NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **May 2009** **LETTER NO.: 09-CU-10**

TO: **Federally Insured Credit Unions**

SUBJ: **Matters Related to "Paid-in Capital" and "Membership Capital" of Corporate Credit Unions**

Dear Board of Directors:

On March 20, 2009, NCUA placed U.S. Central Federal Credit Union (U.S. Central) and Western Corporate Federal Credit Union (WesCorp) into conservatorship and appointed itself conservator of both credit unions.[1] NCUA has since received many inquiries from members concerning the status of their "paid-in capital" (PIC) and "membership capital" (MCA) accounts at the corporates, and how those accounts are applied to absorb losses that U.S. Central and WesCorp are each required to recognize. The purpose of this Letter is to respond to those inquiries.

Regulatory Mandate to Cover Losses. Part 704 of NCUA Rules and Regulations prescribes the capital structure of federally-insured corporate credit unions (Corporates), which consists of two forms of invested capital: PIC and MCA. In addition to requiring both forms of capital to be uninsured, Part 704 expressly requires PIC to be "available to cover losses that exceed retained earnings," and MCA to be "available to cover losses that exceed retained earnings and PIC." In the case of U.S. Central and WesCorp, the regulatory mandate to cover losses was recited by both in the initial offering disclosures for PIC and MCA, in member subscription forms, and in required annual disclosures to MCA holders.[2]

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[1] http://www.ncua.gov/letters/2009/CU/09-CU-06.pdf

[2] U.S. Central has two classes of PIC--"Member Paid-In Capital Shares" and "Paid–In Capital II Shares"--and two classes of MCA--"Corporate Membership Capital Shares" and "Non-Corporate Membership Capital Shares." In addition U.S. Central holds an NCUSIF Capital Note that is applied to cover losses after all other forms of capital are exhausted. WesCorp has a single class of PIC--"Permanent Capital Accounts"--and a single class of MCA--"Member Capital Accounts."

Once a Corporate's retained earnings are exhausted, recognition of further losses creates a retained earnings deficit. From that point forward, the "losses that exceed retained earnings" trigger the regulatory mandate to apply PIC to "cover losses" represented by the retained earnings deficit, on a dollar-for-dollar basis. Once PIC is exhausted, further "losses that will exceed retained earnings and PIC" trigger the regulatory mandate to apply MCA to "cover losses." When that occurs, the impact flows down to the members of the Corporate, who must each evaluate their PIC and MCA investments for impairment and apply the lost value against their own retained earnings.

Exhaustion of Capital. The essential function of PIC and MCA is to serve as an additional reserve of capital to absorb losses in excess of retained earnings. Therefore, when there is a retained earnings deficit in a Corporate, the PIC and MCA are depleted to the extent necessary to resolve the deficit. PIC and MCA are at-risk capital reserves and because they are so designated, a Corporate has no legal obligation or authorization as a going concern to restore, replenish or recoup depleted PIC and MCA out of future retained earnings, even if retained earnings substantially improve. This is the case regardless whether generally accepted accounting principles (GAAP) classify PIC or MCA as a liability or equity.

Dividends. Once PIC and MCA are exhausted, such accounts are not entitled to earn dividends otherwise payable on outstanding PIC and MCA. However, the board of directors may elect to declare a dividend on any or all regular shares (*i.e.*, share, share draft and share certificate accounts) or on still-outstanding PIC and MCA, provided the dividend is paid on a pro rata basis within each class of shares. Such a dividend would indirectly benefit the former holders of depleted PIC and MCA according to their *outstanding* share balances. It would be impermissible to pay such a dividend to the holders of *outstanding* PIC and MCA according to the balance of their *depleted* PIC or MCA.

Impairment of Capital Assets. GAAP defines "impairment" of an asset for financial reporting purposes as the decline in fair value below its cost. The exhaustion of capital, which results from operation of a regulatory mandate (Part 704) to "cover losses" once a retained earnings deficit develops, is not synonymous with the determination by management of the investing credit union that its capital asset is "impaired." It is the responsibility of the board of directors and management of a credit union, in consultation with its independent accountants, to judge whether their credit union's PIC and MCA are impaired as defined by GAAP and, if so, whether the impairment is "other-than-temporary," thus warranting a charge against current period earnings.[3]

[3] The American Institute of Certified Public Accountants (AICPA) recently issued a non-authoritative Technical Practice Aid providing guidance on evaluating the impairment of a credit union's capital investments in a corporate credit union. Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment, AU Section 6995.02, http://www.aicpa.org/download/acctstd/Credit_Union_TPAs.pdf , reference page 5.

Exhaustion of Capital to Date. To date, U.S. Central PIC has been exhausted, and 23 percent of their MCA has been depleted. WesCorp PIC and MCA have both been exhausted. The precise measure of PIC and MCA depleted to absorb losses is reflected in member statements issued by U.S. Central and WesCorp. This information is relevant to each member's determination of the level of asset impairment, as explained above, that must be recognized in its statement of income.

U.S. Central previously reported to its members that 100 percent of PIC was exhausted and 63 percent of MCA were depleted by losses exceeding retained earnings. Though U.S. Central's best estimate of credit losses is still $2.3 billion, discounting the cash flows from these losses in accordance with GAAP results in a reduction in other-than-temporary impairment (OTTI) charges to $1.8 billion. As a result, MCA depletion is 23 percent, not 63 percent as originally reported on April 30.

The exhaustion of WesCorp members' PIC and MCA was insufficient to resolve the deficit in undivided earnings. Thus, NCUA has authorized WesCorp to operate with special assistance under a "prior undivided earnings deficit" (PUED). Once a credit union's capital is exhausted, a PUED provides for regulatory segregation of the retained earnings deficit to capture the permissible accumulated deficit position. As a result, WesCorp is able to continue providing uninterrupted service to members, including the payment of dividends on regular shares (*i.e.*, share, share draft and share certificate accounts).

To authorize special assistance under a PUED *prior* to the exhaustion of PIC and MCA would be contrary to the essential function of PIC and MCA as at-risk capital to absorb losses *ahead of* the National Credit Union Share Insurance Fund (Fund). Such unprecedented pre-exhaustion special assistance would subsidize PIC and MCA holders at the expense of the Fund, exposing natural person credit unions to increased premiums. Putting PIC and MCA holders ahead of the Fund would fundamentally and permanently compromise the purpose and meaning of capital in the credit union system.

Impact on Membership. Credit union membership is based on ownership of a par value regular share. Subsequent to conservatorship, U.S. Central and WesCorp each waived the bylaw requirement that members maintain a prescribed level of MCA in order to continue membership. A credit union's membership in either U.S. Central or WesCorp will not be affected by depletion of capital below the minimum level otherwise required to maintain membership.

Conclusion. The NCUA Board recognizes that the exhaustion of PIC and MCA will adversely impact the members of U.S. Central and WesCorp. For that reason, examiners will continue to monitor events related to corporate stabilization efforts and, consistent with Supervisory Letter 09-01[4], will take into consideration the effect of exhausted corporate capital on natural person credit union capital and earnings. If you have questions about the contents of this letter, please direct them to your examiner, regional office or state supervisor, as appropriate.

Sincerely,

/s/

Michael E. Fryzel
Chairman

[4] LTCUs No. 09-FCU-04 http://www.ncua.gov/letters/2009/FCU/09-FCU-04.pdf
Related Enclosure http://www.ncua.gov/letters/2009/FCU/EnclosureSupLetter09-01.pdf