

CU-ALM REPORT

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NEW NET WORTH STANDARDS PROPOSED BY NCUA

NCUA has released a long-awaited proposal to modify PCA requirements and implement a net worth standard that takes into account the risk posed by each credit union's assets, rather than an arbitrary amount based on total assets. Here is a summary of the NCUA proposal.

- ◆ **Modify net worth and PCA requirements** to bring the NCUSIF in conformance with the Basel II Accords;
- ◆ **Reduce the net worth ratio required** to be considered well or adequately capitalized;
- ◆ **Implement a risk-based net worth measurement system** based on the Basel II guidelines that will supplement the current system;
- ◆ **Consider Modifying the CAMEL Rating System** by adding an "S" (Sensitivity to Market Risk).

Basel Committee

Let's explore these issues one at a time. Already, I can hear you asking, "Who is this Basel guy?" The Basel Committee consists of bank regulators from The Group of Ten Countries. It was established in 1974 with the purpose of establishing uniform worldwide regulatory guidelines for banks. It meets in Basel Switzerland and has no legal authority. It does have pervasive moral authority. Its impact and recommendations are almost uniformly accepted not only by The Group of Ten Countries including the U.S.A., but many nonmember countries as well.

In 1988, the Committee introduced the Basel Capital Accord. This was a framework for implementation of uniform worldwide net worth standards and has been adopted by virtually all countries with active international banks. In June of 2004, a revised framework, Basel II was issued by the Basel Committee and is expected to be implemented worldwide. If you enjoy inflicting pain on yourself, you may read the whole Basel II Accord at www.bis.org/publ/bcbs107.htm. It is only 243 pages.

You may say you are not a bank, so why does this apply to you? The United States is obligated and under pressure from the international banking community to have all of its deposit insurance funds including the NCUSIF, and all of those financial institutions insured by them, implement the Basel II Accords. In this light, NCUA has proposed to adopt the Basel II Accords and has modified them so they would apply effectively to credit unions.

Net Worth Requirement Lowered

The NCUA proposal recommends that the requirement for net worth be adjusted downward. The reduced capitalization levels proposed by NCUA are disclosed in Table 1 below. As you can see, net worth of as little as 5% may get you a well-capitalized rating versus 7% under the current regulation. However, where NCUA giveth, it also taketh away. NCUA is proposing to change the way the NCUSIF deposit and ALLL are treated in the net worth ratio calculation.

TABLE 1
PROPOSED PCA THRESHOLDS FOR CREDIT UNIONS

Net Worth Categories	Proposed Net Worth Ratio*	Traditional Net Worth Requirement
Well Capitalized	5% or Greater	7% or Greater
Adequately Capitalized	4% to <5%	6% to <7%
Undercapitalized	3% to <4%	5% to <6%
Significantly Undercapitalized	2% to <3%	4% to <5%
Critically Undercapitalized.	<2%	<3%
System-wide Net Worth Ratio Based on 6/30/04 Call Reports	12.47%	13.23%

*Adjusted per the Basel II recommendation regarding the NCUSIF Deposit and ALLL.

The accounting treatment for the NCUSIF deposit will remain the same. The deposit will continue to be classified as an asset and the ALLL will be deducted from loans and leases. However, when calculating the net worth ratio, the NCUSIF deposit will be subtracted from net worth and total assets. The ALLL will be added to net worth and subtracted from total assets. NCUA estimates that the new methodology for calculating net worth will reduce net worth ratios system-wide by approximately 75 basis points. In effect, the reduction from 7% to 5% for a well-capitalized classification, is a little misleading because the change in the way the net worth ratio is calculated will probably cost you approximately 75 basis points. Still, the net effect of this proposal would be to reduce the requirement by about 125 basis points.

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NEW NET WORTH STANDARDS PROPOSED BY NCUA *(continued from page 1)*

Risk-Based Net Worth Measurement

NCUA is proposing a risk-based net worth standard to supplement the net worth standard now in use. Risk-based net worth will be measured and based on the risk posed by each individual credit union's assets, rather than arbitrarily by the total of the assets. The current net worth requirement for credit unions subject to NCUA oversight is an arbitrary standard that requires a level of net worth based on the total book value of the credit union's assets. For example, for a \$10 million asset size credit union to be well-capitalized it would have to have a net worth equal to 5% of total assets under the proposed new rule. That would include 5% of all assets, even those that do not present risk such as cash and government securities.

NCUA is proposing to adopt a two-tier net worth requirement that will use traditional net worth adjusted to the Basel II Accords and risk-based net worth to determine capital adequacy. Here's an example. I'm thinking about one of our **ALMPro®** clients that we will call credit union A. It has a mature field of membership, lots of older savers, and only a few borrowers. Its investment portfolio consists largely of short-term deposits at various corporate central credit unions. Almost 75% of credit union A's assets are in these nearly risk-free corporate relationships.

A second client that we will refer to as credit union B comes to mind. It has been very successful in marketing its lending services, and is basically fully loaned. It retains sufficient deposits at corporate to maintain a liquidity position and everything else is loaned out.

Even though both A and B present very different risk profiles, under the current capital requirements of NCUA and most states, both answer to the same net worth requirement (7%) under the current rule for well-capitalized.

This makes no sense to a lot of people, including me. Under a risk-based net worth system, credit union A with its large, low-

risk investment portfolio, would not require the capitalization level of credit union B, whose assets are, for the most part, at higher risk.

The proposed risk weight for typical credit union assets are disclosed in Table 2 (see left) where you can see the risk weight for cash or government securities is proposed to be zero. That means the credit union in its risk-based net worth calculation needs to have no net worth to offset cash on hand or government-issued or -guaranteed securities. Likewise you can see that for your corporate credit union deposits you need only weight those assets at 20%. So, effectively you would need 5% of 20% of your corporate deposits as risk-based net worth. Clearly, this is going to have a huge impact on credit unions. The proposed risk-based net worth requirements are presented in Table 3 below, where we can see that to be considered well-capitalized a risk-based net worth equal to 8% of assets would be required.

TABLE 3

PROPOSED RISK-BASED NET WORTH REQUIREMENTS

Net Worth Categories	Proposed Risk-Based Net Worth Ratio
Well Capitalized	8% or Greater
Adequately Capitalized	8% or Greater
Undercapitalized	6% to <8%
Significantly Undercapitalized	<6%
Critically Undercapitalized.	NA
System-wide Estimated Risk-Based Net Worth Ratio Based on 6/30/04 Call Report	23.63%

TABLE 2

PROPOSED RISK WEIGHTS

Cash on Hand	0%
US Gov't Securities	0%
US Gov't Guaranteed	0%
Deposits in Financial Institutions and Corporate Credit Unions	20%
Residential Real Estate Loans	35%
Most Other Consumer Loans	75%
Past-Due Real Estate Loans	100%
Past Due Consumer Loans	150%
Operational Risk	15% of average gross income over 3 years

How large an impact this has on your credit union depends on your mix of assets. Overall, NCUA estimates that net worth under the proposed rule for the credit union system in June of 2004 would have been 12.47%. Risk-based net worth is estimated to have been 23.63% for that same date. NCUA is proposing to combine the net worth and risk-based net worth so as to be considered well-capitalized; for example, a credit union would need a net worth ratio of >5% and a risk-based net worth ratio of >8%.

There is one additional caveat: Basel II addresses both credit risk and operational risk. As you can see in Table 2, there is a component of operating risk that is included in the risk-based net worth ratio. The calculations for the operational risk component are very vague at this point and hopefully will be clarified in the near future.

Modifying the CAMEL Score to Incorporate Interest Rate Risk

The Basel II Accords do not address IRR. The Accords apply solely to credit and operations risks. The Basel Committee found implementing a regulatory IRR criteria to be overly burdensome, expensive, and highly complex. In other words, *continued on pg 3*

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it gave them a headache to think about it. The Committee effectively transferred that headache and responsibility to NCUA.

The Basel II Accords leave the implementation of a risk factor for IRR to what they refer to as a "robust" regulatory oversight. NCUA has indicated that they are considering an enhancement to the CAMEL ratio specifically for IRR. The enhancement under consideration would be adding to the CAMEL system an "S" component, the "S" standing for Sensitivity to Market Risk. NCUA has indicated that it is only under consideration and has given no insight as to how it would be implemented or what guidelines would be used for the score.

What is the Extent of the Impact?

Virtually all U.S. credit unions will be impacted. Even those privately insured credit unions will find that their state regulator may informally or formally adopt this proposal once it is finalized.

A summary of the impact was estimated by NCUA in their proposal based on call reports for June 30, 2004 as they apply to federally insured credit unions. The results of those estimates are provided in Table 4 below.

**TABLE 4
IMPACT TO NET WORTH CLASSIFICATIONS**

Net Worth Categories	# of NCUA Insured Credit Unions		Difference
	Based on Current Net Worth Ratios	Based on Proposed Net Worth Ratios	
Well Capitalized	8,983	9,105	122
Adequately Capitalized	125	42	(83)
Undercapitalized	62	21	(41)
Significantly Undercapitalized	23	9	(14)
Critically Undercapitalized.	17	33	16
TOTAL	9,210	9,210	0

Summary

Major changes are coming in the way net worth is calculated, the way net worth requirements are applied, and the way PCA is administered. Implementation will require congressional approval and NCUA rulemaking; credit unions should follow the process closely and participate when appropriate. It appears for the most part that credit unions will find the proposed regulations less restrictive and allow more flexibility in planning for future growth and service to members. The movement toward a risk-based component is ultimately sensible. It is our opinion here at Mark H. Smith Incorporated that this proposal will be good for most all credit unions.

**FREE RISK-BASED NET
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Mark H. Smith Incorporated will provide you with a free forecast of the impact the NCUA proposal may have on your credit union. The forecasts will be based on your December 31, 2004 Call Report data and will include:

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- **Estimated risk-based net worth ratio;**
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- **Comparative balance sheet matrix, showing how all of the ratios are calculated;**
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