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STATEMENT

OF

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"FINANCIAL SERVICES REGULATORY RELIEF: THE REGULATORS VIEWS"

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
UNITED STATES HOUSE OF REPRESENTATIVES

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Chairman Bachus, Representative Sanders, and Members of the Subcommittee: on behalf of the National Credit Union Administration (NCUA) I am pleased to be here today to present our agency's views on regulatory efficiency and reform initiatives being considered by Congress. Enacting legislation that will directly and indirectly benefit the consumer and the economy by assisting all financial intermediaries and their regulators perform the role and functions required of them is prudent.

REGULATORY RELIEF AND EFFICIENCY

The Subcommittee on Financial Institutions and Consumer Credit has been taking the lead over the last several years in many areas of interest to consumers, financial institutions such as credit unions and their members. Legislation of the type being considered today epitomizes the real connection between, and benefits of, effective financial institutions efficiently delivering consumer credit to the public.

In July of 2004 I testified in favor of the credit union provisions included in the "Financial Institutions Regulatory Relief Act of 2004," (H.R. 1375), approved by the Financial Services Committee and passed by the House of Representatives by a vote of 392-25. That legislation was a significant bipartisan achievement that NCUA greatly appreciated and enthusiastically supported as it moved through the House of Representatives. They have merited your support in the past and NCUA supports inclusion of those credit union provisions in any new legislation that is introduced this year.

The recent introduction of the "Credit Union Regulatory Improvements Act of 2005," H.R. 2317 (CURIA), by Representatives Royce, Kanjorski, Sanders, LaTourette, Maloney, Gutierrez and Paul from the House Financial Services Committee to name a few, addresses some of the most compelling statutory and consequently, regulatory reform issues being discussed within the credit union industry today. HR 2317 also includes many of the same credit union provisions approved in H.R. 1375 last Congress. On May 25, 2005 NCUA provided a response and letter of support for CURIA which is included with this testimony.

CURIA of 2003 made the suggestion that NCUA should be authorized to design and implement a risk based prompt corrective system for federally insured credit unions. Without more details, policy makers and credit unions could not make an accurate assessment of the proposal, so NCUA went to work to demonstrate how such a system could be implemented. Title I of CURIA of 2005 now includes the necessary statutory changes required. I have provided the complete plan as an attachment to this testimony and would like to briefly discuss it here.

Prompt Corrective Action Reforms

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This mandate is good public policy and consistent with NCUA's fiduciary responsibility to the insurance fund. While NCUA supports a statutorily mandated PCA system, the current statutory requirements for credit unions are too inflexible and establish a structure based primarily on a "one-size-fits all" approach, relying largely on a high leverage requirement of net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to design a meaningful risk-based system.

Reform of capital standards is vital for credit unions as the other federal banking regulators explore implementation of BASEL II and other capital reforms for banks in the United States. While maintaining a leverage ratio, NCUA's PCA reform proposal incorporates a more risk-based approach to credit union capital standards consistent with BASEL I and II. In recognition of the inherent limitations in any risk-based capital system, our proposal incorporates leverage and risk-based standards working in tandem. The risk-based portion of the proposed tandem system uses risk portfolios and weights based on the BASEL II standard approach.

For the leverage requirement, NCUA supports a reduction in the standard net worth (i.e., leverage) ratio requirement for credit unions to a level comparable to what is required of FDIC insured institutions. The minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, compared to the threshold of 5% for FDIC-insured institutions. There are important reasons why the leverage ratio for credit unions ratio should be lowered to work in tandem with a risk-based requirement.

First, credit unions should not be placed at a competitive disadvantage by being held to higher capital standards when they are not warranted to protect the insurance fund. For FDIC insured institutions, a 5% leverage requirement coupled with a risk-based system has provided adequate protection for their insurance fund. In comparison, the credit union industry has a relatively low risk profile, as evidenced by our low loss history. This is largely due both to the greater restrictions on powers of credit unions relative to other financial institutions and credit unions' conservative nature given their member-owned structure. In fact, our experience has shown that given economic needs and their conservative nature, the vast majority of credit unions will operate with net worth levels well above whatever is established as the regulatory minimum.

In addition, the current 7% leverage requirement is excessive for low risk institutions and overshadows any risk-based system we design, especially if you consider that under BASEL the risk-based capital requirement is 8% of risk assets. A meaningful risk-based system working in tandem with a lower leverage requirement provides incentives for financial institutions to manage the risk they take in relation to their capital levels, and gives them the ability to do so by reflecting the composition of their balance sheets in their risk-based PCA requirements. The current high leverage requirement provides no such ability or incentive and, in fact, it can be argued could actually contribute to riskier behavior to meet these levels given the extra risk isn't factored into the dominant leverage requirement.

We recognize, however, that achieving comparability between the federal insurance funds does require us to factor in the NCUSIF's deposit-based funding mechanism. Thus, our reform proposal incorporates a revised method for calculating the net worth ratio for PCA purposes by adjusting for the deposit credit unions maintain in the share insurance fund. However, our proposed treatment of the NCUSIF deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles, or NCUA's steadfast support of the mutual, deposit-based nature of the NCUSIF.

As for capitalization investments in corporate credit unions, these are not uniformly held by all credit unions. Indeed, not all credit unions even belong to a corporate credit union. Thus, these investments are appropriately addressed under the risk-based portion of PCA. Our reform proposal addresses capitalization investments in corporate credit unions consistent with BASEL and the FDIC's rules applicable to capital investments in other financial institutions.

For the risk-based requirement, our proposal tailors the risk-asset categories and weights of BASEL II's standard approach, as well as related aspects of the FDIC's PCA system, to the operation of credit unions. The internal ratings-based approach of BASEL II for the largest internationally active banks is not applicable to credit unions. However, it is our intention is to maintain comparability with FDIC's PCA requirements for all other insured institutions and keep our risk-based requirement relevant and up-to-date with emerging trends in credit unions and the marketplace.

As there are limitations in any regulatory capital scheme, NCUA's reform proposal also includes recommendations to address these other forms of risk under the second pillar of the supervisory framework, a robust supervisory review process. Through our examination and supervision process, NCUA will continue to analyze each credit union's capital position in relation to the overall risk of the institution, which may at times reflect a need for capital levels higher than regulatory minimums.

I would also point out that our reform proposal addresses an important technical amendment needed to the statutory definition of net worth. NCUA anticipates that the Financial Accounting Standards Board (FASB) will act soon to lift the current deferral of the acquisition method of accounting for mergers by credit unions, thereby eliminating the pooling method and requiring the acquisition method. When this change to accounting rules is implemented it will require that, in a merger, the net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as "acquired equity," a term not recognized by the "Federal Credit Union Act" (FCUA). Without this important change, only "retained earnings" of the continuing credit union will count as net worth after a merger. This result would seriously reduce the post-merger net worth ratio of a federally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has adverse implications under the statutory "prompt corrective action" (PCA) regulation. This result will discourage voluntary mergers and on occasion make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF). Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost. Thus, our reform proposal provides for a revised definition of net worth to include any amounts that were previously retained earnings of any other credit union.

Enabling NCUA to adopt a PCA system that remains relevant and up-to-date with emerging trends in credit unions and the marketplace provides safety, efficiency, and benefits to the credit union consumer. I believe our reform proposal achieves a much needed balance between enabling credit unions to utilize capital more efficiently to better serve their members while maintaining safety and soundness and protecting the share insurance fund. A well-designed risk-based system would alleviate regulatory concerns by not penalizing low risk activities and by providing credit union management with the ability to manage their compliance through adjustments to their assets and activities. A PCA system that is more fully risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

PROVISIONS FOR REGULATORY REFORM SUGGESTED BY NCUA AND PREVIOUSLY APPROVED BY THE HOUSE OF REPRESENTATIVES

Check Cashing, Wire Transfer and Other Money Transfer Services

The Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members (12 USC 1757(12)). To reach the "unbanked," federal credit unions should be authorized to provide these services to anyone eligible to become a member. This is particularly important to federal credit unions in furthering their efforts to serve those of limited income or means in their field of membership. These individuals, in many instances, do not have mainstream financial services available to them and are often forced to pay excessive fees for check cashing, wire transfer and other services. Allowing federal credit unions to provide these limited services to anyone in their field of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations. Representative Gerlach introduced this provision as H.R. 749 in the 109th Congress and it has been passed by the House of Representatives on April 26, 2005.

The Twelve-Year Maturity Limit on Loans

Federal credit unions are authorized to make loans to members, to other credit unions and to credit union organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a twelve-year maturity limit that is subject to only limited exceptions (12 USC 175(5)). This maturity limit should be eliminated. It is outdated and unnecessarily restricts federal credit union lending authority. Federal credit unions should be able to make loans for second homes, recreational vehicles and other purposes in accordance with conventional maturities that are commonly accepted in the market today. It is our view that NCUA should retain the rulemaking authority to establish any maturity limits necessary for safety and soundness.

Increase One Percent Investment Limit in CUSOs to Three Percent

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations (12 USC 1757(7)(I)). These organizations, commonly known as credit union service organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risks are isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the NCUSIF, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation. Increasing the CUSO investment limit from 1 percent to 3 percent, is an improvement over the current limit, and NCUA supports the change.

Expanded Investment Options

The Federal Credit Union Act limits the investment authority of federal credit unions to loans, government securities, deposits in other financial institutions and certain other very limited investments (12 USC 1757(7)). This limited investment authority restricts the ability of federal credit unions to remain competitive in the rapidly changing financial marketplace. The Act should be amended to provide such additional investment authority as approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state chartered credit unions or other financial institutions. As drafted last Congress, the provision appropriately addresses the issues NCUA has presented in our recommendation, limits additional investment to corporate debt securities (as opposed to equity) and further establishes specific percentage limitations and investment grade standards.

Voluntary Merger Authority
The Federal Credit Union Act, as amended by the Credit Union Membership Access Act, allows voluntary mergers of healthy federal credit unions, but requires that NCUA consider a spin-off of any group of over 3,000 members in the merging credit union (12 USC 1759(d)(2)(B)(i)). When two healthy federal credit unions wish to merge, and thus combine their financial strength and service to their members, they should be allowed to do so. There is no reason to require in connection with such mergers that groups over 3,000, or any group for that matter, be required to spin off and form a separate credit union. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns. These groups are already included in a credit union in accordance with the statutory standards, and that status should be unaffected by a voluntary merger.

Regulatory Relief from SEC Registration Requirements
NCUA is seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker-dealers when engaging in certain de minimus securities activities.
The Gramm Leach Bliley Act, enacted in 1999, created exemptions from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisers Act of 1940. The principle established by these exemptions is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate. The provision would provide similar exemptions for federally insured credit unions. NCUA supports these exemptions. Because of significant differences between broker-dealer capital requirements and depository institution capital requirements, it is virtually impossible for depository institutions, including credit unions, to register as a broker-dealer and submit to broker-dealer requirements. Without an exemption credit unions may find that although they are authorized under their chartering statutes to engage in particular securities-related activities, their inability to register as a broker-dealer would keep them from engaging in these activities. Recently, the Securities and Exchange Commission proposed a rule that would exempt credit unions from the definition of broker and dealer for a few of the activities exempted for banks under Gramm Leach Bliley, including third party brokerage arrangements and sweep account arrangements. NCUA supports the SEC proposal. We believe, however, that the SEC's proposal does not go far enough, and we continue to support legislative relief. The relief sought for credit unions would be more limited in scope and application than that which is available to banks and requested by thrifts. Credit union powers are limited by

their chartering statutes, and credit unions do not have certain powers, such as general trust powers, that are available to banks and thrifts. The requested parity relief for credit unions would apply only to those activities otherwise authorized for credit unions under applicable credit union chartering statutes, currently including third-party brokerage arrangements, sweep accounts, and certain safekeeping and custody activities.

Technical Corrections to the Federal Credit Union Act

Included and approved in H.R. 1375 last Congress, these provisions are purely drafting, numerical and incorrect references without any policy impact that need to be made to the Federal Credit Union Act.

ADDITIONAL CREDIT UNION PROVISIONS

I would also like to take this opportunity to comment on credit union provisions not originating from NCUA, but included in CURIA or H.R. 1375 as passed by the House of Representatives last Congress.

NCUA has reviewed all of these additional credit union provisions and the agency has no safety and soundness concerns with these provisions. Among these are provisions which address leases of land on Federal facilities for credit unions; member business loans for non-profit religious organizations; criteria for continued membership of certain member groups in community charter conversions; credit union governance changes; revising the economic factors the NCUA Board must use when considering adjustments to the statutory 15% interest rate that can be charged by federal credit unions on loans; and an exemption from pre-merger notification requirements of the Clayton Act.

Conclusion

Thank you, Mr. Chairman, for the opportunity to appear before you today on behalf of NCUA to discuss the public benefits of regulatory efficiency for NCUA, credit unions and 84 million credit union members. I am pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.

NATIONAL CREDIT UNION ADMINISTRATION

PROMPT CORRECTIVE ACTION
PROPOSAL FOR REFORM

January 2005

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1. INTRODUCTION

NCUA believes the statutory mandate to take prompt corrective action to resolve problems at the least long-term cost to the National Credit Union Share Insurance Fund (NCUSIF) is sound public policy. Further, this policy is consistent with NCUA's fiduciary responsibility to the NCUSIF. Appropriate PCA standards serve as a restraint on growth that outpaces a credit union's ability to generate commensurate earnings, especially aggressive growth strategies that have a high correlation to problems in financial institutions. The framework of PCA also needs to provide institutions with recognition for low-risk, prudent portfolio management strategies.

However, PCA for credit unions does not adequately distinguish between low-risk and higher risk activities. The current PCA system's high leverage requirement (ratio of net worth to total assets) coupled with the natural tendency for credit union's to manage to capital levels well above the PCA requirements essentially creates a "one-size fits all" system. This penalizes institutions with conservative risk profiles. While providing adequate protection for the insurance fund, a well designed risk-based system with a lower leverage requirement would more closely relate required capital levels with the risk profile of the institution and allow for better utilization of capital.

The current high leverage ratio imposes an excessive capital requirement on low-risk credit unions. With a lower leverage requirement working in tandem with a well-designed risk-based requirement, credit unions would have greater ability to serve members and manage their compliance with PCA. By managing the composition of the balance sheet, credit unions could shift as needed to lower risk assets resulting in the need to hold less capital.

A PCA system comparable to that employed in the banking system will provide sufficient protection for the insurance fund. Such a system for credit unions would also remove charter bias and level the playing field by eliminating differing capital standards unrelated to risk. While credit unions are not able to raise capital as quickly in some cases as other financial institutions,[1] the majority of credit unions have a relatively conservative risk profile (driven by the restrictions of powers relative to other institutions and their cooperative, member-owned structure) and a comparatively low loss history. Thus, credit unions should not be required to hold excessive levels of capital.

[1] Stock-owned financial institutions are constrained by the market (and regulatory restrictions on Tier II capital) when raising capital from other sources than retained earnings once the institution's capital level has declined markedly or is otherwise encountering difficulty.

2. TIMELINE OF CAPITAL STANDARDS

Date	Event
1988	Basel I accord.
1991	Congress enacts a system of Prompt Corrective Action for FDIC-insured institutions.
1991	GAO report entitled "Credit Unions Reforms for Ensuring Future Soundness" recommends minimum capital standards and Prompt Corrective Action for credit unions. "*Nevertheless, we believe that credit unions should be required to achieve and maintain some minimum level of GAAP capital (regular reserves plus retained earnings) in order to demonstrate and help ensure that they are economically viable and that their members' money, and ultimately the insurance fund, is as safe as possible.*" p65
1997	Treasury Study recommends Prompt Corrective Action for credit unions. "*Prompt corrective action helps counteract the perverse incentives [e.g., moral hazard, regulatory forbearance, etc.] created by deposit insurance … Prompt corrective action better aligns the incentives of depository institutions' owners, managers, and regulators with the interests of the deposit insurance fund.*" p74
1998	Congress enacts a system of Prompt Corrective Action for NCUA-insured institutions. "*The purpose of this section is to resolve the problems of insured credit unions at the least possible long-term loss to the Fund.*" - § 1790d(a)(1)
2000	NCUA implements prompt corrective action regulations.
2004	Basel II accord. "*It should be stressed that the revised Framework is designed to establish minimum levels of capital …More generally, under the second pillar [supervisory review process], supervisors should expect banks to operate above minimum regulatory capital levels …It is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second*." p3
2004	GAO report entitled "Credit Unions Available Information Indicates No Compelling Need for Secondary Capital." "*In addition, GAO believes that any move to a more risk-based system should provide for both risk-based and meaningful leverage capital requirements to work in tandem.*" p6

3. EXECUTIVE SUMMARY

The purpose of prompt corrective action for credit unions is to protect the share insurance fund. It is not to regulate what constitutes sound capital management relative to the business needs of an institution. It is also not designed to encompass all of the possible risks, nor factor in all relevant variables (both qualitative and quantitative), to be able to stand on its own. As the BASEL II[2] report stresses, the capital standards are designed to establish *minimum* levels of capital that work in tandem, not isolation, with a supervisory review process (i.e., an examination and supervision program). Financial institutions will be expected to operate above minimum regulatory capital levels based on their institution specific business needs and holistic assessment of all relevant risks. It is within this context that we offer the following recommendations for PCA reform for credit unions.

A. Tandem Net Worth (Leverage) and Risk-Based Net Worth Requirements

We propose adoption of the following thresholds for PCA net worth categories for credit unions. The net worth ratio thresholds are comparable to those used by the FDIC for the leverage requirement, and the risk-based net worth ratio thresholds are based on the comparable FDIC total risk-based capital requirements and the BASEL II 8% standard.

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[3]
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.

[2] International Convergence of Capital Measurement and Capital Standards, A Revised Framework, June 2004, Basel Committee on Banking Supervision, Bank for International Settlements, is commonly known as Basel II.

[3] The FDIC PCA system does not impose any requirements on banks unless they fall below adequately capitalized. However, PCA for credit unions imposes an earnings retention requirement on less than well capitalized credit unions, but only for the standard net worth requirement (i.e., leverage ratio) as the risk-based net worth requirement by statute is based only on the adequately capitalized level. In contrast, adequately capitalized banks are not subject to a requirement to increase the leverage ratio beyond adequately capitalized. Further, the FDIC's Tier 1 capital to risk assets threshold for well capitalized is only 6%. Thus, the proposed risk-based thresholds do not distinguish (i.e., are the same) between well and adequately capitalized for credit unions with risk-based net worth ratios of 8 percent or greater. This is also consistent with the 8% target established under BASEL.

Bank PCA Thresholds for Comparison (FDIC-Insured)

Capital Categories*	Tier 1 Capital to Total Assets	Tier 1 Capital to Risk Assets	Total Capital to Risk Assets
Well Capitalized	5% or greater	6% or greater	10% or greater
Adequately Capitalized	4% to < 5%	4% to < 5%	8% to < 10%
Under Capitalized	3% to < 4% or < 3% for CAMEL 1	3% to < 4%	6% to < 8%
Significantly Under Capitalized	2% to < 3%	< 3%	< 6%
Critically Under Capitalized	< 2% (tangible equity)	NA	NA

* The lowest category governs.

B. BASEL II – Standard Approach to Credit and Operational Risk

We propose using the BASEL II Standard Approach for credit risk and the basic indicator approach for operational risk for the risk-based net worth requirement. To the extent applicable to the operations of credit unions, this proposal incorporates all the risk portfolios and risk weights as specified in BASEL II, with no noteworthy variation. The portfolios and risk weights are as follows (see Appendix 1 for an in-depth discussion of each risk portfolio):

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)

C. Interest Rate Risk

We recommend adjusting the statute so the risk-based net worth requirement for credit unions takes account of the comparable risks addressed by the FDIC's risk-based capital requirements. The current statutory language "to take account of any material risks" in relation to the risk-based net worth requirement (§1790d(d)(2)) obligates NCUA to incorporate interest rate risk into the risk-asset weights. However, BASEL (I and II) and the FDIC's risk-based capital system only address credit and operational risk (and market risk in limited situations not relevant to credit unions). They have taken this approach because a balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental."[4] As such, the BASEL and FDIC system deal with interest rate risk under the second pillar, a robust supervisory review process.

Thus, NCUA recommends a comparable approach for credit unions. This is also consistent in principle with the internal ratings based approach for credit risk used in BASEL II in that complex, judgmental areas warrant institution specific modeling. To complement this approach and bolster the supervisory review process in relation to interest rate risk, we are recommending adding more flexibility for reclassification authority to lower net worth categories for concerns involving inadequate net worth levels relative to interest rate risk based on institution specific model results. Further, we will explore adding an "S" component[5] to CAMEL to specifically rate interest rate risk, and tying procedures for reclassification to a lower net worth category institutions with other than acceptable "S" ratings.

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[4] Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, paragraph 8.

[5] The "S" in CAMELS refers to Sensitivity to Market Risk. The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates.

4. STATUTORY CHANGES RECOMMENDED

A. NET WORTH CATEGORIES - § 1790d(c)(1)

Change
(A) **Well capitalized.** - An insured credit union is 'well capitalized' if - (i) it has a net worth ratio of not less than *5 percent*; and (ii) *it has a risk-based net worth ratio of not less than 8 percent.*
B) **Adequately capitalized.** - An insured credit union is 'adequately capitalized' if - (i) it has a net worth ratio of not less than *4 percent*; and (ii) *it has a risk-based net worth ratio of not less than 8 percent*.
C) **Undercapitalized.** - An insured credit union is 'undercapitalized' if - (i) it has a net worth ratio of less than *4 percent*; or (ii) *it has a risk-based net worth ratio of less than 8 percent.*
D) **Significantly undercapitalized.** - An insured credit union is 'significantly undercapitalized' if - (i) it has a net worth ratio of less than *3 percent*; or (ii) *it has a risk-based net worth ratio of less than 6 percent; or* (iii) it has a net worth ratio of less than *4 percent* and (aa) it fails to submit an acceptable net worth restoration plan within the time allowed under subsection (f); or (bb) materially fails to implement a net worth restoration plan accepted by the Board.
E) **Critically undercapitalized.** - An insured credit union is 'critically undercapitalized' if it has a net worth ratio of less than 2 percent (or such higher net worth ratio, not to exceed 3 percent, as the Board may specify by regulation).

These changes (additions in italics, strikethrough for deletions) reset the benchmarks for the net worth categories, beginning with the well capitalized level at 5%, down from 7%. This is equivalent to the leverage ratio for FDIC-insured institutions.

The changes also set a statutory threshold for the risk-based net worth ratio comparable to that used for the total risk-based capital requirement of FDIC-insured institutions, as well as that adopted under BASEL II (8%).

B. RISK-BASED NET WORTH REQUIREMENT - § 1790d(d)

Change	Comment
(1) **In general. -** The regulations required under subsection (b)(1) shall include a risk-based net worth requirement for insured credit unions ~~that are complex~~, ~~as defined by the Board~~ based on the portfolios of assets and liabilities of credit unions *as defined by the Board*.	As the risk-based net worth requirement applies to all insured credit unions based on the portfolios of risk assets they hold, there is no need to limit this to "complex" credit unions.
(2) **Standard.** - The Board shall design the risk-based net worth requirement *in relation to risk assets, as defined by the Board*, to take account of any material risks *that the comparable standards for institutions insured by the Federal Deposit Insurance Corporation take account that are applicable to credit unions* ~~against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection~~.	This change incorporates reference to risk assets as defined by the NCUA board. The reference to adequately capitalized is no longer necessary given the change to the net worth category definitions. In addition, we recommend removing the requirement to address all risks and tying the requirement to address the risks addressed under BASEL and the FDIC system. BASEL and the FDIC capital system only address credit and operational risk.[6] A balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental."[7] As such, the BASEL and FDIC system deal with interest rate risk under the second pillar, a robust supervisory review process. NCUA recommends a comparable approach for credit unions. This is also consistent in principle with the internal ratings based approach for credit risk used in BASEL II in that complex and judgmental areas warrant institution specific modeling. (See recommendation below related to more stringent treatment based on other supervisory criteria.)

[6] The BASEL and FDIC system also includes market risk for institutions with large trading portfolios (over 10% of assets or $1B). This has negligible application to credit unions.

[7] Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, para. 8.

C. MORE STRINGENT TREATMENT BASED ON OTHER SUPERVISORY CRITERIA. - § 1790d(h)

Change	Comment
(2) the Board may ~~not~~ delegate its authority to reclassify an insured credit union into a lower net worth category or to treat an insured credit union as if it were in a lower net worth category *when the supervisory review process determines that unsafe and unsound levels of interest rate risk relative to net worth levels exist*.	This change supports the recommendation to exclude interest rate risk from the risk-based net worth requirement in favor of addressing this risk on an institution specific basis through the supervisory review process. Any such delegation by the board would, of course, remain subject to appeal to respective review committees and ultimately the NCUA Board. NCUA will also explore incorporating an "S" component into CAMEL and developing procedures for reclassifying to a lower category institutions with other than 1 or 2 "S" ratings.

D. DEFINITIONS. - § 1790d(o)

Change	Comment
(2) **Net worth.**—The term 'net worth'— (A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, *together with any amounts that were previously retained earnings of any other credit union with which it has combined*; and	This revised definition addresses the problem related to mergers of credit unions. Based on new GAAP standards (purchase versus pooling method), the retained earnings of the acquired institution would not be considered retained earnings of the continuing institution. This would make mergers of healthy credit unions virtually impossible. The change makes it clear that for regulatory purposes, net worth of any continuing credit union involved in a merger includes retained earnings acquired from other credit unions by a merger.
(2) **Net worth.**—The term 'net worth'— (B) with respect to a low-income credit union, includes secondary capital accounts *to the extent permitted by the Board* that are – (i) uninsured; and (ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.	For safety and soundness purposes, this revision clarifies that the Board may through regulation provide limitations on the types and characteristics of secondary capital permitted for low-income credit unions, and the extent to which these count as net worth. Comparable hybrid equity instruments in FDIC insured institutions are subject to limitations in terms of how much may be used to meet capital requirements (50% of Tier 1 for subordinated debt and 100% of Tier 1 for all hybrid equity instruments), as well as reducing pro-rata the amount that counts toward capital as they approach maturity (decline below 5 years).

(3) **Net worth ratio.** - The term 'net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union *minus its deposit in the Fund* to the total assets of the credit union minus its *deposit in the Fund*.	"*If Congress does not require that the 1-percent deposit be expensed, NCUA should require credit unions to exclude the amount from both sides of their balance sheet when assessing capital adequacy.*" – 1991 GAO Report Credit Unions Reforms for Ensuring Future Soundness - page 174. The 1997 Treasury study of credit unions reached a slightly different conclusion. This report suggested the net worth category thresholds be increased by 1% to address the "double-counting" of equity (both credit union net worth and the Fund) within the credit union system. The report admits this would "more than" compensate for the double-counting effect of the insurance fund deposit. In fact, since the deposit is based on insured shares and not total assets, this results in requiring on average an extra 30 to 40 basis points of net worth in relation to assets. Using the recommended approach of deducting the Fund deposit from both net worth (numerator) and total assets (denominator) results in an accurate capital charge to each insured credit union and places the equity within the credit union system on a comparable basis to that of FDIC-insured institutions. Expensing the 1% deposit in the insurance fund would represent an appropriation by NCUA of these funds that is inconsistent with the statutory treatment of the deposit. Further, it would be inconsistent with GAAP, which the FCU Act mandates credit unions follow.
(5) ***Risk-based net worth ratio****. - The term 'risk-based net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union plus any loan loss reserves (subject to limit by the Board), less the credit union's deposit in the Fund to risk assets of the credit union, as defined by the Board.*	This incorporates similar treatment of the insurance fund deposit, as well as allows the Board through regulation to define risk assets. This proposal incorporates the BASEL II limit on inclusion of loan loss reserves of 1.25% of risk-weighted assets.

E. NET WORTH RESTORATION PLAN REQUIRED. - § 1790d(f)

Change	Comment
(1) **In general.**— *Except as determined by the Board in the case of a credit union that remains marginally undercapitalized for no longer than 180 days,* each insured credit union that is undercapitalized shall submit an acceptable net worth restoration plan to the Board within the time allowed under this subsection.	The authority to waive the requirement to submit a NWRP for credit unions that have a temporary, growth-related, marginal drop in their net worth ratio below "adequately capitalized", as determined on a case-by-case basis, would help address the burden of PCA compliance in situations that don't warrant concern. NCUA envisions defining "marginal" as no greater than 50 basis points below the adequately capitalized level. In addition, growth-related would be limited to an unsolicited influx of deposits (e.g., a "flight to quality"). Declines in net worth due to unprofitable operations or extraordinary losses would not qualify.

F. OTHER TECHNICAL CORRECTIONS

Change	Comment
§ 1790d(e)(2) **(A) In general. –** The Board may, by order *or by approval of a Net Worth Restoration Plan*, decrease the 0.4 percent requirement in paragraph (1) with respect to a credit union to the extent that the Board determines that the decrease -	This clarifies that approval of a Net Worth Restoration Plan that involves for a period of time the credit union earning below the 0.4 percent requirement serves as such an order of the Board.

§ 1790d(i)(3) **(A) In general. –** Notwithstanding paragraphs (1) and (2), the Board shall appoint a liquidating agent for an insured credit union if the credit union is critically undercapitalized on average during the ~~calendar quarter~~ *3-month period* beginning 18 months after the date on which the credit union became critically undercapitalized.	This replaces the reference to calendar quarter with 3-month period. The calendar quarter reference delays measurement and subsequent action until a calendar quarter has elapsed. For situations where the 18 months end a month into a calendar quarter, this adds an additional 2 months to the timeframe upon which measurement and subsequent action occur.
§ 1790d(l)(3)(A) Deciding whether to appoint conservator or liquidating agent. (ii) give that official an opportunity to take the proposed action, *provided that the Board determines that such action by the official will carry out the purpose of this section*;	This clarifies that for PCA based concerns, the Board need only allow a State official to take a conservatorship or liquidation action in lieu of action by the Board if it will carry out the purposes of PCA.

5. IMPACT ANALYSIS

Average NWR = 13.23
Average Proposed NWR = 12.47%[8]
Average Proposed RBNWR = 23.63%

The new tandem system would result in 7 credit unions currently above PCA thresholds falling below them. However, 120 credit unions would no longer be below PCA thresholds.

Net Worth Categories 6/30/2004 Data	#FICU based on Current Net Worth Ratio	#FICU based on Proposed New Net Worth Ratio
Well Capitalized	8,983	9,105
Adequately Capitalized	125	42
Undercapitalized	62	21
Significantly Undercapitalized	23	9
Critically Undercapitalized	17	33

Well Capitalized Plus 6/30/2004 Data	#FICU based on Current Net Worth Ratio	#FICU based on Proposed New Net Worth Ratio
> 2%	7,492	8,553
> 3%	6,357	7,697
> 5%	4,331	5,553

Net Worth Categories 6/30/2004 Data	#FICU based on Current Risk-Based Net Worth Ratio	#FICU[9] based on Proposed New Net Worth Ratio
Adequately Capitalized	9,193	9,125
Undercapitalized	17	51
Significantly Undercapitalized	NA	33
Critically Undercapitalized	NA	NA

[8] The deduction of the NCUSIF deposit results in an average decline in the net worth ratio of 76 basis points.
[9] Does not exclude credit unions less than $10M in assets.

Adequately Capitalized Plus 6/30/2004 Data	#FICU based on Current Risk-Based Net Worth Ratio	#FICU based on Proposed New Risk-Based Net Worth Ratio
> 2%	NA	8,900
> 3%	NA	8,670
> 5%	NA	7,948

6. DEFINITIONS

Capital. Used interchangeably with net worth.

Corporations. Synonymous with the term "corporates" in BASEL II. Corporates has meaning within industry as Corporate Credit Unions.

Direct Credit Substitute. An arrangement in which a credit union assumes, in form or in substance, credit risk directly or indirectly associated with an on or off-balance sheet asset or exposure that was not previously owned by the credit union and the risk assumed by the credit union exceeds the pro rata share of the bank's interest in the third-party asset. If the credit union has no claim on the asset, then the bank's assumption of any credit risk is a direct credit substitute.

Individual Exposure Limit. The level at which loans no longer qualify for inclusion in the regulatory retail loan portfolio. This level is determined by multiplying the potential regulatory retail loans by 0.2%, subject to a floor of $200,000 and a ceiling of $1,000,000.

NRSRO. An entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) as a Nationally Recognized Statistical Rating Organization. Any applicable rating source relied upon for purposes of PCA risk-weighting must be identified at the time of purchase and must be used for risk-weighting purposes as long as the rating is still publicly available. In the event the rating is no longer available, the credit union may choose a rating from another NRSRO and must use the applicable rating from this source as long as it is available.

Potential Regulatory Retail Loans. All loans minus real estate secured loans minus loans to non small businesses minus government guaranteed portion of loans.

Small Business. Any business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

"Unrated." Any corporation or security that does not receive a rating from an NRSRO.

7. APPENDIX 1 - REGULATORY RISK PORTFOLIOS

A. Summary of Risk Portfolios

Cash and Investments

Risk Portfolio	Examples	Risk Weight
1. Cash on Hand	Cash	0%
2. Government Issued or Guaranteed	U.S. Treasury Notes, Federal Agency Notes, Local or State Government Notes, SBA Guaranteed Portion of Business Loans. (Excludes non-guaranteed amounts.)	0%
3. Claims on Financial Institutions	Bank & Credit Union Deposits and Notes	20%
4. Claims on Corporations - Investments (includes GSE issued or guaranteed)	GSE Debentures, Corporate Bonds, Mutual Funds, asset backed and mortgage related (MBS & CMOs) securities, and CUSO investments accounted for under the equity or cost methods.	20% to 150%
5. Membership Interests and Bank Equity Instruments	Corporate capital, CLF stock, FHLB stock, and bank stock.	100%

Loans

Risk Portfolio	Examples	Risk Weight
6. Regulatory Retail Loans	Consumer Loans, Loans to Small Businesses	75%
7. Claims Secured by Residential Property (includes business loans secured by residential real estate)	Fixed and Adjustable Rate Residential Real Estate Secured Loans.	35%

8. All Other Loans • Claims Secured by Commercial Real Estate • Large Retail Loans • Claims on Corporations – Loans	- Business loans secured by commercial real estate. - Consumer loans or loans to small businesses in excess of the lesser of $1M or 0.2% of the regulatory retail portfolio, but not less than $200,000. - Business loans to other than small businesses. Includes loans to CUSOs accounted for under the equity or cost methods.	100%
9. Past Due Loans - Secured by Residential Property	Residential property secured loans in non-accrual status or Delinquent 2 or More Months (90 days past due)	100%
10. Past Due Loans - All Other:	All non-residential property secured loans in non-accrual status or Delinquent 2 or More Months (90 days past due)	150%

Other

Risk Portfolio	Examples	Risk Weight
11. NCUSIF Deposit	Share insurance fund deposit.	Deduct
12. ALLL	Allowance for Loan and Lease Losses account.	Add
13. All Other Assets	Fixed assets, other assets net of those captured specifically.	100%

Off-Balance Sheet

Risk Portfolio	Examples	Risk Weight
14. Commitments	Unused portion of guaranteed lines of credit. Net of those with MAC clauses or unconditionally cancelable.	Varies
15. Recourse Obligations and Direct Credit Substitutes	Loans sold with recourse that qualify for true sales accounting (low level exposure rule).	Varies

Operational Risk

Risk Portfolio	Risk Weight
16. Operational Risk	BASEL II basic indicator approach, 15% of average gross income over 3 year period.

B. Supporting Details for Risk Weights

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1. CASH ON HAND

Recommended Risk Weight:	0%

Bank weight (current):	0%

Basel II weight (standard):	0%

Rationale
Cash on hand is not subject to credit risk. Apply Basel II standard approach (¶81, footnote 28).

Impact Model
5300 Account Code 730A

Implementation Issues
None

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2. GOVERNMENT ISSUED OR GUARANTEED

Recommended Risk Weight:	0%

Bank weight (current):	0%

Basel II weight (standard):	0%

This portfolio excludes any portion of these assets that are not guaranteed.

Rationale
Government Issued or Guaranteed are not subject to credit risk. Apply Basel II standard approach. - (¶53)

Impact Model
Proxy - 5300 Account Codes 741C+742C+(0.8*400F)

Implementation Issues
Will necessitate call report adjustments.

3. CLAIMS ON FINANCIAL INSTITUTIONS

Recommended Risk Weight:	20%
Bank weight (current):	20%
Basel II weight (standard):	20%

Comparable to current and BASEL II approaches.

Rationale
Apply Basel II standard approach (¶61, first option). For credit risk mitigation techniques, implement the simple approach (¶119 and ¶145) as a voluntary supplement to the call report (alternative component). This can result in a 0% weight - e.g. investment repurchase agreements using government securities with qualifying securities using commercially prudent collateral practices.

Impact Model
Proxy - 5300 Account Codes 730B+730C+744C+652C+672C

Implementation Issues
Will necessitate call report changes.

4. CLAIMS ON CORPORATIONS - INVESTMENTS[10]

Recommended Risk Weights:

NRSRO Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

Bank weight (current):	20%, 50%, 100% or 200%, depending on investment type and NRSRO rating.
Basel II weight (standard):	Same as recommended.[11]

[10] With only a few minor exceptions (like mortgage related securities), federal credit unions are not permitted to invest in instruments with any noteworthy credit risk (mostly government, federal agency, and GSE debt instruments). However, state-chartered credit unions in some states are authorized to invest in corporate debt instruments.
[11] Short-term ratings are associated with risk weights, based on current FDIC rules and Basel II (¶103), as follows: A-1 to 20%, A-2 to 50%, A-3 to 100%, other ratings (including non-prime, B and C) to 150%, and unrated to 100%.

Rationale

Apply Basel II standard approach (¶66). Using the approach of FDIC's current rule (App. A to Part 325, Section II.B.1.), indirect holdings (e.g., mutual funds and common trusts) are assigned an unrated risk weight or, if identifiable, to the risk category for the highest risk-weighted asset the fund is permitted to hold, with a minimum 20% risk weight. For GSEs, senior debt receives an implicit rating of AAA and mortgage-backed securities guaranteed by GSEs rank *pari passu* with the senior debt (QIS 4).

Impact Model

Proxy - 5300 Account Codes 768-730B-730C-744C-769A-769B-652C+743C+655C

Implementation Issues

Will necessitate call report changes.

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5. MEMBERSHIP INTERESTS AND BANK EQUITY[12] INTERESTS

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

As per BASEL II (¶36), must be a non-significant minority interest (less than 20%), otherwise deducted from Net Worth and weighted at 0%.

Rationale

Applies Basel II standard approach (¶36). Also consistent with current treatment for instruments that qualify as capital issued by other banks that are not intentional cross-holdings (i.e., reciprocal holdings). Part 704 does not permit corporate credit unions to hold capital instruments of natural person credit unions. Also, this is more stringent than FDIC's current treatment of FHLB stock.[13] See Appendix 3 for a more detailed discussion of the basis for treatment of membership interests.

Impact Model

Proxy - 5300 Account Codes 769A+769B.

Implementation Issues

Will necessitate call report changes for CLF and FHLB stock.

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[12] Bank equity instruments are not permissible for federal credit unions. However, state-chartered credit unions in some states are authorized to invest in bank equity instruments.

[13] 0% for Federal Reserve bank stock (App. A to Part 325, Section II.C, Category 1.b), 20% for FHLB stock (App. A to Part 325, Section II.C, Category 2.b), and 100% for bank capital instruments (App. A to Part 325, Section II.C, Category 4(c)).

6. REGULATORY RETAIL LOANS

Recommended Risk Weight:	75%
Bank weight (current):	100%
Basel II weight (standard):	75%

As per BASEL II, excludes consumer loans or loans to small businesses in excess of the individual exposure limit (see definitions section).

Rationale
Applies Basel II standard approach (¶69), using the four criteria (¶70): orientation, product, granularity, and low level of individual exposure limit. Under the orientation criterion, we define small business per the SBA. We set the granularity criterion at 0.2% of total potential regulatory retail loans of the credit union, with a de minimus level of $200,000. We set the low value of individual exposure limit to $1 million, rather than €1million. The individual exposure limits and the de minimus levels to be indexed to increases in the CPI. In addition to loans exceeding the individual exposure limit, does not include loans secured by residential property, loans secured by commercial real estate, and loans to businesses that do not meet the definition of a small business.

Impact Model
Proxy - 5300 account codes 396+397+385+370+002+698-(400-718)-(041B-(714-771+716-775))

Implementation Issues
Need to adjust account 698 and exclude loans that don't meet the individual exposure limit.

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7. CLAIMS SECURED BY RESIDENTIAL PROPERTY

Recommended Risk Weight:	35%
Bank weight (current):	50%
Basel II weight (standard):	35%

As per BASEL II, includes business loans secured by residential property.

Rationale
Apply Basel II standard approach (¶72).

Impact Model
Proxy – 5300 account codes 703+386+003-714+771-716+775

Implementation Issues
Modify to exclude commercial property.

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8. ALL OTHER LOANS

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Encompasses three primary categories in BASEL II:
1. Large Retail Loans.
2. Claims Secured by Commercial Real Estate.
3. Claims on Corporations.

Rationale
Large Retail Loans - As per BASEL II, includes consumer Loans or loans to small businesses in excess of the lesser of $1M or 0.2% of the regulatory retail portfolio, but not less than $200,000. Applies the FDIC's current weights for commercial and consumer loans (App. A to Part 325, Section II.C, Category 4.(b)(7)). This same weight applies to claims on unrated corporates under Basel II.

Claims Secured by Commercial Real Estate - Applies Basel II standard approach (¶74). Does not adopt the preferential treatment (50% weight) approach for loans with low loan-to-value ratios (footnote 25).[14]

Claims on Corporations - BASEL II unrated weight is 100%, but ranges from 20% to 150% based on credit rating (see table in Claims on Corporations – Investments). Applies Basel II standard approach (¶66) for unrated claims. Does not adopt the NRSRO rating table since credit union loans to corporations are not likely to have an applicable rating by an NRSRO (¶68). Loans to credit union service organizations fall into this category.

Impact Model
Large Retail - No proxy.
Commercial Real Estate – No proxy.
Claims on Corporations - 5300 Account codes 400-(.8*400F)-ACCT_718

Implementation Issues
Will necessitate call report change.

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[14] The preferential treatment of footnote 25 may be implemented as a risk mitigation credit available upon request and subject to NCUA approval.

9. PAST DUE LOANS - SECURED BY RESIDENTIAL PROPERTY

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Comparable to BASEL II past due definition of 90 days or more, includes loans 2 or more months delinquent. BASEL II weight is net of specific provisions.

Rationale
Applies Basel II standard approach (¶78). Does not adopt the netting provision for specific provisions since under GAAP credit unions rarely have loans that qualify for specific provisioning.

Impact Model
5300 Account codes 714-771+716-775.

Implementation Issues
Call report needs to add non-accrual and separate commercial real estate.

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10. PAST DUE LOANS - ALL OTHER

Recommended Risk Weight:	150%
Bank weight (current):	100%
Basel II weight (standard):	150%

Comparable to BASEL II past due definition of 90 days or more, includes loans 2 or more months delinquent. BASEL II weight is net of specific provisions.

Rationale
Applies Basel II standard approach (¶75). Does not adopt the netting provision for specific provisions since under GAAP credit unions rarely have loans that qualify for specific provisioning.

Impact Model
5300 Account codes 041B-(714-771+716-775)

Implementation Issues
Call report needs to add non-accrual and separate commercial real estate.

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11. NCUSIF DEPOSIT

Recommended Risk Weight:	0%
Bank weight (current):	NA
Basel II weight (standard):	NA

Deduct from net worth.

Rationale
Because this account is dollar for dollar deducted from net worth, the account is excluded from risk assets. If the system were to incur losses in excess of retained earnings in the fund, the NCUSIF deposit would be reduced, then replenished by charges to credit unions, resulting in credit unions' expensing of the deposit. Results in an average decline in net worth ratio of 76 basis points.

Impact Model
5300 Account Code 794.

Implementation Issues
None.

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12. ALLL

Recommended Risk Weight:	0%
Bank weight (current):	0%[15]
Basel II weight (standard):	0%[16]

Add general and specific provisions to Net Worth, limited to 1.25% of risk-weighted assets. Also reduced by balance of loans 6 or more months delinquent.

Rationale
This contra account is an offset to assets. A 0% credit weight therefore removes this contra asset from the balance sheet. Because the ALLL has already been expensed through the income statement, the account represents a cushion against losses and, therefore, is recognized as an additional source of protection for the NCUSIF. Because most credit unions do not qualify under GAAP for specific provisions, there likely is little benefit to be obtained by imposing the administrative burden of requiring specific and general provision data to be reported by loan type. However, loans that are delinquent

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[15] Add general provision to Tier 2 capital, limited to 1.25% of risk-weighted assets.
[16] Add general provision to Tier 2 capital, limited to 1.25% of risk-weighted assets under the standard approach (¶42), while internal-ratings based (IRB) approach withdraws the deduction for the general provision (¶43).

by 6 or more months represent a high probability of charge-off that will reduce the ALLL and increase provisioning. Thus, the balance of these loans are deducted from the amount of the ALLL that may be added back to Net Worth (before the 1.25% limit is applied).

Impact Model
5300 Account Code 719.

Implementation Issues
None.

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13. ALL OTHER ASSETS

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Rationale
All other assets not captured in other portfolio. (BASEL II ¶ 81)

Impact Model
Proxy – 5300 account codes 798A+007+008+009.

Implementation Issues
Will necessitate call report changes.

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14. COMMITMENTS

Recommended Risk Weight:	Varies
Bank weight (current):	Varies[17]
Basel II weight (standard):	Varies[18]

Same as loan type, converted to a credit equivalent amount using the factors in the table below.

[17] CCF of 0% or 50% for terms up to 1 year and over 1 year, respectively (App. A to Part 325, Section II.D.2.b. and 5.). Credit weights of 50% or 100% or 200% (App. A to Part 325, Section II.C, Category 3.d. and Category 4.(b)(8) and Category 5.(a)).
[18] Same as recommended CCF table.

Commitment Type/Original Maturity	Cancelable	Up to 1 Year	Over 1 Year
Credit Conversion Factor (CCF)	0%	20%	50%

Rationale
Apply Basel II standard approach. Cancelable means unconditionally cancelable at any time by the bank without prior notice, to the full extent allowable under consumer protection legislation, or automatic cancellation due to deterioration in a borrower's creditworthiness (¶83 and footnote 29).

Impact Model
Proxy - 5300 Account Codes 814+814A

Implementation Issues
Need to segregate by loan type and commitment type/original maturity.

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15. RECOURSE OBLIGATIONS AND DIRECT CREDIT SUBSTITUTES

Recommended Risk Weight:	Varies
Bank weight (current):	Varies[19]
Basel II weight (standard):	Same

Same as loan type, converted to a credit equivalent amount using a CCF of 100%; with a low level recourse rule limiting the credit charge to the maximum contractual exposure less any recourse liability established under GAAP.

Rationale
Apply general version of bank credit weight rule. Other activities covered by the bank rule generally are impermissible, not undertaken by credit unions, or will be reflected on the balance sheet given GAAP treatment for securitized lending transactions (subject to low-level exposure rule).

Impact Model
Proxy - 5300 Account Code 819.

Implementation Issues
Will necessitate Call Report changes.

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[19] Same as above, with additional provisions for rated obligations and other activities (App. A to Part 325, Section II.B.5.(b)).

16. OPERATIONAL RISK

Added to risk-assets by converting to a risk-asset equivalent.

Rationale
Adopts basic indicator approach of BASEL II (¶649). Calculated by taking 15% of the average annual (positive) gross income over the previous 3 years and multiplying by 12.5 (the inverse of the 8% capital standard).

Impact Model
5300 Account Codes 115+117.

Implementation Issues
None.

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8. APPENDIX 2 – CREDIT UNION LOSS HISTORY

Unit Averages

All Loans

	All Total Loan Loss Average	All Total loan loss ST DEV	Number	> $10 M Total Loan Loss Average	> $10 M Total loan loss ST DEV	Number
1994	0.51%	1.70%	12,031	0.37%	0.56%	3,997
1995	0.51%	1.65%	11,724	0.38%	0.41%	4,050
1996	0.60%	1.29%	11,428	0.46%	0.48%	4,133
1997	0.68%	1.51%	11,273	0.55%	0.57%	4,237
1998	0.72%	1.73%	10,995	0.55%	0.56%	4,358
1999	0.60%	1.34%	10,630	0.50%	0.53%	4,434
2000	0.61%	1.44%	10,316	0.44%	0.43%	4,452
2001	0.62%	1.18%	9,984	0.48%	0.49%	4,634
2002	0.68%	1.16%	9,688	0.55%	0.54%	4,719
2003	0.77%	1.50%	9,369	0.60%	0.75%	4,792
3-yr avg	0.69%	1.28%		0.54%	0.60%	
5-yr avg	0.66%	1.32%		0.51%	0.55%	
10-yr avg	0.63%	1.45%		**0.49%**	**0.53%**	
10-yr min	0.51%	1.16%		0.37%	0.41%	
10-yr max	0.77%	1.73%		**0.60%**	**0.75%**	

Credit Card Loans

	All CC Loan Loss Average	All CC loan loss ST DEV	Number	> $10 M CC Loan Loss Average	> $10 M CC loan loss ST DEV	Number
1994	N/A	N/A	12,031	N/A	N/A	3,997
1995	N/A	N/A	11,724	N/A	N/A	4,050
1996	N/A	N/A	11,428	N/A	N/A	4,133
1997	N/A	N/A	11,273	N/A	N/A	4,237
1998	0.83%	1.60%	10,995	1.59%	1.63%	4,358
1999	0.78%	1.62%	10,630	1.44%	1.54%	4,434
2000	0.73%	1.38%	10,316	1.32%	1.36%	4,452
2001	0.87%	1.65%	9,984	1.49%	1.67%	4,634
2002	1.03%	2.17%	9,688	1.69%	2.33%	4,719
2003	1.08%	1.85%	9,369	1.74%	1.86%	4,792
3-yr avg	0.99%	1.89%		1.64%	1.95%	
5-yr avg	0.90%	1.73%		1.54%	1.75%	
10-yr avg	0.89%	1.71%		1.55%	1.73%	
10-yr min	0.73%	1.38%		1.32%	1.36%	
10-yr max	1.08%	2.17%		1.74%	2.33%	

Member Business Loans

	All MBL Loan Loss Average	All MBL loan loss ST DEV	Number	> $10 M MBL Loan Loss Average	> $10 M MBL loan loss ST DEV	Number
1994	0.07%	1.44%	12,031	0.14%	2.09%	3,997
1995	0.03%	0.80%	11,724	0.05%	1.11%	4,050
1996	0.04%	1.10%	11,428	0.08%	1.51%	4,133
1997	0.02%	0.53%	11,273	0.03%	0.55%	4,237
1998	0.04%	1.03%	10,995	0.08%	1.49%	4,358
1999	0.02%	0.50%	10,630	0.03%	0.74%	4,434
2000	0.02%	0.92%	10,316	0.04%	1.20%	4,452
2001	0.02%	0.82%	9,984	0.05%	1.20%	4,634
2002	0.03%	0.86%	9,688	0.06%	1.21%	4,719
2003	0.02%	0.81%	9,369	0.03%	1.03%	4,792
3-yr avg	0.03%	0.83%		0.05%	1.15%	
5-yr avg	0.02%	0.78%		0.04%	1.08%	
10-yr avg	0.03%	0.88%		**0.06%**	**1.21%**	
10-yr min	0.02%	0.50%		0.03%	0.55%	
10-yr max	0.07%	1.44%		**0.14%**	**2.09%**	

Real Estate Loans

	All RE Loan Loss Average	All RE loan loss ST DEV	Number	> $10 M RE Loan Loss Average	> $10 M RE loan loss ST DEV	Number
1994	0.08%	0.82%	12,031	0.10%	0.69%	3,997
1995	0.05%	0.70%	11,724	0.08%	0.59%	4,050
1996	0.06%	0.89%	11,428	0.07%	0.58%	4,133
1997	0.04%	0.51%	11,273	0.06%	0.40%	4,237
1998	0.02%	0.31%	10,995	0.04%	0.28%	4,358
1999	0.03%	0.42%	10,630	0.05%	0.44%	4,434
2000	0.02%	0.38%	10,316	0.03%	0.32%	4,452
2001	0.02%	0.33%	9,984	0.04%	0.34%	4,634
2002	0.03%	0.38%	9,688	0.05%	0.42%	4,719
2003	0.04%	0.63%	9,369	0.05%	0.52%	4,792
3-yr avg	0.03%	0.45%		0.04%	0.42%	
5-yr avg	0.03%	0.43%		0.04%	0.41%	
10-yr avg	0.04%	0.54%		**0.05%**	**0.46%**	
10-yr min	0.02%	0.31%		0.03%	0.28%	
10-yr max	0.08%	0.89%		**0.10%**	**0.69%**	

updated 2/15/05

All Loans Less Real Estate, Member Business Loans, and Credit Card Loans

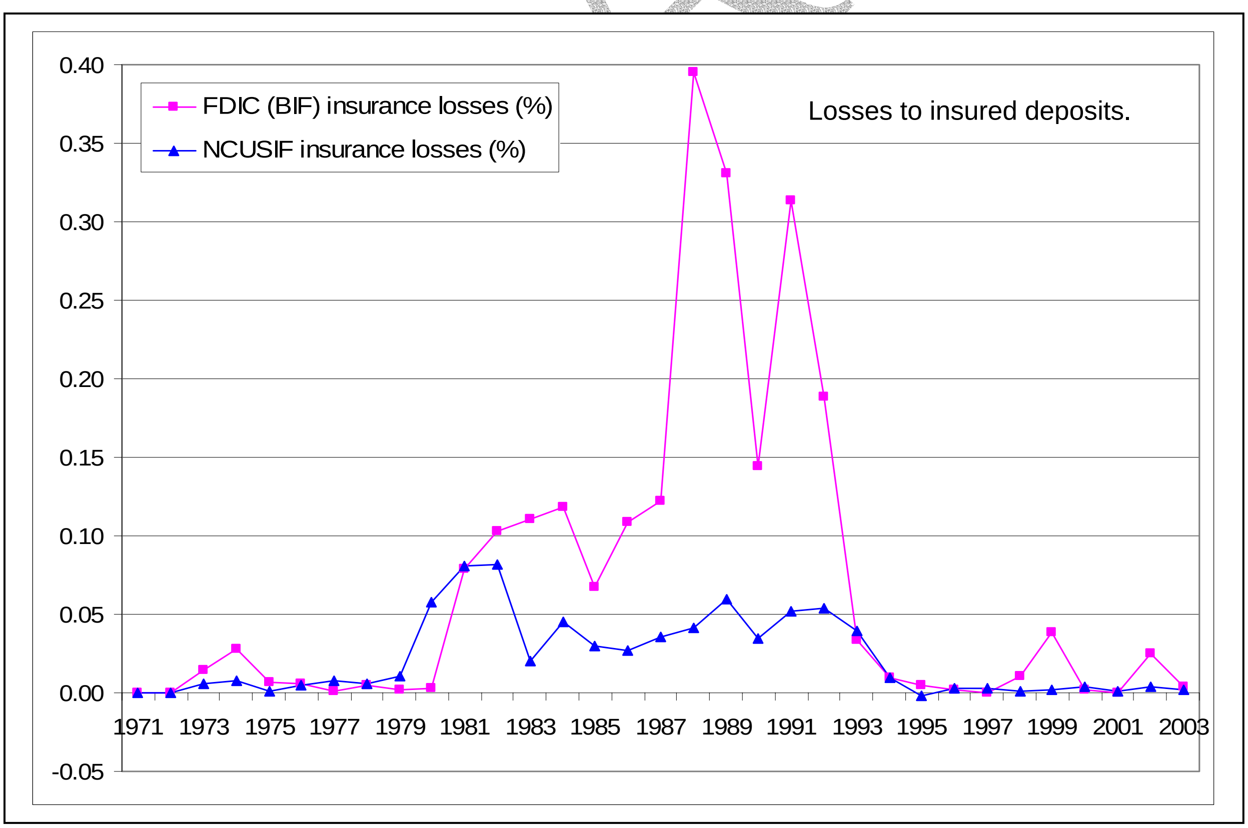
	All	All		> $10 M	> $10 M	
	Non CC RE MBL Loan Loss Average	Non CC RE MBL loan loss ST DEV	Number	Non CC RE MBL Loan Loss Average	Non CC RE MBL loan loss ST DEV	Number
1994	0.57%	1.60%	12,031	0.53%	0.94%	3,997
1995	0.60%	1.45%	11,724	0.56%	0.66%	4,050
1996	0.72%	1.64%	11,428	0.68%	0.78%	4,133
1997	0.84%	1.64%	11,273	0.85%	0.93%	4,237
1998	0.77%	1.85%	10,995	0.64%	0.75%	4,358
1999	0.67%	1.51%	10,630	0.58%	0.73%	4,434
2000	0.66%	1.54%	10,316	0.52%	0.58%	4,452
2001	0.71%	1.50%	9,984	0.58%	0.66%	4,634
2002	0.78%	1.47%	9,688	0.67%	0.74%	4,719
2003	0.90%	1.66%	9,369	0.77%	0.96%	4,792
3-yr avg	0.79%	1.54%		0.68%	0.79%	
5-yr avg	0.74%	1.53%		0.63%	0.74%	
10-yr avg	0.72%	1.58%		**0.64%**	**0.77%**	
10-yr min	0.57%	1.45%		0.52%	0.58%	
10-yr max	0.90%	1.85%		**0.85%**	**0.96%**	

Aggregate Averages

All CUs	Total Loan Loss Average	CC Loan Loss Average	RE Loan Loss Average	MBL Loan Loss Average	Non CC RE MBL Loan Loss Average
1994	0.39%	N/A	0.10%	0.67%	0.59%
1995	0.40%	N/A	0.07%	0.36%	0.63%
1996	0.50%	N/A	0.07%	0.24%	0.80%
1997	0.59%	N/A	0.05%	0.19%	0.99%
1998	0.59%	2.16%	0.04%	0.08%	0.73%
1999	0.49%	1.89%	0.03%	0.13%	0.61%
2000	0.42%	1.63%	0.02%	0.06%	0.55%
2001	0.46%	1.77%	0.02%	0.10%	0.62%
2002	0.51%	1.97%	0.02%	0.10%	0.74%
2003	0.56%	2.15%	0.03%	0.10%	0.84%
3-yr avg	0.51%	1.96%	0.02%	0.10%	0.73%
5-yr avg	0.49%	1.88%	0.03%	0.10%	0.67%
10-yr avg	**0.49%**	**1.93%**	**0.04%**	**0.20%**	**0.71%**
10-yr min	0.39%	1.63%	0.02%	0.06%	0.55%
10-yr max	**0.59%**	**2.16%**	**0.10%**	**0.67%**	**0.99%**

CUs > $10M	Total Loan Loss Average	CC Loan Loss Average	RE Loan Loss Average	MBL Loan Loss Average	Non CC RE MBL Loan Loss Average
1994	0.38%	N/A	0.09%	0.66%	0.60%
1995	0.40%	N/A	0.07%	0.34%	0.65%
1996	0.49%	N/A	0.07%	0.23%	0.82%
1997	0.59%	N/A	0.05%	0.18%	1.02%
1998	0.59%	2.18%	0.04%	0.08%	0.73%
1999	0.48%	1.90%	0.03%	0.13%	0.61%
2000	0.42%	1.63%	0.02%	0.05%	0.55%
2001	0.45%	1.77%	0.02%	0.10%	0.62%
2002	0.51%	1.97%	0.02%	0.09%	0.74%
2003	0.55%	2.15%	0.03%	0.09%	0.84%
3-yr avg	0.50%	1.96%	0.02%	0.09%	0.73%
5-yr avg	0.48%	1.88%	0.03%	0.09%	0.67%
10-yr avg	**0.49%**	**1.93%**	**0.04%**	**0.20%**	**0.72%**
10-yr max	0.59%	2.18%	0.09%	0.66%	1.02%
10-yr min	**0.38%**	**1.63%**	**0.02%**	**0.05%**	**0.55%**

FDIC vs. NCUSIF Insurance Loss Comparison



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9. APPENDIX 3 – MEMBERSHIP INTERESTS

The risk portfolio of "Membership Interests and Bank Equity Interests" includes corporate credit union membership capital, Central Liquidity Facility (CLF) stock, Federal Home Loan Bank (FHLB) stock, and bank stock. The recommended credit risk weight for holdings in this risk portfolio is 100% for a non-significant minority interest (less than 20% of the other entity's equity). Significant interests and reciprocal holdings are deducted from net worth and weighted at 0%. Since credit unions have limited holdings in bank equity interests, most of this risk portfolio is comprised of membership interests in corporate credit unions. The proposed treatment of corporate membership (capital) instruments is grounded on:

1. Basel II Standard Approach

The risk weight is based on paragraphs 28, 29, and 81 of the Basel II standard approach. We deduct the entire amount of significant interests from net worth. We use generally accepted accounting practices (GAAP) as our national accounting standards to determine whether an investment is significant.[20]

2. FDIC's Treatment of Bank Equity Instruments

The FDIC's current credit risk weight is 100% for a number of capital instruments, including stock in other insured banks, provided they are not reciprocal holdings.[21] If they are not otherwise deducted from capital, investments in unconsolidated companies, joint ventures, associated companies, and instruments that qualify as capital issued by other banks are risk weighted 100%. 12 CFR 325, App. A, Section II.C, Category 4.(b)(5), (b)(12), and (c).[22]

Note that corporate membership capital is not issued at a premium to book value. Corporate membership capital is in the form of a term certificate or an adjusted balance account. 12 CFR 704.3. Thus, corporate membership capital, unlike bank stock purchased in the market place, is not subject to market risk (stock price fluctuations), only the minimal credit risk from potential failure.

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[20] Even if corporate credit union membership interests were treated under Basel II as if they were investments in commercial entities (based on paragraphs 35 and 36); the risk weight for the investment would be 100% and only the individual significant investments in equity interests exceeding 15% of a credit union's capital would be deducted from capital. This would be consistent with FDIC's current materiality threshold of 15% of capital for such non-financial equity holdings.

[21] FDIC deducts reciprocal holdings of capital instruments of banks from total capital. Reciprocal holdings means intentional cross-holdings of capital instruments by banks. 12 CFR 325, App. A, Section I.B.(4).

[22] No single credit union owns corporate membership instruments of more than 50% of outstanding voting stock, which is FDIC's definition of an investment in unconsolidated banking and finance subsidiaries that is deducted from capital. 12 CFR 325, App. A, Section I.B.(2). No single credit union owns corporate membership interests of 20 percent or more of the outstanding voting stock, which is the threshold FDIC applies on a case-by-case basis for deducting investments in associated companies or joint ventures from capital.

3. Low Systemic Risk

Corporate credit unions are operated for the purpose of serving natural person credit unions. Corporate credit unions actually reduce risk to the credit union system and provide added protection and benefits due to the following:

Corporate credit unions are subject to extensive regulation.
The scope of activities of corporate credit unions is limited by NCUA Rules and Regulations Part 704. For example, corporate credit union investment authority is essentially limited to investment grade securities.[23] State chartered natural person credit unions in several states have similar investments powers. Thus, the insurance fund is not exposed to higher risk activities. Further, federal credit unions may not purchase shares or deposits in a corporate credit union if the NCUA Board has provided notice that a corporate credit union is not operating in compliance with its regulations. 12 CFR 703.14(b).

Corporate credit unions are subject to extensive supervision.
NCUA annually examines all corporate credit unions and has a program of continuing supervision, including review of monthly financial and management information. Our Office of Corporate Credit Unions is composed of highly trained, skilled, and experienced staff who focus exclusively on examining corporate credit unions.

Corporate credit unions provide expertise and economies of scale.
By aggregating investment funds from natural person credit unions, corporate credit unions are able to provide expertise and economies of scale that would not otherwise be applied to these assets and activities in individual natural person credit unions. This results in a reduction of systemic risk and enables NCUA to efficiently examine these investment assets and operating activities (e.g., item processing).

Corporate credit unions add additional capital to the credit union system.
The retained earnings of corporate credit unions are not reflected in the net worth of member natural person credit unions.[24] Assets of corporate credit unions are funded almost entirely by the deposits of member credit unions.[25] Thus, they provide an additional layer of capital for the underlying assets and activities in natural person credit unions.

[23] Corporate credit unions do have limited holdings of participation loans, investments in credit union service organizations, and fixed assets

[24] Retained earnings of the corporate system totaled $2.5 billion as of Dec. 31, 2004. By way of comparison, member natural person credit unions held $3.3 billion in corporate membership interests.

[25] Corporate credit unions generally have limited leverage. Borrowings of corporate credit unions aggregated only $9.7 billion as of Dec. 2004, versus total assets of $109.9 billion.

4. Low Specific Risk

The risk of failure of an individual corporate credit union is low. Investment securities are investment grade. Principal operating activities of corporate credit unions are the provision of services to member credit unions. Leverage is low. Most other assets are either fully secured or reflect ACH payment services for members.

The assets of corporate credit unions are similar to an indirect holding of a pool of assets (e.g., a mutual fund).[26] When risk of holding corporate instruments is assessed in light of the investment grade quality of a corporate credit union's assets (with the majority of holdings AAA rated), a credit risk weight of 20% would be assigned. This is consistent with the risk weighting of Basel II for claims on financial institutions.

A risk weight for corporate capital instruments needs to cover the limited remaining risks of the corporate: operational risks; the risks arising from the limited leveraging; and assets of corporates that are not investment grade (such as limited holdings of participation loans, investments in credit union service organizations, and fixed assets). A 100% risk weight is more than adequate given:

- Operational risks of the corporate credit union are examined annually by NCUA. Operational risks are adequately covered by the retained earnings of the corporate credit union. In addition, the member credit union is assessed an operational risk charge to further protect the insurance fund. In the absence of a corporate credit union, the member credit union would still need to conduct the service activities.

- Corporate credit unions generally have limited leverage. Borrowings of corporate credit unions aggregated only $9.7 billion as of Dec. 2004, versus total assets of $109.9 billion and total investments of $99.9 billion.

- Corporate assets as of Dec. 2004 other than investments total only $10 billion, including: $4.3 billion in loans to member credit unions (fully secured); $3.6 billion in future dated ACH transactions; $0.9 billion in cash and balances due; $0.5 billion in fixed assets; and $0.4 billion in other loans.

[26] Under the FDIC's rules, an investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 12 CFR 325, App. A, Section II.B.1.

National Credit Union Administration

Office of the Chairman

May 23, 2005

The Honorable Edward R. Royce
The Honorable Paul E. Kanjorski
United States House of Representatives
Washington, D.C. 20015

Dear Representatives Royce and Kanjorski:

Thank you for your May 18, 2005 letter requesting the views of the National Credit Union Administration (NCUA) on H.R. 2317, the Credit Union Regulatory Improvements Act of 2005 ("CURIA").

CURIA addresses several important areas impacting the 8,945 federally insured credit unions operating in this nation. In particular, CURIA's reforms of standards for capital, member business lending, credit union governance, and other regulatory modernization provisions will enable credit unions to remain competitive in the 21st century and better serve their members.

NCUA has reviewed the details of H.R. 2317 and NCUA can recommend and support the legislation. Where provisions impact NCUA, they are helpful to the agency in our supervisory role. Where they impact the operations of an insured credit union, they do so without adding undue risk to the share insurance fund.

Title I: Capital Reforms

Reform of capital standards is currently the most important legislative issue facing credit unions. A system of prompt corrective action (PCA) for federally insured institutions is good public policy and strongly supported by NCUA. However, the current PCA system for credit unions is too inflexible and, given the high leverage requirement, burdensome and not sufficiently risk based.

Setting PCA capital standards for credit unions at comparable levels for FDIC-insured institutions will ensure low-risk credit unions do not have to maintain the "excess" net worth they presently do. Further, this will facilitate application of meaningful risk-based capital standards to all credit unions, more closely relating capital levels to the risk profiles of each specific institution. The tandem leverage and risk-based net worth requirements of Title I of HR 2317 achieves this much needed capital reform while providing adequate safety and soundness safeguards. Also, it preserves net worth in mergers of two healthy credit unions given changes in generally accepted accounting standards for business combinations.

The risk-based prompt correction action provisions of Title I, combined with the use of a minimum leverage ratio as provided, maintains insured credit union comparability with the regulatory capital regime of other federally insured financial institutions. The construction of Title I of H.R. 2317 enables the NCUA Board to incorporate the relevant aspects of BASEL II's standard approach, or any derivations adopted for FDIC insured institutions, into the design of the risk-based net worth requirement for credit unions.

Title II: Economic Growth

The provisions included in this title all relate to allowing insured credit unions to better serve their members by alleviating, but not eliminating, current law limits on member business loans. Since its inception in 1934, the Federal Credit Union Act anticipated that credit unions should be granting business loans to their members as part of their traditional mission and purpose. It was only in 1998 that Congress limited the ability of federal and state chartered credit unions to offer member business loans if they are federally insured. NCUA has testified on several occasions that the agency has not seen any undue risk in this line of lending, before or after the limits were added, that cannot be prudently managed by the industry and NCUA. Therefore NCUA supports these provisions that seek to restore some authority for member business lending curtailed in 1998.

Title III: Regulatory Modernization

The provisions of this title have been previously approved by the House Financial Services Committee and the U.S. House of Representatives. NCUA has recommended some of them and NCUA has testified that all of them pose no safety or soundness concerns to the agency.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman