

REFORMING CREDIT UNION CAPITAL REQUIREMENTS

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Executive Summary

This paper analyzes the role of capital requirements for financial institutions generally and the need for carefully regulated, but expanded capital authority for credit unions in particular. This paper responds, in part, to a 2004 report of the Government Accountability Office (GAO), which concluded that the limited capital authority of credit unions was adequate at that time. The tremendous upheaval in the financial markets and the credit crisis that accompanied the Great Recession of 2007-2009 compel a different conclusion today. The financial landscape has undergone permanent and dramatic changes and the capital authority of credit unions must evolve in response to these changes.

Current credit union capital requirements restrict credit unions' ability both to act as safe harbors for depositors and to act as a countercyclical source of lending. With better access to capital, not only could the safety and soundness of credit unions be enhanced, but credit unions would be positioned to offset the reduction in bank lending that has contributed to past recessions and slowed the current economic recovery.

Recognizing the dynamic nature of financial markets and its risks, Congress has historically provided federal banking regulators with the flexibility to adjust capital requirements in response to changes in economic and financial conditions. This is sound policy. Congress should likewise provide the National Credit Union Administration (NCUA), the federal credit union regulator, with the authority to develop appropriate capital requirements for credit unions and update them as conditions warrant.

Empowering the NCUA to develop appropriate capital requirements for credit unions would promote three important policy objectives:

- Expanded capital authority for credit unions would promote the safety and soundness of the credit union system;
- Expanded capital authority would allow credit unions to enhance their ability to serve their members (increased deposits and lending) and improve the efficiency of their operations; and
- Expanded capital authority for credit unions would benefit the broader economy and help speed up the economic recovery.

This white paper is organized as follows:

- Section I briefly reviews how, over many decades, continual, but unexpected, changes in economic and financial conditions and risks have frequently prompted policymakers to adjust capital requirements for depository institutions.
- Section II explains why current credit union capital requirements must be reformed.
- Section III shows how current capital requirements for credit unions discourage economic and operational efficiency.
- Section IV presents our recommendation that Congress delegate to the NCUA the authority to determine for credit unions what counts as capital and the effective required minimum amounts.
- Section V lays out some of the specific issues that the NCUA should consider in its reform of capital regulations.
- Section VI summarizes the implications of our analysis.

I. Continual, inherently unpredictable changes in economic and financial conditions have required policymakers to frequently update capital requirements.

A. The dynamic nature of economic and financial markets necessitates constant reassessment of the requirements governing financial institutions.

There are continually enormous shifts in the economic and financial landscape. Although the occurrences take place with some frequency, they have significant repercussions and they are largely unpredictable. Examples in recent decades include: stagflation during the 1970s; banking crises during the 1980s and early 1990s; falling inflation, unemployment, and interest rates from the mid 1980s through the mid 1990s; booms in the stock and housing markets starting in the mid 1990s; and the recent severe problems in housing, the financial sector, and the overall economy. In addition to such changes in the landscape, there have been and no doubt will continue to be unexpected changes due to financial innovations and due to changes in financial regulations themselves.

In this context, financial regulations seek to contribute to the efficient operation of the financial system, the safety and soundness of financial institutions, and to contain systemic risk. Among the tools used to advance this objective are competition regulations, supervision of financial institutions, deposit insurance, and capital requirements. Because of the dynamic nature of economic and financial markets, the contours and relative use of these tools must be continuously reassessed.

B. Capital requirements are an important tool in the oversight of financial institutions and have been modified over time to reflect changes in the economic and financial landscape.

Capital requirements provide a good example of ongoing reassessments. A primary role of capital in depository institutions is to support their operations by absorbing shocks from the

unexpected. The greater the proportion of operations that is financed by capital, the more likely an institution will survive periods of adversity.

Failure of depository institutions imposes direct and indirect costs on many parties. Direct costs include losses to stockholders, bondholders, other creditors, uninsured depositors, and the deposit insurer, with much of the costs to the latter passed on to other depository institutions or, in some cases, taxpayers. Indirect costs include (1) those borne by borrowers, depositors, and communities who might lose established business relationships and (2) the disruption of the normal operation of the payment and credit systems for the broader economy. Thus, the objective of imposing higher capital requirements is to reduce the risk of failure, thereby reducing both these direct costs to the deposit insurer and others and indirect costs on communities and the economy at large.

Over the decades, policymakers have continuously modified the structure of capital requirements for both commercial banks and credit unions to reflect changing economic and financial conditions.

1. Congress has delegated broad authority to federal bank regulators to enable timely and flexible adaptations of capital requirements.

Designing capital requirements and updating them as conditions change required consideration of several factors. For example, some of the earliest and largest declines in commercial bank capital ratios largely reflected banks' and bank regulators' views that public policies had reduced some risks for individual banks. The Federal Reserve, launched in 1913, provided banks with short-term liquidity and the Federal Deposit Insurance Corporation (FDIC), launched in 1934, insured depositors' funds. The resulting reductions in liquidity risks meant that banks could prudently hold smaller capital cushions, which had reached levels as high as 40% during the nineteenth century. Higher capital requirements could also restrict depository

institutions' capacity to lend and, particularly during recessions, affect economic growth. Given the multi-faceted nature of this task, throughout most of the 20th century, bank supervisors did not use specific, industry-wide capital requirements but, rather, tailored informal rules to the circumstances of individual institutions.¹

However, by the 1980s, conditions had changed profoundly, resulting in large numbers of U.S. thrift and bank failures and the imposition of very large losses for deposit insurers. Responding in part to changed conditions and their aftermaths, bank regulators in the U.S. and other industrialized countries developed the Basel Accord in 1988 (i.e., Basel I), which set forth internationally-standardized explicit capital requirements.² Congress transposed part of the Basel Accord into statute by including a section on prompt corrective action (PCA) in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.³

Basel I highlights how policymakers periodically reassess capital requirements. By increasing the effective capital requirements on internationally-active banks Basel I emphasized reducing the direct losses imposed on deposit insurers. Congress required federal banking regulators to “take prompt corrective action to resolve the problems of insured depository institutions ... at the least possible long-term cost to the Deposit Insurance Fund.”⁴ The objective was to reduce losses by identifying troubled depository institutions early enough to prevent potential losses from becoming larger. For instance, Congress specifically required federal bank regulators to appoint a receiver (or conservator) no later than 90 days after a bank's

¹ See FDIC. 2003. “Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back.” www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html.

² In July 1988, the Basel Supervisors Committee, comprising representatives from Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the U.K. and the U.S., issued “International Convergence of Capital Measurement,” which is widely known as the Basel Accord (or Basel I).

³ Section 131 FDICIA added section 38 to the Federal Deposit Insurance Act (FDIA). This section is codified as 12 U.S.C. 1831o.

⁴ 12 U.S.C. 1831o(a)(1).

tangible equity falls below 2% of total assets.⁵ Congress further required federal bank regulators to develop sets of industry-wide, specific capital requirements⁶ and for depository institutions found to be undercapitalized under those requirements to forgo asset growth and to submit capital restoration plans.⁷ These requirements also encouraged depository institutions to issue various securities other than common stock (e.g., subordinated debt) that might reduce the direct costs that failures impose on deposit insurers.⁸

2. In contrast, capital requirements for credit unions are set in statute, denying NCUA the regulatory flexibility to adjust capital requirements in response to changing conditions.

In the case of credit unions, capital requirements have been set by statute. Consequently, Congress has had to revisit the issue of capital requirements repeatedly as economic and financial conditions have changed. State legislatures and, in 1934, Congress first set capital requirements not as percentage of assets, but as a percentage of earnings that was to be added to reserves (i.e., capital).⁹ In 1949, Congress permitted federal credit unions to forgo accumulating more capital once they met higher, preset capital-to-deposit ratios.¹⁰ In 1970, Congress established share (i.e., deposit) insurance for credit unions; in conjunction, Congress introduced

⁵ 12 U.S.C. 1831o(g)(3)(A) and 12 U.S.C. 1831o(c)(3)(B)(i).

⁶ 12 U.S.C. 1831o(c)(1) requires federal banking agencies to develop capital requirements based on total assets (i.e., a leverage limit) and risk-based assets. The section also authorizes federal banking agencies to rescind those requirements and to set up others.

⁷ 12 U.S.C. 1831o(e)(3).

⁸ Consider a simplified example with two institutions A and B. Institution A has \$100 in assets, \$92 in insured deposits, and \$8 in equity. Institution B has \$100 in assets, \$88 in insured deposit, \$4 in subordinated debt, and \$8 in equity. If loan losses reduce the value of assets in both institutions to \$80, losses to the deposit insurer would be \$12 from institution A and \$8 from institution B. Thus, losses to the deposit insurer would be lower at the institution that relied more on subordinated debt.

⁹ Section 12 of the Federal Credit Union (FCU) Act of 1934 (Public law 467 – 73rd Congress) required that “20 per centum of the net earnings of each year, before the declaration of any dividends, shall be set aside ... as a reserve fund against possible bad loans.” Most states set up credit union laws with similar capital requirements from as early as 1909.

¹⁰ In 1949, Public law 376 – 81st Congress stated “when the regular reserve thus established shall equal 10 per centum of the total amount of members’ shareholdings, no further transfer of net earnings to such regular reserve shall be required except that such amounts not in excess of 20 per centum of the net earnings as may be needed to maintain this 10 per centum ratio shall be transferred.” Among the states, New York, for instance, similarly amended its credit union law in 1925.

several changes that effectively lowered capital requirements.¹¹ In 1977, Congress once again lowered credit union capital requirements.¹²

The relationship between changes in formal capital requirements and actual capital-to-asset ratios is complex. Figure 1 presents an estimate¹³ of the credit union capital-to-assets ratio during 1911-2010Q3. Despite loosening in capital requirements in 1949 and 1977, capital-to-asset ratios increased substantially in the following years. The loosening in 1970, coinciding with the introduction of federal insurance for credit union deposits, was followed by a substantial decline in the aggregate credit union capital-to-asset ratio. Nonetheless, despite additions to reserves being set as a fraction of earnings until 1998, over the long-term, credit union capital-to-asset ratios steadily increased from 0.96% in 1911, to 6.68% in 1933, 8.00% in 1970, and 11.01% in 1997 (immediately before CUMAA).¹⁴

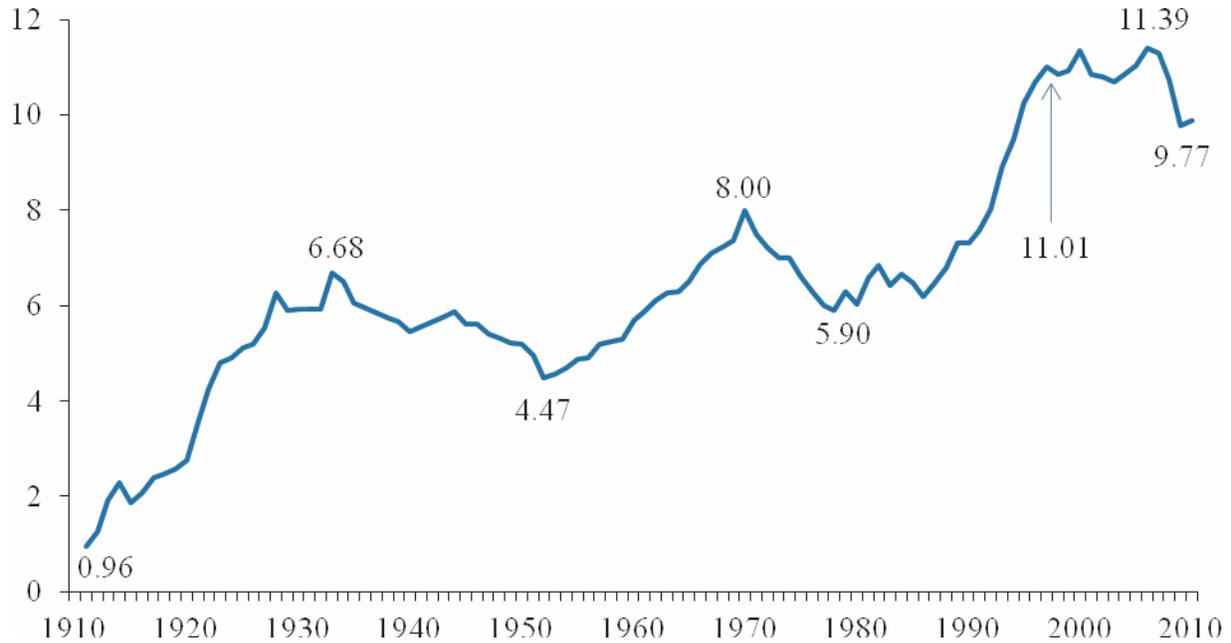
¹¹ See Harold Black and Robert H. Dugger. 1981. "Credit Union Structure, Growth, and Regulatory Problems." *The Journal of Finance* XXXVI(2): 529-538. Congress changed the capital-to-deposit ratio into a capital-to-risk assets (i.e., largely loans) ratio. A lower capital ratio was also added, above which credit unions would have to set aside smaller fractions of earnings. Congress also modified the formula for the amount of capital to be set aside from a fraction of net earnings (after noninterest expenses) to a fraction of gross earnings (before noninterest expenses). In particular, Public Law 91-468, Section 9 states "set aside ... as a regular reserve ... 10 per centum of gross income until the regular reserve shall equal 7½ per centum of the total of outstanding loans and risk assets, then 5 per centum of gross income until the regular reserve shall equal 10 per centum of the total of outstanding loans and risk assets."

¹² Section 305(b) of the Depository Institutions Act of 1977 (Public law 95-22) states "a credit union in operation for more than four years and having assets of \$500,000 or more shall set aside (A) 10 per centum of gross income until the regular reserve shall equal 4 per centum of the total of outstanding loans and risk assets, then (B) 5 per centum of gross income until the regular reserve shall equal 6 per centum of the total of outstanding loans and risk assets."

¹³ Attaining complete consistency since 1911 is problematic. We estimated the credit union capital-to-assets ratio that we plotted in Figure 1 as follows. We used the ratio of regular reserves to assets in Massachusetts and New York credit unions for 1911-1928, the same ratio for all (nationwide, state- and federally-chartered) credit unions for 1929-1951, the ratio of regular reserves plus undivided income (i.e., net worth) to assets for federal credit unions for 1952-1969, the ratio of regular reserves plus undivided income and the allowance for loan losses to assets for all credit unions for 1970-1979, and the ratio of regular reserves plus undivided income (i.e., net worth) to assets for all credit unions for 1980-2010Q3.

¹⁴ The aggregate capital-to-assets ratio did not increase linearly throughout the overall period, reaching lows of 4.47% in 1952 and 5.90% in 1978.

Figure 1
 Credit Union Capital-to-Assets Ratio
 (% , annual, 1911-2010Q3, BLS, CUNA, NCUA)



3. Congress last adjusted credit union capital requirements in 1998 in response to a bank problem, not a credit union problem.

When Congress mandated federal bank regulators to develop specific numerical capital requirements in 1991, it did not address the structure of credit union capital requirements. Perhaps the relatively better performance of credit unions during the 1980s and early 1990s and judgment that credit unions then posed much less risk to their deposit insurance fund left the focus almost entirely on banks and their problems. As shown in Figure 2, credit union capital-to-asset ratios were higher than those at commercial banks throughout the 1980s. Further, the credit unions' deposit insurer, the National Credit Union Share Insurance Fund, NCUSIF, remained solvent, unlike those for commercial banks and thrifts, and NCUSIF losses were far lower

(0.018% of insured deposits in 1971-2004) than those that commercial banks (0.073%) imposed on the FDIC.¹⁵

Figure 2
Capital to Asset Ratio:
Credit Unions and Commercial Banks
(%, annual, 1910-2010Q3, BLS, CUNA, NCUA, Fed, FDIC)

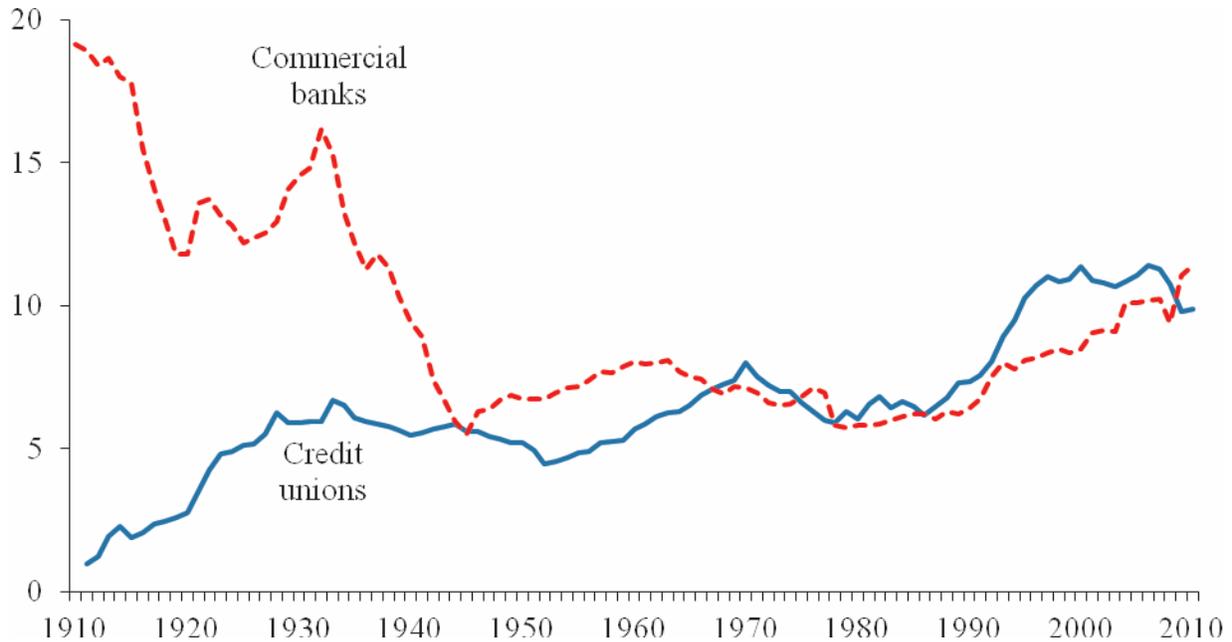
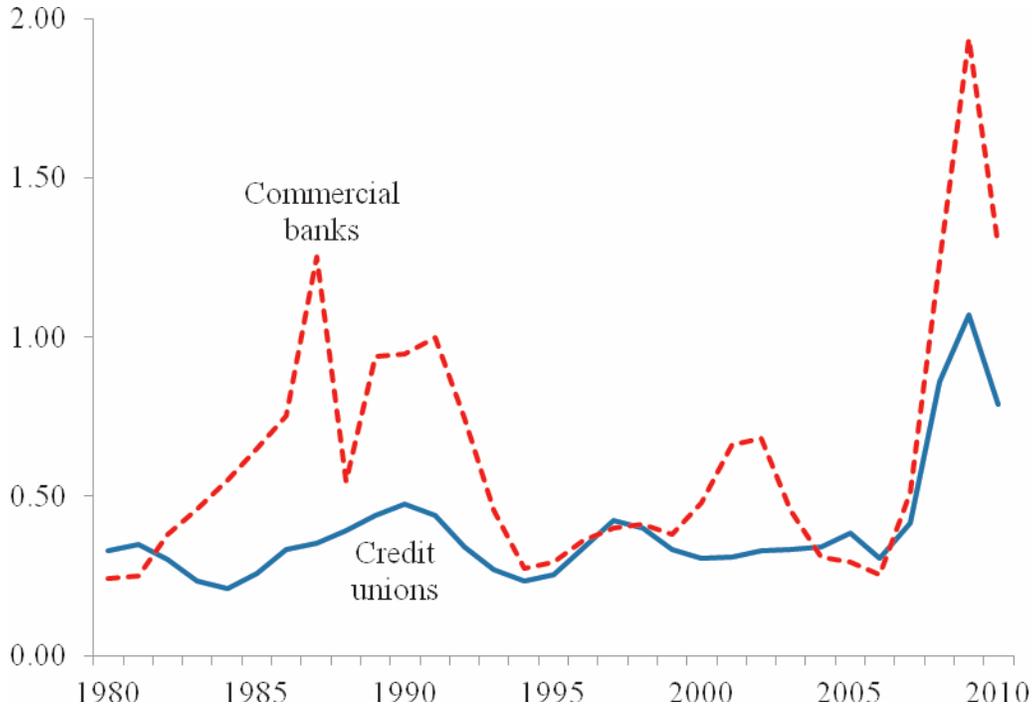


Figure 3 compares credit unions' and commercial banks' provisions for loan losses per assets during 1980-2010Q3. The figure similarly shows that provisions for loan losses at credit unions during the late 1980s and early 1990s were far smaller than those at commercial banks.

¹⁵ James A. Wilcox. 2005. "Failures and Insurance Losses of Federally-Insured Credit Unions: 1971-2004." Filene Research Institute, Madison, WI.

Figure 3
 Provisions for Loan Losses per Assets:
 Credit Unions and Commercial Banks
 (% , 1980-2010Q3, NCUA, FDIC)



Congress eventually enacted minimum capital-to-asset requirements for credit unions several years later, in 1998, at a time when overall economic and financial conditions had improved and losses to the deposit insurer had largely subsided for both commercial banks and for credit unions.

It is important to note that Congress did not introduce minimum capital-to-asset requirements for credit unions directly as a result of a crisis or emergency among credit unions. Rather, in response to litigation in federal courts regarding credit union fields of membership (FOM), Congress engaged in a wide-ranging overhaul of the credit union regulatory system. Through the Credit Union Membership Access Act (CUMAA) of 1998,¹⁶ Congress grandfathered the FOM expansions that the NCUA had granted to credit unions since the 1980s.

¹⁶ Public law 105-219.

However, Congress also introduced restrictions for credit union member business lending, explicitly permitted the conversion of credit unions into mutual savings banks (and thus eventually into stock-owned institutions), and introduced a very detailed schedule of minimum capital-to-asset requirements for credit unions. Since (1) credit unions had suffered far lower loan losses during the 1980s, (2) credit unions had imposed far lower losses on their deposit insurer (and none on taxpayers), and (3) credit union capital-to-asset ratios had already climbed from 5.90% in 1978 to 11.01% in 1997, CUMAA largely appears to have applied to credit unions the solution to a bank problem.

4. The Great Recession of 2007-2009 has forced policymakers to reevaluate capital requirements, demonstrating once again the need for regulatory flexibility.

The recent housing, financial, and economic crises have demonstrated the need to renew discussions on capital requirements among international bank regulators (i.e., Basel III).¹⁷ These discussions reflect yet another shift in emphasis among bank regulators, from reducing the direct costs of failures to reducing the risks that a financial institution will fail. While regulators will continue to close depository institutions with very low capital levels, Basel III also proposes to use higher capital ratio triggers to provide bank managements with incentives to avoid capital ratios falling too far, which would increase the likelihood of failures. For instance, under Basel I, banks with core capital that is less than 4% of risk-based assets were considered undercapitalized and were required to forgo asset growth. Under Basel III, banks with core capital that is less than 7% of risk-based assets would be required to forgo dividends (to stockholders) and bonuses (to executives).

¹⁷ An earlier round of discussions, Basel II, was only in its earliest stages of implementation abroad and, particularly, in the U.S. and has largely been superseded by the recent crises and Basel III.

Basel III will also require banks to set up a “capital conservation buffer” of up to 2.5% to capital ratios when economy-wide credit growth is abnormally high.¹⁸ This is consistent with Section 616 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public law 111-203), which also requires that “each appropriate federal banking agency shall seek to make the capital standards ... for insured depository institutions countercyclical so that the amount of capital required ... increases in times of economic expansion and decreases in times of economic contraction.”

Basel III will further tighten risk-based capital requirements by restricting the types of items that may be counted as capital and shifting various types of assets from lower-risk to higher-risk categories. Thus, the Basel Committee estimated that while the 91 largest banks in the world reported on average capital equal to 11.1% of risk-based assets under the old rules, the same capital would only equal 5.7% of risk-based assets under the new rules.¹⁹ Basel III may also shift the nature of instruments that count as capital, from those that would solely reduce deposit insurer losses due to failures to new instruments that would reduce the likelihood of failures. For example, upon reaching a preset, low capital ratio, such instruments would automatically reduce the depository institutions’ liabilities (and increase their capital ratios to higher levels), thereby reducing their likelihoods of failure.²⁰

Thus, Basel III effectively requires banks not only to hold more capital, but also to hold forms of capital that are more likely to help institutions to survive. While federal banking regulators have yet to implement Basel III entirely, having agreed on them in international

¹⁸ Abnormally high credit growth is to be detected comparing recent credit growth and the historical trend using Hodrick-Prescott statistical filters (Financial Times, “Basel III,” January 12, 2011, P. 12).

¹⁹ Financial Times, “Basel reveals liquidity gap for world’s biggest banks,” December 17, 2010.

²⁰ These instruments would reduce a depository institution’s liabilities either by reducing their face value irrevocably or by converting into common shares. The trigger for these reductions could be breaching a preset capital ratio, an announcement from bank regulators, or a decision to otherwise inject public funds into the depository institution. Financial Times, “Tough requirements on bonds that banks count toward capital,” January 14, 2011, P. 14.

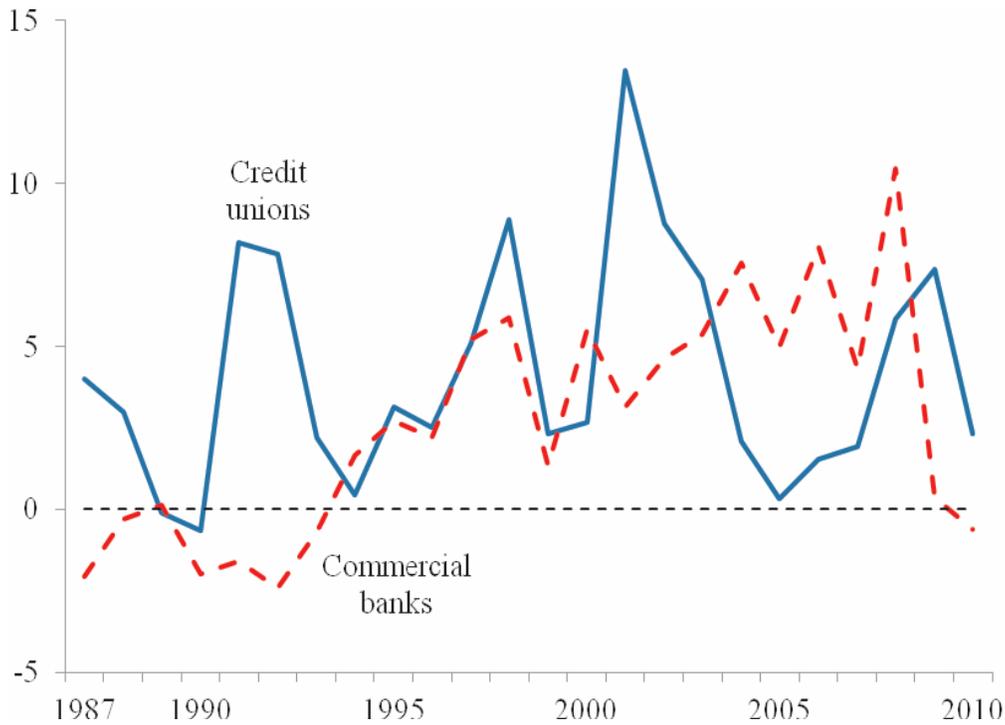
discussions, U.S. banking regulations are very likely to be implement many of its provisions in coming years.

II. Current capital requirements restrict credit unions' abilities to serve as safe harbors for depositors and to offset the pro-cyclicality of commercial banks' lending, abilities that historically have helped speed up and strengthen recovery when the economy has needed it most.

In recent decades, credit unions have served as “safe harbors” for depositors when financial markets were clouded with uncertainties or in turmoil (as in 2001 or 2009). In times like these, when savers had suffered sharp losses, flows out of stock and bond markets often seemed to seek refuge in credit unions. Figure 4 compares growth rates of credit unions' and commercial banks' inflation-adjusted deposits during 1987-2010Q3. Over this extended period, credit union deposits grew faster (4.2% annually) than commercial bank deposits (2.7%), due to credit unions' generally more favorable interest rates and other factors.²¹ Notably, credit union deposit growth was fastest during and after the recessions and financial market problems of 1990-1991, 2001, and 2007-2009. In contrast, deposit growth was more subdued during the boom years of the mid 2000s. The pattern of commercial bank deposit growth in these episodes was decidedly different from that of credit unions: Bank deposits shrank in 1990-91 and 2007-2009, but grew more strongly during the boom years of the mid 2000s.

²¹ The fraction of deposits in credit unions (out of those in credit unions and commercial banks) has grown steadily over the decades passing 1% in 1954, 2% in 1960, 3% in 1969, 4% in 1975, 5% in 1985, 6% in 1986, 7% in 1991, 8% in 1992, and 9% in 2001.

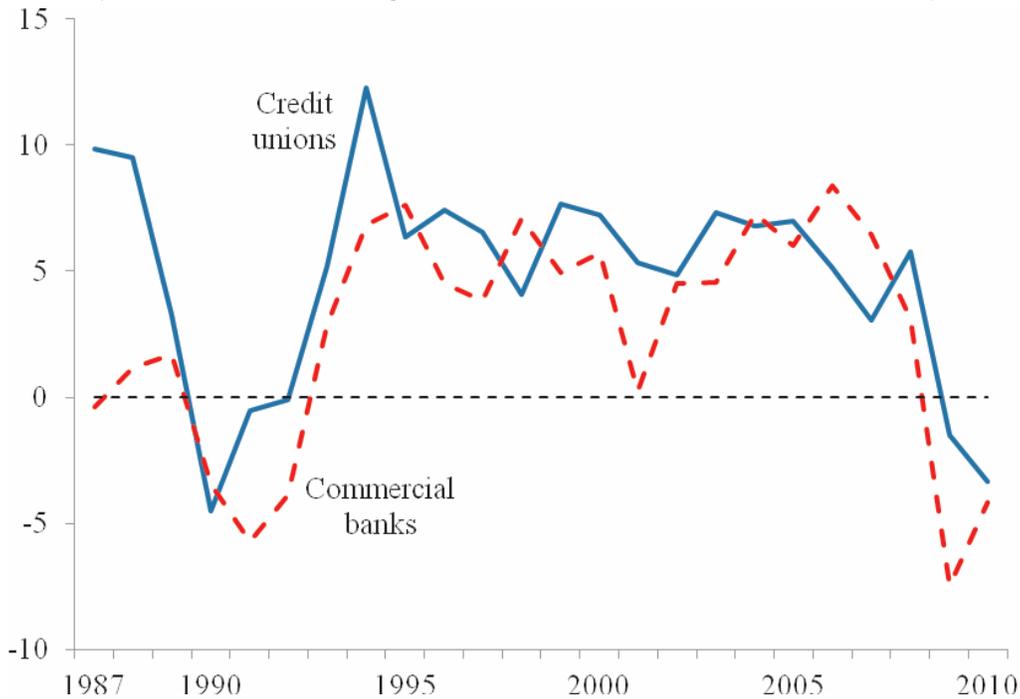
Figure 4
 Deposit Growth
 (% , annual, inflation adjusted, 1987-2010Q3, CUNA, FDIC, BLS)



Credit unions have traditionally also played a countercyclical role, helping to counterbalance declines in commercial bank lending that often occurred when the overall economy was weak. Figure 5 compares credit union and commercial bank growth in inflation-adjusted loans during 1987-2010Q3. Commercial banks cut back lending deeply during and after the recessions of 1990-1991 and 2007-2009. In contrast, credit unions reduced their lending far less than banks during and after the 1990-1991 recession (largely maintaining it in 1991 and 1992), maintained lending growth at rates consistent with a growing economy during and after the 2001 recession, and reduced their lending substantially less than banks during and after the 2007-2009 recession.²²

²² While the nominal value of credit union loans did increase from 2007 to 2008 and from 2008 to 2009, Figure 5 highlights that credit unions may still be unable to fund creditworthy borrowers. As the figure shows, credit union

Figure 5
 Loan Growth
 (% , annual, inflation adjusted, 1987-2010Q3, CUNA, FDIC, BLS)



Note: We adjusted reported commercial bank lending downwards by about \$250 billion in 2010 to take into account the effects of FASB 166 and FASB 167 requiring banks to consolidate previously unconsolidated securitized lending.

Credit union lending has consistently been more countercyclical than that of commercial banks in the recent decades. Figures 4 and 5 also show that credit unions’ ability to counterbalance banks has varied with the structure of credit union capital requirements, as well as with other conditions. Thus, during and after the 1990-1991 recession, when they were not subject to minimum capital-to-asset requirements, credit unions were able to provide safe harbors for depositors and were largely able to support lending during 1991-1992.

lending both fell once adjusted for inflation and grew at rates far below those consistent with average long-term economic growth. (The nominal value of credit union loans did fall from December 2009 to September 2010.)

A. Relatively high capital ratios at credit unions after the 2001 recession led the GAO to conclude in 2004 that credit union capital requirements were adequate at that time.

During and after the 2001 recession, many individual credit unions became concerned that heavy deposit inflows were pushing them down to minimum capital-to-asset ratios. On the whole, however, credit unions were able to provide safe harbors to depositors and to maintain loan growth rates that were consistent with sustained growth of the economy. In light of these conditions and results, a 2004 report by the Government Accountability Office (GAO)²³ concluded that credit unions could service their members adequately under the prevailing capital-to-assets requirements. However, the GAO report made little allowance for the reality that events and conditions were predictably going to change in unpredictable ways.

1. GAO's snapshot in time must be revisited in light of recent, dramatic changes in the financial landscape.

The 2007-2009 recession highlighted the shortcomings in current credit union minimum capital-to-asset requirements. The then-prevailing, and still-prevailing, structure of capital requirements did not substantially restrict credit unions in the aggregate during and after the 2001 recession because, at the onset of the 2001 recession, the aggregate credit union capital-to-asset ratio was high and the modest loan losses meant that provisions for loan losses per assets needed to be increased only slightly. With provisions remaining between 0.31% and 0.34% every year within 1999-2004 (see Figure 3 above), credit union deposits grew 13.5% from 2000 to 2001 and the average capital-to-asset ratio fell less than 1%, from 11.36% to 10.86%.

²³ Government Accountability Office. 2004. "Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital." Washington, D.C.

2. GAO failed to address how capital authority could restrict credit union operations during a recession.

In contrast, credit union minimum capital-to-asset requirements substantially restricted credit unions' abilities to accept deposits and extend credit during and after the 2007-2009 recession. Credit unions endured large and rapid declines in capital: The aggregate capital-to-asset ratio fell from 11.39% in 2006 to 9.77% in 2009, with many much larger declines at individual credit unions. As a result of capital pressures, many credit unions have been forced to limit their traditional role as safe harbors for depositors, accommodating far less deposit growth than during and after past recessions, and have cut their inflation-adjusted lending substantially. Some credit unions have been forced to ask large depositors to temporarily shift their deposits elsewhere.

III. Reforming capital requirements would improve credit unions' ability to bolster safety and soundness, while enabling better service to members and helping to speed up and strengthen the national economy's recovery.

A. In contrast to banks, credit unions cannot access supplemental capital.

Current credit union capital requirements, as defined in detail in statute, unfortunately combine (1) the minimum capital-to-asset requirements that apply to banks and (2) a holdover from pre-CUMAA credit union legislation by which only retained earnings may count toward credit union capital requirements.²⁴ Commercial banks are sensibly allowed to meet an asset-based capital requirement by using a combination of retained earnings and capital instruments. Being able to use capital instruments greatly helps banks to meet capital requirements as conditions change, whether because of (1) increases in assets (whether driven by deposit inflows

²⁴ According to 12 U.S.C. 1757a(c)(2), low-income credit unions may also count secondary capital accounts as net worth and, thus, toward capital requirements. Risk-based credit union capital requirements also count other items, such as allowance for loan losses. In December 2009, 1,085 credit unions were classified as low income (14% of credit unions but, being on average smaller, holding only 4.2% of credit union assets). Among low-income credit unions, only 40 have outstanding amounts of secondary capital. Their secondary capital accounts for 4.4% of their assets but 39% of their net worth.

or the pursuit of valuable loan opportunities) or (2) decreases in their capital (e.g., loan losses or falls in the values of assets held). However, as a result of the pre-CUMAA holdover that allows only retained earnings to be counted toward their capital requirements, U.S. credit unions – unlike commercial banks, stock-owned and mutually-owned thrifts, stock-owned and mutually-owned insurance companies, and even credit unions abroad²⁵ – are not able to remedy shortfalls of their actual capital ratios below regulatory minimums by issuing capital instruments.

Modifying credit union capital requirements from a minimum fraction of earnings to a minimum fraction of assets fits within a long tradition of capital updates specified by Congress. Prior to CUMAA, credit unions with high enough capital-to-loan ratios were not required to set aside additional reserves from earnings, but credit unions with low capital-to-loan ratios were required to do so. In CUMAA, Congress imposed on low-capitalized credit unions penalties that were similar to those it had mandated for low-capitalized banks. However, Congress did not provide the corresponding authority for the NCUA to permit credit unions to raise supplemental capital – a key tool available to banks.

As a result, credit unions with low capital-to-asset ratios can no longer meet their requirements by retaining a fixed fraction of low earnings (e.g., 10% of gross earnings), but rather have to retain over time whatever amount of earnings is necessary to close potentially large shortfalls of their actual capital ratios below the new legislated minimums. Until credit unions meet the capital-to-asset requirements, Congress requires them to forgo growth in assets.²⁶ To improve current credit union capital requirements, Congress should retain capital

²⁵ For example, in Canada, credit unions are able to issue certain forms of supplemental capital.

²⁶ Section 216(c)(1)(C) of the FCU Act (as amended by CUMAA) states that “an insured credit union is ‘undercapitalized’ if it has a net worth ratio of less than 6 percent.” Section 216(g)(1) states that “an insured credit union that is undercapitalized shall not generally permit its average total to assets to increase.” For instance, a credit union with a net worth-to-loans ratio of 6% (or about 4% of assets) in 1997 (i.e., one then not required to set aside more reserves under pre-CUMAA legislation) would have to set aside an additional 2% of assets as reserves before it was allowed to grow again.

requirements as a minimum fraction of assets but allow credit unions, subject to appropriate regulatory oversight, access to supplemental capital.

It is important to note that some capital instruments currently used by banks or other financial institutions convey voting rights and are, thus, not consistent with credit union governance structures. However, most financial institutions other than credit unions²⁷ can use several other, non-voting instruments (e.g., preferred stock, subordinated debt, and other hybrids) or items (e.g., the allowance for loan losses) to meet capital requirements.²⁸

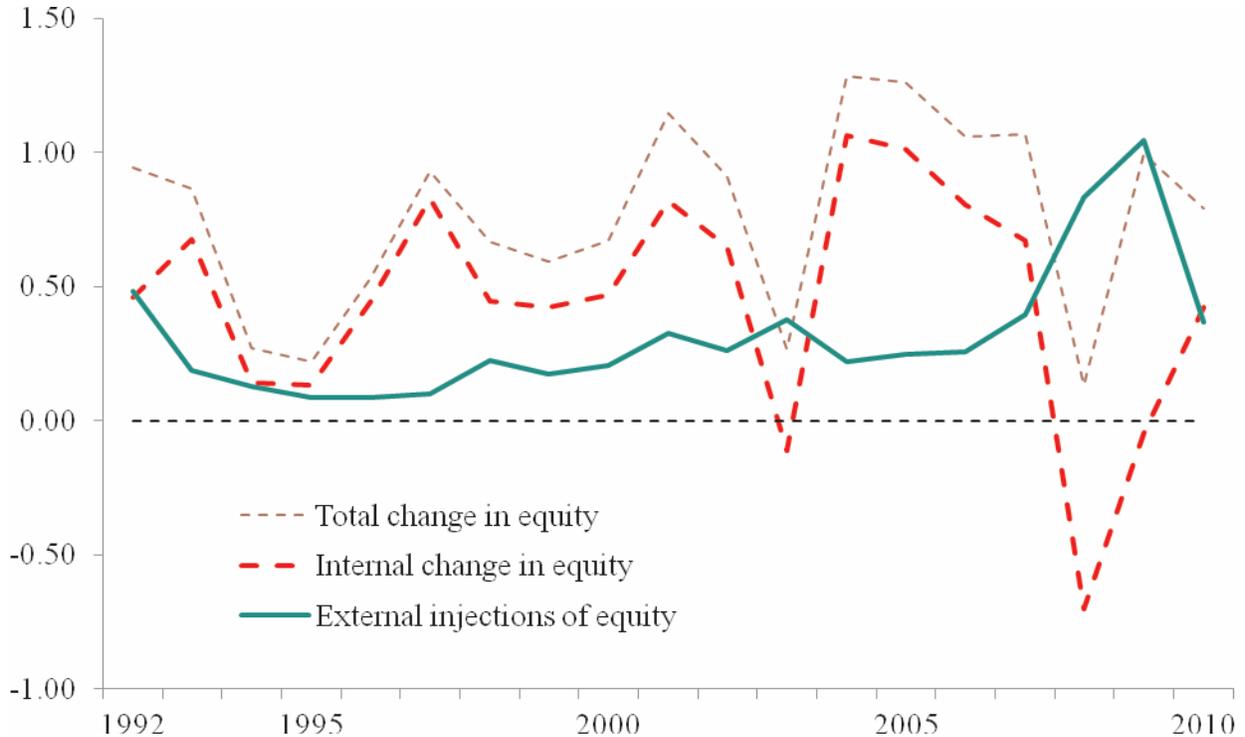
B. Access to supplemental capital strengthens depository institutions and benefits the economy.

The ability to raise supplemental capital is important for banks during both normal and troubled times. Figure 6 presents commercial banks' capital raised internally (e.g., retained earnings, changes in values of securities held, and restatements), raised externally (e.g., capital instruments sold and injections from their parent bank holding companies, BHCs), and the total of the two. Commercial banks routinely rely on raising capital externally: They obtained 27% of their increased capital externally during normal times (e.g., 1993-2006 or the period between, or excluding, the two most recent banking crises). However, commercial banks relied even more heavily on raising capital externally (at 93% of their increases in capital) during troubled times (e.g., 2007-2010). The figure also shows that commercial banks' external capital raising allowed them to increase their equity levels despite enduring large losses (i.e., despite negative internal changes in equity).

²⁷ Under some circumstances, some of these instruments are also already counted as capital for credit unions. Low income credit unions may count subordinated debt as net worth, and complex credit unions may count the allowance for loan losses toward their risk-based requirements.

²⁸ As we describe elsewhere, while international discussions are reassessing the characteristics to be permitted in the future for such instruments, Congress and federal bank regulators continue to anticipate a role for non-voting instruments in capital requirements.

Figure 6
 Changes in Commercial Bank Equity:
 Internal (e.g., retained earnings, changes in values of securities held, and restatements),
 External (e.g., capital securities sold and injections from their parent BHCs), and Total
 (% of assets, annual, 1992-2010Q3, FDIC)



C. The lack of access to supplemental capital harms credit unions, their members, and the broader economy.

Without access to supplemental capital credit unions are restricted in their ability to respond to changes in conditions. Credit unions faced with loan losses and/or with lower capital ratios have to restrict the growth of their assets. In effect, to deter deposit inflows, these credit unions are forced to offer their members worse interest rates on deposits than available at other institutions. To build capital by retaining earnings, these credit unions would also have incentives to close branches, reduce employment, and charge higher interest rates on loans, thereby limiting their services to their members. Because of these restrictions, credit unions

cannot provide the safe harbors for savers or extend the requisite amount of loans to creditworthy borrowers.

Federal bank regulators commonly view the use of capital instruments as a part of prudent financial management and as an aid to safety and soundness, because higher levels of capital are likely to reduce the probability of failure and provide greater protection to deposit insurers.

Because credit unions currently do not have access to supplemental capital, they may be required to endure long periods in which they charge high loan rates, pay low rates on deposits, cut costs (and thus services to members), and are far less attractive to their members in order to preserve their regulatory capital ratios. These credit unions are faced with the unpalatable choice of strengthening their capital position quickly or providing good service to their members. A sufficiently large reduction in its capital ratio, then, might entail services and deposit and loan rates so unattractive to its members that the credit union would be unlikely to recover from otherwise survivable challenges. Access to supplemental capital would provide an effective tool for healthy credit unions to enhance safety and soundness and expand services and credit to their members. By ensuring that institutions can remain attractive as they rebuild their capital, access to supplemental capital would likely reduce the number of troubled institutions that actually failed and reduce the costs imposed on deposit insurers.

IV. Congress should delegate to NCUA authority to determine capital requirements.

As discussed previously, Congress currently delegates to federal banking regulators the authority to set, by regulation, nearly all the detail in the structure of bank capital requirements, ranging from what may count as capital to nearly all the numerical values in those

requirements.²⁹ With CUMAA, Congress set by statute nearly all the key details of the structure of credit union capital requirements.³⁰ Therefore, in light of the inevitable, but unpredictable changes in conditions, federal bank regulators can readily update bank capital requirements. In contrast, the NCUA cannot.

In these circumstances, credit unions often find that making necessary adjustments to their capital requirements, small or large, is needlessly slow, complex, and uncertain. By delegating to federal bank regulators the authority to update key details in bank capital requirements, but not delegating similar authority for credit unions, Congress finds that it does not have to update legislation on bank capital requirements very often, but it does have to revisit many details of credit union capital requirements regularly. For example, changes in generally accepted accounting principles (GAAP) regarding the treatment of mergers recently required Congress to adjust capital requirements so that the continuing credit union in a merger could count as capital both its retained earnings and the retained earnings (which GAAP had reclassified as acquired equity) in the merging credit union.³¹ Similarly, on January 4, 2011, a law was enacted which allows credit unions to count assistance to avoid liquidation toward their capital requirements.³²

The goals, tradeoffs, and issues involved in capital requirements for both commercial banks and credit unions are broadly similar. Thus, Congress should structure capital

²⁹ 12 U.S.C. 1831o(b)((2)(G) states “the term ‘required minimum level’ means, with respect to each relevant capital measure, the minimum acceptable capital level specified by the appropriate federal banking agency by regulation.”

³⁰ Capital requirements for both commercial banks and credit unions include some elements that Congress set by statute and some elements that regulators set by regulation. However, the legislated elements for commercial banks are very limited, including tangible equity worth 2% of total assets. In contrast, the legislated elements for credit unions are very extensive, including a schedule of net worth requirements ranging from 2% of total assets for critically undercapitalized institutions to 7% of total assets for well capitalized institutions. Both commercial banks and credit unions have additional sets of risk-based capital requirements that regulators set by regulation. However, since the legislated requirements per total assets are much lower for commercial banks and much higher for credit unions, the risk-based requirements are the main binding constraint for most commercial banks and the requirements per total assets are the main binding constraint for most credit unions.

³¹ Financial Services Regulatory Relief Act of 2006 (Public law 109-351).

³² Public law 111-382.

requirements for both sets of institutions so that, when various conditions inevitably and importantly change unexpectedly, capital requirements can be adjusted readily and appropriately. The extent to which Congress sets capital requirements in statute and delegates authority to federal regulators should be broadly similar for banks and for credit unions.

Thus, Congress should set in statute the broad outline of credit union capital requirements and delegate to the NCUA the authority to set and update, by regulation, the details of those requirements.³³ Moreover, by delegating authority to the NCUA now, Congress would not forgo its ability to correct or restrain the NCUA in the future. For instance, Congress recently updated the contours of the authority granted to federal bank regulators.³⁴

If Congress delegated the authority, the NCUA could set and update, by regulation, what counts as capital for credit unions. Using such authorization, the NCUA should permit by rule credit unions to use various capital instruments to meet their capital requirements. Individual credit unions could, then, raise capital externally to respond, as needed, to various changes in conditions, ranging from recessions and loan losses to inflows of deposits and loan opportunities. Thus, Congress could aid credit unions' efforts to serve their members, their communities, and to assist the economic recovery.

³³ In letters to the leaders of the House Financial Services Committee and the Senate Banking Committee, NCUA Chairman Debbie Matz recently presented similar but more limited proposals to exclude government securities from assets in the denominator of the net worth ratio and to allow capital instruments in the numerator of the net worth ratio. Excluding government securities from the net worth ratio would help credit unions to accommodate deposit inflows during and after recessions and harks back to earlier structures of credit union capital requirements, such as those between 1970-1998 when some requirements were based on risk-based assets (largely loans). The NCUA also released its Supplemental Capital White Paper in April 2010 presenting possible approaches. The White Paper, prepared by an internal NCUA working group and led by NCUA Board Member Gigi Hyland, reviews NCUA's current authority, offers three possible models for supplemental capital, and provides modeling and suggested statutory revisions. NCUA. 2010. "Supplemental Capital White Paper." Alexandria, VA.

³⁴ Through section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public law 111-203), Congress required federal bank regulators to apply the same capital requirements to banks and to their BHCs. In effect, this change forbid larger banks from counting trust preferred securities (a hybrid instrument combining some characteristics of subordinated debt and of preferred stock) toward bank core (Tier 1) capital requirements. Section 616 also requires federal bank regulators to seek that capital requirements be countercyclical.

A. Examples: Illustrating the implications.

Figure 7 further highlights the importance of being able to raise supplemental capital during troubled times. Since the onset of the financial crisis, reported commercial bank capital ratios were strengthened by massive injections of new capital, from both the private and public sectors. Had they received such injections, credit unions could have avoided declines, and perhaps even increased, their capital ratios. Capital injections would, regardless of their net effects on capital ratios, have likely boosted the deposits and loans that credit unions would have supplied to the benefit of their members, of their communities, and of the economy more broadly.

More specifically, Figure 7 compares actual capital-to-asset ratios for credit unions and commercial banks during 1987-2010Q3, as well as two hypothetical cases. The actual capital ratio for commercial banks barely declined during the crisis, falling from 10.23% in 2007 to 9.38% in 2008, and has even grown steadily since then reaching 11.40% in 2010. In contrast, the actual capital ratio for credit unions declined markedly from 11.29% in 2007 to 9.77% in 2009. Combined with Figure 5 (on loan growth), this figure highlights the potential impact on lending due to small changes in average capital-to-asset ratios, even if the averages are well above required regulatory minimums. Loan growth may decline substantially for several reasons. Small changes in average capital ratios may mask large declines for individual institutions that become deeply constrained. A high average capital ratio may also mask far lower capital ratios among faster-growing institutions that may have delivered outsized fractions of loan growth. Further, lending decisions may not respond solely to actual declines in capital but to the uncertainty of how large those declines may become.

Figure 7
 Credit Union and Commercial Bank Capital to Asset Ratios:
 Actuals in 1987-2010Q3 and Two Hypotheticals,
 For Credit Unions: Adding Commercial Banks' Capital Raisings in 2008-2010Q3
 For Commercial Banks: Subtracting their Capital Raisings in 2008-2010Q3
 (% , annual, 1987-2010Q3, CUNA, FDIC)

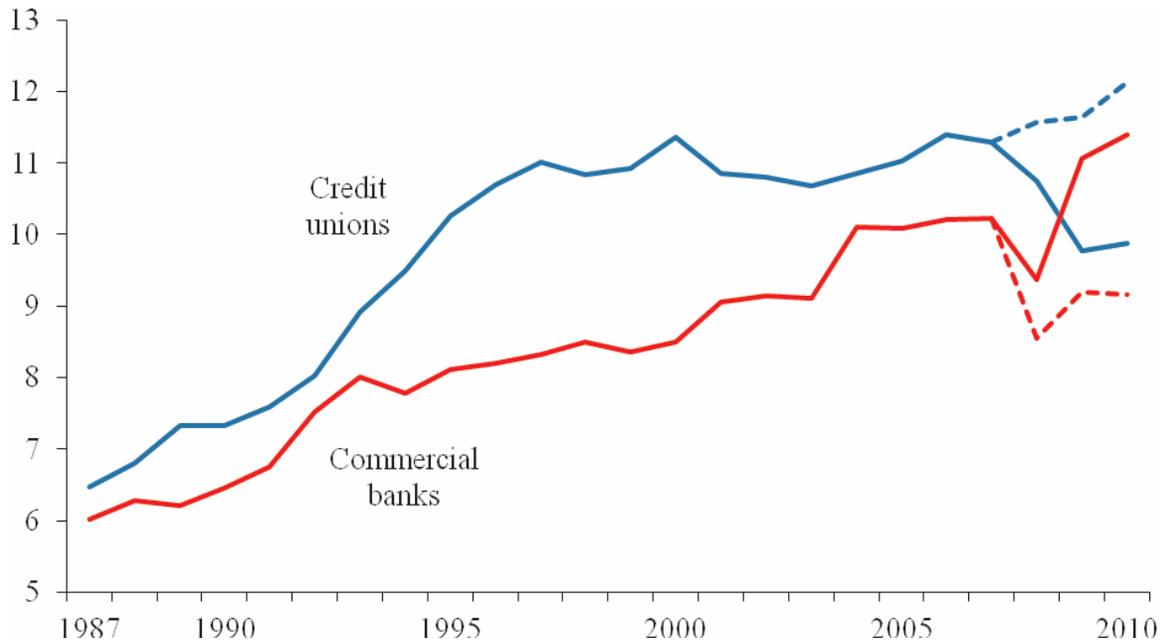


Figure 7 also includes a hypothetical case for commercial banks, assuming that they were not able to raise capital externally in 2008-2010. In such circumstances, their capital ratio would have fallen to 8.55% in 2008 and would have barely recovered since. The hypothetical case for credit unions assumes that they would have raised the same amount of supplemental capital (per assets) as banks did during 2008-2010. In this hypothetical, credit union capital ratios would not have fallen and would have reached 12.12% by 2010.

These hypotheticals are not predictions, but rather highlight the implications of being able to raise capital externally. If commercial banks had not been able to raise capital externally, they would likely have raised more capital internally by charging higher rates on loans, paying even lower rates on deposits, and, thus, retaining more earnings. If credit unions had been able to

raise capital externally, they might have raised less capital internally, by charging lower rates on loans, paying higher rates on deposits, and, thus, retaining fewer earnings.

Similarly, credit unions would likely not have sought to increase their capital ratios but, rather, accepted more deposits and made more loans, such that their capital ratios remained constant. In a simple projection, had credit unions been permitted access to supplemental capital in the same amount (per assets) as commercial banks and credit unions had sought to maintain their capital ratio at their 2008 level, they could have expanded their lending by an additional \$37 billion in 2008-2010.³⁵ Under such a projection, instead of cutting their inflation-adjusted loan growth by -3.34% in 2010, credit unions would have increased it by 1.24%, in line with their traditional practice of counterbalancing declines in commercial bank lending during recessions.

V. Specific issues must be considered in regulating capital instruments.

Expanding eligible capital instruments for credit unions must be carefully considered. Some of the considerations that should inform NCUA regulation of capital instruments are well recognized. In general, depositories, their regulators, their insurers, their customers, and taxpayers all benefit when depositories can raise capital quickly and in large amounts. Depository institutions with more capital are less likely to fail. Even if they do fail, institutions that used capital instruments to bolster their cushions before they became troubled are likely to impose lower costs on deposit insurers.

Other considerations regarding expanded capital instruments for credit unions include:

- Credit union capital instruments should be consistent with their cooperative structure.

Holders of credit union capital instruments should not gain more votes or control

³⁵ Credit union loans in 2010Q3 would total \$615 billion instead of the actual \$578 billion, or 6.5% more. While this difference may not be large from the point of view of the economy as a whole, it does highlight that while a small player in the market of depository institutions, credit unions can play a countercyclical macroeconomic role.

beyond what they would otherwise have as regular members with a single vote per member in elections to credit unions' Boards of Directors.

- Capital instruments should place funds at risk. The claims of their owners should not be insured as deposits and should be subordinated to the claims (1) of all regular depositors and (2) of the depositor insurer.
- Capital instruments should be long-term in nature. Common minimum maturities are 10 years, with the fraction of instruments that count as capital being reduced as an instrument's maturity reaches 1-5 years remaining.³⁶
- Credit unions should not be required to use any capital instruments beyond retained earnings. Like banks, credit unions should be permitted to meet all their capital requirements with retained earnings. Credit unions should be permitted to use other capital instruments to meet part of their requirements, but not required to use them.
- The NCUA, like federal bank regulators, should update its credit union capital requirements periodically as conditions warrant. These updates may change required capital levels, the factors and formulas that help determine those levels, and the types and characteristics of permitted capital instruments.

However, even while the NCUA exercises strong regulatory oversight over emerging capital instruments, the NCUA and individual credit unions will face several important choices about the regulation and use of capital instruments. These choices include:

- What specific capital instruments to permit? Options range from (1) more equity-like instruments without maturity dates and with adjustable rates to (2) more debt-like

³⁶ Some items that may be counted as core or supplemental capital are not instruments that are issued, but various reserves ranging from, of course, retained earnings, but also the allowance for loan losses.

instruments with preset maturity dates and preset rates. Whatever the instrument, it is important to note that it would be highly regulated.

- How should capital instruments be issued? Options range from (1) making them available to regular members at the credit union to (2) making them available to credit union-related entities (e.g., other highly-capitalized natural person credit unions, corporate credit unions, CUNA Mutual, etc.), (3) making them available to all investors through brokerages, or (4) making them available to qualified or institutional investors (e.g., pension funds, insurance companies, mutual funds, ETFs specialized in the hybrid capital instruments of depository institutions). The tradeoffs involved in these choices range from the size of the potential market to the rates credit unions would have to offer, the speed with which capital could be raised in normal or troubled times, and the protection of less well informed savers. To enforce this last goal, the NCUA could require credit unions to apply suitability requirements before it issues some types of capital instruments to retail savers.

In its 2004 report, GAO also suggested that credit unions did not have a consensus on whether capital requirements should be reformed or what shape that reform should take. This paper is not advocating a one-size-fits-all approach. We recognize, however, that collectively credit unions would benefit from the ability to use capital instruments even if credit unions' use of capital instruments would likely vary widely. Some credit unions may use them regularly. Others may never use them. Yet others may use them occasionally. Many will simply use them as conditions change, raising capital during and after recessions to accommodate inflows of deposits, to be able to maintain their lending, or to offset loan losses. This variety underscores the need for empowering the NCUA with the authority to develop appropriate regulations.

VI. Conclusions

Capital requirements for credit unions must be adjusted to respond to fundamental changes in the financial landscape. Current credit union capital requirements restrict credit unions' ability both to act as safe harbors for depositors and to reduce the pro-cyclicality of total lending. Recent experience confirms that the structure of capital requirements can greatly affect credit unions' ability in assisting recovery. The recession of 2007-2009 involved large increases in provisions for loan losses and declines in capital for many depository institutions. While commercial banks again restricted deposit and loan growth far more than credit unions, declines in capital ratios forced credit unions to limit or forgo their traditional countercyclical role. Reaching -3% by 2010, growth rates in inflation-adjusted credit union lending fell 8% below rates consistent with long-term economic growth. With better access to capital, not only could the safety and soundness of credit unions be enhanced, but they would be positioned to offset the reduction in bank lending that has contributed to past recessions and slowed the current economic recovery.

Accordingly, Congress should provide the NCUA with the authority to determine capital requirements for credit unions and to update them as appropriate. These changes would parallel existing authorities of the other federal financial regulators. Empowering the NCUA to develop appropriate capital requirements for credit unions would also promote three important policy objectives:

- Expanded capital authority for credit unions would promote the safety and soundness of the credit union system;

- Expanded capital authority would allow credit unions to enhance their ability to serve their members (increased deposits and lending) and improve the efficiency of their operations; and
- Expanded capital authority for credit unions would benefit the broader economy and help speed up the economic recovery.