as well. For example, as of year-end 1996, automobile loans averaged 57 percent of the loan portfolio at credit unions with less than $10 million in assets, but 34 percent at credit unions with more than $250 million in assets. Mortgage loans, on the other hand, averaged only 5 percent of the loan portfolio at credit unions with less than $10 million in assets, but 28 percent at credit unions with more than $250 million in assets. Between 1991 and 1996, automobile lending increased from 27 percent to 34 percent of average credit union assets, mortgage lending held steady, and unsecured lending declined.[30]

Investments can provide credit unions with a prudent degree of liquidity (e.g., to meet deposit withdrawals and future loan demand) and a profitable way to employ unloaned funds. As credit union lending activity has increased in recent years, investments have declined as a percentage of total assets at institutions of all sizes. Nevertheless, investments remain an important component of credit unions' aggregate balance sheet. Between 1991 and 1996, federal agency securities (primarily GSE securities) supplanted deposits in corporate credit unions as credit unions' largest single type of investment.[31] As a proportion of total credit union investments, federal agency securities increased from 20 percent to 38 percent during that period.[32]

Corporate credit unions provide wholesale financial services, such as investment services, to credit unions. By collecting and investing surplus funds from hundreds of different credit unions, a corporate credit union provides investment expertise, diversification of risk, and economies of scale in buying and selling securities. Credit union investments in corporate credit unions declined between 1991 and 1996. However, corporate credit unions remain a vital resource for credit unions with less than $10 million in total assets. These small credit unions make approximately 45 percent of their investments through corporate credit unions.[33]

2. Credit Union Net Worth

Credit unions, like banks and thrift institutions, have increased their net worth over the past five years. These gains generally reflect the nation's sustained macroeconomic expansion and

---

[30] Sheshunoff Information Services, Inc., *BankSearch* (Austin, TX: Sheshunoff, 1997).

[31] This investment concentration in securities issued by GSEs underscores the critical need to keep GSEs safe and sound. *See, e.g.*, U.S. Department of the Treasury, *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation* (Washington, DC: Treasury, 1996); Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (Washington, DC: Treasury, 1991); and Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (Washington, DC: Treasury, 1990).

[32] Sheshunoff Information Services, Inc., *BankSearch* (Austin, TX: Sheshunoff, 1997).

[33] Ibid.

interest rate stability, as well as individual credit unions' decisions to strengthen their capital base. Credit unions as a group held capital (in the form of retained earnings) equal to 11 percent of total assets as of year-end 1996.[34] Among credit unions, the ratio of capital to total assets varies inversely with credit unions' total assets -- averaging 15 percent for credit unions with less than $2 million in total assets, but about 10 percent for credit unions with more than $250 million in total assets. Banks and thrifts exhibit a similar inverse relationship between capital ratios and institution size.[35]

D. STUDY REQUIREMENTS, METHODOLOGY, AND DESIGN

1. Requirements

The Treasury conducted this study pursuant to section 2606 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, which President Clinton signed into law on September 30, 1996.[36] That section required the Treasury to evaluate:

- the feasibility of having some entity other than the NCUA administer the Share Insurance Fund, and the implications of such a change;
- whether the 1 percent deposit that federally insured credit unions have made into the Share Insurance Fund should continue to be treated as an asset on credit unions' books or whether credit unions should, instead, expense that deposit;
- the NCUA's regulations;
- the condition of the 10 largest corporate credit unions -- including their investment practices, financial stability, financial operations, and financial controls; and
- the NCUA's supervision of corporate credit unions.

The statute required us to conduct the study in consultation with the NCUA, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). It also specifically required us to evaluate the 10 largest corporate credit unions "in cooperation with appropriate employees of other federal agencies with expertise in the examination of federally insured financial institutions."[37]

---

[34] Ibid. By contrast, commercial banks average 8 percent capital to total assets, although among small banks and thrifts the ratio typically exceeds 10 percent. Ibid.

[35] Ibid.

[36] Pub. L. No. 104-208, § 2606, 110 Stat. 3009-394, 3009-473 (1996) (codified at 12 U.S.C. § 1752a note).

[37] *Id.* § 2606(b)(1)(C), 110 Stat. 3009-394, 3009-474.

2. Methodology

To better understand the issues raised by this mandate, we reviewed past research on credit unions and met with a broad range of credit union representatives and regulators. We also solicited the opinions of a wide range of interested parties on the various study topics. In particular, we actively sought the views of credit unions on the study topics and on how they viewed credit unions' role in the financial marketplace.

To ensure the broadest public comment from interested parties, we published a notice in the *Federal Register* describing our approach to the study and inviting comment on 15 specific questions and on the study topics generally.[38] We received 181 written responses to our notice.

We met with about 50 credit union chief executive officers (CEOs), individually and in small groups. We participated in a conference call with the CEOs of 11 state-chartered credit unions. We met with the CEOs of eight corporate credit unions. In connection with our study, we also visited eight credit unions and two corporate credit unions.

We had several meetings each with CUNA, the National Association of Federal Credit Unions (NAFCU), and the National Association of State Credit Union Supervisors (NASCUS). We met with the Executive Director of the National Federation of Community Development Credit Unions. Early in our study, representatives of the Association of Corporate Credit Unions made a half-day long presentation to us and to the interagency team of banking examiners (described below) on the operations of corporate credit unions.

We met with representatives of the American Bankers Association, the Independent Bankers Association of America, and America's Community Bankers.

We also met with representatives of the Consumer Federation of America and the U.S. Public Interest Research Group.

We held numerous meetings with NCUA officials to learn about the NCUA's supervision of credit unions and corporate credit unions as well as the NCUA's operation of the Share Insurance Fund. We also attended numerous NCUA board meetings and reviewed many NCUA documents, manuals, directives, policy statements, and the like. We also shared a draft of this study with the NCUA and gave the NCUA an opportunity to comment on it.

We consulted with officials from the OCC, the Federal Reserve, the Office of Thrift Supervision (OTS), and the FDIC.

With assistance from the OCC, we assembled an inter-agency team of federal banking examiners to assist in our review of the financial condition of the 10 largest corporate credit

---

[38] 60 Fed. Reg. 1,358 (1997).

unions. The six-member team included examiners from the OCC, FDIC, OTS, and Federal Reserve. This team conducted off-site reviews of the 10 largest corporate credit unions as well as on-site reviews of the two largest corporate credit unions, and met with NCUA officials on several occasions to discuss those institutions.

We received full cooperation from all the credit unions, corporate credit unions, trade associations and other parties that we contacted during the course of our study. We also received information that we requested from the NCUA and, with one exception, had access to appropriate NCUA officials. After encouraging us to meet with the Director of the Office of Community Development Credit Unions, the NCUA canceled our scheduled meeting with her, asserting that the mission of that office lay outside the scope of our study.

3. Overview

We divided the study mandate into three subject-areas -- the Share Insurance Fund, the NCUA's regulations, and corporate credit unions -- and we devote one chapter to each of these topics. Chapter II analyzes issues relating to the Share Insurance Fund. Chapter III examines the NCUA's regulations. Chapter IV discusses corporate credit unions. Chapter V analyzes credit union liquidity issues that emerged during our review of corporate credit unions. We offer recommendations within each of these chapters.

CHAPTER II

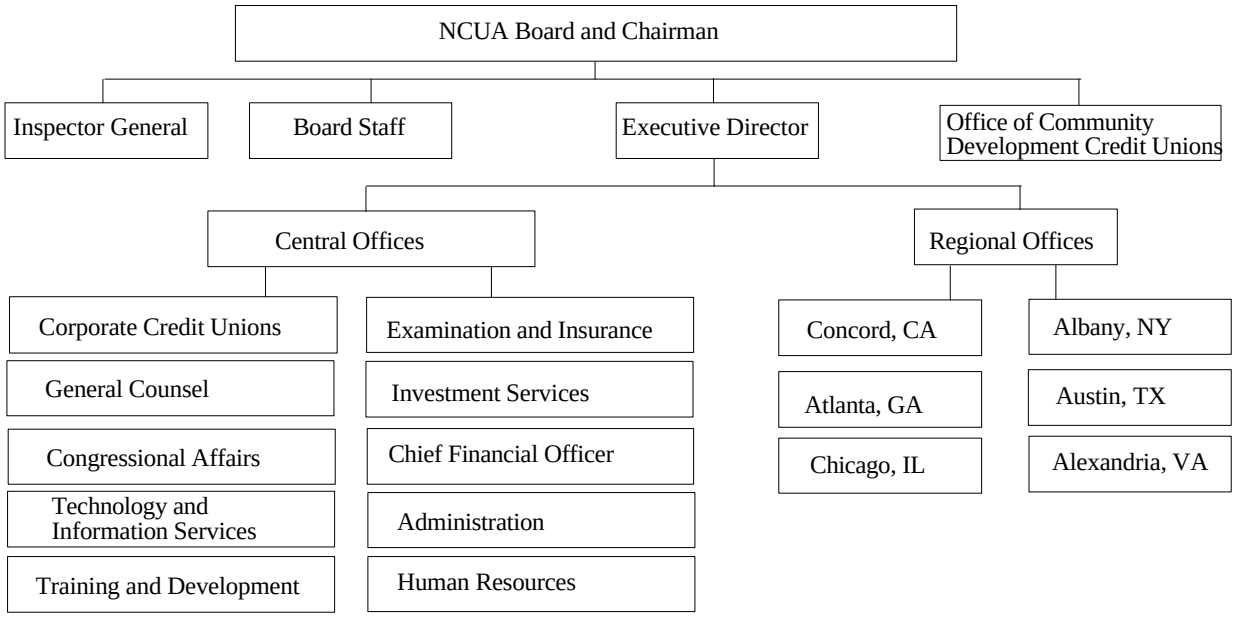
THE SHARE INSURANCE FUND

The Share Insurance Fund insures deposits at all federally chartered credit unions and those state-chartered credit unions that obtain federal insurance. This chapter will discuss three issues related to the Fund: (1) the NCUA's oversight of the Fund; (2) whether some entity other than the NCUA should oversee the Fund and the implications of such a change; and (3) the 1 percent deposit system, under which federally insured credit unions maintain on deposit at the Fund an amount equal to 1 percent of their own insured deposits.

A. THE NCUA'S OVERSIGHT OF THE SHARE INSURANCE FUND

The NCUA's Office of Examination and Insurance carries out the agency's oversight of the Share Insurance Fund. The Office of Examination and Insurance has headquarters in the NCUA's central office, but delegates routine supervision to six regional offices (see Figure II.1).

Figure II.1: Organization of the NCUA



Source: NCUA, <http://www.ncua.gov/org/orgchart.html>.

The NCUA's responsibilities for overseeing the Share Insurance Fund fall into three areas, to which we will now turn:

- developing policies for examining and supervising credit unions;
- formulating policies for resolving troubled credit unions;[39] and
- managing the Share Insurance Fund, including monitoring the adequacy of its reserves, modeling its risks, and selling the assets it acquires from failed credit unions.

1. Examining and Supervising Credit Unions

The NCUA carries out its examination and supervisory responsibilities through on-site visits by its 504 regional examiners and through off-site monitoring. In the case of a federally chartered credit union, the main on-site contact is an annual examination: (1) to evaluate the institution's financial soundness; (2) to determine whether the institution is complying with applicable laws and regulations; and (3) working with the institution's management, to develop plans to correct any problems.[40] In the case of a state-chartered credit union insured by the Share Insurance Fund, a federal examiner makes an on-site contact only if, after reviewing the state authority's examination report, the examiner has safety and soundness concerns about the institution.[41] The NCUA also makes on-site quality control contacts at a random sample of state institutions and may participate in examinations led by the state examiner.

Off-site monitoring consists mainly of reviewing the financial reports of condition and income (known as call reports) that federally insured credit unions submit to the NCUA semi-annually or quarterly, depending on the institution's size.[42] These call reports resemble those filed quarterly by banks and thrifts. Examiners review the reports filed by the credit unions in their district, looking for such adverse trends as declining net income or declining net worth. Staff in the Office of Examination and Insurance also monitor call report data to identify institutions with existing or emerging problems and to gauge the performance of credit unions as a group.

Examiners use information from on-site contacts and call reports to rate credit unions' condition using the CAMEL rating system.[43] The NCUA's CAMEL rating system provides an

---

[39] In the context of this study, "resolving" a troubled credit union means giving it special assistance, helping it to merge with a healthy credit union, or liquidating it.

[40] NCUA, *Federal Credit Union Handbook* (Alexandria, VA: NCUA, 1996), 3.

[41] Each region and the respective state authority develop mutually satisfactory procedures for on-site contacts to accommodate each state's procedures. NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996), 21.1.

[42] Credit unions with assets over $50 million file quarterly; the rest file semi-annually. 12 C.F.R. § 741.6(a).

[43] State examiners assign CAMEL ratings to state institutions, just as NCUA examiners assign CAMEL ratings to federal institutions.

assessment of a credit union's financial condition in the areas of: Capital adequacy, Asset quality, Management, Earnings, and Asset/Liability Management. The NCUA's system differs from that used by the bank and thrift regulators mainly in that the NCUA has not incorporated the "S" component (denoting Sensitivity to market risk) that the Federal Financial Institutions Examination Council adopted on December 19, 1996.[44] NCUA officials told us that they believe the "S" component is unnecessary because the Asset/Liability component includes an assessment of interest-rate risk sensitivity and exposure.

Examiners rate each CAMEL component on a 1 to 5 scale and then assign a composite rating (also on a 1 to 5 scale) reflecting the credit union's overall condition. A CAMEL rating of 1 indicates the strongest performance and least degree of supervisory concern, while a CAMEL rating of 5 indicates the weakest performance and highest degree of supervisory concern. Table II.1 shows the number and assets of institutions in each CAMEL rating at year-end 1996.

Table II.1: Distribution of CAMEL Ratings
(Dollars figures in millions; data as of December 31, 1996)

CAMEL rating	Total		Federal Credit Unions		State Credit Unions	
	Number	Assets	Number	Assets	Number	Assets
CAMEL rating 1	2,040	$138,899	1,287	$94,520	753	$44,379
CAMEL rating 2	6,578	$165,095	4,004	$97,895	2,574	$67,200
CAMEL rating 3	2,515	$21,207	1,691	$13,390	824	$7,817
CAMEL rating 4	273	$1,822	180	$1,053	93	$769
CAMEL rating 5	15	$41	8	$4	7	$37
Total	11,421	$327,064	7,170	$206,862	4,251	$120,202

Source: NCUA, *Response to the Treasury's Data Request*, Jun. 27.

At the end of 1996, a quarter of all credit unions had CAMEL ratings of 3, 4, or 5 -- indicating some degree of supervisory concern. These credit unions, however, hold only about 7.1 percent of all credit union assets. Troubled credit unions, which the NCUA defines as those rated CAMEL 4 or 5, represent an even smaller portion of credit union assets -- less than

[44] 61 Fed. Reg. 67,021 (1996). The L component in bank and thrift CAMEL ratings stands for Liquidity.

1 percent.[45] As Table II.2 illustrates, the number of troubled credit unions has steadily declined over the past 6 years, from 665 institutions (5 percent of all credit unions) in 1990 to 288 institutions (3 percent) in 1996. The proportion of total credit union assets in troubled credit unions has declined even more over this period, from 5 percent to under 1 percent.

Table II.2: Troubled Credit Unions: Number and Assets, 1990-1996
(Dollar figures in millions)

Year	Troubled Credit Unions		Assets in Troubled Credit Unions	
	Number	Percent of Total	Amount	Percent of Total
1990	665	5%	$10,301	5%
1991	654	5%	$9,814	4%
1992	583	5%	$3,263	1%
1993	418	3%	$4,340	2%
1994	308	3%	$2,523	1%
1995	273	2%	$2,282	1%
1996	288	3%	$1,863	1%

Source: NCUA, *Response to the Treasury's Data Request*, Jun. 27.

2. Resolving Troubled Credit Unions

When examiners identify problems in a credit union or downgrade its CAMEL rating below a 2, they help the institution develop a plan for corrective action. NCUA officials told us that the majority of troubled credit unions overcome or work out their problems on their own, or successfully merge with another credit union at no cost to the Share Insurance Fund. If the credit union's problems persist, the NCUA can use an array of formal actions to help improve the institution's condition. Such actions can include issuing a cease-and-desist order or an order to remove a management official.

If a credit union is unable to improve its condition and problems persist, the NCUA can resolve the institution by: (1) providing special assistance (e.g., cash or loans) to help it return to financial health; (2) merging it with a healthy credit union; or (3) liquidating it. The NCUA's

[45] The NCUA's regulatory definition of a troubled credit union also includes any institution receiving special assistance. 12 C.F.R. § 701.14(b)(3)(ii).

policies direct an examiner to recommend one of these resolution methods based on the examiner's judgment of the credit union's viability, potential costs to the Share Insurance Fund, and the potential effect of each method on the institution's members. NCUA officials told us that examiners consider the following factors in determining an institution's viability:[46]

- whether the institution has corrected the root causes of its problems;
- the competence of management officials, including their progress in resolving existing problems or their record of resolving past problems;
- the adequacy of the institution's written policies and business plan;
- the condition of the institution's books and records, including whether management has fully and fairly disclosed the institution's condition; and
- the viability of the institution's field of membership.

The NCUA told us that if the examiner, having weighed these factors, concludes that the credit union is viable, the examiner will recommend providing special assistance from the Share Insurance Fund to keep the institution open while it works out its problems.[47] If the examiner concludes that the credit union is not viable, the examiner will recommend arranging a merger with a sound credit union. If the NCUA fails to find an appropriate merger partner, it will liquidate the institution.[48] Figure II.2 depicts the typical decision-making process. A more detailed description of the three resolution methods follows.

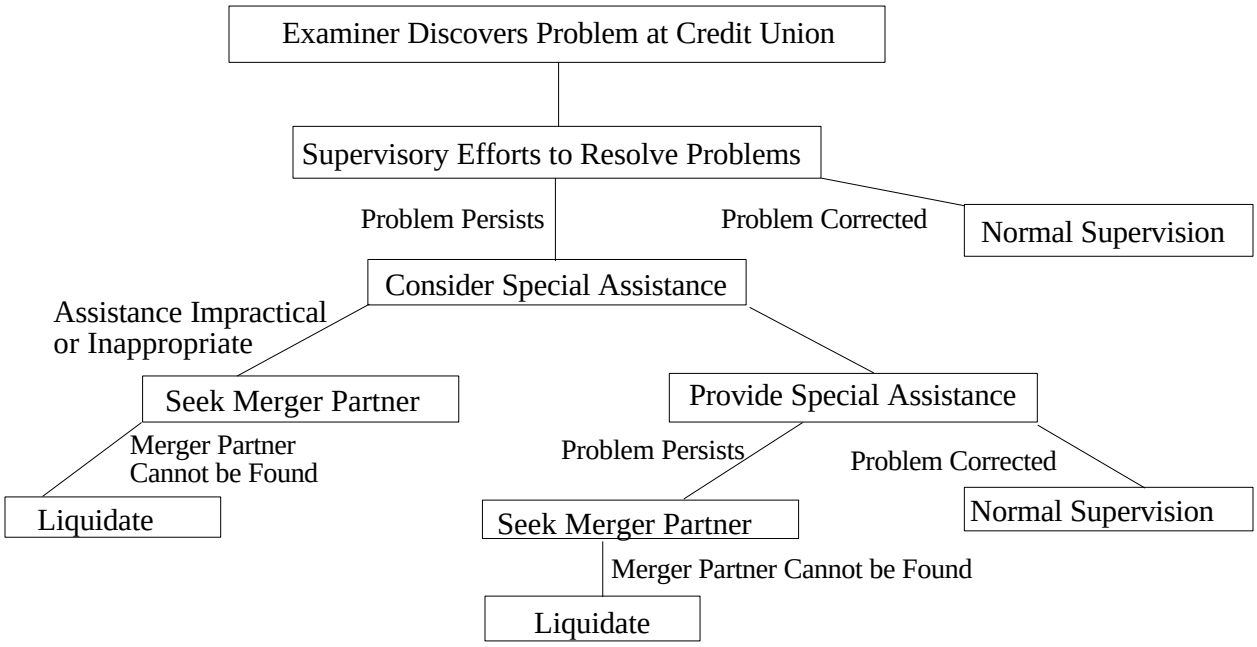
---

[46] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 6. These factors resemble the criteria in the NCUA's *Risk Management Processing Guidelines* that a credit union must satisfy and that an examiner must document for the institution to be eligible for special assistance. NCUA, *Risk Management Processing Guidelines* (Alexandria, VA: NCUA, 1997), 1.4. The criteria also appear in various forms in informal examiner guidance. NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996), chaps. 20 and 29.

[47] Depending on the requested amount, the decision to provide assistance may be made by the regional director (up to $200,000), the Office of Examination and Insurance (up to $2 million), or the NCUA Board (over $4 million).

[48] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 6.

Figure II.2: The Resolution Decision-Making Process



a. Special Assistance

The Federal Credit Union Act authorizes the NCUA to provide troubled credit unions cash and noncash assistance from the Share Insurance Fund.[49] Cash assistance includes capital notes, loans, deposits, or asset purchases. The cash infusion can be used, for example, to hire new management or to acquire income-producing assets to offset accumulated losses. The NCUA also uses cash assistance to facilitate mergers, purchase and assumption transactions, or liquidations. The amount of outstanding cash assistance has steadily declined from a peak of $101 million in 1992 to just one capital note for $265,000 in 1996.[50]

Noncash assistance, also called a guarantee account, involves the NCUA permitting a troubled credit union to create an account on its books equal to the institution's negative net worth.[51] Without the noncash assistance the credit union would be insolvent, and the Federal Credit Union Act would require the NCUA to close the institution.[52] Noncash assistance can be

[49] 12 U.S.C. § 1788.

[50] NCUA, *Response to the Treasury's Data Request*, Jun. 27 (Alexandria, VA: NCUA, 1997), tab 6.

[51] The name "guarantee account" reflects the Share Insurance Fund's implicit decision to cover the credit union's negative net worth if the credit union fails before amortizing the assistance.

[52] 12 U.S.C. § 1787(a)(1)(A); and NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996), 27.3.

viewed as capital forbearance in that it allows a credit union to operate while otherwise insolvent. At year-end 1996, 11 credit unions had some $1.2 million in outstanding guarantee accounts. Noncash assistance is more common than cash assistance. Over the past 10 years, for example, the NCUA granted noncash assistance to 224 institutions but gave cash assistance to only 30.[53]

Before providing assistance, NCUA policy requires examiners to justify that the institution has reasonable prospects for recovery. The examiner must also demonstrate that keeping the institution open is the best available course of action for its members and the Share Insurance Fund. If a less costly alternative to assistance is available, the examiner must justify the decision to pursue the more costly approach. The institution must agree to a detailed plan for solving the credit union's financial problems and returning to profitability and solvency. If the credit union fails to return to solvency within 12 to 24 months, the NCUA's policy is to close it.

b. Closing Failed Credit Unions

Once the examiner concludes that a troubled credit union is not viable, the NCUA's policy is to close it in one of three ways: merger, purchase and assumption transaction, or liquidation.[54] In a merger, the continuing credit union absorbs the failed credit union's assets, liabilities, deposits, and field of membership. In a purchase and assumption transaction, the NCUA technically liquidates the troubled institution and the continuing credit union purchases assets and assumes liabilities and deposits. The Share Insurance Fund becomes responsible for assets not purchased and liabilities not assumed -- including any nondeposit or other uninsured liabilities. A purchase and assumption transaction may or may not involve transferring the failed credit union's entire field of membership. If the NCUA cannot arrange a merger (usually because the institution is too small, has severe asset quality problems, or does not have a readily transferable membership base), the NCUA will liquidate the credit union.[55]

The average cost to the Share Insurance Fund per dollar of assets (i.e., the charge rate) is lower for mergers (about 4 percent of assets) than for purchase and assumption transactions (about 18 percent of assets) or liquidations (about 69 percent of assets).[56] The cost to the Fund

---

[53] NCUA, *Response to the Treasury's Data Request*, Jun. 27 (Alexandria, VA: NCUA, 1997), tab 6.

[54] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 7.

[55] In a liquidation, the NCUA distributes recoveries on the failed institution's assets in the following order: (1) the administrative costs of the liquidation; (2) claims for wages and salaries; (3) unpaid federal and state taxes; (4) debts owed to the U.S., including the NCUA in its corporate capacity (not as deposit insurer); (5) general creditors; and (6) uninsured depositors and the Share Insurance Fund (as successor to the claims of insured depositors). 12 C.F.R § 709.5(b). Credit union deposits are technically equity -- whereas bank deposits are liabilities of the bank. Accordingly, in a liquidation, the Fund is paid only after all creditors. The FDIC, by contrast, benefits from a depositor preference statute that puts it ahead of other creditors in a liquidation.

[56] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 3. The reported charge rates reflect the NCUA's actual experience over the period January 1, 1994 to October 31, 1996. Over that period there were 16 assisted mergers, 21 purchase and assumptions, and 10 liquidations.

of closing a troubled credit union comes from providing assistance and from losses on asset sales. These costs depend more on the characteristics of the failed credit union than on the closure method. For example, mergers have the lowest charge rate because the failed credit unions that cost the Fund the least (i.e., those with the most attractive franchise values, the least severe problems, and the fewest troubled assets) are more likely to attract merger bids.[57] A failing credit union with an attractive franchise, but a large portfolio of troubled assets, is more likely to attract purchase and assumption bids because the continuing institution may not want to deal with some or all of the problem assets. Thus purchase and assumption transactions have a slightly higher charge rate than mergers because the NCUA is responsible for selling the assets not assumed by the continuing credit union. These assets, likely to be of poor quality, have often contributed to the credit union's failure.

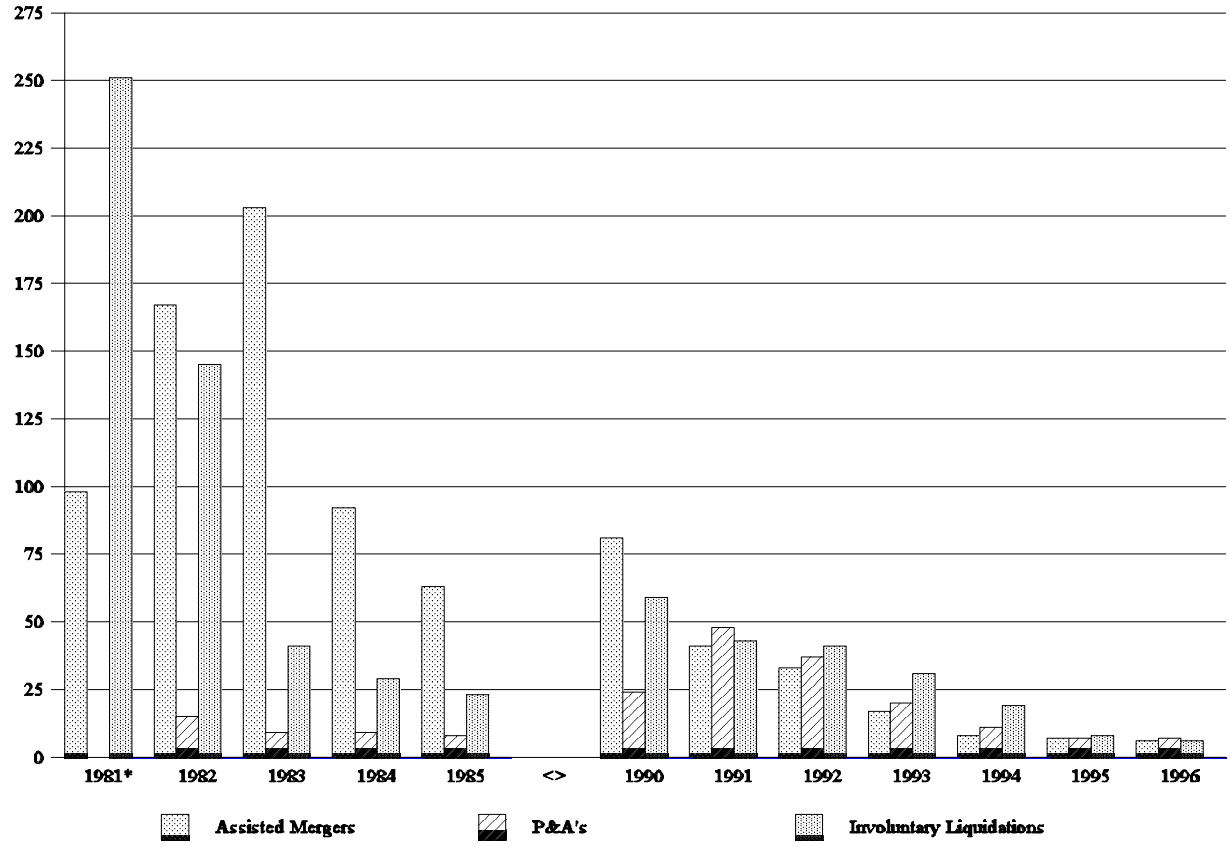
Credit unions with the least desirable characteristics (e.g., severe asset quality problems) are more likely to end up in liquidation. The NCUA usually incurs significant costs to make good on its guarantee of insured deposits and dispose of the institution's assets. Credit unions needing quick resolution are also more likely to end up in liquidation, as the NCUA may lack sufficient time to market the institution and find a viable acquirer. Cases involving significant uncertainty about the severity of the credit union's problems (e.g., fraud-induced failures) almost always result in liquidation because of potential merger partners' reluctance to take on the uncertainty.

Figure II.3 shows that the NCUA must often liquidate failed institutions because it cannot find viable merger partners. In 1981, for example, the NCUA liquidated over twice as many credit unions as it merged. A 1982 change in the NCUA's field of membership policies facilitated finding acceptable merger partners.[58] However, even as the number of credit union failures has declined, the NCUA has in some years liquidated more institutions than it has merged.

[57] The discussion here focuses on mergers involving assistance from the Share Insurance Fund. Mergers between healthy credit unions involve no financial assistance from the Fund.

[58] Interpretive Ruling and Policy Statement 96-1, Federal Credit Union Field of Membership and Chartering Policy, 61 Fed. Reg. 11,721 (1996) (incorporated by reference at 12 C.F.R. § 701.1; and relying upon the statutory membership requirements of 12 U.S.C. § 1759).

Figure II.3: Number of Failures By Closure Method: Selected Years, 1981-1996



Sources: NCUA, *1996 Annual Report*, *Share Insurance Fund Annual Reports* 1984-1992, and the NCUA.

*Involuntary liquidations for 1981 include purchase and assumption transactions for which separate data are unavailable.

c. Analysis and Recommendations

When resolving a failed or failing bank or thrift, the FDIC must select the resolution method that is "least costly to the deposit insurance fund of all possible methods" of meeting the FDIC's deposit insurance obligation.[59] In deciding whether to provide special assistance to keep a troubled credit union open, seek a merger partner, or liquidate the institution, the NCUA's *Examiner's Guide* encourages examiners to weigh the institution's viability against such other

[59] 12 U.S.C. § 1823(c)(4)(A). The FDIC can depart from this strict rule of least-cost resolution only in extraordinary cases of systemic risk, and then only pursuant to a rigorous set of procedural safeguards. *Id.* § 1823(c)(4)(G).

factors as continued credit union services and the cost to the Share Insurance Fund.[60] Neither the law nor policy, however, requires the NCUA to make the cost to the Fund determinative in this decision. For example, as depicted in Figure II.2, the NCUA will always first consider giving a troubled credit union special assistance. If the NCUA decides against special assistance, or if special assistance fails to turn the credit union around, the NCUA will seek a merger partner. The NCUA will liquidate the credit union only after failing to find a merger partner that will minimize loss to the Fund and allow service to continue to the institution's members.

Should the NCUA select a resolution option that is not the least costly to the Share Insurance Fund, other insured credit unions will bear the additional cost. Credit unions have historically viewed such assistance as a form of "mutual aid." The World Council of Credit Union's International Credit Union Operating Principles describe mutual aid as follows: "credit unions within their capability actively cooperate with other credit unions . . . in order to best serve the interests of their members and their communities."[61]

Yet this tradition may be challenged as more credit unions begin to compete directly with each other for members. For example, a credit union trade journal recently reported that credit union executives are increasingly concerned about credit unions expanding into markets already served by other credit unions.[62] Credit unions serving the same market may be less supportive of helping each other and more likely to object to the NCUA assisting a competitor.[63]

Apart from the nascent competition among credit unions, the growing size and complexity of some credit unions raise questions about the NCUA's approach to resolving troubled institutions. In some ways, large, complex credit unions may reduce risk to the Share Insurance Fund. For example, compared to smaller, less complex credit unions, such institutions may have more experienced management, a more diverse asset portfolio, and better technology. Larger credit unions are also more likely to have a larger, more diverse membership base, which may help cushion the institution against the troubles of a single employer or a single group of members.

Yet large, complex credit unions may also pose new or increased risks to the Share Insurance Fund. Such a credit union may:

- Present greater risk of "moral hazard" -- here the risk that deposit insurance permits an institution to act in a way that increases the risk of loss to the deposit insurance fund.

---

[60] NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996), 30.4.

[61] World Council of Credit Unions Membership Council, *International Credit Union Operating Principles* (Madison, WI: World Council of Credit Unions, 1984), leaflet.

[62] Dianne Molvig, "What Pushes CEOs' Worry Buttons," *Credit Union Management* (Jul. 1995): 11-18.

[63] Competition among credit unions has sparked disagreement within the NCUA Board in recent months. Credit unions applying for community charters often propose a field of membership that overlaps with that of an existing credit union. The NCUA Board has been split over whether to seek to protect the existing credit union by excluding persons in its field of membership from the community credit union's field of membership.

-- For example, if a large, complex credit union gets into serious financial straits, the institution's professional management may be more likely to make excessively risky loans or investments in an effort to turn the institution around. If successful, such risk-taking may preserve the credit union and the managers' jobs. If unsuccessful, such risk-taking is likely to increase the ultimate loss to the Share Insurance Fund. We believe that smaller, less complex credit unions generally have both less incentive and less opportunity to engage in such excessive risk-taking. Insofar as their operations are simpler, small credit unions are easier for members and regulators to oversee. Insofar as members share a greater affinity with one another, and identify more closely with the credit union, they are less likely to tolerate a strategy based on excessive risk-taking.

! Be harder for a board of directors consisting of unpaid member-volunteers to oversee. Such member-volunteers may or may not have the expertise needed to oversee and set policy for a complex financial institution.

! Be more difficult for the NCUA to resolve (should they fail) because there are likely to be fewer viable acquirers.

-- The NCUA's resolution strategy centers on finding a suitable merger partner for a failing institution. The NCUA may, however, be unable to find an interested credit union with sufficient management expertise and infrastructure to absorb a large failed credit union's membership, much less its assets. If the NCUA must liquidate the institution, or sell it off piecemeal, the Share Insurance Fund may face greatly increased costs because the NCUA would receive little, if any, premium for selling the membership base and because it would probably incur larger transaction costs.

-- To date, the largest -- and costliest -- federally insured credit union to fail had $180 million in assets. According to the NCUA, this institution's demise resulted from a diverse set of problems, including speculative real estate loans, illegal loans to non-members, unsafe and unsound business loan policies, excessive operating costs and high cost of funds, the collapse of the New England real estate market, and poor management.[64] Although the NCUA ultimately resolved this credit union through a purchase and assumption transaction, the Share Insurance Fund's losses totaled about 50 percent of the credit union's assets -- an enormous charge rate for a credit union of this size.

-- At year-end 1996, only 223 of the 11,392 federally insured credit unions had assets above $250 million, yet these credit unions held 39 percent of all federally insured credit union assets.[65] If one of these larger credit unions were to fail, especially

[64] NCUA, *Response to the Treasury's Data Request*, Sept. 30 (Alexandria, VA: NCUA, 1997).

[65] Sheshunoff Information Services, Inc., *BankSearch* (Austin, TX: Sheshunoff, 1997).

> one of the 23 with assets above $1 billion, it is unclear how the NCUA would resolve the institution or how high the cost might be. Although a large bank failure can impose high costs on the FDIC, banks are (or can be readily converted into) stock institutions, therefore the potential pool of acquirers is less constrained than it is for credit unions as member-owned cooperatives.

On balance, it is difficult if not impossible to say whether large, complex credit unions pose relatively greater or lesser risk of loss to the Share Insurance Fund than smaller, less complex, less diversified credit unions. Of course, the actual dollar losses associated with the failure of a large, complex credit union probably would be much greater than those associated with a small credit union. We believe that the trends outlined here raise significant concerns about how well the NCUA's resolution practices may work should a large, complex credit union become seriously troubled.

We know from past experience that when regulators practice forbearance toward large troubled institutions (i.e., fail to take needed action to correct problems), they exacerbate the insurance fund's losses. For the Share Insurance Fund to avoid such problems, we believe that the NCUA's process for dealing with troubled institutions should be more rigorously formulated, especially for large credit unions. To that end, we recommend in Chapter III that Congress adopt a system of prompt corrective action to deal with troubled credit unions.[66] This structure would be a streamlined version of that already applicable to banks and thrifts, and would be appropriately tailored to credit unions' unique characteristics. Such a system would lead to more rigorous guidelines for dealing with troubled credit unions, especially large ones.

3. Managing the Share Insurance Fund

Beyond the supervision and resolution responsibilities already described, the NCUA's management of the Share Insurance Fund involves (at least) three additional responsibilities:

- managing the assets of failed credit unions;
- monitoring the adequacy of reserves; and
- modeling and anticipating potential risks to the Share Insurance Fund.

Table II.3 shows the condition of the Share Insurance Fund at the end of 1996.

---

[66] See pp. 73-79.

Table II.3: The Share Insurance Fund's Balance Sheet
(Dollar figures in millions, totals may not add due to rounding; data as of December 31, 1996)

Assets	
Investments	$2,924.5
Cash and equivalents	$500.2
Assets acquired in assistance to insured credit unions	$21.8
Other Assets	$77.3
Total Assets	$3,524.0
Liabilities and Fund Balance	
Liabilities	
Estimated losses from supervised credit unions	$89.7
Estimated losses from asset and merger guarantees	$0.2
Other Liabilities	$22.0
Total Liabilities	$111.8
Fund Balance	
Insured credit unions' accumulated contributions (1% deposit)	$2,637.7
Insurance fund balance	$774.4
Total Fund Balance	$3,412.2
Commitments and Contingencies	--
Total Liabilities and Fund Balance	$3,524.0

Source: NCUA, *1996 Annual Report*.

The Share Insurance Fund's earnings (mainly on its investment portfolio) reached a record $187 million in 1996. Indeed, the Fund's earnings for the past two years have been sufficient to keep it at its normal operating ratio, pay its operating expenses, cover the costs of credit union failures, and pay a cash dividend to all federally insured credit unions. Moreover, the NCUA has made no provisions for losses since 1994 because the Fund's balance has been sufficient to cover any anticipated losses. In fact, the NCUA's auditors concluded that the Fund was over-reserved and the agency accordingly adopted new reserving procedures in January 1997.[67]

[67] NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996), 5.1-5.4.

a. Asset Management and Liquidation

The NCUA manages assets acquired from failed or troubled credit unions through its Asset Management and Assistance Center (AMAC), which is located in Austin, Texas.[68] At the end of September 1997, AMAC managed a total of $42 million of such assets, the majority of which were consumer loans ($26 million). The remaining $8 million was real estate loans ($5 million) and real estate ($3 million).[69] The relatively small amount of assets under management reflects the small number of credit union failures in recent years.

b. Monitoring the Adequacy of Reserves

The Share Insurance Fund's reserve ratio -- its ratio of total reserves to total insured deposits -- is the standard measure of the Fund's health. For the past two years, the Fund has been at its statutory ceiling of 1.3 percent.[70] However, we identified two concerns about this measure. First, the ratio does not indicate whether the Fund's assets are actually available to cover losses at failing credit unions, thereby potentially overstating the Fund's strength. Second, the NCUA's procedures for calculating this ratio do not measure reserves and insured shares at the same point in time, thereby overstating the Fund's actual reserve ratio.

The reserve ratio does not reflect the actual composition of the Share Insurance Fund's assets. When credit unions are under stress (e.g., during an economic recession), illiquid assets acquired from failed or troubled institutions will tend to increase at the expense of liquid assets -- leaving the Fund less able to provide cash assistance to other ailing credit unions. Beyond its own assets, the Fund has only limited access to working capital -- cash available to the Fund to finance assets recovered from failed credit unions until such assets may be liquidated. The Fund's working capital sources, beyond its own assets, are a $100 million line of credit at the Treasury and advances from the Central Liquidity Facility.[71] We are concerned that these sources could prove inadequate if significant credit union failures created a liquidity crunch for the Fund.

In 1991, the GAO recognized this problem and proposed that the NCUA establish a minimum "available assets" ratio for the Share Insurance Fund. The Fund would have to achieve this ratio before distributing dividends to insured credit unions.[72] The NCUA concurred in this recommendation.[73] We believe that the GAO's recommendation is even more appropriate now,

---

[68] The NCUA occasionally provides cash assistance to troubled credit unions through asset purchases.

[69] NCUA, *Response to the Treasury's Data Request*, Sept. 30 (Alexandria, VA: NCUA, 1997).

[70] 12 U.S.C. § 1782(h).

[71] 12 U.S.C. § 1783(d)(1), (f).

[72] GAO, *Credit Unions: Reforms for Ensuring Future Soundness* (Washington, DC: GAO, 1991), 176-77.

[73] Ibid., 345. This change would have required Congressional action because of the statutory 1.3 percent limit on the Share Insurance Fund's reserve ratio, which makes no distinction between available assets and other assets. 12 U.S.C. § 1782(c)(3), (h)(2). The NCUA includes this ratio as one of its annual performance measures included

with credit unions growing rapidly. Thus we recommend that Congress require the Share Insurance Fund to maintain an available assets (i.e., liquid assets) ratio of 1.0 percent. Should the available assets ratio fall below this level, the NCUA would not be permitted to pay dividends, even if the Fund's reserve ratio exceeded 1.3 percent. By ensuring that the Fund's reserves are not concentrated in holding illiquid assets obtained from failed credit unions, the Fund would have the liquidity needed to handle additional credit union demands for assistance.

As an alternative, or a complement, to an available assets ratio, the Share Insurance Fund could receive expanded access to working capital from the Treasury: that is, Congress could increase the Fund's current $100 million line of credit. The FDIC, for example, may borrow from the Federal Financing Bank up to 90 percent of the value of its non-cash assets plus its reserves and any remaining line of credit with the Treasury.[74] Although a similar arrangement could be established for credit unions, it would be less in keeping with credit unions' traditional approach of dealing with such matters from their own resources, rather than relying upon government sources of funding.

We are also concerned that the NCUA's method of measuring the Share Insurance Fund's reserve ratio generally overstates the reserves actually available. The NCUA calculates the reserve ratio each month by dividing the Fund's reserve balance for that month by the previous year-end total of insured deposits. Thus each year-end reserve ratio is calculated using a denominator that may be up to 12 months old -- which tends to inflate the ratio.[75] For example, as Table II.4 shows, at year-end 1996 the Fund had $3.4 billion in reserves and insured $275.5 billion in deposits, implying a reserve ratio of 1.24 percent.[76] However, the NCUA calculated the Fund's year-end 1996 reserve ratio as 1.3 percent by dividing the year-end 1996 total Fund reserves by the year-end 1995 total insured deposits.[77]

---

in the strategic plan required by the Government Performance and Results Act, which the NCUA submitted to Congress on September 30, 1997. Pub. L. No. 103-62, § 3, 107 Stat. 285, 286 (1993).

[74] 12 U.S.C. § 1825(c)(5).

[75] In collecting its insurance premiums from FDIC-insured depository institutions, the FDIC uses the latest quarterly data available on assessable deposits.

[76] NCUA, *1996 Annual Report* (Alexandria, VA: NCUA, 1997), 60-61.

[77] Ibid.

Table II.4: Reported Versus Actual Reserve Ratio of the Share Insurance Fund: 1990-1996
(Dollar figures in billions)

Year	Number of Federally Insured Credit Unions	Total Insured Deposits	Fund Balance	Reported Reserve Ratio	Actual Reserve Ratio
1990	12,860	$180.0	$2.1	1.25	1.14
1991	12,960	$199.8	$2.3	1.23	1.13
1992	12,653	$229.5	$2.6	1.26	1.11
1993	12,317	$240.3	$2.8	1.26	1.17
1994	11,991	$247.7	$3.1	1.27	1.23
1995	11,687	$261.4	$3.3	1.30	1.24
1996	11,392	$275.5	$3.4	1.30	1.24

Source: NCUA, *1996 Annual Report*.

Note: Because of rounding, the "actual reserve ratio" reported here may not be the same as that calculated from the data reported in this table.

Because the NCUA must, by law, distribute dividends to member credit unions whenever the Share Insurance Fund's reserve ratio exceeds 1.3 percent,[78] the NCUA's procedure has led it to pay dividends when the Fund's reserve ratio, measured contemporaneously, was actually less than 1.3 percent. Paying dividends under such circumstances dissipates the Fund's reserves without good reason. Accordingly, we recommend that the NCUA correct this non-contemporaneous measurement of the reserve ratio.

Such a correction should have two related components. First, we recommend that the NCUA use the most current data available on insured deposits. Credit unions report their insured deposits to the NCUA quarterly (for credit unions with more than $50 million in assets) or semi-annually (for credit unions with less than $50 million in assets). Thus, to calculate the Share Insurance Fund's year-end reserve ratio, the NCUA should use the September data reported by large credit unions and the June data reported by small credit unions. Similarly, we recommend that the NCUA not declare dividends on credit unions' 1 percent deposit until the close of the year in order to ensure that the actual reserve ratio exceeds the target ratio. Technical changes in the Federal Credit Union Act regarding the timing of dividends may facilitate more contemporaneous measurement of the reserve ratio than possible under current law.

[78] 12 U.S.C. § 1782(c)(3), (h)(2).

Second, the Federal Credit Union Act currently requires credit unions to adjust their 1 percent deposit annually. We recommend that Congress direct the NCUA to require these adjustments up to four times per year, and to measure deposits using a four-quarter average to account for seasonal fluctuations in deposits. Credit unions would thus generally have to adjust their 1 percent deposit each time they submit call report data to the NCUA on insured deposits. (Credit unions currently make this adjustment each January 31.) Thus large credit unions would adjust their deposit quarterly and small credit unions would adjust their deposit semi-annually.

These two changes would increase the timeliness and accuracy of both components of the Share Insurance Fund's reserve ratio.

c. Modeling Risk to the Share Insurance Fund

Officials in the Office of Examination and Insurance told us that they estimate potential risks to the Share Insurance Fund using a variety of microeconomic and macroeconomic analyses. On a macroeconomic level, the office analyzes overall trends and reports them quarterly to the NCUA Board and to credit unions. The office continually monitors the number of credit unions rated CAMEL 4 or 5 as well as the amount of insured deposits in those institutions. This macroeconomic analysis also includes general monitoring of such potential system-wide problems as increasing levels of consumer debt, bankruptcies, and delinquencies.

On a microeconomic level, the Office of Examination and Insurance produces risk management reports to identify and track various risk factors within individual credit unions (e.g., troubled assets over 2 percent of total assets). At the end of every month, examiners notify the Office of Examination and Insurance of any potential losses to the Share Insurance Fund identified during this risk review process so that it can set aside the necessary reserves.

We asked NCUA officials if they undertook any stress testing to see how the Share Insurance Fund would withstand various possible catastrophic loss scenarios. They said that they did not do such testing. To test the strength and resiliency of the Fund, we identified several possible scenarios that could generate large insurance fund losses. We then ran some simple simulations to see how well the Fund could withstand the losses generated under the various stress scenarios.

Table II.5 provides data on the Fund for 1996, the baseline for our stress tests.

Table II.5: Status of the Share Insurance Fund at Year-End 1996
(Dollar figures in billions)

Amount of Insured Deposits	$275.5
Total Equity	$3.4
Reported Reserve Ratio	1.30%
Actual Reserve Ratio	1.24%

Source: NCUA, *1996 Annual Report*.

Note: We calculated the actual reserve ratio using 1996 year-end deposits and 1996 year-end reserves.

For our stress tests, we estimated the potential effect on the Share Insurance Fund of:

- the failure of the largest credit union;
- the failure of three of the ten largest credit unions (assuming each was the average size of the ten largest);
- the failure of all credit unions with CAMEL ratings of 4 or 5; and
- a repetition of the worst loss period in the Share Insurance Fund's history (1981-1983).

These stress tests are hypothetical -- they do not represent a judgment that the outcomes in question are likely. Rather, the tests seek to gauge the Share Insurance Fund's ability to withstand various negative effects. For the first three stress tests, we assumed a 20 percent charge rate to calculate total losses to the Fund.[79] The final test used the actual cumulative loss rate over the three-year period. Table II.6 presents the results of the stress tests.

[79] Using credit union failure data from January 1, 1994, to October 31, 1996, we calculated the weighted average charge rate to the Share Insurance Fund to be 19 percent. We rounded this to 20 percent, which we used as our charge rate in the stress tests reported here.

Table II.6: Results of Stress Tests for the Share Insurance Fund
(Dollar figures in billions)

Size of Loss	Amount of Insured Deposits	New Reserve Ratio @ 20% Charge Rate
Largest credit union	$6.5	0.79%
Average of 10 largest credit unions (x3)	$6.8	0.77%
CAMEL 4 and 5 Credit Unions	$1.9	1.12%
Loss Rate from 1981-1983	N/A	0.97%

Sources: Sheshunoff, *BankSearch*, and NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions.*

Note: The reserve ratio for each test uses estimated year-end deposits and year-end reserves. The last row applies the Fund's cumulative losses for 1981 to 1983 as a percent of average insured deposits to total year-end 1996 insured deposits.

In general, the Share Insurance Fund fared well under the stress tests. Credit unions' insured deposits are not so concentrated in the largest credit unions that the failure of one or more large institutions would greatly impair the Share Insurance Fund. Still, the failure of the largest credit union, or three of the largest credit unions, could require credit unions to write off about 20 percent of their deposits at the Share Insurance Fund. And insofar as consolidation of credit unions continues to lead to fewer but larger credit unions, the potential effects of such failures may become more severe in the future.

Because we are in the sixth year of an economic expansion, the number and assets of credit unions with CAMEL ratings of 4 or 5 are currently small, and thus the failure of all such institutions would have little effect on the Share Insurance Fund. However, should the economy take a downturn, experience suggests that the number and total assets of such low-rated institutions would significantly increase. The recessions of the early 1980s produced the three largest annual loss rates for the Fund.[80] To test how a repeat of those high loss years might affect the Fund today, we analyzed the cumulative losses of 1981 through 1983 as a percentage of insured shares.[81] We calculated that such a repetition of losses would still only reduce the Fund's reserve ratio to 0.97 percent.

[80] Dollar losses per $1,000 of insured deposits were 0.99 for 1981, 1.48 for 1982, and 0.88 for 1983. NAFCU, *National Credit Union Share Insurance: 25 Years Safe and Strong* (Washington, DC: NAFCU, 1995), 9.

[81] Our calculations adjusted the 1981-1983 losses for inflation.

B. THE ADMINISTRATION OF THE SHARE INSURANCE FUND

Congress directed us to evaluate the potential costs and benefits of having some entity other than the NCUA administer the Share Insurance Fund.

Neither the statutory language requiring this study nor its legislative history indicates what entity or entities Congress had in mind as possible candidates to administer the Share Insurance Fund. Nor do they indicate the policy objective of such a change. Accordingly, we cast our net widely and reviewed past discussions of this issue by the Treasury, the GAO, and various trade groups.[82] We considered the structural problems that some analysts have linked to the failure of the Federal Savings and Loan Insurance Corporation (FSLIC), the old thrift deposit insurance fund administered by the Federal Home Loan Bank Board (Bank Board). We also examined the structure of the FDIC.

1. The Potential for Conflicts of Mission

We began our analysis of the NCUA's role in administering the Share Insurance Fund by asking whether that role, as currently structured, could create conflicts of mission: i.e., significant unresolved tensions between the agency's role or duties in administering the Fund and the agency's other roles and duties.

From our review of past research, our discussions with interested parties, and the comment letters we received, we identified two possible conflicts of mission. The first involves the NCUA's role in chartering federal credit unions and in administering the Share Insurance Fund. The second involves the NCUA's role in supervising credit unions and administering the Share Insurance Fund. These two possible conflicts, although distinguishable, significantly overlap (e.g., a chartering entity also supervises the institutions it charters). They raise many of the same issues and invite many of the same arguments. In the interest of simplicity, we will generally refer to supervising (rather than chartering), but we believe that the same considerations hold true of chartering -- both in the charterer's capacity as a supervisor and otherwise.

A potential conflict of mission between deposit insurance and supervision could conceivably arise in several ways.

First, economists have long observed that regulators (however able and upright) have some tendency to identify (however unconsciously) with the entities that they regulate.[83] In an agency responsible for both supervision and deposit insurance, such a tendency might leave the agency reluctant to take stringent action against an institution, even if such action would protect

---

[82] GAO, *Credit Unions: Reforms for Ensuring Future Soundness* (Washington, DC: GAO, 1991), 187-198; and U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (Washington, DC: Treasury, 1991), 63-64, XIII-6-XIII-8.

[83] Richard Posner, "Theories of Economic Regulation," *The Bell Journal of Economics* 5 (1974): 335-58; and George Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics* 2 (1971): 3-21.

the insurance fund. It may, for example, prefer to nurse the institution back to health even at the cost of increased risk to the insurance fund. Moreover, just as legislators create depository institution charters to advance a public purpose, regulators see their role as including the general advancement of that public purpose.

Second, supervisors of federally insured depository institutions (whether banks, thrifts, or credit unions) have some short-term incentives to practice forbearance toward troubled institutions (i.e., fail to take needed action to resolve institutions' problems). Forbearance has short-term, easily identifiable benefits -- and long-term, less obvious costs. Stringency runs the risk of immediate criticism and perhaps even blame for causing the problem regulators seek to resolve.[84] Forbearance, on the other hand, is inconspicuous and defers unpleasant consequences, and is therefore less likely to draw criticism. Thus forbearance, although against the interests of the deposit insurance fund, may well serve the supervisor's self-interest.

Third, a deposit insurer that is also a supervisor has incentives to resolve failed or failing institutions in ways that conceal the agency's supervisory mistakes. If observers would perceive an institution's failure as reflecting poorly on the supervisor, the insurer/supervisor can use the deposit insurance fund to resolve the institution in a way that does not draw attention to its failure, even though such a course of action might increase the cost to the insurance fund.

Fourth, a supervisor that administers an insolvent insurance fund has incentives not to force the resolution of deeply insolvent institutions -- lest it render the fund's insolvency more conspicuous and risk precipitating its collapse.

Critics of the NCUA's dual responsibilities often use the old Bank Board as a case study. Before its abolition in 1989, the Bank Board had responsibility for chartering federal thrift institutions, supervising federally insured thrift institutions, and administering FSLIC, whose insolvency ultimately cost the nation's taxpayers some $130 billion. For example, there is widespread belief that the Bank Board's control of FSLIC rendered FSLIC less effective as an insurer. The GAO emphasized the Bank Board's statutory mandate to promote housing finance and the thrift charter.[85] Some scholars have stressed the perverse incentives created by FSLIC's own deep insolvency, the Bank Board's coziness with the thrift industry, and the agency's reliance on examiners employed by the industry-owned Federal Home Loan Banks. In fact, so much went so wrong in so many different ways that the Bank Board's problems, far from resolving debates about agency structure, provide grist for competing sides of those debates.

Although many policy issues divide the American Bankers Association (ABA) from CUNA and NAFCU, all three trade associations share a disinclination to have the FDIC administer the Share Insurance Fund. The ABA told us that banks would probably oppose

---

[84] Edward J. Kane, *The Savings and Loan Insurance Mess: How Did It Happen?* (Washington, DC: The Urban Institute, 1989), 103.

[85] GAO, *Credit Unions: Reforms for Ensuring Future Soundness* (Washington, DC: GAO, 1991), 190.

requiring the FDIC to manage the Fund. Credit unions would also oppose having the FDIC as insurer because they believe such an arrangement would create additional and duplicative oversight costs, and that the FDIC may be more inclined to treat credit unions like banks.

The GAO's 1991 report recommended, among other things, placing the NCUA's regulatory and insurance responsibilities in two separate offices, with each director reporting individually to the Board.[86] The National Association of State Credit Union Supervisors (NASCUS), in its letter to us, also recommended having a separate office within the NCUA administer the Share Insurance Fund.[87] NASCUS views the NCUA's use of the same staff to examine and supervise federally chartered credit unions -- and to determine their continued insurability -- as heightening the potential for conflict.

2. Analysis and Recommendations

We found no compelling case for removing the Share Insurance Fund from the NCUA's oversight and transferring it to another federal agency such as the FDIC. The NCUA maintains some level of separation between its insurance activities and its other responsibilities by separating the operating costs of the Fund from its non-insurance expenses.[88] Moreover, separating the Fund from the NCUA would provide no assurance of improved supervision or strengthened fund health. We are also concerned that without the Fund, the NCUA might be too small to be viable or efficient. An insurer with limited supervisory authority would have more limited control over the risks taken by credit unions. Under the current structure, the NCUA can use supervision to control risks taken by credit unions -- providing an additional measure of protection for the Fund. We also believe that separating the Fund from the NCUA could: (1) reduce the regulator's incentives to concern itself with insurance costs, should an institution fail; (2) create possible confusion over the roles and responsibilities of the insurer and of the regulator; and (3) place the insurer in the situation of safeguarding the insurance fund without having control over the risks taken by the insured entities.

Moving responsibility for managing the Share Insurance Fund out of the NCUA would reduce the potential for conflicts between supervising credit unions and protecting the insurance fund. Such a move would, however, be a large undertaking involving moving staff and functions

---

[86] GAO, *Credit Unions: Reforms for Ensuring Future Soundness* (Washington, DC: GAO, 1991), 194.

[87] NASCUS, *Letter Responding to the Treasury's Request for Comments*, Feb. 28 (Washington, DC: NASCUS, 1997), 6.

[88] The NCUA estimates the portion of its expenses that are insurance-related, and then charges that portion to the Share Insurance Fund through an accounting procedure called the "overhead transfer." The current overhead transfer rate (i.e., that portion of the NCUA's operating expenses allocated to insurance-related activities) is 50 percent. The NCUA told us that establishing the overhead transfer rate is highly subjective because the agency expends most of its resources on tasks that carry out both its insurance and non-insurance responsibilities. The NCUA pointed out that the GAO, the NCUA's independent auditors, and a bi-partisan credit union committee have reviewed the NCUA's method for determining the overhead transfer rate and all found it fair. NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 11.

out of the NCUA and into another entity (e.g., the FDIC). Keeping these responsibilities within the NCUA but separating them into two offices could reduce potential conflicts between the insurance and supervisory functions -- with much less disruption than removing the Fund from the NCUA. Each office director would report separately to the NCUA Board, and the staff responsible for managing the Fund would be separate from supervisory examiners, which could serve as an important check on supervisory examiners' use of the insurance fund to manage troubled credit unions out of their problems.

Keeping examination and insurance in the same office may make examiners feel more responsible for ensuring that the credit unions they examine do not cause losses to the Share Insurance Fund. Separating examination and insurance into two offices, on the other hand, could reduce the amount of communication on supervisory and failure resolution issues. Moreover, the paucity of credit union failures in recent years makes it difficult to justify establishing a separate office for insurance -- much less a separate agency. We believe that if the NCUA Board finds conflicts or weaknesses in the current organizational structure, it can reorganize the agency's examination and insurance functions as appropriate.

In the case of the NCUA and the Share Insurance Fund, we believe any potential for conflicts of mission is best handled by applying a system of prompt corrective action to credit unions. For banks and thrifts, the regulator, which may also be the charterer, decides when to close an institution. The tension between the incentives of the charterer and the goals of the regulator are balanced by prompt corrective action rules that require the regulator to take certain corrective actions when a depository institution's condition deteriorates. For credit unions, charterer, examiner, and insurer are the same entity and, in a sense, make the decision together. The NCUA, with no comparable statutory prompt corrective action requirements, has more discretion about whether, when, and how to take corrective action. To be sure, prompt corrective action rules are a recent development responding to costly delays in dealing with troubled banks and thrifts. We believe, however, that prompt corrective action rules for credit unions would introduce an important and highly constructive discipline on the NCUA's supervisory and insurance functions that should largely offset any incentive to permit the promotion of credit unions to interfere with the NCUA's responsibilities for the Fund. We set forth our prompt corrective action proposal in the next chapter.[89]

C. THE ONE PERCENT DEPOSIT SYSTEM

1. Background

When established in 1970, the Share Insurance Fund had a funding structure similar to that of the FDIC (the Permanent Insurance Fund, now the Bank Insurance Fund) and FSLIC. Insured credit unions paid premiums to the Share Insurance Fund, which used the proceeds to protect depositors at failed credit unions, pay the Fund's operating expenses, and build reserves.

---

[89] See pp. 73-79.

This system appeared to work reasonably well during the 1970s. The Share Insurance Fund faced only minimal insurance losses. In many years, the Fund could cover both its losses and its operating expenses from the interest earned on its reserves. Premiums paid by credit unions enabled the Fund to continue to build its reserves. By 1979, the Fund had a reserve ratio of 0.32 percent.

But during the economic recession of the early 1980s, credit union failures mounted, the Share Insurance Fund's losses increased sharply, and the Fund's reserve ratio -- far from rising steadily toward the statutory target of 1 percent[90] -- steadily declined. Even a steep increase in premium rates failed to reverse that decline. Faced with the prospect that the Fund would remain weak for the foreseeable future and could become insolvent, the NCUA and credit union trade associations devised a new system for capitalizing the Fund. Congress enacted that system in 1984 and, with only minor changes, it remains in effect.

The system aims not only to ensure the Share Insurance Fund's solvency but to keep the Fund's reserve ratio at or near 1.3 percent. Each insured credit union maintains on deposit in the Fund an amount equal to 1 percent of the credit union's insured deposits.[91] The Fund's reserves consist of this 1 percent deposit plus any additional amounts accumulated through interest earnings and insurance premiums.[92] The reserves are invested in Treasury securities, and the interest on those securities becomes part of the reserves. In addition, the NCUA has discretion to impose an annual premium of 1/12 of 1 percent of insured deposits. Although the NCUA has no formal policy about when to assess premiums, its officials told us that it has an informal policy of keeping the Fund's normal operating range for the reserve ratio between 1.25 percent and 1.30 percent. The NCUA Board would seriously consider assessing a premium if the reserve ratio were to fall below 1.25 percent.[93] If the Fund's reserve ratio exceeds 1.3 percent, the NCUA must pay the excess as a dividend on credit unions' 1 percent deposit.[94]

---

[90] Congress originally set the "normal operating level" at 1 percent. Pub. L. No. 91-468, § 1(3), 84 Stat. 994, 999 (1970). But in 1984, it raised the level to 1.3 percent. Pub. L. No. 98-369, § 2809, 98 Stat. 494, 1205 (1984).

[91] 12 U.S.C. § 1782(c).

[92] A reserve ratio of 1.3 percent means that the Share Insurance Fund reserves has a 1.3 percent ratio of reserves to total insured deposits. Of the 1.3 percent, 1.0 percentage point comes from the 1 percent deposit and 0.3 percentage point reflects the Fund's accumulated insurance premiums and interest earnings.

[93] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 10.

[94] 12 U.S.C. § 1782(c)(3), (h)(2).

The 1 percent deposit constitutes an asset on credit unions' books.[95] When covering losses and expenses, the Share Insurance Fund first uses reserves other than the 1 percent deposit (namely, the amount by which the reserve ratio exceeds 1 percent). But if the reserve ratio ever falls below 1 percent, credit unions must write off a proportionate amount of their 1 percent deposit and treat that amount as an expense on their income statements.[96] Having thus recognized any impairment of the deposit, credit unions must restore the deposit to 1 percent by January 31 of the following calendar year. The following example illustrates the process of impairment and restoration. If the Fund's reserve ratio fell to 0.75 percent (i.e., if the 1 percent deposit were 25 percent impaired), each credit union would have to write off, and expense, 25 percent of its 1 percent deposit. Then, by January of the following year, each credit union would have to increase its deposit so that it once again equaled 1 percent of the credit union's insured deposits.

The Share Insurance Fund's reserve ratio has not fallen below 1 percent since January 1985, when the new funding structure took effect. During every succeeding year but one, investment earnings on the Fund's reserves have sufficed to cover losses and expenses. The NCUA imposed a premium only in 1991. And the Fund paid dividends on the 1 percent deposit for 1995 and 1996 (at a rate of approximately 4 percent).

2. Current Debate

The Share Insurance Fund counts the 1 percent deposit as its reserves. At the same time, credit unions count the 1 percent deposit as an asset on their own books, making their reported net worth (i.e., total reserves) higher than it would be than if they had expensed the deposit. This treatment of the same dollars as reserves of the Fund and as an asset of credit unions results in double counting if one views the Fund and institutions' net worth as the total buffer available to absorb credit union losses. If the Fund has losses large enough to dip into the 1 percent deposit, credit unions must then expense that portion of the cost and replenish the deposit. Incurring these expenses during a time of stress could further debilitate already weak institutions.

Proponents of the 1 percent deposit system, including virtually all credit union managers, argue that this funding structure appropriately treats the deposit as an asset because it is

---

[95] If a credit union chooses to withdraw from the Share Insurance Fund or voluntarily liquidate, it can withdraw its 1 percent deposit. If the NCUA must involuntarily liquidate a credit union, it uses that credit union's deposit -- as it would any other asset -- to satisfy claims against the institution.

In an assisted merger, the NCUA transfers the troubled credit union's 1 percent deposit to the continuing credit union along with the insured deposits of the merging institution. In a purchase and assumption transaction, the NCUA transfers all of the troubled credit union's insured deposits to the acquiring institution along with the 1 percent deposit. If in a purchase and assumption transaction the NCUA transfers only part of the credit union's deposits, it likewise transfers a pro rata portion of the 1 percent deposit. The remainder of the deposit may be transferred to any other credit union participating in the purchase and assumption transaction, or may be liquidated, depending on the structure of the purchase and assumption agreement. NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 1.

[96] 12 U.S.C. § 1782(c)(1)(B)(iv).

refundable (under certain conditions) to a credit union should the institution elect to liquidate, become privately insured, or convert to another charter (e.g., become a mutual savings institution), and because it earns dividends when the Share Insurance Fund's reserve ratio exceeds 1.3 percent. Furthermore, the American Institute of Certified Public Accountants (AICPA) has certified that the accounting treatment of the deposit conforms with generally accepted accounting principles.[97] Critics, however, charge that the 1 percent deposit lacks the characteristics of a true asset because credit unions do not make the deposit voluntarily and cannot draw upon it as a normal asset to cover losses.

Proponents argue that the 1 percent deposit system is superior to a traditional premium-based system because it:

- provides a mechanism for promptly correcting any deficiencies in the Share Insurance Fund's reserves;

- in effect, gives the Share Insurance Fund a claim on the entire net worth of all insured credit unions -- and thus helps ensure that the Fund can meet its obligations to insured depositors without becoming a burden on taxpayers;

- gives credit unions strong incentives to keep the Share Insurance Fund healthy and support prompt, efficient resolution of problems at other credit unions; and

- promotes fairness among credit unions with different growth rates by more closely linking credit unions' contribution to the Share Insurance Fund with their deposit size.[98]

Credit unions and their trade associations strongly support the 1 percent deposit system, including both the legitimacy of its accounting treatment and its effectiveness as a device for capitalizing the Share Insurance Fund. They assert that the 1 percent deposit system reflects the cooperative character of credit unions and, by fostering a sense of ownership, encourages credit unions to protect the Fund by monitoring their own behavior as well as the behavior of other insured credit unions.[99] The NCUA also lauds the 1 percent deposit system for enabling the Fund to grow proportionally with credit unions without having to charge a premium.

---

[97] AICPA, *Letter to U.S. Representative Marcy Kaptur*, Apr. 3 (Washington, DC: AICPA, 1989), 1-2.

[98] In a deposit insurance system financed by premiums, a long-established, slow-growing credit union will have contributed far more to the insurance fund over the years than a new, rapidly growing credit union. Moreover, the new credit union's rapid growth helps dilute the Fund, thereby increasing the premiums required of every other member institution, including the older institution. By contrast, under the 1 percent deposit system, credit unions must *maintain* a deposit equal to 1 percent of their insured deposits. The old, slow-growing credit union must increase its deposit only if its insured deposits increase. The new, fast-growing credit union must increase its deposit in direct proportion to the growth of its insured deposits.

[99] For example, in its letter to the Treasury, NAFCU described the 1 percent deposit system as a "cooperative insurance system for a cooperative industry." NAFCU, *Letter Responding to the Treasury's Request for Comments*, Feb. 28 (Washington, DC: NAFCU, 1997), 5.

On the other hand, many bankers' comment letters argued that the accounting treatment of the 1 percent deposit overstates the resources available to offset losses to the Share Insurance Fund. During times of economic stress, credit unions are likely to have reduced income or even have losses, and credit union failures are likely to increase. If the Fund's reserve ratio falls below 1.25 percent, the NCUA may begin assessing premiums. If losses are large enough to impair the 1 percent deposit, then credit unions must write off and replenish the amount that was impaired. Critics of the 1 percent deposit point out that credit unions would thus have to pay premiums and write off and replenish the impaired deposit at a time when earnings are depressed and net worth may already be declining. By expensing the 1 percent deposit now, credit unions would not have to expense it during a time of economic stress. They would, however, still have to pay premiums to rebuild the Fund's reserves.

Because of the risks associated with this type of scenario, bankers recommend that the deposit be expensed over a given number of years and that credit unions begin paying regular, explicit premiums. In 1991 the GAO and the Bush Administration both recommended that the 1 percent deposit be expensed.[100] However, the NCUA contends that simultaneously paying premiums and expensing and replenishing the 1 percent deposit would not likely lead to additional credit union failures.

Although the NCUA has authority to assess insurance premiums, those premiums must, by law, be priced at a flat rate of 1/12 of 1 percent of deposits.[101] Bankers argue that premiums should be risk-based to discourage risky behavior and more accurately reflect individual credit union's risk.[102]

FDIC officials told us that, in their view, the 1 percent deposit system creates the same incentives for credit unions as the FDIC funding structure does for banks and thrifts. The officials view the difference in funding structures as essentially a matter of timing. Credit unions write down the 1 percent deposit only if the Share Insurance Fund's reserve ratio falls below 1 percent. But if that happens, credit unions recognize the impairment immediately and then replenish the 1 percent deposit by the following January. By contrast, FDIC-insured institutions prepay for losses to the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) through premiums that they expense when paid. But FDIC-insured institutions have up to 15 years in which to bring a depleted insurance fund's reserve ratio up to the statutorily required 1.25 percent.[103] On balance, FDIC officials concluded that the 1 percent deposit system fosters neither stronger nor weaker incentives to safeguard the insurance fund than does the FDIC system.

---

[100] GAO, *Credit Unions: Reforms for Ensuring Future Soundness* (Washington, DC: GAO, 1991), 174; and U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (Washington, DC: Treasury, 1991), 64.

[101] 12 U.S.C. § 1782(c)(2).

[102] ABA, *Letter Responding to the Treasury's Request for Comments*, Feb. 28 (Washington, DC: ABA, 1997), 2, 6.

[103] 12 U.S.C. § 1817(b)(3).

3. Analysis and Recommendations

The overriding federal interest in the Share Insurance Fund's financial structure lies in protecting taxpayers from potential losses, while creating a healthy set of incentives for insured credit unions. Thus, whatever the accounting issues and their resolution, the ultimate policy concern must be the Share Insurance Fund's fiscal soundness.

Although the Share Insurance Fund's financial structure differs from that of BIF and SAIF, that does not necessarily make one approach better than the other. We believe that both approaches are reasonable and work well for their respective insurance funds. The financing structure of the Share Insurance Fund fits the cooperative character of credit unions. Because credit unions must expense any losses to the Share Insurance Fund, they have an incentive to monitor each other and the Fund. This financing structure makes transparent the financial support that healthier credit unions give to the members of failing credit unions. Credit unions understand this aspect of the Fund and embrace it as a reflection of their cooperative character.

The current structure gives each credit union a financial incentive to ensure that it and others remain solvent and do not require Share Insurance Fund assistance. Because their 1 percent deposit is at risk when other credit unions fail, and because the Share Insurance Fund may have to levy additional assessments on surviving credit unions, credit union managers have an incentive to alert federal regulators to unsound or illegal practices at other credit unions. Although credit unions cannot directly prevent excessive risk-taking by other credit unions, they can report undesirable practices by other credit unions to regulators, who can take remedial actions. Similar incentives should, however, exist in the FDIC funds.

The 1 percent deposit does present a double-counting problem. And it would be feasible for credit unions to expense the deposit now, when they are healthy and have strong earnings. However, expensing the deposit would add nothing to the Share Insurance Fund's reserves, and -- as we will explain -- better ways of protecting the Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.

Instead, we recommend a strengthened reserving requirement. Under current law, credit unions set aside a small percentage of their gross earnings as reserves until their net worth reaches 6 percent of total assets. We recommend increasing the 6 percent threshold to 7 percent and basing the measure on the ratio of total net worth to total assets. Thus we would require credit unions not to write off part of their net worth but to add to it (if they did not already meet the 7 percent target). This additional net worth cushion would more than offset the double counting of the 1 percent deposit. This approach should ultimately strengthen both individual credit unions and the Share Insurance Fund. We discuss net worth requirements in detail in the next chapter.[104]

[104] See pp. 66-73.

In addition, four changes directly relating to the Share Insurance Fund would better enable the Fund to deal with potential future losses. First, establishing an available assets ratio (as recommended above) would help to ensure that the Share Insurance Fund has adequate liquidity to cover credit union losses. Second, correcting the NCUA's measurement of its reserve ratio and requiring credit unions to adjust their 1 percent deposit each time they submit call report data (also recommended above) would ensure that the Share Insurance Fund's reported reserve ratio accurately reflects what reserves the Fund actually possesses at any given time.

Third, the NCUA should have some additional flexibility to let the Share Insurance Fund accumulate additional investment earnings in good times that would increase its resiliency during economic downturns. The Federal Credit Union Act currently imposes a rigid 1.3 percent ceiling on the Fund's reserve ratio. We recommend that Congress give the NCUA the discretion to let investment earnings increase the Fund's reserve ratio to 1.5 percent. This flexibility would likewise better enable the NCUA to protect the Fund -- as well as protect credit unions' 1 percent deposit -- from possible future losses. The NCUA would, of course, have discretion to distribute as dividends any reserves above 1.3 percent (and any interest they had earned).

Fourth, current law permits the NCUA to assess insurance premiums only at a fixed rate of 1/12 of 1 percent of insured deposits. Here again, we recommend that Congress give the NCUA more flexibility to ensure adequate, timely financing of the Share Insurance Fund. Specifically, the NCUA should have authority to charge premiums higher or lower than 1/12 of 1 percent.

Similarly, it may be appropriate to consider authorizing the NCUA to assess risk-based premiums or make risk-based adjustments in dividends from the Share Insurance Fund. Although this study does not recommend such changes, we see value in a broader debate over their possible advantages and disadvantages.

D. SUMMARY

In analyzing issues relating to the Share Insurance Fund, we examined the NCUA's oversight of the Fund, the advantages and disadvantages of having some entity other than the NCUA administer the Fund, and the strengths and weaknesses of the 1 percent deposit system.

In carrying out the Congressional requirement that we evaluate how the NCUA has exercised its responsibility for the Share Insurance Fund, we focused on three key areas: (1) developing standards and procedures for examination and supervision; (2) formulating policies and procedures to resolve troubled credit unions; and (3) managing the Share Insurance Fund. We found no weaknesses in the NCUA's examination and supervision process. In the resolution area, however, we are concerned that neither the law nor policy requires the NCUA to make cost to the Fund determinative in deciding how to resolve a troubled institution. We believe that the NCUA needs a more rigorously formulated resolution decision-making process to deal adequately with the new and increased risks posed by the growing size and complexity of some

credit unions. To this end, we recommend that Congress establish a prompt corrective action system tailored to credit unions' unique characteristics.

As for the NCUA's management of the Share Insurance Fund, we found that the Fund is in good condition, but that the techniques used to monitor the adequacy of its reserves need improvement. We performed stress tests to assess the Fund's strength and resiliency. The results showed the Fund to be strong and resilient. However, because the current reserve ratio includes in its numerator both liquid and illiquid assets, we believe that the NCUA should maintain an available assets ratio of 1 percent and that maintaining that ratio should take precedence over distributing dividends to insured credit unions. In addition, we found that the NCUA calculates the Share Insurance Fund reserve ratio using non-contemporaneous figures, which inflates the reported ratio. We recommend that the NCUA correct this measurement problem by using the most current data on insured deposits it possesses as well as by requiring credit unions to adjust their 1 percent deposit each time they submit data to the NCUA on their insured deposits.

In considering whether some entity other than the NCUA should administer the Share Insurance Fund, we acknowledged that possible conflicts of mission exist between the NCUA's role in administering the Fund and its role as a charterer and supervisor. We concluded, however, that on balance it is unclear if the benefits of having an entity other than the NCUA manage the Fund would outweigh the substantial costs involved in making such a change. Moreover, we believe that prompt corrective action rules for credit unions would introduce a constructive discipline on the NCUA's supervisory and insurance functions, which should largely offset any incentives to permit the promotion of credit unions to interfere with the NCUA's responsibilities for the Fund.

Congress also directed the Treasury to examine the Share Insurance Fund's 1 percent deposit system. All insured credit unions currently maintain in the Share Insurance Fund a deposit equal to 1 percent of their assets. Although the Fund carries these deposits on its balance sheet as reserves, credit unions simultaneously carry them as assets, thereby increasing credit unions' reported net worth. The double counting implicit in this structure may exacerbate credit union failures during stressful periods if the 1 percent deposit becomes impaired. Many have suggested abolishing the system and requiring credit unions to pay insurance premiums just as banks and thrifts do in order to eliminate the double-counting problem. We found, however, that the 1 percent deposit system -- although different from the financing of the FDIC -- is effective. Credit unions' ownership of the Share Insurance Fund reflects their cooperative character while giving them a financial incentive to monitor and seek to curtail unsound or illegal practices at other credit unions.

Although we recommend maintaining the funding structure of the Share Insurance Fund, we do recommend other ways to strengthen the Fund and credit unions as a whole. As already noted, we recommend establishing prompt corrective action rules as well as requiring the NCUA to maintain an available assets ratio for the Fund and to correct its methodology for measuring the Fund's reserve ratio. We recommend loosening the current statutory ceiling of 1.3 percent on the

Share Insurance Fund's reserve ratio to give the NCUA some flexibility to build up the Fund. We also recommend granting the NCUA the authority to assess premiums, when it deems necessary, at a rate higher or lower than the current statutory requirement of 1/12 of 1 percent of insured deposits. Furthermore, as risk levels among credit unions become more varied, the idea of risk-based premiums warrants consideration. Finally, imposing net worth requirements and tightening reserving requirements (as we recommend in the next chapter) would be preferable to expensing the 1 percent deposit.[105] Rather than forcing credit unions to write off the 1 percent deposit (thereby lowering their net worth), these steps involve credit unions carrying additional net worth to support the 1 percent deposit.

[105] See p. 71.

CHAPTER III

THE NCUA'S SAFETY AND SOUNDNESS REGULATIONS

Fostering the safe and sound operation of banks, thrifts, and credit unions constitutes the most important goal of depository institution regulation. How well regulation achieves this goal affects the economy, consumers, taxpayers, and the financial services system. The NCUA charters and supervises federal credit unions and provides federal deposit insurance to both federal and state credit unions. Integral to these responsibilities is the NCUA's establishment and enforcement of safety and soundness regulations.

Congress directed the Treasury to "conduct a study and evaluation of . . . the regulations of . . . the [National Credit Union] Administration."[106] The NCUA's regulations occupy over 250 pages of the *Code of Federal Regulations*. Congress did not identify which of these regulations it considered most important. Given the central importance of safety and soundness regulations to the NCUA's regulatory mission and the relevance of those regulations to the other study topics (including the Share Insurance Fund), we analyzed those regulations. We consider the NCUA's regulations regarding corporate credit unions in the following chapter. This chapter focuses on the NCUA's safety and soundness regulations for all other credit unions.

In view of the statutory and administrative modernization of bank and thrift regulation over the past decade, we used the federal banking agencies' safety and soundness regulations as a starting point for our review of the NCUA's safety and soundness regulations. When we identified differences between the two sets of regulations, we evaluated them in light of credit unions' distinctive character and their size and complexity relative to banks and thrifts.

A. COMPARISON OF DEPOSITORY INSTITUTION SAFETY AND SOUNDNESS REGULATIONS

As part of our process of comparing the safety and soundness regulations governing credit unions with those governing banks and thrifts, we asked the NCUA, OCC, and OTS to provide us with a list of the most important safety and soundness rules -- both statutory and regulatory -- applicable to the institutions they regulate. We also asked CUNA and NAFCU each to provide us with a list of the most important safety and soundness rules applicable to federally insured credit unions. From these lists, we selected the provisions that we judged to be most important. Appendix B presents a side-by-side comparison of the safety and soundness regulations of the NCUA, OCC, and OTS -- the three federal agencies that charter depository institutions.

We identified four key differences between the NCUA's regulations and those of the federal banking agencies that we believe warrant action by Congress or the NCUA:

---

[106] Pub. L. No. 104-208, § 2606, 110 Stat. 3009-394, 3009-473 (1996) (codified at 12 U.S.C. § 1752a note).

- In formulating fundamental safety and soundness policies that do or should rise to the level of rules, the NCUA has often relied on such informal means as examiner manuals, policy statements, or model bylaws, which provide no opportunity for public comment and may not clearly indicate the operative norms to those who must comply with them.

- Credit unions must set aside reserves, but are not required to maintain a minimum level of net worth.

- Credit unions are not subject to a system of prompt corrective action.

- The NCUA does not generally require even large credit unions to obtain outside independent audits.

This chapter will discuss each of these points in turn. We note at the outset, however, that the NCUA's safety and soundness regulations are in some respects more demanding than those of the federal banking agencies (e.g., the NCUA has stricter real estate appraisal requirements and more stringent business lending limitations).[107]

B. SAFETY AND SOUNDNESS REGULATIONS

By "regulations" we mean rules formally promulgated by a federal agency and having the force of law.[108] A federal agency must generally publish a proposed regulation in the *Federal Register* and give interested persons an opportunity to comment. After considering the comments received, the agency may issue a final regulation. The *Code of Federal Regulations* codifies all current federal regulations. The NCUA's regulations, like those of the other federal agencies that regulate depository institutions, appear in title 12 of the *Code of Federal Regulations*.

The NCUA follows a more informal approach to safety and soundness regulation than the federal banking agencies, relying more on guidance and less on formal rules. To some degree, this informal approach reflects the historical prevalence of small credit unions with relatively simple operations. Such informality has its benefits for the NCUA and for credit unions, but it may also have significant potential drawbacks, such as the following:

- Documents not easily accessible to the public contain important credit union safety and soundness rules.

---

[107] Banks generally have considerable experience in commercial lending; for them it represents a major line of business. By contrast, most credit unions offer business loans more as a courtesy to members with their own businesses than as a product line important in itself. It is reasonable that stricter standards apply to the institutions with more limited experience in dealing with the risks of commercial lending.

[108] Such regulations, known in administrative law as "legislative rules," affect the rights and duties of both the agency and the regulated entities.

- An important lesson of the thrift debacle is that unstructured, informal oversight can result in undue leniency by depository institution regulators in times of stress.

- Establishing rules in an informal manner reduces or eliminates the opportunity for public comment.

- The absence of clear, public rules increases the risk of the NCUA treating or being perceived as treating similarly situated credit unions differently without good reason.

Limits on loans to one borrower illustrate the informality of the NCUA's approach -- and a significant weakness in the agency's regulations. The Federal Credit Union Act limits a credit union's loans to one borrower to 10 percent of its "unimpaired capital and surplus."[109] The NCUA has construed "capital" as including deposits.[110] Thus the statutory limit on loans to one borrower is 10 percent of deposits plus 10 percent of net worth. This exceeds the limit on other depository institutions, which is generally 15 percent of capital.[111] The NCUA told us it views the statutory lending limit as an outer bound and that it determines the appropriate limit case by case, when an institution adopts bylaws. But bylaws are not regulations and thus do not have the force of law. The NCUA recently published proposed changes in its model bylaws in the *Federal Register* and solicited public comments on them[112] -- but only after a court ruled that it owed no deference to the model bylaws because the NCUA had not promulgated them as a regulation.[113]

We recommend that the NCUA make important safety and soundness rules, like the limit on loans to one borrower, readily accessible to all interested parties. If the NCUA intends rules to have the force of law, and apply to credit unions generally, it should promulgate them as regulations and codify them in the *Code of Federal Regulations*,[114] preferably after publishing a proposal in the *Federal Register* and soliciting comments from interested parties. Such a

---

[109] 12 U.S.C. § 1757(5)(A)(x); 12 C.F.R. § 701.21(c)(5).

[110] NCUA, *Comments on Treasury's Comparison of OCC, OTS, and NCUA Safety and Soundness Rules*, Apr. 11 (Alexandria, VA: NCUA, 1997), 4.

[111] 12 U.S.C. §§ 84 (national banks); 1464(u) (federal savings associations). The following example illustrates how much greater the limit on loans to one borrower is for credit unions than for other depository institutions. Assume that a federal credit union and a national bank each have $100 million in assets and $8 million in net worth (8 percent). The national bank's lending limit is 15 percent of $8 million -- or $1.2 million. By contrast, a federal credit union's statutory lending limit is keyed to the sum of its deposits and its net worth, a sum roughly equaling the credit union's total assets. Thus the credit union's lending limit is 10 percent of approximately $100 million -- or $10 million. The credit union therefore has a lending limit over 8 times larger than that of the bank.

[112] 62 Fed. Reg. 11,778 (1997).

[113] *Madias v. Dearborn Fed. Credit Union*, 929 F. Supp. 1059, 1063 (E.D. Mich. 1996).

[114] *See, e.g., American Mining Congress v. Mine Safety and Health Admin.*, 995 F.2d 1106 (D.C. Cir. 1993) (citing factors to be considered in determining whether a rule is intended to have the force of law).

procedure "gives notice to an entire segment of society . . . [and] agencies discover that they . . . learn from the suggestions of outsiders and often benefit from that advice."[115]

The law does not require an agency to publish policy statements and guidance if they are not intended to be legally binding,[116] although they must be published in the *Federal Register* if they are of general applicability. The NCUA should decide whether to solicit comments, keeping in mind how the comment process can "force important issues into full public display and in that sense make . . . for more responsible administrative action."[117]

In recent years the NCUA has issued formal interpretive ruling and policy statements (IRPS) establishing regulatory and safety and soundness standards. The NCUA has published some of these statements for public comment and thus can give them the force of law. Although comporting with the requirements for rulemaking, these statements are still less readily accessible than rules codified in the *Code of Federal Regulations.*

C. CREDIT UNION NET WORTH REQUIREMENTS

1. Moral Hazard

Regulators of FDIC-insured depositories establish minimum net worth requirements to help ensure that such institutions have a sufficient buffer to absorb unforeseen losses without in turn imposing losses on depositors or the deposit insurance fund. Requiring institutions to have adequate net worth also helps counteract the moral hazard of deposit insurance (i.e., the tendency of deposit insurance to permit or encourage insured depository institutions to take excessive risks -- risks that they would not take in a free market).[118] Net worth is like the deductible on an insurance policy: the higher the deductible, the greater the incentive to avoid loss. Adequate net worth gives a depository institution's owners incentives compatible with the interests of the insurance fund because the fund absorbs losses only after the institution has exhausted its net worth and thus eliminated the economic value of the owners' investment.

The thrift debacle of the 1980s stands as ample warning of the possible consequences of inadequate or unenforced capital requirements. Regulators permitted thrift institutions to continue operating with little or no capital. Some of these institutions' owners and managers -- having little left to lose -- took excessive risks that increased the losses of the insurance fund.

---

[115] *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 777-78 (1969) (Douglas, J., dissenting).

[116] 5 U.S.C. § 552(a)(1)(D).

[117] *NLRB*, 394 U.S. at 779 (Douglas, J., dissenting) (noting the statutory requirement that all rules intended to be generally applicable and legally binding must be formally promulgated).

[118] Deposit insurance impairs the discipline that depositors would otherwise exert over depository institutions' risk-taking. It permits a depository institution to take increased risks without suffering a corresponding increase in its cost of funds.

2. Credit Union Net Worth

A credit union's net worth represents the sum of the various reserve accounts on its balance sheet. These reserve accounts -- some required by statute or regulation and some established at the institution's discretion -- reflect the cumulative net retained earnings of the credit union since its inception. These accumulated net reserves form the buffer that protects the institution and the Share Insurance Fund from possible losses. During the 1990s, credit unions have increased their net worth, as shown in Table III.1. On average, credit union net worth stands at 11 percent of total assets, a 3 percentage point increase over the past five years.

Table III.1: Ratio of Total Reserves to Total Assets for Credit Unions, Commercial Banks, and Thrifts: 1991-1996

	1991	1992	1993	1994	1995	1996
Credit Unions	8%	8%	9%	10%	10%	11%
Commercial Banks	7%	8%	8%	8%	8%	8%
Thrifts	7%	7%	8%	8%	8%	8%

Source: Sheshunoff Information Services, Inc., *BankSearch*.

The strength of credit union net worth is consistent across all asset categories, as shown in Table III.2. Smaller institutions have a higher ratio of net worth to assets than larger ones, but all categories boast strong total reserves.

Table III.2: Ratio of Total Reserves to Total Assets for Credit Unions by Asset Size: 1991-1996

Asset Size Category	1991	1992	1993	1994	1995	1996
<$2 Million	11%	11%	12%	13%	14%	15%
$2-10 Million	9%	9%	10%	11%	12%	13%
$10-50 Million	8%	8%	9%	10%	11%	11%
$50-250 Million	7%	8%	9%	9%	10%	11%
>$250 Million	8%	8%	9%	9%	10%	10%
All Credit Unions	8%	8%	9%	10%	10%	11%

Source: Sheshunoff Information Services, Inc., *BankSearch*.

3. Credit Unions Are Not Subject to Net Worth Requirements

The NCUA's regulations do not impose any net worth requirement on credit unions -- in the sense of requiring credit unions to have at least a given ratio of net worth to assets in order to be in good standing. When we asked the NCUA to describe credit union net worth requirements, it pointed to three things: the statutory reserving requirement (discussed next); an NCUA *Letter to Credit Unions* setting forth criteria that examiners employ to evaluate the adequacy of credit unions' net worth; and the NCUA's use of capital ratios to identify risky institutions.

a. Reserves

The agency's regulations implement the statutory requirement that a federal credit union transfer a certain percentage of its annual gross income into a reserve account, known as "regular reserves," until that account reaches a specified level. Specifically:

- A credit union in operation for more than four years and having at least $500,000 in assets must annually transfer 10 percent of its gross income to its regular reserve account until its regular reserves reach 4 percent of outstanding loans and "risk assets,"[119] then 5 percent of gross income until its regular reserves reach 6 percent of outstanding loans and risk assets.

[119] 12 U.S.C. § 1762. Risk assets consist of all assets (including outstanding loans), except for specific types of assets that the NCUA has determined present less risk to credit unions. These exceptions include: (1) cash; (2) loans, and other assets insured by the federal government having remaining maturities of five years or less; (3) loans fully insured or guaranteed by the federal or state government with maturities of three years or less; and (4) shares on deposits in state-insured depository institutions or in a corporate credit union with remaining maturities of five years or fewer. 12 C.F.R. § 700.1(h)(i).

- A credit union in operation for less than four years or with less than $500,000 in assets must annually transfer 10 percent of its gross income to its regular reserve account until those reserves reach 7.5 percent of outstanding loans and risk assets, then 5 percent of gross income until reserves reach 10 percent of outstanding loans and risk assets.[120]

This is, however, merely a *reserving* requirement -- not a net worth requirement. It simply sets forth the circumstances under which a credit union must add to its reserves a specified percentage of its current earnings. It neither requires the credit union to keep its net worth above a particular ratio nor even requires that the credit union ever reach that level.

One can legitimately view the reserving requirement as implying a net worth target (for most credit unions, 6 percent of risk assets). Risk assets include most loans and most investments with a maturity exceeding five years. As a practical matter, for most credit unions, risk assets roughly correspond to total loans, and, at year-end 1996, loans amounted to some 65 percent of total credit union assets. Thus the implied net worth target amounts to about 3.9 percent of total assets (65 percent of 6 percent).[121] But the only legal consequence of failing to meet the target is that a credit union must set aside as reserves a small percentage of its current gross income.

b. Examiner Guidance

The NCUA's *Letter to Credit Unions*, number 161, dated December 1994 (as summarized by the NCUA), "explains . . . what the examiners review when evaluating capital adequacy," "provides the formulas of the ratios used in determining the component rating for capital," and has "[g]uidelines for assigning component ratings according to asset size."[122] The letter describes in general terms the net worth ratios associated with various ratings for the capital component of the CAMEL rating system.[123] It says that a credit union must have capital "well in excess of NCUA regulatory requirements" to receive the highest rating for capital adequacy, and that an institution will receive the lowest capital rating if it is "critically undercapitalized." However, neither the letter nor the NCUA's regulations defines the "NCUA's regulatory requirements" or what it means for a credit union to be "critically undercapitalized."

---

[120] 12 U.S.C. § 1762. The NCUA permits credit unions to add their allowances for loan losses and for investment losses to their regular reserve for purposes of determining the required transfer. 12 C.F.R. § 702.2. By contrast, bank and thrift capital regulators permit loan loss allowances to count only to a very limited extent toward meeting capital requirements. Such allowances may count, as part of Tier 2 capital, toward part of the risk-based capital requirement; it cannot count at all toward the leverage ratio. We note that regular reserves constitute only part of a credit union's net worth; the remainder consists of other reserve accounts, such as undivided earnings.

[121] As credit unions' loan portfolios tend to grow during good economic times and shrink during bad economic times, the implied net worth-to-asset ratio rises as the economy expands and falls as the economy contracts (other things being equal). The 3.9 percent implied ratio is for credit unions as a group; an individual credit union may have a higher or lower implied ratio, depending on the particular characteristics of its assets.

[122] NCUA, *Responses to Questions about the Share Insurance Fund*, Nov. 22 (Alexandria, VA: NCUA, 1996), tab 5.

[123] For a description of the CAMEL rating system, see pp. 32-33.

The letter does describe the capital-to-assets ratio[124] and the net capital-to-assets ratio[125] that the NCUA associates with each possible rating for the capital component. These ratios vary by credit union size, with small credit unions needing higher net worth ratios than large credit unions to obtain a given capital rating. For example, to receive the highest capital rating of 1: a credit union with less than $2 million in assets should have a capital-to-assets ratio of more than 11 percent; a credit union with $2-10 million in assets should have more than 9 percent; and a credit union with more than $10 million in assets should have more than 8 percent. The net capital requirements are somewhat lower, and the relationship between size groups, and between the two capital ratios, are not consistent across the possible CAMEL ratings.

c. Capital-Based Monitoring

The NCUA also pointed to its use of capital ratios in identifying risky credit unions. The NCUA's Division of Risk Management produces a risk evaluation report that, among other things, identifies all credit unions with a "net equity ratio of less than 3 percent."[126] The NCUA uses this report to identify adverse trends.[127] The six NCUA regional offices also run similar reports "with *their own criteria* for capital levels" (emphasis added).[128]

Despite the considerable weight the NCUA places on credit unions' net worth, its regulations include no net worth requirements or even a statement of the primary measures of capital adequacy. Moreover, even the NCUA's informal net worth-related policies do not amount to net worth requirements.

4. Recommended Credit Union Net Worth Requirements

In considering the role of regulatory net worth requirements as a buffer to protect the Share Insurance Fund, one should also consider the double-counting issues associated with credit unions' 1 percent deposit in the Fund[129] and with credit unions' ownership of capital shares in

---

[124] The capital-to-assets ratio consists of the sum of the allowance for loan and investment losses, regular reserves, investment valuation reserves, other reserves, accumulated unrealized gains or losses on "available for sale" investments, undivided earnings, and net income divided by total assets.

[125] The net capital-to-total assets ratio consists of the sum of all of the capital components identified in the capital-to-total assets ratio, minus the sum of problem loans, other identified losses, and the difference between the book and market value of investments, divided by total assets.

[126] NCUA, *Responses to the Treasury's Questions about the Share Insurance Fund*, Nov. 22 (Washington, DC: NCUA, 1997), tab 5.

[127] Ibid.

[128] Ibid.

[129] See pp. 55-57.

corporate credit unions.[130] Effective net worth requirements for credit unions, set at an adequate level, should allay concerns about such double counting.

We recommend four changes that together should provide adequate, effective net worth requirements.

First and most importantly, Congress should require credit unions to meet net worth requirements (i.e., a specified ratio of net worth to assets). We recommend that Congress require a credit union that has existed for a given number of years or reached a given asset size to have at least a 6 percent ratio of net worth to total assets. As described in Section D, we would make such a requirement part of a system of prompt corrective action designed to ensure that credit unions correct any net worth deficiency expeditiously.

Credit unions that have not existed the specified number of years or reached the specified asset size should be required to build reserves on a schedule aimed at ensuring that they will meet the 6 percent net worth target by the end of the phase-in period. The NCUA should promulgate appropriate regulations to achieve this goal. Also, the phase-in period could be automatically ended once the credit union reaches a certain asset size as specified in regulation.

Second, the reserving requirement (i.e., the requirement that a credit union set aside as reserves a certain percentage of its gross income) should have a higher target reserve ratio. Specifically, we recommend that Congress raise the current reserving target from 6 percent of "risk assets"[131] to 7 percent of total assets. A one percentage point increase in the reserving target would approximate credit unions' 1 percent deposit in the Share Insurance Fund.

Third, we recommend that Congress require credit unions to deduct from their reserves some portion of any member capital accounts at a corporate credit union and all paid-in capital issued by a corporate credit union. We propose deducting member capital accounts and paid-in capital from reserves, rather than increasing the reserve target, because not all credit unions have such assets. Consequently, a deduction requirement would affect only those credit unions holding member capital accounts or paid-in capital.

Fourth, we recommend that Congress require the NCUA to develop an appropriate risk-based net worth requirement for larger, more complex credit unions. This risk-based requirement would supplement the simple 6 percent net worth requirement and permit the NCUA to take account of risks -- such as off-balance sheet risks or interest rate risk (from, for example, a large mortgage portfolio) -- that may exist only for a small subset of credit unions.

---

[130] See pp. 94-96.

[131] "Risk assets," as currently defined by the NCUA, excludes most securities with maturities under five years, and thus does not require a credit union to build net worth against such securities. Yet maturity alone is a poor measure of credit risk, interest rate risk, prepayment risk, or other relevant risks. On balance, we regard the five-year rule as an inadequate test of a security's riskiness. We also found risk assets to be unnecessarily cumbersome.

Our recommendations respect credit unions' cooperative character and would leave credit unions and the Share Insurance Fund stronger and more resilient than they are now. We recognize that the net worth requirements outlined here may require a credit union to hold somewhat more net worth than would be required of a similarly situated bank or thrift. Even if that were the case, we believe that a higher level would be justified. Chapter II describes how a credit union's 1 percent deposit in the Fund commits an appreciable part of the institution's net worth to the Fund's reserves, and Chapter IV describes how an institution's member capital account (or paid-in capital) at its corporate credit union in effect transfers that part of the credit union's net worth to the corporate credit union. Thus the credit union records as assets both the 1 percent deposit and member capital accounts. Yet these assets effectively assign part of the credit union's net worth to the net worth of the Fund and to the net worth of its corporate credit union, respectively.

Additionally, credit unions cannot increase their net worth quickly. They cannot raise capital by issuing stock,[132] and they are not subject to the market discipline brought to bear by stockholders and by potential owners who think they could operate the institution more efficiently. Although credit unions can take steps to reduce expenses and increase revenues, accumulating retained earnings takes time -- and may be particularly difficult during times of stress, when earnings tend to decline.

It should be noted that credit unions' exemption from federal income tax gives them an advantage over banks and thrifts in generating net worth internally.[133] Also, unlike banks and thrifts, most credit unions would not be subject to risk-based capital requirements. We also note that the NCUA's guidance to examiners generally calls for credit unions to have higher net worth levels than we are proposing here as regulatory minimums.

As shown in Table III.3, credit unions' balance sheets indicate that credit unions themselves recognize the wisdom of maintaining a net worth exceeding 7 percent of total assets.

---

[132] Credit unions differ from mutual savings associations and mutual savings banks, which can convert to stock form if they must raise significant equity.

[133] A credit union that retains a dollar of earnings adds the entire dollar to its net worth. A bank or thrift that retains a dollar of earnings must first pay income tax on that dollar. Thus it can add only the after-tax portion of that dollar to its net worth.

Table III.3: Credit Union Net Worth
(Dollar figures in millions, totals may not add due to rounding, data as of December 31, 1996)

	Institutions			Assets		
Net Worth	Number	% of Total	Cumulative %	Amount	% of Total	Cumulative %
Under 3%	86	1%	1%	$246	1%	1%
3-6%	314	3%	4%	$5,603	2%	2%
6-7%	400	4%	7%	$16,004	5%	7%
7-8%	669	6%	13%	$31,681	10%	17%
8-9%	961	8%	21%	$43,505	13%	30%
9-10%	1,121	10%	31%	$46,644	14%	44%
Over 10%	7,841	69%	100%	$183,199	56%	100%
Total	11,392	100%		$326,883	100%	

Source: Sheshunoff Information Services, Inc., *BankSearch*.

Of the 11,392 credit unions operating at year-end 1996, 10,591 (93 percent) had more than 7 percent net worth, and those institutions held 93 percent of total credit union assets. More specifically, 7,840 credit unions (69 percent of all credit unions) had more than 10 percent net worth, another 2,082 (18 percent) had 8-10 percent net worth, and an additional 669 (6 percent) had 7-8 percent net worth. Of the 800 credit unions that did not have at least 7 percent net worth, 400 (with 5 percent of total credit union assets) had at least 6 percent. Only 400 credit unions (4 percent) had less than 6 percent net worth, and those institutions held only 2 percent of total credit union assets. Thus the vast majority of credit unions would already satisfy both the net worth requirement and the reserving targets we propose.

Insofar as these reforms would require a small minority of credit unions to increase their net worth, we note that achieving such an increase now -- in a stable, prosperous economic environment -- would be much easier than doing so under more difficult economic circumstances. In any event, increased net worth would help ensure that those credit unions have the financial strength to meet their members' needs even during difficult economic times.

D. PROMPT CORRECTIVE ACTION

Prompt corrective action is a capital-based approach to safety and soundness supervision aiming to resolve net worth deficiencies at federally insured depository institutions before they grow into large problems. The goal is to minimize -- and, if possible, avoid -- losses to the deposit insurance fund.

Prompt corrective action helps counteract the perverse incentives created by deposit insurance. The "moral hazard" of deposit insurance occurs as a depository institution depletes its net worth.[134] Regulators, too, may face perverse incentives that prompt corrective action serves to offset. Taking timely, forceful action to deal with emerging problems depository institutions may bring criticism on a regulator, while forbearance may delay unpleasant outcomes until the regulator leaves office, or may permit economic conditions to change in a way favorable to the troubled entity. Prompt corrective action lays clear markers for when regulatory action must occur and identifies a range of acceptable actions for a given degree of net worth deficiency. Prompt corrective action better aligns the incentives of depository institutions' owners, managers, and regulators with the interests of the deposit insurance fund.

1. Prompt Corrective Action for FDIC-Insured Depository Institutions

Congress enacted a system of prompt corrective action for FDIC-insured depository institutions in 1991.[135] This system classifies depository institutions into five categories, according to their capital: well capitalized; adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized.[136] An institution falling below minimum capital standards faces progressively more stringent regulatory restrictions and requirements.

A well capitalized institution is eligible for various benefits (e.g., broader powers and less restrictive regulation) accorded by Congress and the regulators under other laws.

In general, no institution can make any capital distribution (e.g., dividend payment or stock redemption) that would render it undercapitalized, nor can an undercapitalized institution make any capital distribution.[137]

If an institution becomes undercapitalized, it must submit an acceptable plan for restoring its capital, comply with limits on its asset growth, and obtain prior regulatory approval for acquisitions, branching, and new lines of business.[138] Regulators may also take one or more of an array of discretionary actions, such as restricting overly risky activities or requiring the institution to hold a new election for its board of directors.[139]

---

[134] As net worth falls, an institution's incentives to avoid losses falls with it. A decapitalized institution has strong incentives to take risks: if it succeeds, it reaps the benefit; if it fails, the insurance fund bears the loss. By taking big risks, the institution better exploits the value of its insurance. For further explanation, see p. 66.

[135] Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 102-242, § 131, 105 Stat. 2236, 2253-66 (1991) (codified at 12 U.S.C. § 1831o).

[136] *Id.* § 1831o(b)(1).

[137] *Id.* § 1831o(d).

[138] *Id.* § 1831o(e).

[139] *Id.* § 1831o(f). Other such actions include: further restricting the institution's transactions with affiliates; further restricting the institution's asset growth, or requiring the institution to shrink; requiring the institution to

If an institution is significantly undercapitalized, regulators must normally: (1) require the institution either to sell enough stock or subordinated debt to recapitalize, or to undergo a merger or acquisition; (2) restrict the institution's transactions with affiliated depository institutions; and (3) prohibit the institution from paying more than the prevailing regional rates of interest on deposits. Each of these safeguards is mandatory unless regulators determine that the safeguard would not help avoid or minimize loss to the insurance fund. Regulators may also take any of the discretionary actions applicable for undercapitalized institutions.

A critically undercapitalized institution faces stringent activity restrictions aimed at minimizing the potential for loss to the insurance fund, a prohibition against making payments on its subordinated debt, and the appointment of a conservator or receiver. Within 90 days of the institution becoming critically undercapitalized, regulators must either appoint a conservator or receiver for the institution, or take such alternative action as they determine would better achieve the purpose of avoiding or minimizing loss to the insurance fund, after documenting why the action would better achieve that purpose.[140]

Because capital is a lagging indicator of problems, regulators have discretion to reclassify a depository institution into the next lower capital category if: (1) the institution is in an unsafe or unsound condition; or (2) when most recently examined, the institution received an unsatisfactory rating for any of the four noncapital elements of the CAMEL rating (asset quality, management, earnings, or asset/liability management) and has not corrected the deficiency.[141]

Since the prompt corrective action statute took effect in December 1992, capital deficiencies among FDIC-insured institutions have become rare. Problem cases, failures, and the FDIC's insurance losses have fallen to insignificant levels. These favorable developments largely reflect the strength of the national economy. But we believe that the prompt corrective action system has also had a beneficial effect by preserving capital that institutions have accumulated during the economic recovery.

2. Current NCUA Policies

The NCUA pays close attention to credit unions' net worth and has some informal policies analogous to prompt corrective action. If an institution's regular reserves fall below 6 percent of total assets, the NCUA will monitor the interest rate that the credit union pays on deposits.

---

oust a director or senior executive officer, or employ new senior executive officers acceptable to regulators; prohibiting the institution from accepting deposits from correspondent institutions; requiring a parent bank holding company to obtain the Federal Reserve's approval before making a capital distribution; or requiring divestiture of the institution or any affiliate; or requiring other actions that would better carry out the purpose of avoiding or minimizing loss to the insurance fund. A significantly undercapitalized institution also cannot pay a senior executive officer any bonus without prior regulatory approval.

[140] *Id.* § 1831o(h).

[141] *Id.* § 1831o(g). Regulators cannot, however, use this authority to move any institution into the critically undercapitalized category.

Decreasing net worth will lower the capital component of the credit union's CAMEL rating, and the examiner may recommend various actions to strengthen the institution's net worth. Furthermore, the NCUA must approve any changes in a troubled credit union's senior executives.

Most of these possible actions derive from informal rules allowing the NCUA considerable leeway to act or not, and that (unlike prompt corrective action) provide no rigorous structure for decision making that promotes accountability. For example, when we asked the NCUA whether falling net worth levels triggered any particular response from the NCUA, the agency replied:

> The reserve levels that correspond to CAMEL categories are benchmarks, not established by regulation or statute. Examiners are instructed to use the numbers as benchmarks only. However, if a credit union's reserves are trending downward, the examiner may address the situation with credit union officials and develop plans for corrective action. Additionally, if a credit union's problems are severe enough to deplete its reserves to the point where the credit union was insolvent or "in danger of closing" and if NCUA has exhausted all other supervisory solutions, NCUA may grant 208 assistance to continue operations, in lieu of liquidation or merger.[142]

The relevant statutes, regulations, and policies fall short of providing a system of prompt corrective action for credit unions. The NCUA has no regulations or even formal guidelines for taking corrective action regarding a troubled credit union, and once a credit union depletes its net worth, the NCUA's response may be to provide assistance from the Share Insurance Fund rather than to close the institution. Although this approach may sometimes turn around a troubled institution, it also has risks. In particular, regulatory forbearance may delay the actual recognition and correction of serious deficiencies. When this occurs in a general downturn with many institutions getting into difficulty, what might otherwise have produced small losses to the insurance fund could produce much larger losses. The breakdown in regulatory discipline and management discipline becomes difficult to correct. Unstructured regulatory discretion may also promote unfairly disparate treatment of similarly situated credit unions.

3. Prompt Corrective Action for Credit Unions

We recommend that Congress establish a system of prompt corrective action for federally insured credit unions. This system would be a streamlined version of that currently applicable to FDIC-insured institutions and would be specifically tailored to credit unions as not-for-profit, member-owned cooperatives. It would thus, for example, omit the various provisions keyed to the existence of capital stock since credit unions have no capital stock.[143]

---

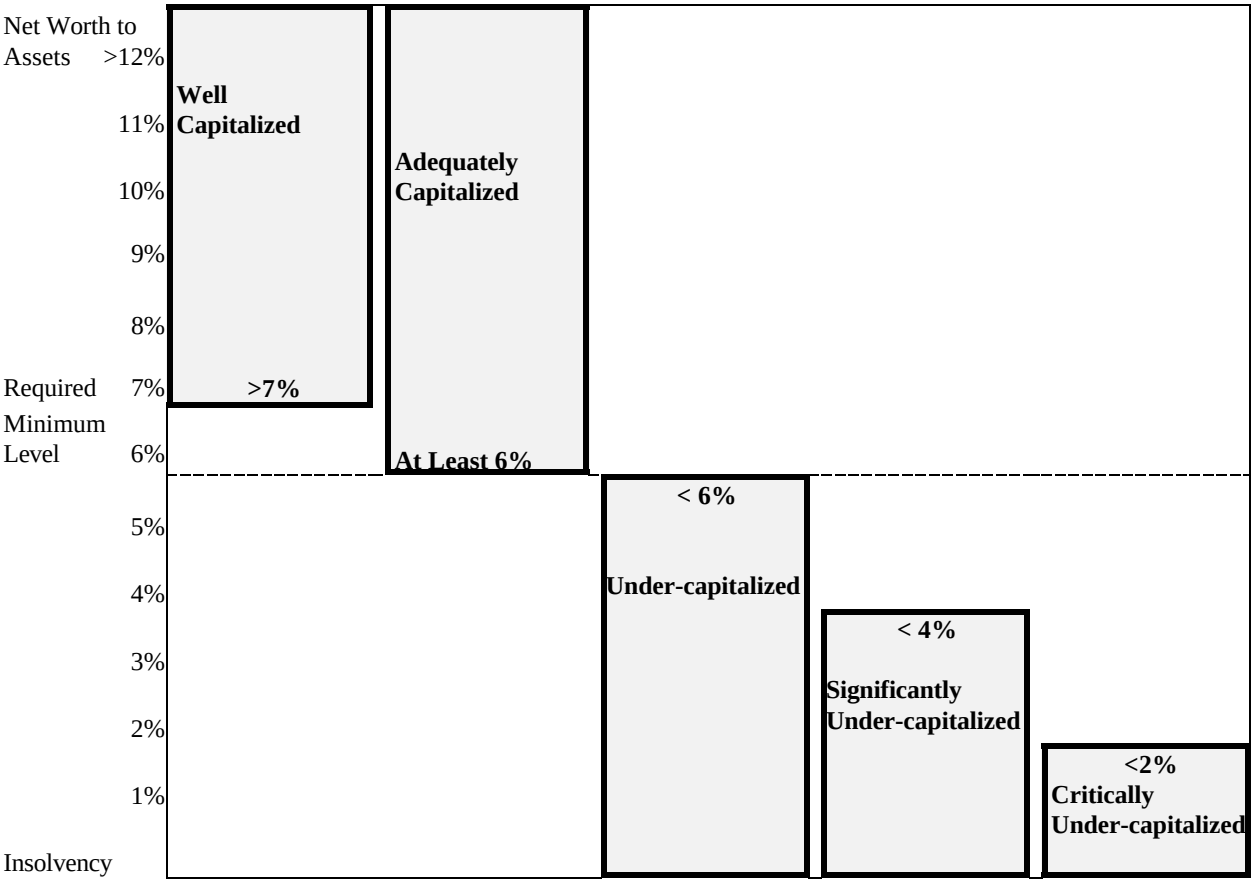
[142] NCUA, *Responses to Questions*, Jun. 4 (Alexandria, VA: NCUA, 1997), 4.b.

[143] Omitted provisions would include the rule that regulators must require a significantly undercapitalized institution either to sell enough stock or subordinated debt to recapitalize or undergo a merger or acquisition. Also omitted would be regulators' discretionary authority to prohibit a significantly undercapitalized institution from accepting deposits from correspondent institutions, require any parent bank holding company to obtain the Federal Reserve's approval before making a capital distribution, or require divestiture of the institution or any affiliate.

We note that the NCUA's authority to administer a prompt corrective action system for credit unions would be in addition to the NCUA's other authorities. In particular, it would not preclude the NCUA from dealing with emerging problems before those problems deplete a credit union's net worth.

A prompt corrective action system for credit unions, like the system already in effect for other federally insured depository institutions, might have five net worth categories. A credit union with a ratio of net worth to total assets meeting the revised reserving target of 7 percent would be "well capitalized." In keeping with our recommendation to generally require credit unions to maintain 6 percent net worth, credit unions with at least 6 percent net worth would be "adequately capitalized," and credit unions with less than 6 percent net worth would be "undercapitalized." A credit union with less than 4 percent net worth would be "significantly undercapitalized." A credit union with less than 2 percent net worth (or such higher level, not exceeding 3 percent, as the NCUA may prescribe by regulation) would be "critically undercapitalized." Figure III.1 depicts these categories.

Figure III.1: Proposed Net Worth Ratios for Credit Union Prompt Corrective Action



The rules applicable to credit unions with net worth deficiencies might be along the following lines:

An undercapitalized credit union would have to submit an acceptable net worth restoration plan to the NCUA, specifying the steps it would take to become adequately capitalized. The credit union could not increase its average total assets unless it had an approved plan, the asset growth comported with the plan, and the credit union's net worth ratio increased at a rate sufficient to enable the institution to become adequately capitalized within a reasonable time. An undercapitalized credit union would also need NCUA approval to establish new offices or commence new lines of business.

If a credit union were significantly undercapitalized, the NCUA would have to take at least one action from an array such as the following: limiting the interest (dividend) rate paid on deposits; restricting overly risky activities; further restricting the institution's asset growth, or

requiring the institution to shrink; requiring the institution to hold a new election for its board of directors, oust a director or senior executive officer, or employ new senior executive officers acceptable to the NCUA; or requiring the institution to take other action that the NCUA determines would better carry out the purpose of avoiding or minimizing loss to the Share Insurance Fund than the specific actions listed here. In addition, a significantly undercapitalized credit union could not pay any senior executive officer a bonus without the NCUA's approval.

The NCUA would be required to prescribe regulations governing the activities of a critically undercapitalized credit union -- with the goal of stabilizing the institution to minimize the potential for additional losses to the Share Insurance Fund. The applicable restrictions and requirements might vary according to the size and complexity of the credit union.

The NCUA would have discretion to liquidate a critically undercapitalized credit union. However, if a credit union remained critically undercapitalized for longer than a specified period (such as 180 or 270 days), the NCUA would have to either liquidate the institution, or take such alternative action as it determined would better achieve the purpose of avoiding or minimizing loss to the Share Insurance Fund, after documenting why the action would better achieve that purpose.

The NCUA could reclassify a credit union into the next lower capital category if: (1) the NCUA formally determined that a credit union were in an unsafe and unsound condition;[144] or (2) when most recently examined, the credit union received an unsatisfactory rating for any of the noncapital elements of the CAMEL rating and had not corrected the deficiency.

We would not apply these statutory prompt corrective action provisions to credit unions that had not existed for the minimum number of years or reached the minimum asset size, whichever comes first. Such credit unions should, however, be subject to prompt corrective action if they are not making sufficient progress towards meeting the 6 percent requirement. Congress should direct the NCUA to implement by regulation a system of prompt corrective action appropriate for credit unions that had not existed for the specified number of years or reached the specified asset size.

A system of prompt corrective action would reinforce the commitment of credit unions and the NCUA to resolve net worth deficiencies promptly, before they become more serious. Its clarity and predictability should promote fair, consistent treatment of similarly situated institutions. It should also ultimately reduce the number and cost of credit union failures. In so doing, it should conserve the resources of the Share Insurance Fund, make it even more resilient, and make more money available for lending to credit union members. And it would respect and complement the cooperative character of credit unions.

---

[144] The NCUA would make such a determination under section 206(b)(1) of the Federal Credit Union Act, after notice and a hearing. 12 U.S.C. § 1786(b)(1).

E. ANNUAL OUTSIDE INDEPENDENT AUDITS

The NCUA requires each federal credit union to undergo an annual audit satisfying criteria prescribed by the NCUA.[145] The credit union's supervisory committee, which consists of volunteer members of the credit union appointed by the credit union's board of directors,[146] has responsibility for conducting the audit itself or retaining an independent, licensed certified public accountant to do so.[147] The supervisory committee must, in any event, ensure that the credit union's financial statements accurately and fairly represent the institution's financial condition, and that the credit union's management practices and procedures sufficiently protect members' assets. The NCUA requires an independent audit only if: (1) the supervisory committee has not conducted an annual audit; (2) the supervisory committee's audit failed to meet the NCUA's requirements; or (3) the credit union has had serious and persistent recordkeeping deficiencies.[148]

With the rise of large, financially complex credit unions, the audit becomes increasingly more difficult for unpaid volunteers to carry out personally.[149] The NCUA has noted the inadequacies of supervisory committee audits in general.[150] Accordingly, we recommend that the NCUA require each large federally insured credit union to obtain an annual audit from an independent certified public accountant. The audit should be at least comparable to those required by the FDIC under section 36 of the Federal Deposit Insurance Act. The credit union would engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards. The audit's scope should be sufficient to permit the accountants to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Moreover, during the audit, the accountant should be required to attest to the adequacy of the credit union's internal controls for financial reporting. Internal controls play an important role in safeguarding assets, protecting against fraud, and ensuring reliable data.

---

[145] 12 C.F.R. § 701.12(c). The NCUA revised these regulations in 1996. 61 Fed. Reg. 41,312 (1996). However, the final rule differed markedly from the 1993 proposal to require credit unions with over $50 million in assets to obtain annual independent audits of their financial statements. 51 Fed. Reg. 17,808, 17,809 (1993).

[146] 12 U.S.C. § 1761(b).

[147] 12 C.F.R. § 701.12(c)(5).

[148] 12 C.F.R. § 701.13(a), (implementing 12 U.S.C. § 1782(a)(6)(A)).

[149] The NCUA requires that supervisory committee audits be performed by "persons having adequate technical training and proficiency as an auditor commensurate with the level of sophistication and complexity of the credit union under audit," but does not require that even the most complex credit union hire a professional accountant. 12 C.F.R. § 701.12(c)(2)(i).

[150] The "NCUA continues to have concerns with the scope of the supervisory committee audit . . . because: Many supervisory committee audits have been inadequate; Examiners have been placed in the position of brokering disputes between external auditors and supervisory committees relative to audit inadequacy; The standards supervisory committee[s] have been held to are not definitive . . . [and] greater uniformity in audit scope is needed . . . . " 61 Fed. Reg. 41,312, 41,313 (1996).

The FDIC requires banks and savings associations with at least $500 million in assets to obtain such audits.[151] We believe the $500 million asset threshold to be reasonable for credit unions as well. As of the end of 1996, 74 credit unions (with $77 billion in aggregate assets) exceeded that threshold. The independent audit requirement should not impose any hardships on these institutions; according to the NCUA, all credit unions of that size voluntarily obtained audits by certified public accountants in 1996. Numerous smaller credit unions also obtained outside independent audits. The NCUA should also have discretion to require independent audits of smaller credit unions.

F. TOWARD THE FUTURE

Financial markets and financial products continue to change rapidly, presenting consumers with an increasingly broad array of financial services. Credit unions are also continuing to grow, evolve, and expand their product offerings. These trends pose three significant challenges for the NCUA as a safety and soundness regulator.

First, although most credit unions remain relatively small institutions with simple product offerings, a growing number are large and have extensive, complex product offerings.[152] These credit unions commonly compete head-on with other depository institutions. This increasing size and complexity raises several related issues:

- As credit unions increase in size and complexity -- competing directly with banks and thrifts and taking on similar financial risks -- policymakers need to ensure that comparable safeguards apply to credit unions' risk-taking. Insofar as credit unions truly differ from other federally insured depository institutions (e.g., in their cooperative ownership and capital structure), safety and soundness regulation should reflect those differences. But insofar as activities and risks are similar without safeguards being comparable, more stringent safeguards are appropriate.

- Experience indicates some correlation between federally insured depository institutions rapidly expanding their asset size and product offerings, and subsequent problems. Some institutions grew too rapidly to understand or properly manage the risks they were undertaking. Such problems played a significant role in the thrift debacle. The NCUA should be mindful of how to limit any increased risk to the Share Insurance Fund posed by rapid growth in credit unions' asset size or product offerings.

- Another, more general factor in the thrift debacle involved the failure to update and strengthen regulatory safeguards in light of changes in markets and in the activities permissible for federally insured depository institutions. For decades, federal regulation

---

[151] 12 C.F.R. § 363.1(a) (implementing 12 U.S.C. § 1831m).

[152] Table I.4 shows the extensive product offerings of the nation's large credit unions, and Chapter I also describes the rapid growth taking place at these credit unions. See p. 23.

narrowly constrained thrift institutions' business activities (e.g., the original Home Owners' Loan Act limited a federal savings association to making first mortgage loans on real property located within 50 miles of its main office).[153] Such constraints may have diminished the impetus for more formal safeguards. Yet as Congress and thrift regulators liberalized the thrift charter, they failed to provide an adequate alternative set of safeguards to limit risk to the deposit insurance fund.

Second, changes in a credit union's charter type -- specifically, in whether the credit union has an associational, occupational, or community field of membership -- may affect its risk profile. NCUA officials commented to us that, for example, a credit union with a community charter would tend to have a relatively higher risk profile than a similar-sized credit union with an occupational charter. The occupational charter tends to foster a greater sense of affinity among members (and encourages them to identify more closely with the credit union). It also directly connects employment and credit union membership. Both of these factors may tend to make an occupationally based credit union less risky than an institution in which members' affinity rests only on geography and in which members may or may not be employed. (On the other hand, a credit union with a community charter may have greater diversity of credit risk if its members do not have the same employer.) The recent trend has been for credit unions to convert from occupational charters to community charters. If this trend continues, the NCUA and other policymakers will need to carefully consider its implications for credit union safety and soundness, and bolster such safeguards to the extent appropriate.

Third, credit unions, like other depository institutions, can choose between state and federal charters. Not all of the NCUA's safety and soundness rules apply to state-chartered, federally insured credit unions. For example, the recent changes in the NCUA's investment regulation (part 703) apply only to federal credit unions. As part of its responsibilities to manage and protect the Share Insurance Fund, the NCUA should ensure that the safety and soundness safeguards applicable to state-chartered credit unions are equivalent to those applicable to federal credit unions. If a state regulates an activity or type of risk inadequately, the NCUA should ensure that the Share Insurance Fund remains adequately protected.

G. SUMMARY

Credit unions have generally been regulated more informally than banks and thrifts, primarily because they have typically been engaged in less risky activities and are smaller in size. The difference between safety and soundness regulation of credit unions and that of other federally insured depository institutions increased after the bank and thrift failures of the 1980s and early 1990s, when bank and thrift regulations underwent significant updating and transformation.

---

[153] Pub. L. No. 73-43, § 5(c), 48 Stat. 128, 132 (1933).

The continuing informality of credit union regulation raises some concerns as a growing number of credit unions evolve into larger and more complex financial institutions. The NCUA's approach to safety and soundness regulation is still basically geared to the small local credit union with limited products and limited risk. Safety and soundness regulation must keep pace with expanding credit union operations.

Our comparison of credit union safety and soundness rules with those applicable to banks and thrifts highlighted four areas in which the NCUA's safety and soundness regulations need improvement:

- The NCUA should codify its key safety and soundness rules, after publishing them for public comment.

- Congress should enact, and the NCUA should implement, net worth requirements for credit unions.

- Congress should enact, and the NCUA should implement, a system of prompt corrective action for dealing with credit unions that have low net worth deficiencies.

- The NCUA should require large credit unions to obtain annual independent audits.

We view these as the most important -- but not necessarily the only -- changes needed. The NCUA should undertake its own review of its safety and soundness regulations to identify and implement other improvements as appropriate. In particular, we encourage the NCUA to continue to develop regulations like the recent changes in part 703 that are flexible enough to deal with the differences in operational risks and risks to the Share Insurance Fund posed by $2 million credit unions and $200 million credit unions. We also encourage the NCUA to be watchful of emerging trends among credit unions, including their:

- increasing size and complexity;

- movement from occupational to community charters; and

- separate regulation of state-chartered credit unions.

CHAPTER IV

CORPORATE CREDIT UNIONS

Corporate credit unions serve their member credit unions' needs for transaction, investment, and liquidity services. In recent years, some observers have questioned corporate credit unions' safety and soundness and the NCUA's oversight of these institutions. Since corporate credit unions hold a considerable portion of credit unions' unloaned deposits, their safety and soundness is critically important to credit unions and the Share Insurance Fund.

We begin this chapter by describing the various functions of corporate credit unions, noting why their operations raise public policy issues, and explaining how we conducted this portion of our study. We then evaluate: (1) the financial condition of the 10 largest corporate credit unions; (2) the NCUA's safety and soundness regulation of corporate credit unions; and (3) the NCUA's supervision of corporate credit unions.

A. INTRODUCTION AND BACKGROUND

1. A Credit Union for Credit Unions

Corporate credit unions are financial institutions that are cooperatively owned by their member credit unions.[154] Corporate credit unions serve their members primarily by investing and lending excess funds (unloaned deposits) that member credit unions place with them. Additional services provided by corporate credit unions include automated settlement, securities safekeeping, data processing, accounting, and paper-based and electronic payment services. These services are roughly comparable to the correspondent services that large commercial banks have traditionally provided to smaller banks.

The first corporate credit union commenced operations in 1968. Most corporate credit unions grew out of the various state credit union leagues. Director interlocks between corporate credit unions and these state-level trade associations were prohibited by the NCUA in 1994.[155]

As of year-end 1996, credit unions had $23 billion -- representing 7 percent of their total assets -- invested in corporate credit unions. The majority of these deposits in corporate credit unions exceed the $100,000 limit on federal deposit insurance and are thus uninsured.[156] It is this

---

[154] Ownership in corporate credit unions is represented by the deposit (share) accounts of their member credit unions, with each member having equal voting rights.

[155] This prohibition became effective on January 1, 1996. 59 Fed. Reg. 59,357, 59,360 (1994) (codified at 12 C.F.R. § 704.12).

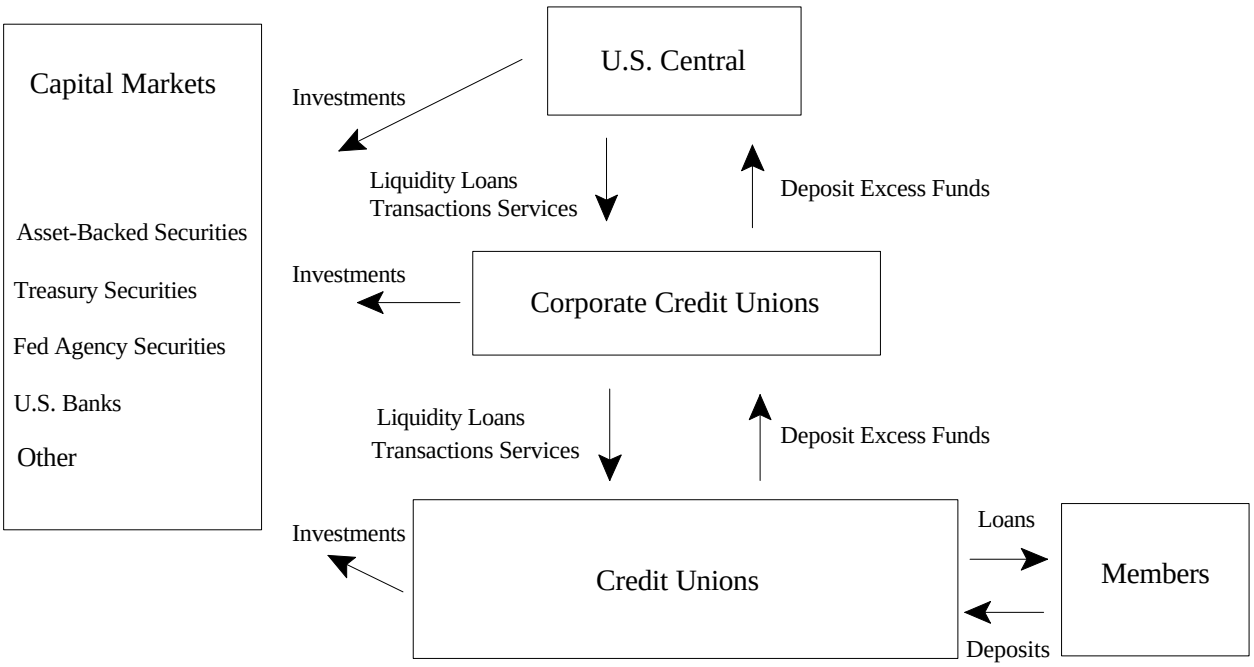
[156] Dividing the $23 billion in corporate credit unions by all 11,392 credit unions yields an average investment in corporate credit unions of roughly $2 million per credit union.

concentration of credit union assets that creates a public policy interest in the financial condition of corporate credit unions.

At year-end 1996, there were 41 corporate credit unions in operation. Of these, U.S. Central Credit Union serves as a "corporate's corporate" -- providing investment and liquidity services to 38 of the other 40 corporate credit unions. The remainder of this chapter considers only these 38 institutions and U.S. Central.[157]

Thus the nation's credit union system consists of three distinct tiers: the top tier at the national level (U.S. Central); the middle tier at the state or regional level (corporate credit unions); and the bottom tier at the local level (credit unions). Figure IV.1 depicts this structure.

Figure IV.1: The Structure of the Credit Union System



At the end of 1996, corporate credit unions had over $13 billion in deposits at U.S. Central, representing 57 percent of credit union deposits in corporate credit unions. This results

[157] Two corporate credit unions are not members of U.S. Central. The League of IBM Credit Unions (LICU), Endicott, NY, which provides limited services to a narrow membership group. LICU has total assets of $5 million and a core capital-to-assets ratio of 22 percent. The other is the Central Credit Union Fund, Inc., Auburn, MA. This corporate credit union has total assets of $14 million and a core capital-to-assets ratio of 4 percent.

in a significant investment concentration for credit unions and corporate credit unions. Because of the deposit linkages between the three tiers, the financial health of U.S. Central is of considerable importance in maintaining the safety and soundness of the nation's credit unions.

The 38 corporate credit unions considered here control some $30 billion in total assets. Table IV.1 presents data on the size of these institutions.[158] The largest corporate credit union (Western Corporate (WesCorp) with $9.7 billion in total assets) dwarfs the smallest (South Dakota Corporate Credit Union with $54 million in total assets). Although the average corporate credit union has $790 million in total assets, the median has only $366 million.

Table IV.1: Asset Distribution of Corporate Credit Unions
(Dollar figures in millions; data as of December 31, 1996)

Total Assets	$30,013
Largest	$9,672
Smallest	$54
Mean	$790
Median	$366

Source: NCUA, *5310 Call Report*.

Corporate credit unions have a dual (state and federal) chartering system. Of the 41 corporate credit unions, 15 have federal charters and 26 (including U.S. Central) have state charters. The NCUA's rules apply to all federally chartered corporate credit unions and all state-chartered corporate credit unions that accept deposits from federally insured credit unions.[159]

Corporate credit unions have designated fields of membership, typically consisting of the credit unions and credit union service organizations located in a particular state or group of states.[160] Fourteen state-chartered corporate credit unions have national fields of membership.[161] Some federally chartered corporate credit unions have also received approval to expand their

[158] These calculations omit U.S. Central to avoid double counting many assets.

[159] 12 C.F.R. § 704.1(a); 12 C.F.R. § 703.5(e).

[160] A credit union service organization (CUSO) is a corporation or limited partnership that provides services primarily to credit unions or members of affiliated credit unions.

[161] Five other state-chartered corporate credit unions have multi-state fields of membership.

fields of membership. As a result, most corporate credit unions have overlapping fields of membership.[162]

2. U.S. Central Credit Union

U.S. Central, located in Overland Park, Kansas, is a state-chartered credit union that provides wholesale financial services to corporate credit unions. It has historically functioned as a central depository for corporate credit unions and a conduit between those institutions and the capital markets. Table IV.2 summarizes U.S. Central's year-end 1996 balance sheet by asset type. Not surprisingly, investments constitute the vast majority of U.S. Central's assets (96 percent).

Table IV.2: U.S. Central Credit Union Asset Composition
(Dollar figures in millions; data as of December 31, 1996)

Assets	Total Amount	Percent of Assets
Net Investments	$17,165	96%
Net Loans	$685	4%
Net Fixed Assets	$3	0%
Other Assets	$72	0%
Total Assets	$17,925	100%

Source: NCUA, *5310 Call Report*.

U.S. Central keeps most of its assets in short-term investments of high credit quality to offset the overnight nature of its liabilities (50 percent of its deposits are overnight). Table IV.3 shows that 67 percent of U.S. Central's investment portfolio is in asset-backed securities.[163] Of these, 53 percent are backed by credit card receivables, 21 percent by home mortgages, and 16 percent by automobile loans. Some 97 percent of these asset-backed securities have AAA ratings.

[162] For example, Southwest Corporate Credit Union has the widest field of membership among federally chartered institutions. Its charter allows it to serve credit unions in 23 states plus Puerto Rico and the U.S. Virgin Islands.

[163] This figure also includes privately issued mortgage-backed securities.

Table IV.3: U.S. Central Credit Union Investments
(Dollar figures in millions; data as of December 31, 1996)

Investments	Total	% of Investments
U.S. Government Obligations	$473	3%
Federal Agency Securities	$84	0%
Central Liquidity Facility Stock	$678	4%
U.S. Banks	$278	2%
Repurchase Agreements	$2,788	16%
Government / Agency Mortgage Related Issues	$1,096	6%
Privately Issued Mortgage / Asset-Backed Securities	$11,506	67%
Corporate Debt	$255	1%
Credit Union Service Organizations	$4	0%
Total Investments	$17,162	100%

Source: NCUA, *5310 Call Report.*

U.S. Central's concentration in asset-backed securities represents a marked change in its investment strategy -- as it has moved away from very-short-term federal funds and repurchase agreements. For example, the proportion of U.S. Central's investment portfolio in repurchase agreements fell from 35 percent at year-end 1994 to 16 percent at year-end 1996. Likewise, U.S. bank deposits fell from 23 percent of the portfolio to 2 percent.

U.S. Central's asset-backed portfolio currently has a weighted average life of two years. In order to hedge some of the additional risk associated with mismatched assets and liabilities, U.S. Central often enters into interest rate swap agreements to match the cash flows from its asset-backed securities. To eliminate basis risk, it then matches these swaps with specific assets based on the same index.[164] Although these hedges mitigate interest rate risk, they do not eliminate the risk that market spreads could change (e.g., the price of a class of asset-backed securities could fall relative to other securities).

[164] Fitch Research, *Special Report: U.S. Central Credit Union,* Jun. 5 (New York: Fitch Investors Service, L.P., 1995), 4.

3. Investing Member Deposits

Most credit unions are small relative to other depository institutions; for example, 64 percent of all credit unions have less than $10 million in total assets. These small credit unions rely relatively more heavily on their corporate credit unions than do larger credit unions. Table IV.4 presents the average investment in corporate credit unions for various size classes of credit unions. For example, on average, credit unions with less than $2 million in total assets place 52 percent of their unloaned funds with corporate credit unions, while those with $2-10 million in assets place 44 percent of such funds with corporate credit unions. By contrast, credit unions above $50 million in total assets make more than 80 percent of their investments themselves. Nevertheless, their $13 billion investment in corporate credit unions dwarfs small credit unions' $448 million. These data indicate that, although large credit unions make a significant portion of their investments independently of corporate credit unions, their corporate credit union deposits are nevertheless sizable in dollar terms. As such, deposits from large credit unions represent corporate credit unions' dominant funding source.

Table IV.4: Credit Union Investments in Corporate Credit Unions
(Dollar figures in millions; data as of December 31, 1996)

Asset Category	Number of Institutions	Total Assets	Total Invest.	CCU Invest.	CCU Inv. (% Invest.)	CCU Inv. (% Assets)
< $2 million	3,352	$2,855	$860	$448	52%	16%
$2-10 million	3,942	$19,806	$6,029	$2,634	44%	13%
$10-50 million	2,814	$63,809	$18,618	$6,483	35%	10%
> $50 million	1,284	$240,413	$72,767	$13,188	18%	5%
All Credit Unions	11,392	$326,883	$98,274	$22,753	23%	7%

Source: NCUA, *1996 Yearend Statistics for Federally Insured Credit Unions*.

Corporate credit unions vary greatly not only in their asset size but also in the scope of their activities. Corporate credit unions historically acted as conduits of investment funds between credit unions and U.S. Central. In recent years, however, many corporate credit unions have begun investing directly in eligible fixed-income securities in order to earn higher yields. Most corporate credit unions still tend to place their overnight investments with U.S. Central. Table IV.5 compares the 10 largest corporate credit unions' investments at U.S. Central with those of the 28 other corporate credit unions. The 10 largest institutions have some 40 percent of their investments at U.S. Central, while the other 28 institutions have some 76 percent.

Table IV.5: Corporate Credit Unions' Investments in U.S. Central
(Dollar figures in millions; data as of December 31, 1996)

	Total Investments	U.S. Central Investments	U.S.C. Investments (% of Investments)
10 Largest CCUs	$19,381	$7,786	40%
28 Smallest CCUs	$7,586	$5,725	76%
Total	$26,967	$13,511	50%

Source: NCUA, *5310 Call Report.*

4. Corporate Credit Unions' Consolidated Balance Sheet

Corporate credit unions' balance sheets consist of high-quality, short-term investments funded by members' short-term deposits. Corporate credit union capital is segmented into primary and secondary accounts.

a. Assets

The composition of corporate credit unions' consolidated assets suggests that their investment function is currently more important than their role as liquidity provider (as proxied by loans to members). Indeed, Table IV.6 shows that investments constitute nearly 90 percent of corporate credit union assets.[165]

[165] This consolidated schedule aggregates the individual balance sheets of the 38 corporate credit unions. To avoid double counting, the analysis does not include U.S. Central.

Table IV.6: Corporate Credit Unions' Consolidated Assets
(Dollar figures in millions; data as of December 31, 1996)

Assets	Total	% of Total Assets
Net Investments	$26,967	90%
Net Loans to Members	$368	1%
Cash	$176	1%
Other Assets	$2,502	8%
Total Assets	$30,013	100%

Source: NCUA, *5310 Call Report*.

(1) Investments

In general, corporate credit unions' investment portfolios are of very high credit quality. At year-end 1996, deposits at U.S. Central (50 percent), asset-backed securities and corporate debt (26 percent), and federal agency securities (20 percent) comprised 96 percent of all corporate credit union investments (see Table IV.7).[166]

[166] Federal agency securities consist primarily of securities issued and guaranteed by GSEs. This category also includes federally guaranteed securities such as those of Ginnie Mae. Private securities consist of corporate debt and asset-backed securities. The new corporate credit union call report (5310) will have a specific line item for asset-backed securities. Currently, corporate credit unions itemize their "other investments" in schedule B of the 5310. However, there is significant variation in the level of reporting detail on these schedules.

Table IV.7: Corporate Credit Unions' Consolidated Investments
(Dollar figures in millions; data as of December 31, 1996)

Investment	Total	% of Total Investments
U.S. Govt. Obligations	$85	0%
Federal Agency Securities	$5,355	20%
U.S. Central	$13,511	50%
CMOs / REMICs	$688	3%
Commercial Banks	$278	1%
Credit Unions / CUSOs	$26	0%
NCUSIF Deposit	$9	0%
Other Investments	$7,032	26%
Investment Loss Provision	($18)	
Total Investments	$26,966	100%

Source: NCUA, *5310 Call Report*.

(2) Loans to Members

Corporate credit unions are currently well positioned to meet their members' normal liquidity needs as corporate credit unions' balance sheets consist of high-quality investments with relatively short maturities. Some of the larger corporate credit unions have also taken steps to ensure contingency funding by establishing commercial paper programs or obtaining lines of credit. In addition, corporate credit unions (including U.S. Central) are currently developing a credit union loan securitization program that will serve to provide credit unions with an additional liquidity option. Although these initiatives should help increase credit union liquidity, we have concerns about the extent to which the credit union system would have sufficient access to liquidity during periods of financial stress. Chapter V examines credit union liquidity -- particularly credit unions' access to emergency liquidity.

b. Liabilities

Corporate credit union liabilities include general liabilities and deposit (share) accounts. Credit union deposits in corporate credit unions total $25 billion, or 86 percent of total corporate credit union liabilities. The remainder of corporate credit union liabilities consist of notes payable

and uncollected deposits. As Table IV.8 indicates, overnight deposits constitute 57 percent of total credit union deposits, while time deposits constitute an additional 36 percent.

Table IV.8: Corporate Credit Unions' Consolidated Deposit Accounts
(Dollar figures in millions; data as of December 31, 1996)

Account	Total	% of Total Deposits
Shares/Daily Transactions Accts.	$14,369	57%
Time Certificates	$8,975	36%
Membership Shares*	$1,673	7%
Repurchase Certificates	$5	0%
Total Deposits	$25,022	100%

Source: NCUA, *5310 Call Report.*

* Membership shares may include membership capital accounts, which constitute secondary capital.

---

c. Capital

Like other credit unions, corporate credit unions accumulate capital -- net worth -- by retaining earnings in various reserve accounts. These reserves and undivided earnings constitute core capital for regulatory purposes. Core capital can also include paid-in capital. The NCUA describes paid-in capital as funds obtained from credit union and non credit union sources, having no maturity, and being callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital after the funds are called.[167] To date, only WesCorp has issued paid-in capital.

Corporate credit unions may also raise secondary capital -- in the form of "membership capital" -- from their members. Membership capital involves an uninsured deposit that, if the corporate credit union were to fail, would be subordinated to both the Share Insurance Fund and member deposits. Membership capital can be withdrawn only on one to three years notice. Table IV.9 provides the weighted-average capitalization of corporate credit unions (excluding U.S. Central). As of year-end 1996, core capital equaled 3.3 percent of corporate credit union assets, while secondary capital equaled 5.4 percent.[168]

---

[167] 12 C.F.R. § 704.2.

[168] The data on secondary capital include membership capital share deposits and membership capital accounts.

Table IV.9: Corporate Credit Unions' Consolidated Capital
(Dollar figures in millions; data as of December 31, 1996)

Capital	Total	Percent of Assets
Core Capital	$979	3.3%
Secondary Capital	$1,612	5.4%
Total Capital	$2,591	8.7%

Source: NCUA, *5310 Call Report*.

Corporate credit unions' total assets -- and thus their regulatory capital ratios -- vary seasonally and cyclically. For example, many credit unions experience significant deposit outflows around the holiday season and, in turn, draw down their corporate credit union accounts. In addition, both U.S. Central and WesCorp participate in the Treasury Tax and Loan program, which has its own seasonality. Because corporate credit unions have difficulty in quickly adding reserves, large inflows (outflows) of deposits may decrease (increase) their core capital-to-assets ratio.

Recent studies of corporate credit unions by the GAO (1991) and Black, et al. (1994) emphasized the need for higher capital ratios.[169] Managers of corporate credit unions had long questioned the need for having more than 2 percent capital, citing their cooperative structure and the high credit quality of their investment portfolios. However, in addition to credit risk, corporate credit unions face market (interest rate) risk, liquidity risk, and operational risk.

The adequacy of corporate credit unions' capital is particularly important because of the interdependence of the credit union system's three tiers. Membership capital accounts, which constitute secondary capital for corporate credit unions, are essentially a device for up-streaming net worth from credit unions to corporate credit unions. Effective January 1998, an NCUA rule will limit the sum of a credit union's investment in membership capital accounts and paid-in capital to 1 percent of its total assets.[170] If a corporate credit union were to fail, credit unions holding membership capital accounts could have to write off some (or all) of the value of these accounts. Credit unions would then take a charge against their net worth for the amount written

[169] GAO, *Credit Unions: Reforms for Ensuring Future Safety* (Washington, DC: GAO, 1991), 144-51 and 164-65; and Harold Black, Albert DePrince, William Ford, James Kudlinski, and Robert Schweitzer, *Corporate Credit Union Network Investments: Risks and Risk Management* (Alexandria, VA: NCUA, 1994), 45-54.

[170] 62 Fed. Reg. 33,989, 34,003 (1997) (to be codified at 12 C.F.R. § 703.100(c)); effective on January 1, 1998).

off. If losses exceeded a corporate credit union's reserves, any paid-in capital, and membership capital accounts, the uninsured portion of each member's deposits would then be at risk.

5. Recent History

Two recent incidents -- U.S. Central's investment in a failed foreign bank, Banco Espanol de Credito (Banesto), and the failure of a large corporate credit union, Capital Corporate Credit Union (Cap Corp) of Lanham, Maryland -- led to increased scrutiny of both corporate credit unions and the NCUA. In the first instance, U.S. Central recouped all of its $255 million investment in Banesto, a bank seized by the Spanish government in 1993. Following that incident, an immediate, voluntary moratorium ensued on all foreign investments until the NCUA could comprehensively review corporate credit union investments.

The failure of Cap Corp in January 1995 raised specific concerns about the interest rate risk that corporate credit unions were taking, particularly with their investments in collateralized mortgage obligations. Congress held hearings in early 1995 to examine these issues. The GAO testified that Cap Corp's failure resulted from "inadequate board oversight of an inappropriate investment strategy." The GAO also criticized the NCUA's supervision of Cap Corp. The GAO outlined five factors that precipitated the failure of Cap Corp:

- Cap Corp lacked an effective risk management system and effective board oversight.
- Cap Corp's accounting did not reflect declining market values.
- The NCUA's examination and supervision of Cap Corp were inadequate.
- The NCUA's call report data were too limited and inaccurate.
- The NCUA's capital standards were inadequate and not targeted to corporate credit union risks.[171]

Two other studies also focused attention on corporate credit unions and the NCUA. The GAO's (1991) study presented the following recommendations -- each of which the NCUA subsequently implemented:

- Permit a federally insured credit union (or corporate credit union) to invest in other credit unions only if those institutions are federally insured.[172]

---

[171] GAO, *Credit Unions: The Failure of Capital Corporate Federal Credit Union*, statement of Charles A. Bowsher, Comptroller General, Feb. 28 (Washington, DC: GAO, 1995), 2-6.

[172] This recommendation sought NCUA supervisory authority over state-chartered corporate credit unions. In 1991, the NCUA prohibited federal credit unions from purchasing shares or deposits from corporate credit unions that either did not comply in significant respects with the NCUA's corporate credit union regulation, part 704, or were not examined by the NCUA. 56 Fed. Reg. 56,000, 56,003 (1991). This prohibition became effective on

- Increase corporate credit unions' capital ratios and set maximum limits (based on total assets) on loans to or investments in a single entity by corporate credit unions.

- Obtain more complete information about corporate credit unions for use in assigning CAMEL ratings.

Commissioned by the NCUA, Black, et al.'s (1994) study, *Corporate Credit Union Network Investments: Risks and Risk Management*, included the following recommendations, which the NCUA also subsequently implemented:

- The NCUA should establish stronger capital standards, including primary and risk-based requirements. Risk-based requirements should take account of credit risk, interest rate risk, and derivative activities.

- Corporate credit unions, instead of simply reviewing published reports by rating agencies or the financial press, should develop internal credit quality systems to monitor all assets subject to credit risk.

- The NCUA should revise its limit on a corporate credit union's maximum allowable exposure to one borrower by making the limit a percentage of core capital rather than a percentage of assets.

- The NCUA should improve its oversight of corporate credit unions' interest rate risk management practices.

- Corporate credit union management should understand the investments in their portfolios.

- The NCUA needs to retain corporate credit union examiners that specialize in derivatives.

Part 704 of the NCUA's regulations, together with the relevant provisions of the Federal Credit Union Act, constitute the primary rules governing corporate credit unions.[173] The NCUA first issued part 704 in 1982. In 1995, the NCUA proposed a comprehensive revision of part 704 in response to concerns arising from the failure of Cap Corp, the findings and recommendations in the GAO's 1991 and 1994 reports, and the Black, et al. (1994) study of corporate credit unions' risk management practices. In 1996, the NCUA revised that proposal and re-issued it for public

---

December 1, 1992. 57 Fed. Reg. 22,626, 22,626 (1992). Effective January 1, 1998: (1) corporate credit unions must adhere to the requirements of part 704, which will require them to submit to NCUA examinations in order to accept deposits or shares from federally insured credit unions; and (2) federal credit unions may not purchase the shares or deposits of corporate credit unions identified by the NCUA as not complying with part 704. 62 Fed. Reg. 12,929, 12,938 (1997) (to be codified within the corporate credit union regulation at 12 C.F.R. § 704.1(a)); 62 Fed. Reg. 33,989, 34,003 (1997) (to be codified within the regulation on investment and deposit activities of federal credit unions at 12 C.F.R. § 703.100(c)).

[173] 12 C.F.R. pt. 704.

comment. The NCUA issued a final regulation in March 1997 after evaluating the 289 comments received and making relatively minor revisions. The new regulation, described in detail in Section C, becomes effective January 1, 1998.

6. Study Mandate and Methodology

Congress directed us to study and evaluate: the 10 largest corporate credit unions in the United States including their "investment practices" and their "financial stability, financial operations, and financial controls"; and the NCUA's supervision of corporate credit unions.[174]

Congress directed us, in evaluating the 10 largest corporate credit unions, to work with "appropriate employees of other Federal agencies with expertise in the examination of federally insured financial institutions." Working with the OCC, we assembled an interagency team of six bank and thrift examiners. The interagency team consisted of three examiners from the OCC (New York, Chicago, and San Francisco offices), and one each from the Federal Reserve System (Federal Reserve Bank of Atlanta), the FDIC (Dallas office), and the OTS (New York office). The examiners spent three months working nearly full-time on this project.

The interagency team did not itself conduct a formal, on-site examination of the corporate credit unions. Instead, the team observed and evaluated the results of the NCUA's examinations of these institutions, and discussed the approach to and findings of such examinations with appropriate NCUA staff.

At the beginning of its work, the interagency team attended a half-day presentation on corporate credit unions' activities and operations made to the Treasury by the Association of Corporate Credit Unions. In evaluating the 10 largest corporate credit unions, the interagency team reviewed and assessed NCUA documentation, including examiner work papers, correspondence, and reports of examination. The team also interviewed various NCUA officials. At the end of one month, the team completed its initial review of the NCUA documents. The team then spent two weeks conducting on-site visits to U.S. Central in Overland Park, Kansas, and WesCorp in San Dimas, California. During these visits, the team met with each of the two corporate credit unions' senior management team, reviewed credit union documents, and observed certain operational and risk assessment activities to better gauge management performance and overall operations.

The interagency team also evaluated the NCUA's supervision of corporate credit unions. The team reviewed the organization of the Office of Corporate Credit Unions and the examiner guidance used. The team also reviewed the NCUA's part 704 regulation.

---

[174] Pub. L. 104-208, § 2606, 110 Stat. 3009-394, 3009-473 (1996) (codified at 12 U.S.C. § 1752a note).

Throughout its existence, the interagency team worked closely with Treasury staff. The team concluded its work by reporting its findings to the Treasury. The findings and recommendations in this study, although reflecting the significant contributions made by the interagency team, are those of the Treasury.

We have organized the remainder of this chapter as follows: Section B describes the financial condition of the 10 largest corporate credit unions and U.S. Central. Section C reviews the NCUA's corporate credit union regulations. Section D assesses the NCUA's supervision of those institutions. Section E summarizes our findings and recommendations.

B. THE 10 LARGEST CORPORATE CREDIT UNIONS

This section describes the overall financial condition of the 10 largest corporate credit unions. Specifically, we report on our general findings and observations, followed by our evaluation of the investment practices, and financial stability, financial operations, and financial controls of the 10 largest corporate credit unions. The statutory study mandate did not clearly indicate whether U.S. Central constituted a corporate credit union for purposes of determining the 10 largest corporate credit unions. Accordingly, we decided to evaluate both U.S. Central *and* the 10 largest corporate credit unions serving regular credit unions. Table IV.10 ranks the 11 largest corporate credit unions by asset size.

Table IV.10: The 11 Largest Corporate Credit Unions by Asset Size
(Dollar figures in millions; data as of December 31, 1996)

Corporate Credit Union	Location	Total Assets
U.S. Central	Overland Park, KS	$17,925
WesCorp	San Dimas, CA	$9,672
Southwest	Dallas, TX	$2,660
CenCorp	Detroit, MI	$1,508
Empire State	Albany, NY	$1,367
Mid-States	Naperville, IL	$1,364
Mid-Atlantic	Harrisburg, PA	$1,304
Southeast	Tallahassee, FL	$1,201
Corporate One	Columbus, OH	$829
Indicorp	Indianapolis, IN	$794
Constitution State	Wallingford, CT	$656

Source: NCUA, *5310 Call Report*.

1. General Findings and Observations

Corporate credit unions give small credit unions a safe place to invest their unloaned deposits. Small credit unions turn to corporate credit unions because they often do not have the size or investment expertise necessary to invest on their own. This arrangement, while a strength of the credit union system, demonstrates the importance of safe and sound operations at corporate credit unions.

Based on our review of the 10 largest corporate credit unions and U.S. Central, we have three general findings. First, corporate credit unions are thinly capitalized and operate with narrow margins. Second, an interdependence risk exists among corporate credit unions and U.S. Central. Third, corporate credit unions are facing increasing competitive pressures from each other and from other market participants.

a. Corporate Credit Unions are Thinly Capitalized and Operate with Narrow Margins

Corporate credit unions invest in high-quality assets and thus have limited exposure to credit risk. Their investments are mostly short-term to maintain a liquid balance sheet. At the same time, corporate credit unions tend to be thinly capitalized (that is, have a relatively small ratio of net worth to assets) and operate with very narrow margins (that is, have only a small spread between their interest earnings and interest expenses). These narrow margins hinder corporate credit unions from increasing their capital quickly through retained earnings.

The combination of thin capitalization and narrow margins leaves little room for error and heightens the importance of proper internal controls and strong management. Corporate credit unions' asset size may also fluctuate greatly as member deposits rise and fall, and as member loan demand changes. This potential volatility, combined with the difficulty of building capital quickly through retained earnings, reinforces the need for a sufficient capital base. Table IV.11 shows the return on assets and net interest margin (NIM) for the 10 largest corporate credit unions and U.S. Central during 1996.

Table IV.11: Corporate Credit Union Earnings
(In basis points; data as of December 31, 1996)

Corporate Credit Union	Net Income to Total Assets	NIM to Interest-Earning Assets
U.S. Central	16.07	24.05
WesCorp	24.24	41.74
Southwest	27.87	69.04
CenCorp	27.95	67.94
Empire State	50.48	74.51
Mid-States	37.82	58.21
Mid-Atlantic	30.48	70.07
Southeast	42.45	54.08
Corporate One	34.83	95.00
Indicorp	36.79	66.16
Constitution State	10.73	54.61

Source: NCUA, *5310 Call Report*.

*NIM is calculated as follows: [(interest earnings - interest expenses) / interest-earning assets]*100. Interest-earning assets equal the sum of total loans and total investments. Figures are then converted to basis points by multiplying by 100. A basis point is one hundredth of a percent.

Table IV.12 shows the core, secondary, and total capital ratios for the 10 largest corporate credit unions and U.S. Central.[175] Core capital consists of reserves and paid-in capital; secondary capital consists of membership capital accounts. At the end of 1996, one corporate credit union (Mid-Atlantic) had core capital of less than 3 percent. U.S. Central had core capital of 1.4 percent. However, none of these corporate credit unions had core capital exceeding 4 percent of assets.

[175] The NCUA bases its regulatory capital requirements for corporate credit unions on a percentage of average daily net assets. 12 C.F.R. § 704.2. Our calculations are based on year-end data, because the call report data (through year-end 1996) did not include average daily net assets.

Table IV.12: Corporate Credit Union Capital Ratios
(In percentage points; data as of December 31, 1996)

Corporate Credit Union	Core capital (% Total Assets)	Secondary Capital (% Total Assets)	Total Capital (% Total Assets)
U.S. Central	1.4%	3.5%	4.9%
WesCorp	3.1%	2.2%	5.3%
Southwest	4.0%	6.8%	10.8%
CenCorp	3.3%	7.6%	10.9%
Empire State	3.8%	5.5%	9.3%
Mid-States	3.8%	6.0%	9.8%
Mid-Atlantic	2.7%	8.1%	10.8%
Southeast	3.8%	8.5%	12.3%
Corporate One	3.2%	9.7%	12.9%
Indicorp	3.5%	8.2%	11.7%
Constitution State	3.9%	3.7%	7.6%

Source: NCUA.

In recent years the NCUA has encouraged corporate credit unions to increase their net worth. (In the next section, we will describe in detail the NCUA's recent regulatory changes in corporate credit unions' net worth requirements.) Table IV.13 provides the core capital ratios for the 10 corporate credit unions since 1994.

Table IV.13: Corporate Credit Union Core Capital as a Percent of Total Assets: 1994-1996

Corporate Credit Union	1994	1995	1996
U.S. Central	1.3%	1.3%	1.4%
WesCorp	2.0%	2.3%	3.1%
Southwest	2.1%	3.1%	4.0%
CenCorp	2.8%	3.0%	3.3%
Empire State	2.7%	2.8%	3.8%
Mid-States	2.6%	3.4%	3.8%
Mid-Atlantic	3.4%	2.2%	2.7%
Southeast	3.2%	3.1%	3.8%
Corporate One	2.0%	2.9%	3.2%
Indicorp	1.8%	2.6%	3.5%
Constitution State	2.3%	3.5%	3.9%

Source: NCUA.

The ratios show that corporate credit unions have significantly enhanced their capital positions. In general, these corporate credit unions have accomplished this by increasing their overall levels of core capital, while reducing their total assets. We believe that this trend is critically important and that further increases in net worth are essential. We anticipate that the NCUA's new corporate credit union regulation will encourage corporate credit unions to continue to build their net worth. In particular, we believe that the new regulation correctly bases permissible investment risk on core capital[176] and emphasizes the importance of corporate credit unions coming to rely on core capital rather than secondary capital.

[176] The regulation requires a corporate credit union to limit the effect of changes in interest rates to its net economic value. The required degree of interest rate risk testing is based on a corporate credit union's level of operating powers. Expanded operating powers, which permit corporate credit unions to assume more interest rate risk, require increasing levels of core capital relative to total assets. 12 C.F.R. § 704.8.

b. An Interdependence Risk Exists Among Corporate Credit Unions and U.S. Central

The three-tier cooperative structure of the credit union system creates an interdependence risk among and within the various levels.[177] Specifically, a credit union's deposits at its corporate credit union, and its membership capital account, are assets on its books. At the same time, the credit union's corporate credit union carries these funds as (largely uninsured) deposits and secondary capital, respectively, on its balance sheet. The same relationship holds between corporate credit unions and U.S. Central. Thus, if U.S. Central were to fail, its member corporate credit unions could face losses on their deposits -- reducing their own net worth. Similarly, if a corporate credit union were to fail, its member credit unions could face losses on their deposits and thus a reduction in their net worth.

This interdependence raises at least two issues. First, each level must have sufficient net worth relative to the risks undertaken so as not to pose a risk of losses cascading to the level below it. Second, the current structure facilitates the movement of excess funds around the credit union system to meet the liquidity needs in a particular geographic area or at a particular credit union. However, if a system-wide demand for liquidity arises, corporate credit unions have only limited ability to bring in liquidity from outside the credit union system. Corporate credit unions would largely have to rely on liquidating their investments to meet their members' liquidity needs, but members' deposit withdrawals would tend to deplete those investments. We explore in the next chapter the issue of liquidity risk and the limits on corporate credit unions' ability to deal with a systemic demand for liquidity.

c. Competition

Corporate credit unions face increasing competitive pressure from each other (due largely but not entirely to their overlapping fields of membership) and from other market participants. The investment, liquidity, and transaction services that corporate credit unions offer to their members are by no means unique; viable market alternatives exist, although small credit unions may have access to a far more limited range of alternatives than large credit unions.

In many ways, large credit unions form the backbone of the corporate credit union structure. Large credit unions make the vast majority of the deposits at corporate credit unions and they often provide the volume of transaction services necessary for a given corporate credit union to provide those services economically to its smaller members. At the same time, most, if not all, large credit unions could find alternatives to their corporate credit union. As shown in Table IV.4, large credit unions deposit a much smaller portion of their unloaned funds in their corporate credit union than do small credit unions. This is because many large credit unions have the ability to make investments directly. Large credit unions may also undertake transaction

[177] See Figure IV.1 on p. 86.

services in-house rather than relying on their corporate credit union and, in any event, are large enough to be attractive customers for other firms offering such services to depository institutions.

This competitive environment poses important safety and soundness issues for both the near-term and the long-term. Some consolidation among corporate credit unions has begun and we anticipate more in the future. It is unclear what the corporate system will look like in 5 to 10 years, but it is quite likely to look much different than today. How corporate credit unions and their members respond to competition among themselves and from other market participants -- whether through rapid growth, developing new activities, increased risk-taking, consolidation, shifting business strategy, or standing still -- will determine the sort of safety and soundness issues that will arise. The NCUA will clearly need to monitor these developments closely.

2. Investment Practices

Having analyzed the investment portfolios of the 10 largest corporate credit unions and U.S. Central, we concluded the following: (1) that those portfolios generally have little credit risk exposure, but that concentration risk is an issue; and (2) that some institutions' portfolios are vulnerable to changes in interest rates.

As Table IV.14 indicates, corporate credit unions' investments are almost entirely in U.S. Central, federal agency securities (primarily GSE securities), or asset-backed securities (the principal component of "other investments"). Likewise, as shown in Table IV.3, U.S. Central's investments are primarily in federal agency and asset-backed securities. These investments, most of which carry the highest rating assigned by private rating agencies, have limited credit risk.

Table IV.14: Investments of the 10 Largest Corporate Credit Unions
(In percentage points; data as of December 31, 1996)

Corporate Credit Union	Federal Agency Securities	Deposits in U.S. Central	Other Investments
WesCorp	43%	42%	10%
Southwest	22%	18%	53%
CenCorp	1%	22%	68%
Empire State	6%	58%	34%
Mid-States	0%	36%	58%
Mid-Atlantic	3%	63%	18%
Southeast	2%	88%	10%
Corporate One	11%	17%	67%
Indicorp	31%	33%	25%
Constitution State	13%	15%	40%

Source: NCUA, *5310 Call Report*.

The NCUA's recently revised corporate credit union regulation establishes concentration limits on a corporate credit union's investments in the obligations of a particular issuer (excluding U.S. Central and the federal government and its agencies). However, the regulation does not limit concentration by asset class. Thus for example, a corporate credit union could hold an unlimited share of its investments in, credit card receivables, as long as it did not exceed the limit on exposure to any single issuer. The risk with concentration in a single asset class is the possibility that market events have a deleterious effect on all issuers of that class of securities. For example, a significant increase in the general rate of credit card charge-offs could lower the market's perception of the credit worthiness of credit card receivables, and thus the value of all such securities, regardless of issuer.

A few years ago, collateralized mortgage obligations issued by GSEs and Ginnie Mae were the preferred investment for many corporate credit unions. Although posing limited credit risk, these investments are particularly sensitive to changes in interest rates. Poor management of this interest rate risk brought down Cap Corp and led to significant problems at several other corporate credit unions. Many of the corporate credit unions we evaluated have been moving away from investments in collateralized mortgage obligations and towards other types of asset-backed securities (such as credit card receivables and home equity loans). This shift in investment

practices evidently reflects a desire to reduce the interest rate risk associated with collateralized mortgage obligations, while maintaining a high yield relative to other highly-rated securities.

We have several concerns about this apparent concentration of corporate credit union investments in particular classes of assets. First, corporate credit unions' generally low net worth ratios leave little room for error. Second, although the NCUA limits the amount that a corporate credit union can invest in obligations of a single issuer it does not limit the amount that a corporate credit union may invest in a single class of assets. Third, the risks of concentrating investments in a single asset class are exacerbated by the interdependence risk among corporate credit unions and by the relative homogeneity of different corporate credit unions' balance sheets.

We therefore recommend that the NCUA develop policy guidance or regulations governing asset concentration risks. The NCUA also needs to consider the implications of such concentration risk across all corporate credit unions. That is, although an examiner may conclude that any one corporate credit union's concentration in a particular asset class is within some acceptable level of tolerance, the NCUA should also consider the corporate system's overall exposure to that particular asset class.

3. Financial Stability, Financial Operations, and Financial Controls

Previous reports on corporate credit unions,[178] as well as the NCUA's recent experience with Cap Corp and other corporate credit unions, have indicated concerns about corporate credit unions' financial stability, operations, and controls. Based on our review of the NCUA's examinations of U.S. Central and the 10 largest corporate credit unions, we found continued problems involving internal controls and management quality at some institutions -- although improvements have been made. We also found that, during the most recent examination cycle, the NCUA had various degrees of concern about 6 of the 11 corporate credit unions. Table IV.15 aggregates the NCUA's CAMEL ratings for the 11 corporate credit unions studied.

[178] GAO, *Credit Unions: Reforms for Ensuring Future Safety* (Washington, DC: GAO, 1991); and Harold Black, Albert DePrince, William Ford, James Kudlinski, and Robert Schweitzer, *Corporate Credit Union Network Investments: Risks and Risk Management* (Alexandria, VA: NCUA, 1994).

Table IV.15: Aggregate CAMEL Ratings for the 11 Largest Corporate Credit Unions
(Data as of December 31, 1996)

	CAMEL 1	CAMEL 2	CAMEL 3	CAMEL 4	CAMEL 5
Capital	1	6	3	1	0
Asset Quality	4	4	3	0	0
Management	1	4	5	1	0
Earnings	2	6	3	0	0
Liquidity	2	8	1	0	0
Composite	1	4	5	1	0

Source: NCUA.

The NCUA identified internal control weaknesses in 4 of the 11 institutions. For example, the NCUA cited 2 institutions for internal control problems relating to access and authority levels for data processing and wire transfer systems. The NCUA described these weaknesses as readily correctable by the institutions. Nevertheless, corporate credit unions' thin capitalization and margins reinforce the need for strong internal controls.

In 6 of the 11 institutions, the NCUA gave management a CAMEL rating of 3 or worse, indicating some material concern about management (5 had a CAMEL rating of 3; 1 had a rating of 4). According to the NCUA, a rating of 3 reflects performance that is lacking in some measure of competence desirable to meet the responsibilities of the situation in which management is found. Either it is characterized by modest talent when above average abilities are called for, or it is distinctly below average for the type and size of the corporate credit union it operates.

Finally, the NCUA classified 5 of the 11 corporate credit unions as "institutions raising a degree of concern," while another raised even more serious concerns. Specifically, 5 had a composite CAMEL rating of 3, and one had a composite CAMEL rating of 4. However, 2 of these 6 institutions had ratings of 2 for each CAMEL component except management; the NCUA has a policy of basing a corporate credit union's composite CAMEL rating on the lowest component rating.

In short, we found that the general condition of the largest corporate credit unions has improved in recent years but that lingering difficulties from past investment problems, weak management, or poor internal controls must be dealt with by individual institutions and monitored by the NCUA.

C. THE NCUA'S CORPORATE CREDIT UNION REGULATIONS

We studied and evaluated the NCUA's corporate credit union regulations -- particularly part 704, which establishes capital requirements and other risk parameters for corporate credit unions. This section refers to the regulation currently in effect as "Old 704" and the regulation that becomes effective in 1998 as "New 704." We reviewed both Old 704 and New 704, as well as the regulations that part 704 incorporates by reference.[179] We compared these regulations with those of the other federal depository institution regulators to help assess the adequacy of the NCUA's guidance and oversight for corporate credit unions. We also reviewed prior studies of corporate credit unions to determine the extent to which changes to the NCUA's regulations resolve past concerns.

New 704 contains numerous changes that should help make corporate credit unions safer and sounder. In particular New 704: (1) strengthens minimum capital requirements; (2) clarifies the responsibilities of a corporate credit union's management and board of directors; (3) explicitly limits exposure to interest rate risk; (4) implements strict credit review procedures; and (5) requires corporate credit unions to formulate liquidity contingency plans.

New 704 specifically requires corporate credit unions to maintain total capital of at least 4-6 percent of total assets, depending on the complexity and risk sensitivity of the institution's investment portfolio.[180] Old 704, by contrast, employs a risk-based standard keyed to credit risk. That standard is inappropriate given that corporate credit unions generally have little credit risk exposure. New 704 also emphasizes the need for corporate credit unions, over time, to rely more on core capital than on secondary capital. In the preamble to New 704, the NCUA wrote:

> This final rule is designed to strengthen core capital so that the corporate credit union network can better withstand financial stress without placing an inappropriate reliance upon its membership resources. Corporate credit unions should gradually reduce their reliance on secondary capital as core capital accumulates over time.[181]

The New 704 also permits corporate credit unions to build core capital by issuing paid-in capital.[182] For corporate credit unions, paid-in capital is subordinate to membership capital accounts. Thus, in order to assume such risk, providers of such capital demand higher returns. The ability of non-credit union investors to have an ownership stake in corporate credit unions could have implications for their operating objectives (i.e., they could become motivated to

---

[179] Other regulations relating to corporate credit unions include parts 701 (organization and operation of federal credit unions), 703 (investment and deposit activities), 709 (involuntary liquidation of federal credit unions and adjudication of creditors), 725 (Central Liquidity Facility), and 741 (requirements for insurance).

[180] 62 Fed. Reg. 12,929, 12,940 (1997) (to be codified at 12 C.F.R. § 704.3(b)); *Id*. at 12,948 (to be codified at 12 C.F.R. pt. 704 app. B).

[181] *Id.* at 12,930.

[182] *Id.* at 12,940 (to be codified at 12 C.F.R. § 704.2).

maximize earnings). However, corporate credit union paid-in capital, as currently structured by the NCUA, does not include voting rights. This structure limits the attractiveness of investment in corporate credit unions from outside the credit union system.

New 704 also specifically articulates the respective duties of a corporate credit union's management and board of directors.[183] For example, it requires the board to "understand the role that financial instruments play in the corporate credit union's business strategies" and to provide adequate staffing as well as the technological and financial resources required to support the institution's investment activities.

In general, New 704 contains more stringent investment restrictions than Old 704, although a corporate credit union can take on more credit and interest rate risk if it meets higher capital, managerial, procedural, and systems requirements.[184] For example, corporate credit unions with at least 5 percent capital may, with NCUA approval, purchase long-term investments rated no lower than AA- and asset-backed securities rated no lower than AA.

New 704 limits corporate credit unions' interest rate risk exposure. First, corporate credit unions must keep their net economic value (NEV) -- i.e., the fair value of their assets minus the fair value of their liabilities -- above 1 percent of their total assets.[185] Second, corporate credit unions must periodically test the interest rate sensitivity of their portfolios to determine the change in NEV resulting from changes in interest rates. Specifically, changes in NEV are based on interest rate shock scenarios in which interest rates are increased and decreased 100 to 300 basis points and resulting changes in a portfolio's NEV are examined.[186] New 704 allows for a maximum simulated decline in NEV of 18-50 percent based on the institutions' level of operating authorities.[187]

Credit review procedures set forth in New 704 establish minimum credit ratings for certain investments as well as specific reporting and documentation procedures.[188] For example, the new regulation limits a corporate credit union's unsecured loans to one member to the greater of 50 percent of total capital or 75 percent of core capital and limits secured loans to one member to the greater of 100 percent of total capital or 200 percent of core capital.[189] The regulation also

---

[183] *Id.* at 12,942 (to be codified at 12 C.F.R. § 704.4).

[184] *Id.* at 12,948-49 (to be codified at 12 C.F.R. pt. 704 app. B).

[185] *Id.* at 12,944 (to be codified at 12 C.F.R. § 704.8(d)(ii)). These calculations must include the value of forward settlements, embedded options, and such off-balance sheet financial derivatives as futures, options, interest rate swaps, and forward rate agreements, and must treat member capital accounts as liabilities.

[186] *Id.* at 12,944 (to be codified at 12 C.F.R. § 704.8(d)(i)).

[187] *Id.* at 12,948-49 (to be codified at 12 C.F.R. pt. 704 app. B).

[188] *Id.* at 12,943-44 (to be codified at 12 C.F.R. § 704.6(d) and (e)).

[189] *Id.* at 12,944 (to be codified at 12 C.F.R. § 704.7(c)).

requires the corporate credit union to compile a monthly "watch list" of existing or potential credit problems -- so that it can justify any decision to hold a downgraded investment.[190]

New 704 limits lending and investment concentrations as a percentage of a corporate credit union's capital -- in contrast to Old 704's limitation of investments to a percentage of assets. Specifically, New 704 limits investments in any mortgage-backed security, asset-backed security, or trust to 200 percent of core capital, and limits repurchase and securities lending agreements to 400 percent of core capital. New 704 does not apply concentration limits to investments in U.S. Central.

The new regulation also requires a corporate credit union to follow strict liquidity policies and procedures, which include having a liquidity contingency plan. Each corporate credit union must evaluate its members' potential liquidity needs under a variety of economic scenarios, monitor its sources of liquidity, and demonstrate that its designation of investments as available for sale or held to maturity are consistent with the corporate credit union's liquidity needs.[191]

The changes just listed reflect significant improvements the NCUA has made in its regulation of corporate credit unions. With corporate credit unions operating in a highly dynamic market and, with financial theory and practice continuing to evolve, the NCUA will, over time, need to reexamine various elements of the new regulation. In fact, when the NCUA published New 704, it committed itself to issuing a report on issues involving the new regulation within 18 months.[192] The NCUA may wish to monitor the following aspects of New 704.

First, with respect to NEV calculations, models offered by various vendors and outside service providers may provide dissimilar results. Thus a corporate credit union may be inclined to select a model that puts the institution's portfolio in the most favorable light, rather than the model that best reflects the risks in that portfolio.

Second, given the intensive risk management required for modeling and managing interest rate risk in New 704, the requirement to test individual securities may be redundant.[193] Although pre-purchase interest rate sensitivity testing is crucial to understanding how the characteristics of a particular security may influence a portfolio, post-purchase testing is unnecessary if prudent risk management systems are in place.

Third, New 704 permits all corporate credit unions to invest in securities with embedded options, such as collateralized mortgage obligations. However, the NCUA permits corporate

---

[190] *Id.* at 12,943-44 (to be codified at 12 C.F.R. § 704.6(e)).

[191] *Id.* at 12,945 (to be codified at 12 C.F.R. § 704.9).

[192] *Id.* at 12,929.

[193] The other federal depository institution regulators (through the Federal Financial Institutions Examination Council), having decided to emphasize institution-wide risk management, are in the process of rescinding existing securities testing requirements. 62 Fed. Reg. 51,862 (1997) (proposed Oct. 3, 1997).

credit unions to invest in interest rate risk reducing derivatives only if they meet rigorous standards.[194] Such restrictions limit corporate credit unions' ability to hedge the risks associated with these permissible investments.

In summary, New 704 represents a significant improvement in the NCUA's corporate credit union regulations. At the same time some of the regulation's prohibitions seemingly reflect concern about corporate credit unions' ability to manage some of the risks they undertake. We anticipate that as the NCUA and corporate credit unions gain experience with the new regulation -- and as both the NCUA's supervisory expertise and corporate credit unions' management expertise continue to develop -- the NCUA can and should make modifications to the new rules.

D. THE NCUA'S OVERALL SUPERVISION OF CORPORATE CREDIT UNIONS

Given the concentration of credit union assets in the corporate credit union system, the safety and soundness of these institutions is critical to the financial soundness of many of their credit union members. Accordingly, under the leadership of Chairman D'Amours, the NCUA has worked systematically during the past four years to update and improve its supervision of corporate credit unions.

Recognizing corporate credit unions' distinct place in the credit union system, the NCUA created the Office of Corporate Credit Unions in 1994. This key development has led to stronger, and more focused, supervision of corporate credit unions. The Office of Corporate Credit Unions has trained 22 examiners charged with annual on-site visitations of the 38 corporate credit unions and U.S. Central. These examiners, on average, have 11 years of depository institution examination experience -- including 8 years with the NCUA.

We evaluated the Office of Corporate Credit Unions' approach to supervising corporate credit unions, including its staffing, its policies and procedures, its examiner guidance, and its safety and soundness standards. The Office is still relatively new, yet it represents a significant improvement over the NCUA's previous, less rigorous approach to supervising corporate credit unions. Based on our evaluation, we identified several areas for continued development.

First, we found that the Office of Corporate Credit Unions is understaffed. The resources currently devoted to supervising corporate credit unions fall short of reflecting the proportionate risk these institutions pose to both credit unions and the Share Insurance Fund. In particular, the amount of time devoted to an on-site examination at a particular corporate credit union may be insufficient for the complex risk analysis that should be done in critical risk areas. We recognize, however, that corporate credit union examiners do receive assistance from the NCUA's Office of

---

[194] Most corporate credit unions are currently unlikely to have the depth of knowledge and experience in management that the NCUA requires for derivatives authority. Moreover, as of January 1998, the NCUA will prohibit institutions with less than a 5 percent ratio of net worth to daily average net assets from using derivatives, even when derivatives may help those institutions manage risk. 62 Fed. Reg. 12,929, 12,948 (1997) (to be codified at 12 C.F.R. pt. 704 app. B).

Investment Services in the evaluation of interest rate risk present in the more complex investment portfolios.[195]

Beyond having sufficient examiner resources for on-site examinations, the Office also needs sufficient resources to evaluate market developments and emerging risks that affect all corporate credit unions. In particular, the Office should develop the capacity to review industry trends and assess potential systemic risks. Given the interdependence risk described earlier, the Office must continually monitor the risk of the entire corporate credit union system, not just its individual institutions.

Second, the NCUA's regulatory practices for corporate credit unions diverge in some respects from the best-practice approaches developed cooperatively by other federal regulatory agencies. In particular:

- the bank and thrift regulators have been developing risk assessment techniques that focus examiner attention on high risk areas and overall portfolio risk;

- our review of NCUA corporate examination reports found a more audit-oriented focus, rather than a focus keyed to the critical risk areas in the particular credit union; and

- examination reports contained excessive detail on small deficiencies, which detracted from the major findings and prescriptions for corrective action.

More generally, the NCUA could benefit from more regular interaction with the federal banking agencies to learn about, and participate in, the development of best practice approaches to managing risks associated with new financial services.

Third, the Office of Corporate Credit Unions has not adequately developed written guidance for examiners and corporate credit unions. Since the Office is still fairly new and has had to manage several serious situations, the delay in developing such guidance is understandable.

Fourth, the CAMEL rating system used for corporate credit unions does not reflect all of the current risks and risk-taking in corporate credit unions. In particular, it does not include a component rating for an institution's sensitivity to market risk like that recently adopted by the federal banking agencies. Since the basic business of most corporate credit unions is managing investments, market sensitivity is a key aspect of their safety and soundness. Making market sensitivity risk a separate component in the examiner rating would highlight its importance for examiners, management, and boards of directors.

Fifth, the NCUA's examination reports and work papers for the 11 corporate credit unions we reviewed did not always sufficiently support CAMEL component ratings for these

[195] The Office of Investment Services aids both credit union and corporate credit union examiners.

institutions. For the Director of the Office of Corporate Credit Unions and the Director of the Office of Examination and Insurance to be fully informed of the condition of a given corporate credit union, the examination report must be complete in both the analysis provided and the rationale for examiner comments and CAMEL composite and component ratings. We found instances where CAMEL component ratings appeared to be inconsistent with the written support provided for the rating given; this created uncertainty as to whether written support or the rating itself best represented the true condition. In other places, an examination report may have little or no written analysis (that is, the factual basis) to support the examiner's comments or the assigned rating. We also have concerns about the Office of Corporate Credit Unions' policy of basing the CAMEL composite rating on the lowest of the five component ratings. NCUA officials contended that the policy focused management attention on problem areas. We believe that the NCUA should be able to focus management's attention on such areas without using a rating scheme that may overstate an overall negative assessment of a corporate credit union's condition.

In view of these findings, we recommend that the NCUA:

- commit greater resources to the Office of Corporate Credit Unions;
- interact more with the four federal banking agencies and make greater use of a risk-based approach to depository institution supervision;
- improve its written corporate credit union examiner guidance;
- add a component for sensitivity to market risk to its CAMEL rating system for corporate credit unions; and
- provide better analysis and documentation in connection with its examinations, including revising the composite CAMEL rating system for corporate credit unions to take account of all of an institution's component scores.

The NCUA responded to these findings and recommendations by noting that:

- it is developing risk-based examination procedures that will focus examiner attention on key risk areas in the corporate credit union being examined;
- a new examination manual should become available in January 1998; and
- as part of the new examiner guidance, it expects to add some measure of market sensitivity to the CAMEL rating.

E. SUMMARY

Corporate credit unions are cooperatively owned by their member credit unions. They serve their members primarily by lending or otherwise investing excess funds (or unloaned deposits) deposited by member credit unions. At the end of 1996, corporate credit unions held 7 percent of all regular credit unions' assets. Corporate credit unions also provide services comparable to the correspondent services that large commercial banks have traditionally provided to smaller banks. U.S. Central Credit Union is a corporate credit union serving 38 of the 40 other corporate credit unions.

Based on our review of the 10 largest corporate credit unions and U.S. Central, we have three general findings. First, corporate credit unions are thinly capitalized and operate with narrow margins. Second, an interdependence risk exists among corporate credit unions and U.S. Central. Third, corporate credit unions are facing increasing competitive pressures from each other and from other market participants.

Corporate credit union assets are primarily high credit quality, short-term investments. Corporate credit unions have historically served as a deposit conduit for U.S. Central. However, the larger corporate credit unions invest the majority of their funds directly rather than through U.S. Central. At the end of 1996, corporate credit unions invested half of their $27 billion investment portfolio with U.S. Central.

For corporate credit unions, total capital consists of core capital (reserves, undivided earnings, and paid-in capital) and secondary capital (membership capital accounts). For the 10 largest corporate credit unions, core capital amounts to roughly 3.5 percent of assets. Although corporate credit unions have been building their capital base in recent years, they should continue to do so.

Corporate credit unions face increasing competitive pressure from each other and from other market participants. This competitive environment poses important safety and soundness concerns for both the near-term and long-term. Consolidation among corporate credit unions has begun and this trend will likely continue.

Having analyzed the investment portfolios of the 10 largest corporate credit unions and U.S. Central, we concluded that, while those portfolios generally have little credit risk exposure, concentration risk is an issue. First, corporate credit unions' generally low net worth ratios leave little room for error. Second, the NCUA limits the amount that a corporate credit union can invest in the obligations of a single issuer but does not limit the amount that a corporate credit union may invest in a single class of assets. Third, the risks of concentrating investments in a single asset class are exacerbated by the interdependence risk among corporate credit unions and by the relative homogeneity of the different corporate credit unions' balance sheets. The NCUA should develop policy guidance or regulations governing concentration risks.

The NCUA's updated corporate credit union regulations represent a significant step toward making corporate credit unions safer and sounder. Of particular note are: (1) minimum capital requirements; (2) statements of board and management responsibilities; (3) explicit limits on interest rate risk; (4) strict credit review procedures; and (5) a requirement for liquidity contingency planning.

The NCUA has made great strides in improving its supervision of corporate credit unions over the past four years. Nevertheless, our review concluded that: (1) the Office of Corporate Credit Unions is understaffed; (2) some of the NCUA's regulatory practices diverge from the best-practices approach developed by the federal banking agencies; (3) written examiner guidance is underdeveloped; (4) the rating system needs to be updated; and (5) documentation and support of examiner ratings should be strengthened. We recommend that the NCUA take steps necessary to improve its supervision in each of these five areas.

CHAPTER V

CREDIT UNION LIQUIDITY AND THE CENTRAL LIQUIDITY FACILITY

Liquidity refers to the relative ease with which one can convert assets into cash. Depository institutions typically maintain an asset mix that enables them to readily meet normal deposit withdrawals or increases in loan demand. To meet abnormal cash outflows, depository institutions may also borrow funds from correspondent institutions, in the public money markets, or -- under exigent circumstances -- from the Federal Reserve System.

Loans and investments constitute depository institutions' primary financial assets. In the case of investment securities, liquidity reflects the issuer's credit quality as well as the security's terms and maturity. Although investment securities are generally more liquid than loans, loan securitization has made certain types of loans much more liquid than before.[196]

Credit unions' aggregate assets consist mainly of loans to members (65 percent of total assets) and investments (30 percent of total assets). For liquidity, credit unions typically hold assets such as cash and short-term Treasury and federal agency securities as well as short-term deposits at corporate credit unions. Corporate credit unions also lend to credit unions needing liquidity. The Central Liquidity Facility (CLF) exists as credit unions' lender of last resort to meet emergency liquidity needs or other liquidity needs corporate credit unions cannot meet.

A. CREDIT UNION LIQUIDITY

Depository institutions manage their liquidity needs in two basic ways. Asset-side liquidity management involves holding sufficient liquid assets, such as cash or short-term Treasury securities, to meet normal increases in deposit withdrawals or loan demand. Liability-side liquidity management involves using credit arrangements with other financial institutions to meet normal liquidity needs. In general, small depository institutions use asset-side liquidity management, while larger institutions tend to rely more on liability-side management.

One of the key functions of corporate credit unions is to provide liquidity to member credit unions. Corporate credit unions are currently well positioned to do so because their portfolios consist primarily of investments of high credit quality with relatively short maturities, which can be readily sold to meet unusually large demands for liquidity.

In recent years, as credit unions have responded to increased loan demand from their members by holding relatively fewer assets at corporate credit unions, some corporate credit

[196] Loan securitization is the process of pooling residential mortgages, automobile loans, or other loans and issuing securities representing interests in the loan pool.

unions have taken steps to strengthen their access to outside liquidity. First, they have obtained lines of credit from U.S. Central or commercial banks. Second, some have begun issuing commercial paper. Corporate credit unions have generally received very high debt ratings for their commercial paper. However, such ratings rest less on corporate credit unions' overall financial strength than on the subordination to creditors (including holders of commercial paper) of member credit unions' deposits. Thus corporate credit unions' reliance on commercial paper or other borrowed money may increase risk for member credit unions.

Corporate credit unions are also helping credit unions manage liquidity in non-traditional ways. For example, a task force organized by the Association of Corporate Credit Unions is considering asset securitization, long-term lending, and corporate credit union loan participations. The Association's "Auto Pilot Project" will soon enable a select number of credit unions to pool automobile loans and issue asset-backed securities backed by these pools. The institutions can use the proceeds from the loan securitization to make more loans or purchase liquid investments.

B. EMERGENCY LIQUIDITY

In rare circumstances, depository institutions may face sudden, large deposit withdrawals -- perhaps prompted by some sort of financial crisis or other crisis of confidence -- in which their normal liquidity sources may prove inadequate. Otherwise solvent institutions may find themselves unable to meet depositors' claims. In such situations, the Federal Reserve acts as a lender of last resort, providing fully collateralized liquidity loans to solvent but illiquid depository institutions to stem panic and to provide sufficient liquidity to the financial system.

Historically, the Federal Reserve served as a governmental provider of liquidity for its member banks, and the Federal Home Loan Banks served this function for savings institutions. For many years, however, credit unions had no access to a governmental provider of liquidity when they could not obtain liquidity from their usual sources. Accordingly, in 1978, Congress created the CLF to help meet the liquidity needs of credit unions.[197] In 1980, however, Congress expanded access to the Federal Reserve's discount window to all depository institutions, including credit unions, that offer accounts subject to reserve requirements.[198]

---

[197] 12 U.S.C. § 1795. By liquidity needs, Congress meant: (1) "short-term adjustment credit . . . to assist in meeting temporary requirements for funds or to cushion more persistent outflows of funds pending an orderly adjustment of credit union assets and liabilities"; (2) seasonal credit; and (3) "protracted adjustment credit . . . in the event of unusual or emergency circumstances of a longer term nature resulting from national, regional, or local difficulties." *Id.* § 1795a(1). This definition resembles the discount window policies set forth in the Federal Reserve's Regulation A. 12 C.F.R. § 201.3(a)-(c). The CLF may also make loans to cooperative share insurers and the Share Insurance Fund under terms and conditions established by the NCUA Board. *Id*. § 1795e(a).

[198] Pub. L. No. 96-221, § 103, 94 Stat. 133, 138 (codified at 12 U.S.C. § 461(7)).

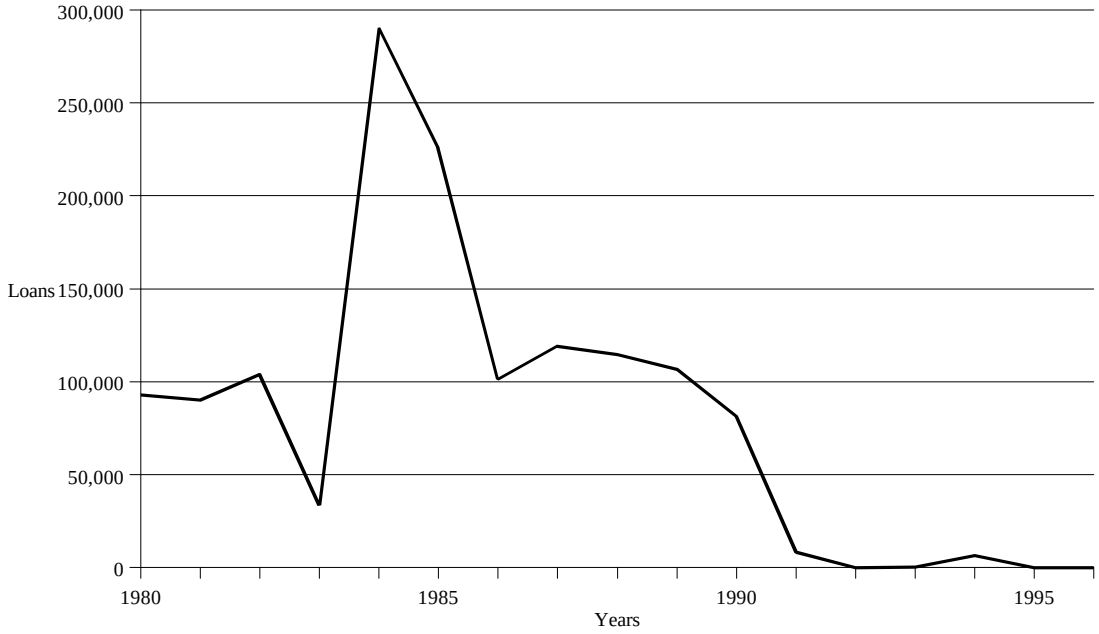
1. The Central Liquidity Facility

The CLF is a mixed-ownership government corporation within the NCUA.[199] The NCUA administers the CLF through the Division of Risk Management in the Office of Examination and Insurance. The NCUA's Director of Risk Management serves as President of the CLF, and the CLF has one additional full-time employee.

Although managed by the NCUA, the CLF is actually owned by its member credit unions. Membership in the CLF is voluntary and available to both federally and state-chartered credit unions. A credit union can join the CLF directly or through a corporate credit union acting as its agent. Although corporate credit unions may be agent members (i.e., conduits for their member credit unions' membership in the CLF) -- they may not join the CLF themselves. As non-members, corporate credit unions cannot borrow from the CLF for their own account.

Figure V.1 illustrates the dollar volume of year-end CLF loans outstanding between 1980-1996.

Figure V.1: CLF Loans Outstanding: 1980-1996
(Dollar figures in thousands)



Source: NCUA, *Response to the Treasury's Data Request*, Mar. 21.

---

[199] *Id.* § 1795b.

To date, use of the CLF has been modest. The CLF had over $200 million in loans outstanding at year-end 1984 and 1985, but none at year-end 1995 and 1996. Although the CLF has been dormant in recent years, credit union loan-to-share ratios are currently rising -- possibly signaling a need for future liquidity.

a. Capitalization

Like corporate credit unions and credit unions themselves, the CLF is structured as a cooperative. To obtain access to liquidity from the CLF, a credit union must be a member of the CLF. To become a CLF member, a credit union must subscribe to CLF capital stock in an amount equal to 0.5 percent of its paid-in and unimpaired capital and surplus.[200] One half of the stock subscription (or 0.25 percent of the unimpaired capital and surplus) must be paid directly to the CLF in exchange for CLF shares.[201] The other half is not actually purchased at the time a credit union joins the CLF. Instead, the credit union agrees to invest in "specific liquid assets" that it could use to purchase the additional stock should the CLF call for such a purchase.[202] Such a call has never been made.

Only about 30 percent of all credit unions joined the CLF during its first four years of operation. To encourage membership growth, the NCUA began to permit credit unions to join the CLF through their corporate credit unions. Although corporate credit unions could not (and cannot) join the CLF, the NCUA allowed corporate credit unions to become agent members, subscribing to CLF stock on behalf of their member credit unions. As agent members, corporate credit unions acquire CLF stock on the same terms as credit unions -- with half of the subscription paid and the other half callable. To calculate the required purchase, a corporate credit union aggregates the paid-in and unimpaired capital and surplus of its members.

Unlike credit unions, however, corporate credit unions do not actually pay cash to the CLF for CLF shares. Through a complex series of accounting transactions involving corporate credit unions, U.S. Central, and the CLF, accounting entries are recorded to show stock purchases, although no funds actually change hands. Figure V.2 illustrates these entries in two steps using simple T-accounts (i.e., recording assets on the left side, and liabilities and equity on the right). First, to become an agent member, a corporate credit union subscribes to CLF stock by taking out a "loan" from U.S. Central and then redepositing the "loan" proceeds at U.S. Central. The loan rate exactly equals the CLF's dividend rate, thereby creating offsetting interest expenses and income. Second, U.S. Central purchases the CLF stock on behalf of its corporate credit union members using the "loan" proceeds. The CLF then redeposits the "loan" proceeds back into U.S. Central. In reality, these transactions are merely bookkeeping entries that artificially inflate the parties' balance sheets.

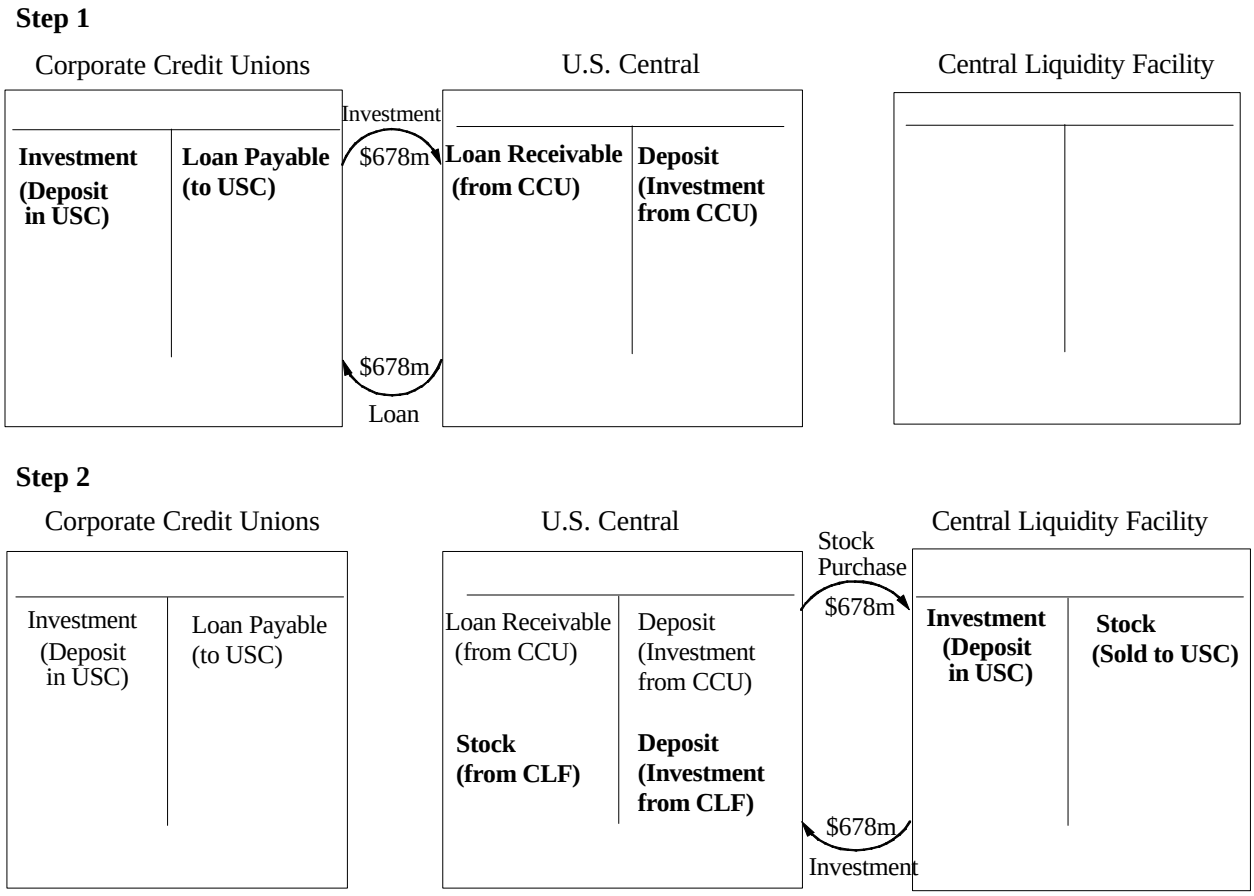
---

[200] These subscriptions are adjusted at the end of each calender year based on the changes in credit unions' paid-in and unimpaired capital and surplus.

[201] 12 U.S.C. § 1795d(d).

[202] 12 C.F.R. § 725.5(c), (d).

Figure V.2: The Redeposit Program



Note: All of these transactions are merely accounting entries; no cash payments are actually made.

Today, most credit unions opt to join the CLF through their corporate credit unions because this method relieves the credit union from having to purchase and hold CLF stock directly. As shown in Table V.1, at year-end 1996, the CLF had $706 million in capital consisting of deposits made by credit unions and corporate credit unions (on behalf of member credit unions). Specifically, credit unions had deposited $28 million directly and $678 million indirectly through corporate credit unions. The $678 million corporate credit union deposit is actually handled by U.S. Central acting as the "agent group representative" for corporate credit unions.

Table V.1: Central Liquidity Facility Balance Sheet
(Dollars figures in millions; totals may not add due to rounding; data as of December 31, 1996)

Assets		Liabilities and Members' Equity	
U.S. Central - Redeposits	$678	Liabilities	$17
U.S. Central - Share Accounts	$47	Capital Stock - Regular	$28
Accrued Interest Receivable	$9	Capital Stock - Agent Members	$678
		Retained Earnings	$12
Total Assets	$734	Total Liabilities and Members' Equity	$734

Source: NCUA, *Response to the Treasury's Data Request*, Mar. 21.

In addition to the capital stock and surplus invested by credit unions, the CLF has authority to borrow up to 12 times its subscribed capital stock (i.e., the required plus on-call subscriptions).[203] As of year-end 1996, that borrowing authority amounted to some $17 billion. The Justice Department's Office of Legal Counsel has said that the full faith and credit of the United States backs such borrowing.[204] Although the CLF may borrow from any source, it has long had a credit arrangement in place (for the full 12 times subscribed capital) with the Federal Financing Bank, which is part of the U.S. Treasury.[205] Although various appropriations acts have limited to $600 million the amount that the CLF can lend directly to credit unions, they have not limited the CLF's ability to borrow the full $17 billion at any one time.[206] Thus nothing precludes the CLF from borrowing the entire $17 billion and lending it to the Share Insurance Fund. Congress could circumscribe the CLF's borrowing authority in future appropriations acts; however, given the breadth of the authorization, such language would have to be very specific.

[203] 12 U.S.C. § 1795f(a)(4)(A).

[204] The Justice Department's Office of Legal Counsel issued an opinion to that effect on May 24, 1982. 6 Op. O.L.C. 262, 263 (1982).

[205] A separate provision authorizes the Secretary of the Treasury to lend up to $500 million to the CLF in the event that the NCUA Board certifies to the Secretary that the CLF does not have sufficient funds to meet the liquidity needs of credit unions. 12 U.S.C. § 1795e(b).

[206] *See, e.g.*, Pub. L. No. 105-65, 111 Stat. 1344, 1379 (1997); Pub. L. No. 104-204, 110 Stat. 2874, 2918 (1996).

b. Member Loans

The CLF acts as a signal for the Share Insurance Fund. If a corporate credit union seeks a line of credit from the CLF for a particular credit union, then the corporate credit union has probably concluded, in light of its own lending standards, that it would be better off not bearing the credit risk involved. The corporate credit union might reach such a conclusion because of the size of the line needed, the creditworthiness of the institution, or the quality of its collateral. Given the close relationship between the CLF and the Share Insurance Fund, such an inquiry should signal a potential problem to the Fund. The CLF and the Fund can then work together to help liquidity-constrained, financially troubled credit unions.

As an alternative to CLF loans, the NCUA may extend credit to a credit union by using the Share Insurance Fund to guarantee a loan from a corporate credit union to a member credit union. Such guaranteed loans are a form of special assistance. The NCUA believes that lines of credit guaranteed by the Share Insurance Fund are an efficient means of providing liquidity to a troubled credit union, are less expensive for the credit union involved, and reduce risk to the Share Insurance Fund. In particular, NCUA officials told us that guaranteed lines of credit may be more efficient than direct CLF lending when timing is critical. For example, advances from the Federal Financing Bank typically take up to three days, whereas a loan guaranteed by the Fund may be approved and issued within a few hours.

As for reducing risk to the Share Insurance Fund, some questions remain because loan guarantees place all credit risk squarely on the Fund. Specifically, the CLF should be extending credit to illiquid, but solvent, credit unions. In such cases, loan guarantees may ultimately reduce risk to the Fund by avoiding the failure of basically healthy but temporarily illiquid institutions. However, in the case of illiquid and otherwise weak or insolvent credit unions, loan guarantees may increase risk to the Fund. Specifically, the CLF could allow the NCUA to keep weak or insolvent credit unions open beyond the point that would minimize losses to the Fund.

2. The Federal Reserve Discount Window

Because of the constraints on the CLF, the Federal Reserve System's discount window is a logical alternative governmental source of liquidity. Like the CLF, the discount window offers adjustment credit, seasonal credit, and extended credit.[207] The Federal Reserve generally makes funds available through the discount window only in cases where funds are not reasonably available from usual sources, such as correspondent institutions or the money markets.

---

[207] 12 C.F.R. § 201.3. The Federal Reserve Board also has authority to authorize a Federal Reserve bank to offer emergency credit to non-depository institutions. 12 U.S.C. § 347b(b)(3).

To be eligible to borrow from the discount window, a depository institution must offer reservable transaction accounts (e.g., checking accounts) or nonpersonal time deposits.[208] Most credit unions, although eligible for discount window access on the same terms as other depository institutions, have chosen not to take the steps necessary to be able to borrow.[209] According to the Federal Reserve Board, as of year-end 1996, only 333 credit unions had filed discount window agreements and of these only 20 had pre-pledged collateral.

In short, almost all but the smallest credit unions have full access to the Federal Reserve as a governmental source of liquidity. They face no barrier to relying on the Federal Reserve rather than the CLF, although the NCUA and the Federal Reserve may need to improve coordination.

3. Conclusions

When Congress established the CLF in 1978, credit unions had no access to emergency liquidity from a governmental liquidity provider. However, the Monetary Control Act of 1980 accorded credit unions access to the Federal Reserve's discount window. The Federal Reserve is the preeminent lender of last resort.

The CLF's current borrowing authority raises serious policy and budget concerns. It has legal authority to advance several billion dollars to the Share Insurance Fund without regard to its ability to repay. In a systemic crisis, taxpayers could be put at risk if such funds were advanced to shore-up troubled credit unions or a troubled insurance fund.

We are also concerned that the CLF creates a concentration of credit risk for itself by holding all of its investments at U.S. Central. If U.S. Central were ever to become impaired, the CLF's elaborate redeposit-based capital structure could collapse and its share accounts could suffer losses; the combined effect could largely eliminate the CLF's net worth. If the CLF continues to operate, credit unions should capitalize it directly and the concentration of credit risk should be eliminated, perhaps by depositing CLF funds at the Treasury as the Share Insurance Fund does.

4. Recommendations

The CLF provides minimal public benefits (i.e., acting as a signal to the Share Insurance Fund). The CLF's explicit public costs, like its benefits, are small: it had a 1997 operating budget

---

[208] 12 C.F.R. § 201.2(c)(1). Since most credit unions with fewer than $2 million in assets do not offer transaction accounts, they may not be eligible for discount window advances. Still, the vast majority of credit unions with more than $5 million in assets do offer transaction accounts and hence are eligible for discount window advances. See Table I.4 on p. 23.

[209] Corporate credit unions, on the other hand, generally may not borrow from discount window because they are classified as "banker's banks." 12 U.S.C. § 461(b)(9). Corporate credit unions could waive their banker's bank exemption from maintaining reserves at the Federal Reserve. In that case, a corporate credit union would be eligible to borrow from the discount window.

of only $167,000. However, the CLF imposes several *implicit* public costs by being able to increase taxpayer risk through its full faith and credit borrowing authority. Of course, these costs are difficult to quantify and would be realized only if U.S. Central or the Fund were to suffer significant losses.

We recommend that Congress discontinue the CLF. Credit unions, particularly larger ones, should apply to their Federal Reserve Bank for discount window access. Smaller credit unions should at least have firm lines of credit for emergency liquidity from their corporate credit unions or other depository institutions. In addition, we recommend that corporate credit unions and the NCUA each evaluate credit unions' potential liquidity needs and the options available for credit unions and corporate credit unions to meet those needs. In New 704, the NCUA directs each corporate credit union to "develop a contingency funding plan that addresses alternative funding strategies in successively deteriorating liquidity scenarios."[210]

[210] 62 Fed. Reg. 12,929, 12,945 (1997) (to be codified at 12 C.F.R. pt. 704 app. B).

APPENDIX A

RECOMMENDATIONS

Chapters II through V contain recommendations to Congress, the NCUA, and credit unions. This appendix lists those recommendations and provides references to the pages where they appear in the report.

Chapter II: The Share Insurance Fund

We recommend that:

- Congress require the Share Insurance Fund to maintain an available assets ratio of 1.0 percent, and specify that the NCUA could not pay dividends from the Fund if the available assets ratio fell 1.0 percent, regardless of the Fund's overall reserve ratio (page 45).

- The NCUA, when calculating the Share Insurance Fund's reserve ratio, use the most current data available on insured deposits (pages 46).

- The NCUA not declare dividends on credit unions' 1 percent deposit until the close of the year in order to ensure the actual reserve ratio exceeds the target ratio (page 46).

- Congress direct the NCUA to require credit unions to adjust their 1 percent deposit in conjunction with submitting their call reports, and direct the NCUA to measure deposits using a four-quarter average to account for seasonal fluctuations (pages 47).

- Congress give the NCUA discretion to let investment earnings raise the Share Insurance Fund's reserve ratio up to 1.5 percent (page 59).

- Congress give the NCUA flexibility to set the premium rate for the Share Insurance Fund as it deems appropriate, rather than requiring the NCUA to set the premium only at 1/12 of 1 percent (page 59).

We also suggest that Congress, the NCUA, credit unions, and other interested persons consider whether Congress should authorize the NCUA to charge risk-based insurance premiums (particularly in view of the growth of larger, more complex credit unions) or make risk-based adjustments in dividends paid by the Share Insurance Fund (page 59).

Chapter III: The NCUA's Safety and Soundness Regulations

We recommend that:

- The NCUA make important safety and soundness rules, such as the limit on loans to one borrower, readily accessible to all interested parties. If the NCUA intends rules to have the force of law and apply to credit unions generally, it should promulgate them as regulations and codify them in the *Code of Federal Regulations*, preferably after publishing a notice in the *Federal Register* and giving interested parties an opportunity to comment (page 65-66).

- Congress require credit unions that have existed for a given number of years or reached a given asset size to maintain a 6 percent ratio of net worth to total assets, and require the NCUA to prescribe a regulation requiring other credit unions to build net worth so as to meet the 6 percent level by the time they have existed for that number of years or reached that asset size (page 71).

- Congress raise the current reserving target from 6 percent of risk assets to 7 percent of total assets (page 71).

- Congress require credit unions to deduct from their reserves some portion of any member capital accounts at a corporate credit union and all paid-in capital issued by a corporate credit union (page 71).

- Congress require the NCUA to develop an appropriate risk-based net worth requirement for larger, more complex credit unions (page 71).

- Congress adopt a system of prompt corrective action for credit unions. This system would be a streamlined version of that currently applicable to FDIC-insured institutions, and would be specifically tailored to credit unions as not-for-profit, member-owned cooperatives (pages 76).

- Congress set at 6 percent the threshold at which a credit union can be considered adequately capitalized within a prompt corrective action system for credit unions (page 77).

- The NCUA require each large credit union to obtain an annual audit from an independent certified public accountant (page 80).

Chapter IV: Corporate Credit Unions

We recommend that the NCUA:

- **!** Develop policy guidance or regulations governing the risks associated with concentrations of corporate credit unions' portfolios in particular classes of assets. In so doing, the NCUA should consider both the exposure of individual corporate credit unions, and the overall exposure of corporate credit union system to any particular asset class (page 107).

- **!** Commit greater resources to the Office of Corporate Credit Unions (page 114).

- **!** Interact more with the four federal banking agencies (page 114).

- **!** Make greater use of risk-based approaches to depository institution supervision (page 114).

- **!** Have the Office of Corporate Credit Unions develop adequate written guidance for examiners and corporate credit unions (page 114).

- **!** Include in its ratings of corporate credit unions a component rating for sensitivity to market risk (page 114).

- **!** Revise its composite CAMEL rating system for corporate credit unions to take account of all of an institution's component scores (page 114).

Chapter V: Credit Union Liquidity and the Central Liquidity Facility

We recommend that:

- **!** Congress discontinue the Central Liquidity Facility (page 125).

- **!** Large credit unions apply to their local Federal Reserve bank for access to liquidity through the discount window, and smaller credit unions should have firm lines of credit for emergency from their corporate credit union or other depository institution (page 125).

- **!** Corporate credit unions and the NCUA each evaluate credit unions' potential liquidity needs and the options available for meeting those needs (page 125).

APPENDIX B

COMPARISON OF OCC, OTS, AND NCUA SAFETY AND SOUNDNESS RULES

Regulation/Legislation	OCC	OTS	NCUA
Definition of capital	A national bank's total capital consists of core capital (Tier 1) and supplementary capital (Tier 2). Tier 1 capital includes common stock and noncumulative perpetual preferred stock. Tier 2 includes cumulative perpetual preferred stock, the allowance for loan and lease losses, and hybrid instruments that combine debt and equity features. 12 C.F.R. pt. 3.	Same as the OCC, but with some minor variations (e.g., in the case of mutual savings associations, Tier I capital also includes certain nonwithdrawable accounts and pledged deposits). 12 C.F.R. pt. 567.	Credit union capital consists of revocable reserves and statutory reserves. Revocable reserves consist of undivided earnings and other reserve accounts. Statutory reserves consist of regular reserves [211] and the allowance for loan losses. 12 C.F.R. §§ 702.1, 702.2(c)(1). (Statutes limit certain credit union powers to a stated proportion of unimpaired capital and surplus or of total paid-in and unimpaired capital and surplus. *See, e.g.*, 12 U.S.C. § 1757(7)(I) (1% limit on investments in credit union service organizations), (13) (5% limit on purchases of certain notes of liquidating credit unions). These bases are broader than the definition of capital because the NCUA has construed unimpaired capital to include all deposits (shares) in a solvent credit union.)

[211] Regular reserves consist of required transfers of gross income. 12 U.S.C. § 1762.

Regulation/Legislation	OCC	OTS	NCUA
Capital requirements	National banks must meet three capital requirements: (1) a minimum leverage ratio, generally requiring 4% Tier 1 capital to total assets; (2) a total risk-based capital ratio of 8 percent capital to risk-weighted assets; and (3) a Tier 1 risk-based capital ratio, requiring 4% Tier 1 capital to risk-weighted assets. 12 C.F.R. pt. 3. The risk-based system assigns each class of assets a risk weight of 0%, 20%, 50%, or 100%. The 0% category includes assets such as cash and insured deposits. The 50% category includes some types of mortgage loans, construction loans, and multi-family mortgage loans. Tier 2 capital may count toward meeting the 8% risk-based capital requirement, but only to the extent that the bank also has Tier 1 capital (i.e., Tier 1 capital must constitute at least 50% of the capital that counts toward meeting the 8% requirement).	Savings associations must generally meet the same basic capital requirements as national banks. 12 U.S.C. § 1464(t)(1)(C), (2) (C); 12 C.F.R. pt. 567.	Credit unions are not subject to capital requirements in the sense of having to maintain a specified ratio of net worth to assets in order to be in good standing. A credit union that does not have a specified ratio of regular reserves to risk assets[212] must add to its regular reserves a certain percentage of its annual gross income. 12 C.F.R. § 702.2(a). A credit union in operation for more than four years and having at least $500,000 in assets must set aside 10% of gross income until its reserves reach 4% of outstanding loans and risk assets, then 5% of gross income until its reserves reach 6% of outstanding loans and risk assets. A credit union in operation for less than four years or with less than $500,000 in assets must set aside 10% of gross income until its reserves reach 7.5% of outstanding loans and risk assets, then 5% of gross income until its reserves reach 10% of outstanding loans and risk assets. 12 U.S.C. § 1762.

[212] Risk assets consist of all assets (including outstanding loans), except for specific types of assets that the NCUA has determined present less risk to credit unions. These exceptions include: (1) cash; (2) loans, and other assets insured by the federal government having remaining maturities of five years or less; (3) loans fully insured or guaranteed by the federal or state government with maturities of three years or less; and (4) shares on deposits in state-insured depository institutions or in a corporate credit union with remaining maturities of five years or fewer. 12 C.F.R. § 700.1(h)(i).

Regulation/Legislation	OCC	OTS	NCUA
Risk-based premiums	Congress has required the FDIC to proportion deposit insurance premiums to the risk that a depository institution poses to the deposit insurance fund. 12 U.S.C. § 1817(b)(1). The FDIC has established a premium system that bases an institution's premiums on its capital ratios and on a supervisory judgment of its overall financial condition. 12 C.F.R. § 327.9.	Same as the OCC.	None. The NCUA may assess premiums only at a uniform rate of 1/12 of 1%. 12 U.S.C. § 202(c)(2).
Interest rate risk	In evaluating a national bank's capital adequacy, the OCC also assesses the bank's exposure to declines in economic value resulting from interest rate changes. Unlike the OTS, the OCC has not prescribed its own supervisory model for calculating an institution's sensitivity to interest rate changes. Instead, the OCC directs a national bank to: (1) ensure that its board of directors and senior management understand the nature and level of interest rate risk it is taking and how that risk fits with the bank's overall business strategies; and (2) develop a comprehensive risk management process that (among other things) identifies and measures interest rate risk, with the formality and complexity of this process tailored to the bank's needs.[213]	The OTS has developed a supervisory model that it uses to assess a savings association's interest rate risk exposure. The model measures the decline in net portfolio value that would result from a 200 basis point increase or decrease in market interest rates. 12 C.F.R. § 567.7. Savings associations with less than $300 million in assets and risk-based capital ratio exceeding 12% (most thrift institutions) need not satisfy the model, although most still voluntarily provide the requisite information and obtain the agency's analysis in an effort to better understand and manage their interest rate risk.	Unless a credit union invests only in insured CDs and shares and deposits in a corporate credit union, the NCUA's rules require the credit union to provide extensive data relating to its sensitivity to changes in interest rates. If the credit union has more risky investments (such as amortizing securities or securities with maturities greater than three years) that exceed the credit union's net worth, then the credit union must model an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points. 62 Fed. Reg. 33, 989, 34,003 (1997) (to be codified at 12 C.F.R. § 703.90).

[213] 61 Fed. Reg. 33,166, 33,170 (1996) (Joint Agency Policy Statement: Interest Rate Risk).

Regulation/Legislation	OCC	OTS	NCUA
Real estate lending standards	National banks must adopt and maintain written policies establishing appropriate limits and standards for all credit secured by real estate or for the purpose of financing construction. These provisions assist institutions in developing and maintaining a real estate lending policy appropriate to the size of the institution and the nature and scope of its operations. 12 U.S.C. § 1828(c) (requiring every federal banking agency to adopt uniform regulations prescribing real estate lending standards); 12 C.F.R. § 34.61-34.62.	Similar to the OCC. 12 C.F.R. §§ 560.100 - 560.101.	Credit unions may extend credit to members, including business members, to finance the acquisition or construction of income producing property. In such cases, the institution's board of directors must adopt specific business loan policies and review them at least annually. In addition, NCUA regulations impose restrictions on these loans (e.g., the borrower must have a 35% equity interest in the property). 12 C.F.R. § 701.21(h). Credit unions may make residential real estate loans to members for one-to-four-family dwellings for a maturity of up to 40 years, if the residence is or will be the member's principal residence and the loan will be secured by a perfected first lien. 12 U.S.C. § 1757(5)(A); 12 C.F.R. § 701.21(g)(1).

Regulation/Legislation	OCC	OTS	NCUA
Lending limits	Lending limits protect the safety and soundness of national banks by preventing excessive lending to one person or related persons. A national bank's total outstanding credit to one borrower generally may not exceed 15% of the bank's capital. An additional 10% is permissible if fully secured by readily marketable collateral: i.e., financial instruments and bullion salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market. 12 U.S.C. § 84(a); 12 C.F.R. pt. 32.	Generally the same as the OCC. 12 U.S.C. § 1464(u); 12 C.F.R. § 560.93. In addition, a savings association may make loans to one borrower of up to $500,000 even if its general lending limit is less than that amount.	There is a general 12-year maturity limit for all loans, except that members may obtain a mortgage on their principal residence for up to 40 years and a second mortgage on their principal residence for up to 15 years. A credit union's lending to any one member is limited to 10% of unimpaired capital and surplus. The NCUA has construed a credit union's deposits (shares) as equity for purposes of this limit, making the limit much greater than that applicable to national banks and federal savings associations. 12 U.S.C. § 1757(5)(A)(x); 12 C.F.R. § 701.21(a)-(g). The aggregate amount of business loans outstanding to any one member may not exceed 15% of regular reserves and undivided earnings or $75,000, whichever is higher. 12 C.F.R. § 701.21. Business loans (i.e., construction and development loans) to any one member may not exceed 15% of the institution's regular reserves and undivided earnings, and may not, in the aggregate, exceed 25% of regular reserves and undivided earnings. Loans to non-natural person members must be limited to the amount of the member's shares, except for not-for-profit members. Moreover, loans to other credit unions may not exceed 25% of an institution's paid-in and unimpaired capital and surplus. 12 U.S.C. § 1757(5)(C).

Regulation/Legislation	OCC	OTS	NCUA
Transactions with affiliates	Specific limits apply to a national bank's transactions with affiliated companies (e.g., loans, guarantees, and other extensions of credit to those companies, and purchases of assets from those companies). The bank's total transactions with any one affiliate cannot exceed 10 percent of the bank's capital. The bank's total transactions with all of its affiliates cannot exceed 20 percent of the bank's capital. High-quality collateral must fully secure all transactions between the bank and its affiliates. 12 U.S.C. § 371c. Any transactions between the bank and its affiliates must also be conducted at arm's length. 12 U.S.C. § 371c-1.	Same as the OCC. 12 U.S.C. § 1468(a). In addition, a savings association may not make any extension of credit to any affiliate engaged in activities not permissible for a bank holding company. 12 U.S.C. § 1468(a)(1)(A).	These limits do not apply to federal credit unions. A credit union may invest up to 1% of its total paid-in and unimpaired capital and surplus in -- and lend another 1% of its total paid-in and unimpaired capital and surplus to -- credit union service organizations. The NCUA has construed unimpaired capital to include deposits. 12 U.S.C. § 1757(5)(D), (7)(I). A specific conflict of interest provision prohibits persons who serve as a credit union official or in senior management, or any of their immediate family members, from receiving any compensation from a credit union service organization. All transactions with the organization must be conducted at arm's length. 12 C.F.R. § 701.27.

Regulation/Legislation	OCC	OTS	NCUA
General audit requirements	National banks, like other FDIC-insured institutions, must complete annual reports on their financial condition and management, and must have annual independent audits to determine whether their financial statements are presented fairly. 12 U.S.C. § 1831m(a), (d).	Same as the OCC.	A credit union's board of directors must appoint a supervisory committee. The supervisory committee must conduct, or hire competent parties to conduct, an annual audit. 12 U.S.C. § 1761b(5). The supervisory committee must also verify that the institution's financial statements accurately and fairly represent the institution's financial condition and that management practices and procedures sufficiently protect member assets. 12 U.S.C. § 1761d; 12 C.F.R. § 701.12. A credit union's financial statements must provide full and fair disclosure of all assets, liabilities, and member equity. 12 C.F.R. § 702.3.

Regulation/Legislation	OCC	OTS	NCUA
Independent audit requirements	A large national bank, like any large FDIC-insured institution, must establish an independent audit committee and obtain an annual independent audit of its financial statements. 12 U.S.C. § 1831m(d), (g)(1). This requirement does not apply to institutions with less than $500 million in assets. 12 C.F.R. § 363.1(a).	Same as the OCC, except that the OTS also requires any savings association with an unsatisfactory CAMEL rating (3, 4, or 5) to obtain an independent audit. 12 C.F.R. § 562.4(b)(1).	A credit union, regardless of its size, is generally not required to obtain an independent, outside audit. 12 C.F.R. § 701.12(c)(5)(i)(D). A credit union may satisfy the supervisory committee audit requirement by hiring a licensed, certified public accountant; with a compensated independent accountant that need be neither licensed nor certified; or with an "agreed upon procedures engagement" performed by a licensed, certified, independent accountant. 12 U.S.C. § 1782(a)(6); 12 C.F.R. § 701.12(c)(5)(i)(A)-(C). A credit union must have an outside, independent audit by a certified public accountant only if: (1) the supervisory committee has not conducted an annual audit; (2) the supervisory committee's audit did not meet the NCUA's requirements ; or (3) the institution has experienced persistent and severe record keeping deficiencies. 12 U.S.C. § 1782(a)(6); 12 C.F.R. § 701.13.

Regulation/Legislation	OCC	OTS	NCUA
Examination frequency	National banks, like other FDIC-insured institutions, must generally be examined at least once each year. However, an 18-month examination cycle is permissible for certain healthy, well-capitalized institutions with less then $250 million in assets. 12 U.S.C. § 1820(d).	Same as the OCC.	No statutory annual examination requirement applies, but since 1985 the NCUA has had a policy of examining federal credit unions annually, and allowing exceptions only with the approval of the agency's Executive Director. Federally insured state-chartered credit unions are examined by their chartering state at least once every 18 months. If these institutions are troubled, however, they may be examined every 120 days either by the NCUA alone or jointly by the NCUA and the state.[214]
Liquidity requirements	National banks must be members of the Federal Reserve System and maintain reserve balances at their local Federal Reserve bank. 12 U.S.C. § 222; 12 C.F.R. § 204.1. National banks can obtain emergency liquidity from the Federal Reserve discount window.	Savings associations must also maintain reserve balances and (upon making proper arrangements) can obtain emergency liquidity from the Federal Reserve discount window. Also, all savings association must generally maintain specified proportions of their assets in liquid assets and short-term liquid assets. 12 U.S.C. § 1465; 12 C.F.R. § 566.2.	Credit unions must also maintain reserve balances and (upon making proper arrangements) can obtain emergency liquidity from the Federal Reserve discount window. Credit unions can become members of the Central Liquidity Facility and seek liquidity from it. 12 U.S.C. §§ 1795-1795K; 12 C.F.R. pt. 725.

[214] NCUA, *Examiner's Guide* (Alexandria, VA: NCUA, 1996).

Regulation/Legislation	OCC	OTS	NCUA
Prompt corrective action	National banks, like other FDIC-insured depository institutions, are subject to prompt-corrective action: a set of statutory provisions aimed at resolving capital deficiencies before they grow into large problems. The system classifies depository institutions into five categories, according to their capital. An institution falling below minimum capital standards faces progressively more stringent regulatory restrictions and requirements. 12 U.S.C. § 1831o; 12 C.F.R. pt. 6.	Same as the OCC. 12 C.F.R. pt. 565.	No system of prompt corrective action applies to credit unions, although the NCUA has some informal policies that are analogous to some aspects of prompt corrective action. The statutory requirement to replenish regular reserves in effect constrains dividends by credit unions with net worth deficiencies. 12 U.S.C. § 1762; 12 C.F.R. § 702.3(c)(iii).
Enforcement	*Notice of Charges* If a national bank or an institution-affiliated party[215] has engaged or will engage in an unsafe or unsound practice or violate a statute, regulation, written agreement, or the like, then the OCC may issue a notice of charges stating the alleged violation and setting a time for a hearing to determine if the agency should issue a cease-and-desist order. The hearing must occur 30 to 60 days after the notice is issued. 12 U.S.C. § 1818(b)(1).	Same as the OCC.	Same as the OCC. 12 U.S.C. § 1786(e)(1).

[215] Institution-affiliated parties include directors, officers, employees, and agents of the institution; anyone who has or is required to file a change-in-control notice; shareholder, joint venture partner, or consultant who participates in the conduct of the institution's activities; and any independent contractor who knowingly or recklessly participates in any violation of statute or regulation, any breach of fiduciary duty, or any unsafe or unsound practice which has or may harm the institution in a significant fashion. 12 U.S.C. § 1813(u).

Regulation/Legislation	OCC	OTS	NCUA
	Temporary Cease-and-Desist Order If the OCC determines that the activity covered in a notice of charges may weaken the bank or compromise its depositors before the proceedings described above can be completed, it can issue a temporary cease-and-desist order, which becomes effective immediately and remains effective until the issue has been resolved. 12 U.S.C. § 1818(c)(1). The OCC may also limit an institution's activities or functions or require the institution to take affirmative action if necessary (e.g., restitution, growth restrictions, disposition of loans or assets, hiring qualified officers or employees). 12 U.S.C. §1818(b)(6)-(7).	Same as the OCC.	Same as the OCC. 12 U.S.C. § 1786(e)(3)-(4), (f)(1).
	Permanent Cease-and-Desist Order After a hearing on a notice of charges, the OCC may issue a permanent cease-and-desist order against the bank. The order becomes effective 30 days after issuance (except that a consensual order becomes effective immediately). 12 U.S.C. § 1818(b)(1)-(2).	Same as the OCC.	Same as the OCC. 12 U.S.C. § 1786(e)(1)-(2).

Regulation/Legislation	OCC	OTS	NCUA
	Removal and Prohibition Authority If the OCC determines that an institution-affiliated party has, directly or indirectly, engaged in prohibited practices, the OCC may permanently remove the party from office or prohibit the party from any further participation in the affairs of any insured depository institution. Prohibited practices include violations of statutes, regulations, cease-and-desist orders, and written conditions or agreements; unsafe or unsound practices; and breaches of fiduciary duty. Such actions must also: (1) harm or threaten to harm the institution, prejudice or potentially prejudice depositors, or result in financial gain to the party; and (2) involve dishonesty or demonstrate willful or continuing disregard for the institution's safety and soundness. 12 U.S.C. § 1818(e)(1). As with a notice of charges, a notice of intent to remove or prohibit must describe the charge and set a hearing date that must occur 30 to 60 days after issuance. If appropriate, the OCC may suspend the party before the hearing until the matter is resolved. 12 U.S.C. § 1818(e)(3)-(4).	Same as the OCC.	Same as the OCC. 12 U.S.C. § 1786(g)(1), (3), (4).

Regulation/Legislation	OCC	OTS	NCUA
	Civil Money Penalties For violations of statute or regulation, permanent or temporary orders, or written conditions or agreements, the OCC may require an institution, or a person affiliated with the institution, to pay a civil money penalty of up to $5,000 for each day the violation continues. The agency may impose a penalty of up to $25,000 a day for such violations, or for recklessly engaging in an unsafe or unsound practice, or breaches of a fiduciary duty, if those acts: (1) are part of a pattern of misconduct; (2) are likely to cause the institution a significant loss; or (3) result in financial gain to the person committing the act. If the acts described above are committed knowingly, the daily fine may be up to $1 million for individuals or the lesser of $1 million or 1% of assets for institutions. 12 U.S.C. § 1818(i)(1), (2)(A)-(D).	Same as the OCC.	Same as the OCC. 12 U.S.C. § 1786(1), (2)(A)-(D), (H).