June 21, 2007 NCUA Board Meeting
PCA Reform Proposal
Board Q&A

Q. Why is this a good time to change PCA?

There are presently material changes under way in the banking system of prompt corrective action. In studying the banking proposal, we see several parts that would be beneficial for the credit union system as well. The changes we are proposing will allow for more flexibility in developing a more robust risk based system and allow us to achieve closer comparability to the banking system.

Additionally, we have operated under our current system of PCA since it was implemented in 2000. During the last 7 years, we have learned what works well and what changes would improve our system of prompt corrective action. Examples include:

Many credit unions continue to increase their level of net worth in order to avoid PCA based on the current 7% leverage ratio. It is important to note that the 7% leverage ratio was established by taking the 5% leverage ratio for banks and adding 1% for the NCUSIF deposit and 1% due to the inability of credit unions to obtain additional capital except through earnings. Eliminating the NCUSIF deposit from the calculation is a more precise way to address the issue for individual credit unions. Also it is generally agreed that banks and thrifts subject to the need for additional capital to meet the minimum requirements for PCA would find it more difficult and expensive to acquire additional capital.

With this improved understanding of PCA, we want to make changes that address these issues. Our change in the way the leverage ratio is calculated is one way we address the issue as well as increasing the leverage ratio by 25 basis beyond the banking system thresholds.

Q. Short of a statutory change, is there anything NCUA can do to update the capital system we implement?

No, we cannot make credit unions' PCA system comparable and more risk-based without legislation. There are two types of statutory constraints that preclude us from making needed improvements; the high leverage ratio and limitations on our authority to design the risk-based requirement.

First, the high leverage ratio of 7%, which is hard-wired into the statute, precludes us from implementing a system that places more emphasis on the risk-based requirement without creating an unduly high capital standard for credit unions. In order for more focus to be placed on the risk-based requirement, we would have to design the risk-based requirement to regularly result in capital levels above 7%. This would require even higher, unwarranted levels of capital in credit unions. To a large degree, credit unions are already driven by the current PCA system to maintain unnecessarily high capital levels. In addition to managing capital to address other risks and business needs, this results from a natural desire to steer

well clear of PCA territory. So credit unions build up a large cushion above PCA levels in case of an unexpected setback and in recognition of the fact they rely predominantly on retained earnings as their source of capital.

As for the statutory limitations on design of the risk-based requirement, NCUA is required to include "any material risks." The PCA system for other federally insured financial institutions, which is based on BASEL, only explicitly addresses credit and to a limited degree market risk. Our current statute requires NCUA to design the risk-based system on a much broader standard, addressing all material risks such as interest rate risk. Thus, we cannot adopt a comparable risk-based system, which hinders our ability to leverage the research, best practices, and ongoing advancements made in the risk-based system adopted by the other federal financial institution regulators. Also, this is an inordinate demand given credit unions overall are much less complex than other financial institutions. The statue also requires NCUA to apply the risk-based requirement only to credit unions defined as "complex," which results in a relatively narrow application of the risk based requirement. In addition, the statute specifically limits the application of the risk-based requirement to the adequately capitalized and undercapitalized categories, which does not allow for more emphasis on the risk-based requirement since it cannot be applied to well capitalized credit unions or, in cases of significant deficiencies, to result in a credit union being significantly undercapitalized. This also precludes us from mirroring how the PCA system works for other federally insured financial institutions.

Q. The March 2005 PCA proposal utilized risk-asset categories and weights of BASEL II and this proposal applied the risk portfolios and weights of BASEL 1A, why the change?

Basel 1A had not been developed at the time of our March 2005 proposal while Basel II was the current proposal for comparison purposes. BASEL 1A was introduced by the Financial Regulatory Agencies in October 2005 to provide similar risk-based capital rules that would apply to non-Basel II banking organizations. We utilized the more recent Basel 1A risk-based capital rules as they are designed for use by smaller organizations and thus, 1A is more applicable to the credit union industry.

Q. What are the safety and soundness implications of the proposal?

There are several positive implications including:

1) Improved risk measurement and management by the credit unions is the primary benefit.
2) This PCA proposal more closely aligns credit risk with capital requirements for all credit unions. The measurement process is highly transparent which allows credit unions to forecast increases in regulatory capital when evaluating business expansion.
3) The capital standard for the most thinly capitalized credit unions is increased.

Q. Is this proposal consistent with the current examination program and if so, what guidance have we provided to staff concerning this approach to the measurement of capital adequacy?

The proposed PCA system would actually make the PCA system more consistent with the risk-focused examination process and would compliment our overall risk-focused approach implemented in all areas of credit union analysis.

Supervisory review, which is Pillar II of Basel II, would continue to be used to ensure that credit unions have adequate capital to support all the risks in their business including risks not explicitly captured by the regulatory capital requirement such as interest rate risk, credit concentration risk, and operational risk. Examiners would continue to evaluate how well credit unions are assessing their capital needs relative to their risks and intervene, where appropriate. This interaction is intended to foster an active dialogue between credit unions and examiners such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or improve the capital position.

We have issued several types of guidance to assist examiners. In August 2005 we issued a Supervisory Letter providing guidance in evaluating capital adequacy based upon the risk and business needs of a credit union. The message was repeated again in August of 2006 within the Supervisory Letter on the Evaluation of Earnings which was also released to Federal Credit Unions. Additional training would be provided as we move to implement a new regulation.

Q. What is the impact of the proposed changes on the overall industry? Does it change in a broadly neutral way with some institutions seeing an increase and some a decrease, or is the change more one-directional?

The net result of eliminating the NCUSIF deposit from the leverage ratio calculation and the reduction in the proposed threshold to 5.25 percent for well capitalized credit unions is about a 1 percent real decline in the minimum net worth requirement. The specific net reduction levels are outlined in the chart on page 6 of the proposal.

As this chart shows, compression of the leverage ratio range comes into play for the credit unions with lower levels of capital. The new leverage ratio calculation results in a capital requirement for significantly undercapitalized credit unions that is comparable to the current requirement. The threshold for a credit union falling into the critically undercapitalized category is actually higher under this proposal.

The reduction in the leverage ratio requirement is a key factor in the development of a more robust risk-based capital requirement. Our proxy analysis revealed that the risk-based minimum net worth requirement would be the governing minimum capital requirement for 62 percent of the federally insured credit unions, so in these credit unions, their required net worth level would actually be higher than the leverage ratio. The remaining 38 percent of credit unions are the ones with conservative balance sheets and the leverage ratio would govern their minimum level of capital.

The proxy analysis of the proposed risk-based net worth requirement also revealed that:

1) The average risk-based net worth requirement at the 10 percent of risk asset level for well capitalized credit unions is 6.42%, which is significantly higher than the 5.25% leverage ratio needed to be considered well capitalized.

2) The proposed 10 percent risk-based net worth requirement would require 34 percent of credit unions to hold more than the current 7 percent leverage ratio to be considered well capitalized. All of these credit unions are included in the 62 percent that would be governed by the risk-based net worth requirement.

For the smaller credit unions (assets under $10 million) that have not previously been subject to the risk-based net worth requirement, about 45% would experience an increase in the minimum capital needed to remain well-capitalized. Only 76 or 2% of these smaller credit unions are projected to experience a decline in their net worth category and most of those would be able to adjust operations to address the change in measurement prior to the effective date of a new regulation.

Q. How does this proposal achieve comparability with the banking system while addressing the unique features of the credit union industry?

One of the largest differences between the banking and credit union industry is the ability to raise capital. With few exceptions, credit unions are limited to raising capital through retained earnings. In considering this issue, we made the leverage ratio in each PCA tier 25 basis points higher than what is required in the banking tiers. Some would argue that the 25 basis points isn't even needed considering a bank in financial distress would, at best, have very limited opportunities to raise capital needed to meet PCA standards. As such, we are very comfortable that the extra 25 basis points compensate for the differences in each industry's ability to raise capital, yet provides for comparability between the systems.

Our capital requirements would continue to be written into the applicable statutes while the banking system would be defined through the rulemaking process. However, we have structured the proposal to provide a certain level of flexibility within the statute to allow us to adjust our system based on future changes in the banking system with the goal of maintaining comparability in key parts.

Q. Can you highlight some of the key changes in how the risk based net worth ratio would be calculated in the proposal as compared to the current method?

The two systems are very different. The current system tries to measure risk in several areas including a lot of emphasis on interest rate risk. In the proposed system, the asset types most impacted by the change are residential mortgage loans and investments, as well as consideration given to various off balance sheet risks.

The current system requires higher levels of capital to be maintained for long term real estate loans in excess of 25 percent of assets, addressing concentration and interest rate risk. The proposed system allows for lower levels of capital for residential real estate loans with low loan to value ratios, addressing more credit risk.

Under the current system investments with maturities greater than 3 years required higher levels of capital, a focus on interest rate risk. The proposed system focuses on the credit rating of the investments, which once again is a focus on credit risk.

Q. Would implementation of this proposal increase the reporting burden on small credit unions?

For credit unions offering basic services, the reporting burden would not increase. Small credit unions would have an increased burden to the extent they are engaged in the more complex and higher risk activities identified in the risk-based calculation. In cases where the credit union engages in the higher risk activities, they would need to provide additional information fields in order to compute the risk-based capital requirement due to the expanded number of risk weight categories—such as specific loan-to-value categories. However many institutions already have this information readily available. Any additional fields required to comply with the risk-based capital requirement would be consistent with information credit unions should be collecting in order to practice proper risk management.