NCUA PROPOSAL TO RISK-BASE PROMPT CORRECTIVE ACTION CATEGORIES FOR FEDERALLY INSURED CREDIT UNIONS

CURRENT LAW

In 1998, the U.S. Congress amended the Federal Credit Union Act (FCUA) to apply prompt corrective action (PCA) requirements to federally insured credit unions based on "net worth" levels. Under this law a credit union is considered;

- "well capitalized" if it has a net worth ratio of not less than 7%; falling below 7% triggers an earnings retention requirement and involvement with NCUA that most insured credit unions would like to avoid;
- "adequately capitalized" if it has a net worth ratio of not less than 6%; falling below 6% requires the credit union to produce a net worth restoration plan and further regulatory involvement;
- "undercapitalized" if it has net worth below 6%; and with this status comes restrictions on asset growth and member business loans;
- "significantly undercapitalized" if it has a net worth ratio of less than 4%:
- "critically undercapitalized" if it has a net worth ratio less than 2%; in these instances the NCUA Board has 90-days to take action as the Board determines, such as conserving, liquidating the credit union or other appropriate action.

NEED FOR REFORM

NCUA and federally insured credit unions have now had more than six years of experience operating under the 1998 PCA rules and this experience and call report data indicate that:

- The PCA categories, which act as a leverage requirement for federally insured credit unions, are too high; they penalize low risk institutions resulting in inefficient use of capital; overshadow any risk-based system, limiting behavioral modification benefits; contribute to unwarranted charter bias against credit unions; establish a "one-size fits all" effect for federally insured credit unions; cause inappropriate treatment for both the required deposit in the National Credit Union Share Insurance Fund and membership capital in corporate credit unions.

- Other problematic or burdensome consequences include: a definition of net worth that is too limited given new accounting rules; inability to waive net worth restoration plans for marginally undercapitalized credit unions in limited circumstances; and other technical corrections are needed.

LEGISLATIVE STATUS

On April 4, 2005 NCUA presented a legislative proposal to risk-base PCA to Representative Royce (R-CA), Representative Kanjorkski (D-PA) and Senator Crapo (R-ID). The NCUA proposal would;

1. Establish minimum regulatory capital levels complemented by NCUA's supervisory program.

2. Establish comparability to PCA rules and capital standards for FDIC-Insured Institutions.

3. Establish a tandem system of leverage <u>and</u> risk-based requirements.

4. Maintain appropriate and actionable PCA leverage ratios: "well capitalized" leverage ratio standard at 5%; maintains 2% threshold for "critically undercapitalized" credit unions.

5. Establish that, for PCA purposes only, the NCUSIF deposit is deducted from net worth to place on par with FDIC fund and bank capital standards. Note: Accounting treatment as an asset is strongly supported by NCUA.

6. Establish Risk-Based Standards for Federally Insured Credit Unions; risk-based ratio standard at 8%; portfolios & weights based on BASEL II Standard Approach. Analysis confirms suitability for use of risk weights given credit union loss histories; NCUA proposal tied to those risks addressed by the FDIC risk-based system (thus does not include interest rate risk); expands risk-based to all credit unions, not just those over $10M or otherwise considered complex (current law), since "risk-based" will account for credit unions not engaged in risky activities; includes use of operational risk basic indicator approach (proxy for risk is average of three year's gross income).

7. Make supervisory program adjustments: establish authority to delegate reclassification to one lower net worth category based on supervisory assessment; Add S (for market sensitivity) to CAMEL; Add GAAP capital ratio for all non-PCA capital determinations.

PROPOSED PCA THRESHOLDS FOR CREDIT UNIONS

Net Worth Categories*	Net Worth Ratio	Risk-Based Net Worth Ratio
Well Capitalized	5% or greater	8% or greater
Adequately Capitalized	4% to < 5%	8% or greater
Undercapitalized	3% to < 4%	6% to < 8%
Significantly Undercapitalized	2% to < 3%	< 6%
Critically Undercapitalized	< 2%	NA

* The lowest category a credit union falls into governs.

RISK PORTFOLIO AND WEIGHTS

Risk Weight	Risk Portfolios
0%	- Cash on Hand - Government Issued or Guaranteed
20%	- Claims on Financial Institutions
20% to 150% (100% unrated)	- Claims on Corporations (per rating)
35%	- Claims Secured by Residential Property
75%	- Regulatory Retail Loans
100%	- Membership Interests and Bank Equity Instruments - All Other Loans - Past Due Loans Secured by Residential Property - All Other Assets
150%	- Past Due Loans All Other
Based on Underlying Obligation	- Commitments - Recourse Obligations and Direct Credit Substitutes
Deduction from Net Worth	- NCUSIF Deposit - Significant Minority Interests or Reciprocal holdings of equity instruments
Special	- ALLL (add to Net Worth and deduct from assets) - Operational Risk (add to risk assets)

House of Representatives

On May 12, 2005, H.R. 2317 the "Credit Union Regulatory Improvements Act of 2005" (CURIA) was introduced. Title I of the legislation would amend the Federal Credit Union Act to provide for risk-basing PCA when enacted.

U.S. Senate

Chairman Johnson reiterated the need for PCA reform in her testimony before the Senate Committee on Banking, Housing, and Urban Affairs held on June 21, 2005.

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