Highlights of GAO-04-849, a report to congressional requesters

Why GAO Did This Study

Since the passage of the Credit Union Membership Access Act of 1998 (CUMAA), many in the credit union industry have sought legislative changes to the net worth ratio central to prompt corrective action (PCA). The current debate centers on the issue of allowing federally insured credit unions to include additional forms of capital within the definition of net worth. In light of the issues surrounding the debate, GAO reviewed (1) the underlying concerns that have prompted the credit union industry's interest in making changes to the current capital requirements, (2) the issues associated with the potential use of secondary capital in all federally insured credit unions, and (3) the issues associated with the potential use of risk-based capital in all federally insured credit unions.

What GAO Recommends

GAO observes that the general favorable economic climate for credit unions experienced during the relatively short time that PCA has been in place for credit unions precluded sufficient testing of the current system of PCA and that additional time and greater experience are needed to determine what, if any, changes to PCA are warranted. In comments on this report, the National Credit Union Administration (NCUA) concurred that a case for introducing secondary capital has not been made but believed that adjustments to PCA were needed to make it more fully risk based.

www.gao.gov/cgi-bin/getrpt?GAO-04-849.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

August 2004

CREDIT UNIONS

Available Information Indicates No Compelling Need for Secondary Capital

What GAO Found

The credit union industry's interest in making changes to the current capital requirements for credit unions appears to be driven by three primary concerns: (1) that restricting the definition of net worth solely to retained earnings could trigger PCA actions due to conditions beyond credit unions' control; (2) that PCA in its present form acts as a restraint on credit union growth; and (3) that PCA tripwires, or triggers for corrective action, are too high given the conservative risk profile of most credit unions. Despite these concerns, available indicators suggest that the credit union industry has not been overly constrained as a result of the implementation of PCA. As a group, credit unions have maintained capital levels well above the level needed to be considered well-capitalized and have grown at rates exceeding those of other depository institutions during the three calendar years that PCA has been in place for credit unions.

Allowing credit unions to use secondary capital instruments to meet their regulatory net worth requirements would raise a number of issues and concerns, with perhaps the most important issue centering on who would purchase the secondary capital instruments. While outside investors would provide market discipline, this would raise concerns about the potential impact on the member-owned, cooperative structure of credit unions. Inside investors, however, could impose less discipline and raise systemic risk concerns if it resulted in a situation where weaker credit unions could bring down stronger credit unions due to secondary capital investments. Other issues relate to the specific form of the capital instruments for credit unions. The credit union industry itself appeared divided on the desirability or appropriate structure of secondary capital instruments.

Conceptually, the use of risk-based capital to address the concerns some in the credit union industry expressed about PCA is less controversial. Though two risk-based capital proposals were put forward, neither has garnered industry consensus and both lacked details of key components upon which to base any assessment of their merits. Risk-based capital is intended to reflect the unique risk profile of individual financial institutions; however, there are other factors that can affect an institution's financial condition that are not easily quantified. In recognition of the limitations of risk-based capital systems, bank and thrift regulators use leverage and risk-based capital requirements in tandem. GAO is aware that NCUA is constructing a more detailed risk-based capital proposal that incorporates both risk-based and leverage requirements; however due to the lack of formalized details, GAO could not perform a meaningful assessment of the proposal.