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Credit Union Deposit Insurance: Purpose, Management, and Policy Issues

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Summary

The federal deposit insurance fund for credit unions is the National Credit Union Share Insurance Fund (NCUSIF). The insurance fund is administered by the National Credit Union Administration (NCUA), the federal regulator for the credit union industry. Membership in the NCUSIF is mandatory for federal credit unions. The vast majority of state-chartered institutions are also federally insured. Funds deposited into accounts at credit unions are covered to $100,000, the same as provided by the Federal Deposit Insurance Corporation (FDIC) for banks and thrifts.

To carry out its management responsibilities and protect the insurance fund, the NCUA has developed procedures to evaluate the financial condition of federally insured institutions. The agency has established policies to "resolve" troubled credit unions and to close failed institutions. In addition, the NCUA monitors the adequacy of NCUSIF reserves as a standard measure of the fund's health.

The 107th Congress has shown an interest in examining various issues surrounding federal deposit insurance. A key concern is maintaining a balance between providing the benefits of deposit insurance and promoting sound management practices at banks, thrifts, and credit unions. Current legislative proposals to raise the $100,000 coverage at banks are of interest to credit unions because any increase in the level of coverage would probably be extended to credit unions. This report will be updated to reflect legislative developments.

Background

The federal deposit insurance fund for federal credit unions and state-chartered institutions is managed by the National Credit Union Administration (NCUA), the federal regulator for credit unions. The NCUA is an independent agency governed by a three-member board. The board is responsible for chartering, supervising, and examining federal credit unions. State regulators have primary supervisory authority over state-chartered credit unions. They work in cooperation with the NCUA to ensure that these institutions meet safety and soundness standards.

The NCUSIF was created in 1970 by P.L. 91-468. Insurance is mandatory for federal credit unions. Federal deposit insurance is still optional in a few states but most state-chartered institutions are federally insured. In December 2000, there were 6,336 federal credit unions and 3,980 federally insured state-chartered credit unions. These federally insured institutions held assets totaling $438.2 billion and had a total membership of 77.6 million. The NCUA reports that fewer than 500 credit unions remain non-federally insured.[1]

Deposit insurance coverage is the same for credit unions as for banks and thrifts, insured accounts are covered up to $100,000. Deposits maintained in different categories of legal ownership (e.g.,a trust account) or funds held for retirement purposes (e.g., Individual Retirement Accounts) are separately insured. Therefore it is possible for individuals to have considerably more than $100,000 coverage in an individual institution.

Credit union organization

Many of the financial services provided by credit unions are similar to those offered by banks and thrifts but they are distinguishable because of their cooperative framework and unique charter requirements. The original concept of a credit union was a cooperative organization formed for the purpose of promoting thrift among its members and providing them with a source of low-cost credit. Credit union charters are granted by federal or state governments on the basis of a "common bond." This requirement determines the field of membership, and is unique among depository financial institutions. The common bond for establishing a credit union might be occupational, associational, or community.

Individual credit unions are owned by their membership. Members' savings are referred to as "shares," and earn dividends instead of interest. Credit union loan and investment powers are more restrictive than commercial banks. Credit unions can only make loans to their members, to other credit unions, and to credit union organizations. Credit unions can invest in government or government-guaranteed financial instruments. Because credit unions are considered financial cooperatives, the institutions are exempt from federal income tax. Individual members are taxed on their dividends.

Credit unions rely on volunteers. The members of a credit union elect a volunteer board of directors from their institution's membership (one member, one vote). Only one director may be compensated. The board appoints member-volunteers to a supervisory committee which oversees the institution's financial operations. Professional staff may be hired. This is more common at the larger credit unions.

[1] [http://www.ncua.gov]

Financial Structure of the Fund

The NCUSIF was established in 1970 without start up capital from the U.S. Treasury. Premiums from insured credit unions were the fund's primary source of income. This arrangement was similar to that of the FDIC. Premiums were used to pay the fund's operating expenses, cover losses, and build reserves. Premiums were set at 1/12th of 1% of the total amount of member share accounts. The fund also generated income from investing its reserves in government securities. During the first decade of operations the insurance losses from troubled or failed credit unions were minimal. This situation combined with low operating expenses allowed the fund to build reserves towards the statutory target of 1% set by P.L. 91-468. By 1979 the ratio of equity to insured shares had risen to 0.32 %.[2]

The decade of the 1980s was a period of stress and change for all financial institutions and federal insurance funds. By the early 1980s the NCUSIF was operating under the constant pressure of a growing caseload of problem and failing institutions. Insurance losses threatened the fund's solvency. The NCUA requested recapitalization legislation from Congress. In July 1984. P.L. 98-369 provided for the strengthening of the fund.

Each insured credit union was required to place a deposit with the fund in an amount equaling 1% of its insured shares. The 1% is carried on each individual institution's books as an asset. The NCUSIF's reserves consist of the 1% deposit, the fund's accumulated insurance premiums, and interest earnings. The goal was to achieve a normal operating level for the ratio of fund equity to insured shares of 1.3 %. An annual premium can be imposed to achieve this ratio. In addition, if the reserve ratio exceeds 1.3 %, the NCUA pays the excess as a dividend to insured credit unions. In March 2001, the NCUA announced it would issue a dividend for the sixth consecutive year.[3]

Fund Management

NCUA management of the Fund includes monitoring insured institutions, identifying problems and resolving troubled institutions. The agency has developed policies and procedures for determining the financial condition of insured institutions and dealing with financially troubled credit unions. Credit unions are examined on an annual basis. Insured credit unions also submit financial reports to the NCUA.

Information from exams and reports is used to assess the financial condition of a credit union. The NCUA uses a rating system called CAMEL, a similar system is used by banks and thrift regulators. CAMEL is an acronym representing five key areas that are evaluated: Capital adequacy, Asset quality, Management, Earnings, and Asset/Liability management. A composite rating on a 1 to 5 scale (with 1 indicating the strongest performance) is assigned to reflect the overall condition of a credit union. An institution with a CAMEL rating of 4 or 5 is considered troubled.

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[2] *An Overview of the U.S Credit Union Industry.* FDIC Banking Review. Fall 1990, p.19.

[3] [http://www.ncua.gov]

Attention is given to credit unions with ratings below a CAMEL 2. Working with the institution a plan for corrective action is developed. If problems persist the NCUA may provide additional assistance; in general the policy followed is to avoid liquidation while minimizing loss exposure and risk to the fund. The NCUA can provide cash and noncash assistance from the NCUSIF. If the troubled credit union must be closed the NCUA can arrange a merger, a purchase and assumption, or a liquidation using Fund assets.

Policy Concerns

The extension of federal deposit insurance to credit unions contributed to industry growth, attracting deposits and members. It has been suggested that share insurance might diminish the inherit discipline of a member owned financial institution. Members would know their money was safe whether or not the credit union was well managed.

In general, the intent of federal deposit insurance is to provide a degree of depositor security that benefits institutions and individuals. Deposit insurance can help prevent the type of panic behavior that can cause a "bank run", which in turn can lead to the failure of an institution. When an institution does fail, deposit insurance reduces the effects on households and businesses. In addition, the economic instability that a failed institution can cause a community or region is diminished.

Federal deposit insurance has raised concerns. A major issue focuses on providing the benefits of deposit insurance without lessening the incentives for managerial discipline. With insurance providing greatly diminished concern over depositors withdrawing their funds, managers may take on more risk. This can be a factor for credit unions even with more restrictive loan and investment powers. In addition, credit union management has become more complex as credit unions have grown larger and with the legislative changes provided by P.L. 105-219, the Credit Union Membership Access Act.[4] This increases the need for effective oversight and management of the NCUSIF by the NCUA.

Current Legislation

While legislation does not currently address the NCUSIF, it is likely that an increase in the cap of $100,000 per account for FDIC coverage would result in an equivalent raise in coverage by the NCUSIF for reasons of insurance equity. Recent congressional interest in deposit insurance reform began in the 106th Congress. Various issues surrounding federal deposit insurance and possible changes to insurance programs were raised at hearings. Legislation was not enacted and the interest has carried over into the 107th Congress. Several bills were introduced at the start of the first session.[5] Most of the legislation addresses the operations of the FDIC. Two bills, H.R. 746 and S.128, propose changes to the level of coverage for FDIC insured accounts.

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[4] For more information, see CRS Report 98-933 E, *Credit Union Membership Access Act: Background and Issues, by Pauline H. Smale.*

[5] See CRS Report RS20724, *Federal Deposit Insurance: Proposals for change, by William D. Jackson.*

Proposals to raise the $100,000 level of coverage and tie further increases to rises in inflation have been the subject of debate for several years. The two current bills contain similar provisions that would result in periodic cost of living adjustments to the level of deposit insurance. In addition, they propose making retroactive adjustments that would effectively raise the current level to around $200,000 upon enactment. The core issue for proponents is attracting deposits. Increasing the level of coverage could attract more funds to banks and thrifts away from alternative investment options. An increase in deposits would make more money available for lending. Opponents worry an increase in coverage could require more reserves at insurance funds and therefore would have the potential cost of increased premiums. In addition, increasing deposit insurance could create incentives for risk taking by an institution's owners or managers. The NCUA has not officially commented on proposals to raise the level of deposit insurance.