DCU BULLETIN

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Division's Summary of PCA

Enclosed is a copy of the Division's Summary of the NCUA's Prompt Corrective Action (PCA) rule. The Summary outlines:

1. The main part of the PCA rule, which the NCUA has adopted in final form; and
2. The complex credit union/risk based net worth part of the PCA rule, which the NCUA has issued as a proposed rule.

The Summary has been updated and clarified from prior Division summaries of the PCA rule. Prior summaries provided by Parker ("PC on PCA") may now be inaccurate and should be discarded.

Please feel free to call Parker at (360) 902-8778 if you have questions about the PCA rule.

Summary of NCUA's
Prompt Corrective Action (PCA) Rule

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Overview

1. What is PCA? The Credit Union Membership Access Act (CUMAA), H.R. 1151, mandates a system of Prompt Corrective Action - "PCA" - for all federally insured credit unions, whether federally or state chartered. CUMAA directs the NCUA to adopt rules to implement these PCA provisions.

These PCA provisions:

- **Establish a system of five net worth (NW) categories.**
- **Establish a series of mandatory and discretionary enforcement actions that apply if a credit union falls to one of the three Undercapitalized categories.**

These first two parts are referred to below as the main PCA rule.

- **Require NCUA to adopt a risk-based net worth (RBNW) requirement for "complex" credit unions.**

The third part is referred to below as the complex/RBNW part of the PCA rule.

You will notice that the term "capital" is out. "Net worth" is in.

Essentially, the PCA system forces regulators to take enforcement action against a credit union if its net worth falls below specified levels.

2. What is the current status of PCA? On February 3, 2000, the NCUA Board adopted the final version of the main PCA rule, and proposed the complex/RBNW part of the PCA rule. The NCUA is inviting your comments on the proposed rule, by April 18, 2000.

3. When does PCA take effect? According to CUMAA, the two portions of PCA take effect at different times:

- The main part takes effect August 7, 2000.
- The complex/RBNW part takes effect January 1, 2001.

Note that these dates are not quarter-end dates. More discussion is provided below on the actual dates that NW classifications take effect.

4. Are State regulators involved in the PCA process? Yes, CUMAA requires the NCUA to consult and cooperate with state credit union regulators in adopting PCA rules. In addition, the NCUA is required to work with state regulators when it makes significant PCA decisions regarding state charters.

Operation of Main Part of PCA Rule

5. What are the Net Worth categories under PCA? The Net Worth categories essentially fall into three groups:

- **The Good: 7% or higher NW - Well Capitalized category**
- **The Almost Good: 6% to 7% NW - Adequately Capitalized category**
- **The Not-So-Good: less than 6% NW – Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized categories**

In the final version of the main part of the PCA rule, the NCUA has allowed credit unions to use an average total assets figure (the denominator in the Net Worth ratio) based on the last four quarter-end balances. Credit unions cannot use this averaging for purposes of the complex/RBNW part of the rule.

"New" credit unions, defined by the 10/10 rule, have different net worth categories. The 10/10 rule = in existence less than 10 years with $10 M or less in total assets.

6. What happens when my NW ratio falls below 7%? If your NW ratio is 6% – 7%, you are in the Adequately Capitalized category. The sole PCA ramification is that you must contribute to reserves quarterly from earnings an amount equal to 0.10% of assets, before the payment of dividends.

However, earnings are being squeezed. Many credit unions did not have 40 basis points in ROAA last year. Credit unions with a NW ratio of less than 6% that do not have sufficient earnings to make the 10 basis point reserve transfer must seek regulatory approval before paying dividends.

7. What happens when my NW ratio falls below 6%?

5% to 6% NW

If your NW ratio is 5% – 6%, you are considered first tier Undercapitalized. The credit union is subject to four mandatory supervisory actions:

- Must reserve quarterly from earnings an amount equal to 0.10% of assets.
- Must submit net worth restoration plan (NWRP) to the regulator.
- No growth in assets until NWRP providing for growth in assets is approved by the regulator.
- No growth in the total balance of member business loans (MBL), unless the credit union has been granted an exception from the aggregate MBL limits under CUMAA.

4% to 5% NW

If your NW ratio is 4% - 5%, you are considered second tier Undercapitalized. The consequences are as follows:

- You are subject to the four mandatory supervisory actions described above.
- The NCUA in its discretion may impose a broad range of supervisory actions against the credit union.

The NCUA's discretionary actions become more severe as a credit union deteriorates to Significantly Undercapitalized (2% - 4% NW) and Critically Undercapitalized (less than 2% NW).

8. Will the NCUA allow alternative or secondary capital for credit unions? CUMAA expressly permits low-income credit unions to count secondary capital as NW for PCA purposes.

It appears that Congress did not permit other credit unions to do so. However, the NCUA may count recognized alternative/secondary capital as a mitigating factor when making regulatory determinations under PCA.

9. How will asset growth affect my NW category?

Growth can dilute your NW ratio, causing your credit union to fall into a lower NW category.

Credit unions must learn to effectively manage share/deposit and asset growth. In the PCA era, budgeting and business planning will become more critical. In the planning process, credit unions should develop fairly detailed pro forma balance sheets and income statements, including key ratios. These should be developed before year-end for the upcoming year. The Board should track variances on a regular basis. The pro formas should be based on reasonable, articulated, and achievable assumptions.

The bottom line is that it may be very difficult to maintain your NW ratio if you have significant growth. We looked at some projections on NW maintenance breakeven points with various levels of growth, ROAA, etc. Credit unions with double-digit growth rates and typical ROAA levels will have to look at this issue very seriously if they have a NW ratio in the 7% - 10% range.

In the final version of the main part of the PCA rule, the NCUA has allowed credit unions to use an average total assets figure (the denominator in the Net Worth ratio) based on the last four quarter-end balances, helping to dampen the impact of growth on Net Worth ratios.

10. How often do I figure my NW category? Can I figure my NW category off my Call Reports? When do NW classifications take effect?

Credit unions will determine their NW categories quarterly and provide PCA worksheets with the Call Report forms. (However, the NCUA will need to revise the Call Report forms to pick up certain data for the calculation of the RBNW requirement for complex credit unions.)

Using this approach:

- **If you are a quarterly 5300 filer**, you would figure your NW category quarterly off your Call Reports by using the PCA worksheet.
- **If you are a semi-annual 5300 filer**, you would figure your NW category from your financials for the 1^{st} and 3^{rd} quarters, and from the Call Reports for the 2^{nd} and 4^{th} quarters, by using the PCA worksheets. You will need to provide your regulator with the PCA worksheet on the "off" quarters only if your NW category has lowered.

The NW classifications take effect at the end of the month after each quarter-end. Put another way, your NW category would be in jeopardy four times a year – January 31, April 30, July 31, and October 31. (However, the regulators also have the authority to reclassify a credit union to a lower NW category in certain circumstances, through the exam process or otherwise.)

11. When will the first NW classifications take effect? They will take effect January 31, 2001.

12. Would it be prudent for my Board to establish a target NW spread above the 7% NW threshold? Yes.

13. Is the NCUA's PCA system for credit unions like the FDIC's PCA system for banks and thrifts? Yes and no.

The Yes part – The basic structure is the same; many of the discretionary enforcement actions are similar.

The No part –

- Many of the details of the PCA system are set forth in CUMAA – a federal statute – rather than in federal agency rules, including such critical parts of PCA as the definition of NW, and the net worth ratios and net worth categories. This is a huge difference.

- The net worth ratios for credit union PCA are significantly higher (a bank or thrift is “well capitalized” with a 5% capital ratio).

Complex/Risk-based Net Worth Requirement
Part of PCA Rule

Note: The discussion below is based on the proposed "complex" rule – which may or may not be the final version of the rule adopted by the NCUA. Comments on the proposed complex/RBNW part of the PCA rule are due to the NCUA by April 18, 2000.

14. How do I know if I am a "complex" credit union? Credit unions that exceed any one of 4 specified thresholds would be deemed complex. The thresholds involve:

1. Long-term real estate loans
2. Member business loans (MBL)
3. Long-term investments
4. Loans sold with recourse

See the enclosed Table A for a more detailed description of the thresholds.

15. I'm a "complex" credit union under PCA. What is my RBNW requirement? Complex credit unions would calculate their risk based net worth requirement using net worth factors for 8 specified items:

1. Long-term real estate loans
2. MBLs outstanding
3. Long-term investments
4. Low-risk assets
5. Average-risk assets
6. Loans sold with recourse
7. Unused MBL commitments
8. Allowance for loan and lease losses

Credit unions may use alternative factors for the first three categories of assets to calculate their RBNW requirement.

Ultimately, when you do the calculation, you would end up with an overall RBNW requirement, phrased as a percentage of total assets. See the enclosed Table B for a more detailed explanation of the calculation of the RBNW requirement.

<u>16. Will my RBNW requirement always be higher than 6%?</u> No. In determining their overall RBNW requirement, credit unions would be required to have more than 6% in net worth for certain higher-risk assets and less than 6% in net worth for lower-risk assets. Consequently, complex credit unions may have less than a 6% overall RBNW requirement, depending on the overall risk in their portfolio.

<u>17. How do I determine my Net Worth category?</u>

A. If your NW exceeds 6%, you would first calculate your RBNW requirement.

B. Then:

- If you meet your RBNW requirement, you would maintain your classification as Adequately or Well Capitalized, as applicable.
- If you fail to meet your RBNW requirement, you are Undercapitalized. **In other words, a complex credit union with 6.0% NW or higher that fails its RBNW requirement is Undercapitalized.**

<u>18. How often do I determine if I am complex?</u>

- Quarterly Call Report filers will determine whether they are "complex" quarterly.
- Semi-annual filers will make the determination semi-annually, at the time they file their semi-annual Call Reports.

<u>19. When do I make my first determination of complexity?</u>

- Quarterly Call Report filers will make their initial determination based on Call Reports for the first quarter of 2001, effective April 30, 2001.
- Semi-annual filers will make their first determination based on the Call Report for the first half of 2001, effective July 31, 2001.

NCUA's Letter 161; Statutory (regular) reserving

20. Will Letter 161 be revised with PCA in mind? NCUA should be revising Letter 161 sometime before the main part of the PCA rules takes effect, to make it consistent with PCA.

21. What is Letter 161? Letter 161 is a NCUA pronouncement (last revised in 1994) that provides guidelines for credit unions and federal and state examiners for determining CAMEL ratings.

22. Is it true that the PCA rule repeals the requirement for statutory (regular) reserving? Yes, the final version of the main part of the PCA rule eliminates the current statutory or regular reserving system. It appears that credit unions may cease regular reserving on August 7, 2000.

APPENDICES

Table A -- §702.104 Thresholds to define complex credit unions

Risk portfolios to define complex credit unions	*Thresholds to define "complex" (as percent of month-end total assets)*
1. Long-term real estate loans [fixed-rate loans over 3 years plus variable-rate loans than don't adjust within 3 years; excludes MBL]	25.00%
2. Combined portfolios of: a. MBLs outstanding and b. Unused MBL commitments	12.25%
3. Long-term investments [weighted average life over 3 years]	15.00%
4. Loans sold with recourse	5.00%

TABLE B -- §702.105 RBNW COMPONENTS TO CALCULATE RBNW REQUIREMENT

Risk portfolio	*Amount of risk portfolio (as percent of month-end total assets) to be multiplied by RBNW factor*	*RBNW factor*
1. Long-term real estate loans	0 to 25.00% over 25.00 to 40.00% over 40.00%	.06 .14 .16
2. MBLs outstanding	0 to 12.25% over 12.25%	.06 .14
3. Long-term investments	0 to 15.00% over 15.00%	.06 .12
4. Low-risk assets	All %	.03
5. Average-risk assets	All %	.06
6. Loans sold with recourse	All %	.06
7. Unused MBL commitments	All %	.06
8. Allowance	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets)	(1.00)
A complex credit union's RBNW requirement is the sum of eight RBNW components. An RBNW component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its RBNW factor. A complex credit union is "undercapitalized" if its net worth ratio is less than its RBNW requirement.		