National Credit Union Administration

Office of the Chairman

August 14, 2003

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
U. S. House of Representatives
Washington, DC 20515-3504

The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
U. S. House of Representatives
Washington, DC 20515-2104

The Honorable Brad Sherman
Member, Committee on Financial Services
U. S. House of Representatives
Washington, DC 20515-0524

Dear Chairman Oxley, Ranking Member Frank and Congressman Sherman:

Thank you for the opportunity to respond to your letter and inquiries of June 19, 2003, concerning the issue of possible legislative changes you indicate have been brought to your attention by some in the credit union industry which would allow federally-insured credit unions to include additional forms of capital, other than retained earnings, as part of their net worth for purposes of the prompt corrective action (PCA) requirements of the Federal Credit Union (FCU) Act. The enclosed document and its attachments respond to the eight specific questions asked in your letter. In addition to responding to those questions, I would also like to take this opportunity to offer some general comments, from NCUA's perspective as the Federal regulator of credit unions, on the broad issues of both secondary capital and the statutory PCA requirements for federally-insured credit unions.

The use of secondary capital instruments in federally-insured credit unions is currently limited to low-income designated credit unions and corporate credit unions. In the case of low-income credit unions, NCUA first authorized the issuance of secondary capital instruments in 1996 through its rulemaking authority. This authority was granted in recognition of the special need of these credit unions to raise capital from sources outside of their limited-income communities. When Congress enacted the statutory

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PCA requirements in 1998, as part of the Credit Union Membership Access Act (CUMAA) amendments to the FCU Act, it too recognized the special need of low-income credit unions and authorized these credit unions to count their secondary capital as part of PCA net worth.

Corporate credit unions have been authorized to issue forms of secondary capital to supplement reserves and undivided earnings under NCUA regulations since 1992. The ability of corporate credit unions to build reserves and undivided earnings is limited by the combined effects of conservative investment standards implemented by NCUA, which are necessary in view of overall requirements for safety and soundness and the concentration of credit union funds in the corporate credit union system, and the competitive markets in which the corporate credit unions vie for natural person credit unions' investment funds. Congress recognized this unique characteristic of the corporate credit union system as well, and exempted corporate credit unions from the statutory PCA net worth requirements mandated by the CUMAA in 1998.

Under the current PCA statute, all other federally-insured credit unions are limited to including only their retained earnings, as determined in accordance with generally accepted accounting principles, in meeting their statutory net worth requirements. As you note in your letter, some in the credit union system are now recommending that all federally-insured credit unions should be authorized to have access to additional forms of capital and to include that capital within their PCA net worth. The argument most often advanced in support of secondary capital for all insured credit unions is that during periods of rapid inflow of funds into insured depository institutions, induced by adverse conditions in other segments of the investment economy, well-managed credit unions may find that their rate of share account growth exceeds their ability to accumulate retained earnings to a degree that causes net worth ratios to decline below the well-capitalized or adequately-capitalized levels, triggering net worth restoration plans and other supervisory actions under PCA. These are conditions that all credit union management understandably and quite properly wish to avoid, and the ability to issue secondary capital instruments that would count towards PCA net worth is one possible method to offset the effect of rapid share growth on net worth ratios. There have been widely divergent viewpoints expressed within both the credit union industry and the regulatory community as to the advisability of secondary capital being authorized as an option for all federally-insured credit unions; however, in our response to your letter, we

herein seek to present the facts as we see them and to leave the expression of philosophical viewpoints, pro and con, to the credit unions and their trade associations whose role in expressing the position of the industry itself on this issue is more appropriate.

The questions presented in your letter request information first on the relationships between credit union asset and capital growth and other conditions in the economy, and second on NCUA's experience to date with the use and effectiveness of secondary capital in low-income credit unions and corporate credit unions.

We are pleased to provide the information requested and trust that it will be helpful as Congress continues to consider this important issue. We recognize that whether to allow secondary capital to count as part of PCA net worth for all insured credit unions is a matter of legislative and public policy that only Congress may decide. If Congress were to decide to authorize secondary capital as a component of PCA net worth for all insured credit unions, we can certainly put in place an effective regulatory and supervisory process which can protect its integrity and ensure its safety and soundness. However, to ensure the integrity of any congressional authorization of secondary capital, we would urge that NCUA be provided a broad grant of general rulemaking authority over these accounts in order to assure our ability to properly fulfill our safety and soundness mission. Important issues that would need to be addressed include at least the following.

1. **Permissible investors.** Experience has shown that when uninsured accounts are offered to natural-person customers of a financial institution, and then the accounts suffer losses, confusion about insured status and issues of reputation risk and systemic confidence result. Also, if credit unions were allowed to offer these accounts to one another without limitation, a round-robin effect of creating a seemingly higher capital base through accounting techniques could potentially result, while actually increasing systemic risk. To address these issues, NCUA would need clear authority to regulate the scope of permissible investors in credit union secondary capital accounts.

2. **Maturities of the accounts.** In order for accounts to function effectively as a form of capital, they will need to be long term accounts. It may also be appropriate to require a phase-out of an account's capital value for purposes of net worth ratio requirements as its maturity approaches. The traditional functions of capital include supporting growth and protecting

against losses to creditors, uninsured members and the Insurance Fund. Short term accounts and accounts that are near maturity have little value for these purposes. Thus, NCUA would require authority to regulate maturities of any secondary capital accounts for natural person credit unions as we now currently do for secondary capital in corporate credit unions.

3. **Amount of account in relation to total net worth.** Primary capital is preferred and no financial institution should rely entirely on secondary capital as its source of net worth. The result would be that unexpected losses would always be covered by absorption of secondary capital, with attendant loss to the secondary capital investor and harm to the reputation of the institution and its segment of the financial services industry. NCUA should have the ability to regulate a required minimum amount of primary capital.

4. **Disclosures.** Secondary capital by its very nature must be used to cover losses that exceed available primary capital. In this event, it is critical that potential investors be given a clear understanding of the functions and risks associated with these accounts. In the absence of a clear understanding, costly and time consuming legal disputes will likely arise. Therefore, it is essential that NCUA have the authority to regulate disclosures with respect to secondary capital accounts.

5. **CPA Audits.** Because of the various risks of secondary capital accounts discussed above, it may be appropriate to require an annual CPA opinion audit of any credit union offering these accounts. The opinion audit would be conducted before the credit union is authorized to offer secondary capital, and it would be provided to all prospective secondary capital investors.

At the same time that Congress is considering authorization of alternative forms of capital for all insured credit unions, it also seems appropriate to re-visit the current PCA requirements which fail to accurately and fully reflect individual risk factors in credit unions. Under the current system, the basic net worth ratio requirements are established solely as a percentage of total assets. Thus, for example, two credit unions with the same net worth ratio of just below 6% are considered undercapitalized, and subject to a supervisory net worth restoration plan, even though one credit union may find itself in that position as a result of unsolicited share growth, while the other credit union may have suffered investment or loan losses or a

prolonged period of depressed earnings resulting from poor management practices. The respective risk profiles of these two credit unions are different. Clearly, the two credit unions should not be treated the same under PCA requirements.

The flaw in the present system of PCA is that it focuses from the outset on *all* assets, instead of concentrating exclusively on *risk* assets which is the true source of the risk of loss and more accurately reflects a credit union's ability to manage and absorb risk. While there is a risk-based net worth requirement superimposed on the current PCA structure, it simply comes too late in the process; it identifies risks that a 6% net worth ratio may not protect against only after the broad focus on all assets has depressed a credit union's net worth ratio.

Amending the FCU Act to adopt a comprehensive risk-based approach would fully inform the system of PCA from the start. The Act presently defines the "net worth" numerator of a credit union's net worth ratio as its "retained earnings" under GAAP, and the denominator as its "total assets." For the net worth ratio to reflect individual risk factors, Congress may wish to consider modifying the Act in four ways. First, the denominator of the net worth ratio should be narrowed so that it consists of the "risk-weighted assets" of the credit union. Second, to ensure that the process of identifying risk factors is dynamic, the NCUA Board should have the authority to define "risk-weighted assets" by regulation, based on such safety and soundness issues as type of asset, duration, concentrations, and liquidity. Third, since these modifications would make the present risk-based net worth component of PCA obsolete, it should be repealed. Finally, Congress should authorize NCUA to set a minimum required amount of primary capital.

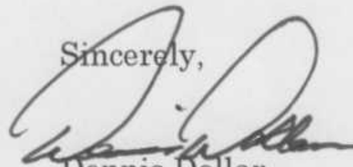
Implementation of such a risk-based system would not be uncharted territory for NCUA or federal credit unions. Prior to the net worth requirements mandated by PCA with the implementation of CUMAA, federal credit unions were permitted to except seventeen different categories of assets from their net worth calculations for purposes of establishing statutorily mandated reserves required under section 116 of the Federal Credit Union Act because they were not considered to be risk assets. Among the items included in these excepted categories were cash on hand, prepaid expenses, the deposit in the National Credit Union Share Insurance Fund which represents a credit union's capitalization account balance of one percent of insured shares, and certain investments and loans guaranteed by the United States government. This structure worked well prior to

enactment of CUMAA in 1998 as credit union capital grew over the previous ten-year period from $12 billion to over $42.3 billion and the capital-to-asset ratio grew from 6.87% at the end of 1988 to 10.88% by the end of 1998. Although some revisions might be required by regulation to risk-weight certain of those pre-1998 factors to accommodate today's risk patterns, these factors could be a logical starting point if Congress were to choose to amend the current definition of net worth to include risk assets rather than total assets as defined under the current PCA requirements.

The suggestion of a system of risk-based PCA is not intended as a substitute or alternative to secondary capital. We recognize that, although both related to PCA, these are two separate issues, neither mutually exclusive of the other. Secondary capital could be authorized by Congress without addressing the need to risk-base the current PCA provision. Another option would be to authorize secondary capital by congressional action and then assign to NCUA the responsibility for a risk-weighting of the secondary capital within a risk-based PCA system. Or Congress might choose to address the problems with the current PCA system by moving to a more comprehensive risk-based system, and not choose to address the secondary capital issue at this time. Should you wish to further pursue the issue of a risk-based PCA system or the authorization of secondary capital, either within or without a risk-based PCA system, we would of course be happy to provide draft amendment language or provide any other assistance that would be helpful to you and the committee staff.

In closing, we wish to again thank you for the opportunity to participate in positive dialogue and constructive discussion on this important issue. The responses to the specific inquiries posed in your June 19 letter are enclosed as an attachment to this letter.

Sincerely,



Dennis Dollar
Chairman

Enclosures