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November 18, 2004

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Credit Union Capital

Dear Ms. Rupp:

On September 16, 2004, the National Credit Union Administration ("NCUA") Chairman Johnson stated that capital is a critical issue and that there is a need for expanded dialogue. Chairman Johnson invited interested parties to share their views on this subject with the NCUA. This letter responds to Chairman Johnson's request.

The American Bankers Association ("ABA") believes that any proposal to reform credit union capital and rules governing Prompt Correction Action ("PCA") needs to limit the risk exposure of the National Credit Union Share Insurance Fund ("NCUSIF") and American taxpayers from loss, while preserving the cooperative structure of the credit union industry.

Summarizing ABA's position on credit union capital:

- Credit unions need a meaningful leverage ratio;
- There should be no substantive difference between bank and credit union leverage ratios standards; and
- Secondary capital would undermine the unique character of credit unions.

The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

Background

In 1998, the Credit Union Membership Access Act ("CUMAA") imposed minimal capital standards and PCA on federally-insured credit unions. As Senator Sarbanes

stated from the Senate floor, this legislation “is a major step in ensuring financial stability in the credit union industry.”¹

As of June 2004, over 98 percent of the credit union industry met the regulatory requirement of being “well capitalized.” The credit union industry has a net worth-to-total asset ratio of 10.72 percent – 3.72 percent above the regulatory minimums for being well capitalized.

ABA’s Position

Even so, some within the credit union industry have contended that the PCA triggers have stifled credit union growth and services to members. In recent years, they contend that uninduced growth² has caused credit unions’ net worth ratios to drop, thereby increasing the prospect that credit unions may be subject to PCA. They contend that this flight to quality necessitates a need to reform credit union net worth requirements. However, the Government Accountability Office (“GAO”) found no evidence “that federally insured credit unions are limiting their services to accommodate a rapidly growing deposit base.”³

Moreover, PCA is intended to curb aggressive growth. If a credit union is growing too fast so that PCA becomes a concern, then this is likely a sign that the credit union is taking excessive risk.⁴ PCA acts as a circuit breaker to limit the exposure of the NCUSIF and American taxpayers to loss.

During the Capital Summit on October 19, 2004, there was a general consensus among presenters that the current leverage ratio should be lowered and augmented with a risk-based capital requirement. Despite credit unions’ desire for more lax regulations, the GAO stated in its August 2004 report, “any proposal to move to a more risk-based system should provide for both risk-based and *meaningful* leverage capital requirements to work in tandem.”(emphasis added)⁵

While it is universally agreed that institutions with greater risk should hold more capital, risk-based capital standards are not a panacea. Bank risk-based capital standards measure credit risk, but do not capture other risks, such as liquidity, interest rate, concentration, reputation, and operation. These other risks are protected against by the leverage ratio.

Additionally, ABA wishes to clear up a misconception about bank versus credit union leverage ratios. Credit union advocates point to the fact that to be adequately

¹ Congressional Record - Senate, July 24, 1998, S8965

² As ABA stated in its January 28, 2003 letter to NCUA, the concept of uninduced growth is somewhat illogical. “Surely one of the few things truly controllable by a financial institution is the ability to limit too rapid growth. ... if the institution opens its doors, advertises rates of interest paid on deposits, ... it must be thought of as inducing growth.”

³ Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital. Government Accountability Office (August 2004), p 14.

⁴ For example, under the new risk-based premium scheme under development at the Federal Deposit Insurance Corporation, aggressive growth is taken as a sign of higher risk, warranting higher deposit insurance premiums.

⁵ *ibid*, pp. 5 – 6.

capitalized credit unions must have a capital ratio of 6 percent versus 4 percent for banks. While on the surface it appears that credit unions are subject to a higher leverage capital requirement than banks, in fact there is very little substantive difference in the actual capital treatments of banks and credit unions. As the old adage goes, “six of one, half dozen of the other.”

Unlike bank regulators, NCUA does not require the deduction from capital of investments that are deemed to be at risk requiring some isolation from the credit union. Federal Deposit Insurance Corporation regulations require the deduction of equity investments and pro rata retained earnings in certain bank subsidiaries.

Section 362.4(e) requires that “any insured state bank that wishes to conduct or continue to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank must:

(1) Be well-capitalized after deducting from its tier one capital the investment in equity securities of the subsidiary as well as the bank's pro rata share of any retained earnings of the subsidiary;

(2) Reflect this deduction in the appropriate schedule of the bank's consolidated report of income and condition; and

(3) Use such regulatory capital amount for the purposes of the bank's assessment risk classification under part 327 of this chapter and its categorization as a "well-capitalized", an "adequately capitalized", an "undercapitalized", or a "significantly undercapitalized" institution as defined in § 325.103(b) of this chapter, provided that the capital deduction shall not be used for purposes of determining whether the bank is "critically undercapitalized" under part 325 of this chapter.”^{6,7}

Therefore, it appears to us that if such standards were applied by NCUA to credit unions, investments in some credit union service organizations, corporate credit unions, and the NCUSIF should be deducted from credit union's net worth before calculating a net worth ratio.⁸

For example, \$821 million Arrowhead Credit Union (San Bernardino, California) would potentially see its net worth fall from almost \$60.1 million to \$33.4 million. Its leverage ratio would fall from 7.82 percent or well capitalized under NCUA's PCA rules, to 4.21 percent or barely adequately capitalized under bank PCA leverage ratio requirements.

Because credit unions do not deduct at risk equity investments from their net worth requirements, while banks do, this accounts for the higher PCA leverage capital trigger for credit unions.

Furthermore, a minority of credit unions is pushing for the ability to issue alternative or secondary capital to members **and non-members** alike. Allowing credit unions to issue secondary capital would fundamentally change the governance structure of

⁶ 12 C.F.R. § 362.4(e).

⁷ 12 C.F.R. § 5.34(e) Authorized activities. A national bank may conduct in an operating subsidiary activities that are permissible for a national bank to engage in directly either as part of, or incidental to, the business of banking, as determined by the OCC, or otherwise under other statutory authority.

⁸ See ABA's comment letter to NCUA from January 27, 1999.

credit unions. Congress specifically reinforced its view that credit unions, in maintaining their distinct character, should rely upon retained earnings to build net worth, while not issuing capital stock. For example, the report of the Senate Banking Committee states that the “NCUA [National Credit Union Administration] must design the system of prompt corrective action to take into account that credit unions are not-for-profit cooperatives that (1) *do not issue capital stock*, and (2) *must rely on retained earnings to build net worth*.” (emphasis added)⁹

Secondary capital is subordinated to the National Credit Union Share Insurance Fund. Non-member investors will not be willing to invest in any credit union without covenants to protect their investments – covenants that give these non-members control over the institution in critical decisions. This transfers control of the credit union from members to holders of secondary capital. In other words, these covenants effectively alter the governance of the credit union, creating a conflict of interest between members and secondary capital holders.

Moreover, the holders of secondary capital will expect to be compensated for the risk they are assuming. This means secondary capital will receive higher dividend rates than the members – creating two classes of owners.

Finally, if credit unions can raise capital from non-members, this undermines the basic philosophical principle of credit unions of members helping members. By moving away from the concept of “member-owned” equity towards a reliance on capital contributions from non-members, the very essence of a credit union’s ownership structure is called into question.

Conclusion

As NCUA explores changes to credit union net worth standards, ABA would like to re-iterate its position from its April 18, 2000 comment letter:

“NCUA should adopt a more bank-like risk-weighted capital system and then work with the banking agencies within the umbrella of the Federal Financial Institutions Examination Council to improve the current risk-based capital adequacy standard to better recognize credit quality and the use of internal risk models to manage financial institution risk.”¹⁰

If you have any questions, please contact the undersigned or John Rasmus at 202-663-5333.

Sincerely,

Keith Leggett
Senior Economist

⁹ Report No. 105-193, p 12.

¹⁰ See ABA’s comment letter to NCUA from April 18, 2000