CREDIT UNION REGULATORY IMPROVEMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

CREDIT UNION REGULATORY IMPROVEMENTS

Tuesday, July 20, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:05 p.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] Presiding.

Present: Representatives Bachus, Royce, Biggert, Kennedy, Hensarling, Brown-Waite, Sanders, Maloney, Watt, Ackerman, Lucas of Kentucky, Sherman and Davis.

Chairman BACHUS. Good morning, I want to call the Subcommittee on Financial Institutions to order.

We have a series of votes on the floor, but what hopefully we can do to expedite things is to give opening statements; then when we come back, we will go right to the testimony.

I want to start by thanking the witnesses for being here today to discuss regulatory improvements to the credit union system. I would like to extend a special welcome to NCUA Administrator, Chairman Joann Johnson, who is making her first appearance before this subcommittee after taking over leadership at the NCUA earlier this year from Chairman Dennis Dollar. And we are excited about your chairmanship.

Credit unions are a vital part of our Nation's financial service infrastructure. As nonprofit cooperatives managed by their members, credit unions excel at providing the services families and small businesses need most.

I have got many constituents who tell me that it was very important for them—their credit union was very important to them in being able to afford a new home, a purchase that would allow their children to attend college, or to obtain a loan for various and sundry things.

Not surprisingly, the Nation's almost 100,000 credit unions consistently rank high in customer satisfaction surveys and play a particularly important role in expanding the financial alternatives available in historically underserved urban and rural areas. And a member of one of our panels, Bill Cheney's credit union recently reached out to four underserved areas, and I commend you for that, Mr. Cheney.

Under Chairman Oxley's leadership, this committee has been at the forefront of efforts to improve the regulatory environment in which credit unions operate, thereby enhancing their availability to meet the needs of their more than 80 million members nationwide. In addition to passing a deposit insurance reform bill out of the House that gives credit unions full parity with their bank and thrift counterparts, the committee developed bipartisan legislation affording significant regulatory relief to credit unions, banks, and thrifts. That legislation, H.R. 1375, was spearheaded by two members of the subcommittee, Ms. Capito of West Virginia and Mr. Ross of Arkansas.

It passed the House last March with over 400 votes, thanks in no small part to the enthusiastic support and grass-roots efforts of the credit union industry. Among other provisions, H.R. 1375 expands credit unions' investment authority, increases the general limit on the limit of credit union loans from 12 to 15 years, authorizes credit unions to provide check cashing and money transfer services to nonmembers so long as they are within the credit union's field of membership, permits privately insured credit unions to join the Federal Home Loan Bank system, and excludes loans made to nonprofit religious organizations from the limits that otherwise apply to credit unions' commercial lending authority.

The bill also includes a provision that I first offered as an amendment when the Judiciary Committee marked up the regulatory relief bill in the 107th Congress granting the credit unions the same exemptions from premerger notification requirements that banks and thrifts already enjoy under Federal antitrust laws.

Last November, Congressman Royce and Congressman Kanjorski, two respected members of this subcommittee, introduced H.R. 3517, the Credit Union Regulatory Improvement Act, which mirrors in many respects the credit union provisions of H.R. 1375 but also includes several additional regulatory reforms. For example, H.R. 3579 would increase the aggregate level of commercial loans that a credit union could make to its members from approximately 12 percent of total assets to 20 percent, as well as establish a risk-based approach for measuring credit union capital.

While action this year on H.R. 3579 is unlikely, given the limited amount of time remaining in the congressional calendar, today's hearing will allow the subcommittee to hear the perspectives of credit union regulators and industry representatives on the legislation and other proposals for improving credit union regulation.

Today's hearing is also an appropriate bookend to a hearing that the subcommittee held in May focusing on the crippling regulatory burdens faced by America's small community banks. Taken together, these hearings demonstrate this committee's continued commitment to identifying and eliminating outdated or unnecessary regulatory requirements which will serve ultimately to benefit American consumers in the form of more innovative financial products and services offered at more competitive prices.

At this time, we are going to recess the committee for the floor vote. When we get back, we will either hear from the Ranking Member of the subcommittee, Mr. Sanders, for any opening statement he may have, or go directly to our first panel. We ask for your patience and indulgence. This subcommittee hearing is recessed. Thank you.

[Recess.]

[The prepared statement of Hon. Spencer Bachus can be found on page 32 in the appendix.]

Chairman BACHUS. The Subcommittee on Financial Institutions will come to order. At this time, I would like to recognize—I should have looked up right away. I would like to recognize Mr. Sanders, the Ranking Member, for any opening statement he wishes to make.

Mr. SANDERS. Thank you very much, Mr. Chairman. And thank you for holding this important hearing on one of the most significant, I think, and successful and important institutions in the United States, and that is our credit unions. And I am proud to be a cosponsor of H.R. 3579, the Credit Union Regulatory Improvement Act, and I applaud Congressman Ed Royce and Paul Kanjorski for their leadership in introducing this legislation.

Mr. Chairman, America's credit unions are one of the most vital and most democratic institutions in a country which in many ways is becoming less democratic. Without the need to focus on having to make huge profits, without heavy advertising costs, without huge bonus packages to corporate executives, credit unions can and are providing loans at lower rates than other financial institutions and in that way improving the lives of millions of Americans.

Today I am pleased to report that credit unions are stronger than ever and serving more people than ever. There are over 9,000 credit unions in existence today, serving over 80 million Americans.

Now, I know, Mr. Chairman, and I am sure this is an issue that will come before this committee, that some of our large banking friends and their lobbyists here are saying, gee, $627 billion in assets for credit unions; we have got to tax them. It ain't fair. We are paying taxes and these guys are not.

Well, you know, Mr. Chairman, the truth is that credit unions pay property taxes, they pay sales taxes, they pay payroll taxes. They are exempt from Federal income taxes for good reasons and not because anyone is doing them a special favor. Credit unions are tax exempt because they are nonprofits, just like churches and hospitals and libraries and universities and other nonprofit institutions. Federal law exempts credit unions from Federal taxes, and in my view we have to maintain that exemption.

You know, the big banks will then tell us, gee, it is not fair, but somehow or another the big banks forget to tell us that the Federal Government through the savings and loan bailout, through the financial collapse in Asia, that the taxpayers of this country have spent tens and tens of billions of dollars bailing out big banks who are investing all over the world, propping up dictatorships, giving their CEOs huge compensation packages. I don't recall that we are spending billions of dollars bailing out the Adamant Credit Union in Adamant, Vermont. And I don't recall that we are bailing out other credit unions.

The bottom line here is that credit unions serve the community in a nonprofit way to provide inexpensive financial services to the people who own the institution. Very different from large banks.

So, Mr. Chairman, I don't know which side we are going to be on, if we are going to be opposing each other on this issue, but when this issue comes before this body, I am going to do everything I can to make sure that the credit unions of this country are not taxed. And with that, I just ask unanimous consent to lay my full remarks into the record.

Chairman BACHUS. Thank you. There is no objection to your unambiguous remarks going into the record.

[The prepared statement of Hon. Bernard Sanders can be found on page 40 in the appendix.]

Chairman BACHUS. Mr. Royce, do you have an opening statement?

Mr. ROYCE. I do, Chairman Bachus. I thank you. I thank you for the hearing, too. And I appreciate Chairman Oxley, his acquiescence in holding this timely hearing on regulatory challenges that face credit unions. Credit unions now serve over 85 million Americans, and this makes that particular industry a very important part of our Nation's financial system. They are an engine of economic activity, an engine of growth for America. They help our constituents finance the purchase of homes and cars and save for college and save for retirement, and, I think, equally as important, help access savings for small business investment. The capital they provide there is very, very critical.

Last November, Mr. Kanjorski and I co-authored H.R. 3579, the Credit Union Regulatory Improvements Act. They are calling it CURIA. This would modernize Federal regulation of chartered credit unions, and the legislation is needed to help credit unions better serve their members.

I would like to point out two important provisions of this bill. The first is that this would allow the National Credit Union Administration to create a risk-based capital standard for credit unions. The National Credit Union Administration could then determine the relative risk of a credit union's assets and improve the safety and soundness of credit unions and the safety of the National Credit Union Share Insurance Fund.

In addition to that, the bill would eliminate the current asset limit on member business loans at a credit union from a lesser of 1.75 times actual net worth or 1.75 times net worth required for well-capitalized credit union, and it would replace that with a flat rate of 20 percent of the total assets of the credit union.

It was important to me that any changes made would satisfy two conditions. First, the change would remove unnecessary regulatory burdens that inhibit credit unions from serving their members. And, two, any changes would not have the potential to put the safety and soundness of the credit union system at risk. Both industry and regulatory officials have offered positive feedback on both counts, and I look forward to further comments from our distinguished panels of witnesses today.

And again, Chairman Bachus, thank you for having this hearing, and I yield back.

Chairman BACHUS. I appreciate that, Mr. Royce.

Mr. Sherman do you have an opening statement?

Mr. SHERMAN. I have a very brief opening statement, and that is that, as other speakers have said, credit unions play a critical role. We have to help them play that role more efficiently and to meet some financial services needs that are not currently being met. And that is why I want to commend Mr. Royce and others for giving us an opportunity to sweep away some of the regulatory problems so they can do that.

Mr. SANDERS. Chairman, his remarks are too brief. Doesn't he have to go on for 2 more minutes?

Chairman BACHUS. Go on.

Mr. SHERMAN. I can prove that this is Brad Sherman and not an impostor, although the length of my statement would argue.

Chairman BACHUS. Are there other members who wish to make opening statements? If not, we will go to the introduction of our first panel.

Our first panelist is the Honorable JoAnn Johnson, Chairman of the National Credit Union Administration. President George W. Bush named Ms. Johnson appointee to the NCUA Board January 22nd, 2002. That appointment was confirmed by the U.S. Senate on March 22, 2002. Senator Johnson was named NCUA Board vice chairman in January of 2003 and the agency's chairman on May 3, 2004.

The Board consists of three members appointed by the President and confirmed by the Senate. And they regulate all federally chartered credit unions and administer the Federal Insurance Fund for approximately 9,500 credit unions nationwide.

Senator Johnson, elected to the Iowa Senate in 1994, chaired both the Senate Ways and Means Committee and the Senate Commerce Committee. As a former teacher, she taught physical education and coached a number of sports, actively involved in family farming, and served her community as a 4-H leader, director of the local Food Pantry, Economic Development Board member, school teacher, library board member, school board member, university alumnae board member, received her bachelor's degree from the University of Northern Illinois. She has two adult children, Clint and Brooke, you and your husband. So, we welcome you.

Our next panelist is Deputy Commissioner Roger W. Little, Chairman of the National Association of State Credit Union Supervisors. Mr. Little has worked for the Office of Financial and Insurance Services since 1984. He is a Deputy Commissioner and directs the Credit Union Division which regulates Michigan's 268 State-chartered credit unions.

He began his OFIS career as a credit union examiner, later serving as regional supervisor in both the Credit Union and Bank And Trust divisions. He graduated with honors from Central Michigan University, and is a CPA. He also completed a graduate School of Banking program at Louisiana State University. He currently serves as Chairman of the NASCUS Board of Directors.

He and his wife Linda have been married 32 years, they have two daughters and reside in central Michigan.

Chairman BACHUS. We welcome both of you. And, Chairman Johnson, we will start with your testimony.

STATEMENT OF JOANN JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Chairman Bachus, Representative Sanders, and members of the subcommittee, thank you for inviting me to appear before you today.

On behalf of the National Credit Union Administration, I am pleased to provide information on the condition of the credit union industry and our agency's views on regulatory efficiency recommendations and the Credit Union Regulatory Improvements Act of 2003.

My written comments, previously provided to you, cover a number of issues, some of which I will highlight for you today. It is my strong belief that effective, not excessive, regulation should be the underlying principle supporting NCUA's critical mission of ensuring the safety and soundness of federally insured credit unions.

In addition to participating with the other four financial institution regulatory agencies in the review project mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, NCUA scrutinizes one-third of NCUA existing regulations annually to find ways to simplify or improve any rule that is outdated or in need of revision. To date, this internal process has brought about important regulatory reform for credit unions in many of NCUA's rules, including those on lending, share accounts, and incidental powers.

I am pleased to report to the subcommittee the state of the credit union industry remains strong and healthy. Our indicators show that credit unions, which serve nearly 83 million Americans, are safe and sound and well positioned for continued strength and vitality in our Nation's financial marketplace.

The National Credit Unions Share Insurance fund also remained strong as of December 31, 2003. The fund had a ratio of 1.27 percent equity ratio. As of May 31, 2004, the equity ratio grew to 1.29 percent.

CURIA addresses some of the most compelling issues being discussed in the credit union industry today, including risk-basing credit union net worth for purposes of prompt corrective action.

Section 301 of CURIA would address inequities in the operation of the current system of setting net worth standards by establishing a risk-based system for PCA.

A well-designed risk-based system would alleviate regulatory concerns by not penalizing low-risk activities and by providing credit union management with the ability to manage their compliance though adjustments to their assets and activities.

While NCUA is continuing to develop its specific recommendations, we suggest that the leverage ratio below which a credit union is critically undercapitalized remain at its current 2 percent and that the minimum leverage ratio for a well-capitalized credit union be set at 5 percent.

Federal credit unions have been authorized since 1934 to make member business loans and have had a successful record of meeting the small business loan needs of their members. NCUA has issued regulations establishing safety and soundness standards for member business lending as a result of some losses on business lending beginning in the early 1980s.

Those regulations have been successful in ensuring that credit union business lending is carried out in a safe and sound manner that does not present undue risk to the National Share Insurance Fund. In fact, since the time that NCUA issued its regulation, defaults for member business lending have consistently been lower than the ratios for member loans generally.

In 1998, the Credit Union Membership Access Act established an aggregate cap on member business lending of 12.25 percent of total assets for well-capitalized credit unions. NCUA continues to believe, as it did in 1998, that a cap on business lending is unwarranted and hampers the ability of individual credit unions to meet the varying needs of their membership. However, raising the cap to 20 percent of total assets and increasing the threshold below which an individual loan is not treated as a business loan for the purposes of the cap from the current $50,000 level to that of $100,000, as proposed by CURIA, are vast improvements.

The time-sensitive recommendation in my testimony today stems from the Financial Accounting Standards Board proposed change in the accounting treatment of credit union mergers. This is a recent development; therefore, it has not previously been included in recommendations NCUA has submitted for your review.

FASB's change will in effect prevent credit unions from moving forward with mergers which are clearly in the best interest of their members. Specifically, the change will provide that when two credit unions merge, their retained earnings of the discontinuing credit union would not be included in the postmerger net worth. FASB expects to implement this change as early as January 2006. FASB has indicated it supports a legislative solution and that such a solution will not impact their standards-setting activities. NCUA has suggested statutory language as well as report language clarifying the limited purpose of this amendment to maintain net worth as it is. That language is attached to and has been made a part of my written testimony for the committee's consideration.

An important area where NCUA does not have jurisdiction comparable to the other financial regulators involves third-party vendors. NCUA does not have direct authority to examine third-party vendors that provide services to federally insured credit unions. Statutory authority previously existed for NCUA, but under a sunset provision expired in 2001, we are currently required to work through credit unions to obtain vendor information or seek voluntary cooperation from vendors. We believe that in these times, privacy, money laundering, and financing of terrorism are issues of paramount national interest as well as general safety and soundness concerns.

NCUA should have direct examination authority over those vendors providing services for federally insured credit unions. A restoration of NCUA's examination authority would provide parity with other financial regulators and would eliminate the need for us to approach the matter indirectly through credit unions, thus providing some measure of regulatory relief. This is consistent with the October 2003 GOA report which states that Congress may wish to consider granting this authority.

NCUA has reviewed all of the additional credit union provisions included in the House-passed bill, and the agency has no safety and soundness concerns with these provisions.

Mr. Chairman and members of the committee, thank you for allowing me to testify today and address these important regulatory reform issues. We hope to gain your support for these recommendations, and I would be pleased to assist your further deliberations on these in any way. Thank you very much.

Chairman BACHUS. Thank you.

[The prepared statement of Hon. JoAnn W. Johnson can be found on page 139 in the appendix.]

Chairman BACHUS. Deputy Commissioner Little.

STATEMENT OF ROGER W. LITTLE, DEPUTY COMMISSIONER OF CREDIT UNIONS, MICHIGAN OFFICE OF FINANCIAL AND INSURANCE SERVICES, REPRESENTING THE NATIONAL ASSOCIATION OF STATE CREDIT SUPERVISORS

Mr. LITTLE. Good afternoon, Chairman Bachus and distinguished members of the Financial Institutions and Consumer Credit Subcommittee. Again, I am Roger Little, Deputy Commissioner of Credit Unions for the Michigan Office of Financial and Insurance Services. I appear today on behalf of the National Association of State Credit Union Supervisors, or NASCUS.

NASCUS applauds the introduction of the proactive credit union legislation in H.R. 3579. My written testimony includes our views in support of the provisions that affect State-chartered credit unions contained in this bill. My comments today focus specifically on the importance of capital reform for credit unions.

NASCUS has studied the risk-based capital reform proposal outlined in H.R. 3579, and NASCUS supports a risk-weighted capital regime for credit unions. H.R. 3579 changes the term "net worth" in section 216 of the Federal Credit Union Act from being the ratio of credit union net worth to total assets of the institutions to being the ratio of net worth to risk assets of the credit union. In effect, this establishes a risk-based capital system for credit unions.

The existing PCA and net worth numerical categories in the statute would remain unchanged; however, NCUA would establish the new risk-weighting categories hopefully in a manner similar to those used by banks and thrifts.

State regulators would assist the NCUA in crafting these regulations. The existing Credit Union Membership Access Act requires the NCUA to consult and cooperate with State regulators in the crafting of PCA and member business lending regulations. This cooperation between the NCUA and State agencies, many of whom also regulate bank and thrift institutions, will help ensure a safe and sound process for determining the risk-weighting categories.

The proposed bill does not change the definition of net worth to permit credit unions to count alternative types of capital for PCA purposes, however, and NASCUS believes that it should. NASCUS strongly supports alternative capital for credit unions. We believe it is complementary to a risk-based capital system and in no way conflicts with proposals outlined in H.R. 3579.

A combination of PCA requirements established by Congress for credit unions in 1998 and significant deposit growth has created a financial and regulatory dilemma for many State-chartered credit unions. With the economic downturn and the flight to safety from the stock market, credit union member savings are growing rapidly and many credit unions are reporting reduced net worth ratios as earnings retention lags growth in assets. Many State-chartered credit unions will not be able to rely solely on retained earnings to meet the capital base required under the current PCA standards.

As a financial institution's regulator, it makes no business sense to deny credit unions the use of other forms of capital to improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this Nation's credit union system.

NASCUS also supports amending the definition of net worth to cure the unintended consequences for credit unions of business accounting rules the Financial Accounting Standards Board will apply to combinations of mutual enterprises. I will refer you to my written testimony for more information about these unintended consequences of FASB's rules on credit union mergers. I do note that FASB also supports such an amendment.

NASCUS firmly believes that nonfederally insured credit unions should be eligible to join the Federal Home Loan Banks. I note this is not a new precedent, since 86 insurance companies, none of which are federally insured, are now members of the Federal Home Loan Bank system. We would appreciate your support by including this proposal in H.R. 3579.

Finally, recent preemptive actions of the Office of the Comptroller of the Currency have a potentially significant impact on the dual-chartering system for commercial banks. We are concerned this could open the door to similar actions by the Federal credit union regulator unless Congress intervenes.

Determining the extent to which such additional Federal banking power should be granted by the OCC is an important matter for all of those who support the dual-chartering system for depository institutions. The importance of this matter dictates that Congress should resolve these conflicts.

This concludes my remarks. NASCUS appreciates the opportunity to testify today. We welcome further participation and dialogue. We urge this subcommittee to protect and enhance the viability of the dual-chartering system for America's credit unions by acting favorably on the provisions we have outlined in our written and oral testimony.

I will be happy to respond to any questions the committee may have. Thank you.

Chairman BACHUS. Thank you.

[The prepared statement of Roger W. Little can be found on page 160 in the appendix.]

Chairman BACHUS. I will start out by asking this question. There has been quite a lot of discussion by some of the banking organizations over credit unions eating into their market share, taking over business. And the reason that I think they have advanced those is in resistance to some of these proposals and some of the proposals in the Royce bill.

In reading the testimony of Mr. Cheney about market share, I would like to read something from his testimony and ask you to comment on that and give me your response to whether you think it is accurate or not.

According to data obtained from the Federal Reserve Board during the 23-year period from 1980 to 2003, the percentage of total household financial assets held by credit unions increased from 1.4 to 1.6 percent, or merely 0.2 percent, over the course of 23 years.

That at least, if that is accurate, that to me gives indication that the credit unions are not capturing market share from anyone. What is your comment? That is one—Mr. Sanders mentioned the whole idea of tax exemptions and that the tax exemption is giving an unfair advantage to the credit unions.

Mr. LITTLE. A couple of comments on that, Mr. Bachus. The evidence as indicated by banks' continuing reporting of record profits quarter after quarter would seem to indicate that they are doing relatively well in the markets that they have. My understanding of the Federal Tax Code is that the tax exemption for credit unions is not based in any way on the products or services or market share of credit unions. It is based on the ownership structure and the fact that they are cooperatives of a financial nature, rather than another nature. As a regulator, we have a neutral position on tax policy, but I don't think the argument is very persuasive in terms of market share.

Ms. JOHNSON. Mr. Chairman, I would like to add just a little bit in the area of the member business lending, because I know there has been some opposition to raising the limits in the member business lending area in particular.

Member business loans granted by credit unions currently amount to, based on loans to total assets, less than 3 percent. For the banking industry, it currently stands at over 20 percent of their assets. The number of credit unions, or the percentage of credit unions that are currently involved in member business lending is approximately 17 percent, a little over 1,600 credit unions. So it is actually——

Chairman BACHUS. One in six.

Ms. JOHNSON. Right. It is a small part of the market.

Chairman BACHUS. All right. Is your information pretty much in keeping with this data and what it seems to indicate; that credit unions don't appear at least to be expanding their market share?

Ms. JOHNSON. Credit unions continually look for ways to serve their members.

Chairman BACHUS. I understand that.

Ms. JOHNSON. But the market share is still relatively small compared to——

Chairman BACHUS. It seems like it is almost the status quo.

Ms. JOHNSON. That's right.

Chairman BACHUS. And I will say this, if someone says to me we have a problem with credit unions taking our market share, then the first response is to find out how much market share they are taking. Not analytical information. I have checked auto loans, and, actually, the percentage of auto loans by credit unions has actually declined——

Mr. LITTLE. Yes.

Chairman BACHUS.—over the last 10 or 15 years. So I am just raising that. I didn't know if you had any comment on that.

Secondly, with 45 seconds, I am simply going to make a comment. The accounting treatment for business combinations of FASB 141, apparently there doesn't seem to be any dissent by any of the witnesses that there needs to be some change of definition of net worth in the Federal Credit Union Act.

Ms. JOHNSON. That's correct.

Chairman BACHUS. Are you aware of any opposition to this change, making that change in definition?

Ms. JOHNSON. No. We know of none. The Accounting Standards Board is favorable to a legislative change.

Chairman BACHUS. If they are for it, you all are for it.

Ms. JOHNSON. But it is actually language in the Federal Credit Union Act that needs to be changed. It is not accounting standards.

Chairman BACHUS. That is right. It is a net worth, just changing—but I am saying, do you know of any opposition in the industry, regulators or anyone saying this isn't a good thing?

Ms. JOHNSON. No.

Chairman BACHUS. No reason why that shouldn't be done?

Ms. JOHNSON. No reason.

Chairman BACHUS. Actually, we are going by members who arrived first. Mr. Davis is our first member.

Mr. DAVIS. Thank you, Mr. Chairman. Let me welcome the witnesses this afternoon and let me try to frame my questions a little bit more broadly than some of the previous comments that you may have made may have been framed.

One of the things that is obvious is that we are going through a period in our economy when a lot of the banks are consolidating and we are having a lot of growth and consolidation among our banks. Certainly looking over the next 5 to 10 years, that is likely to continue. A lot of our smaller banks are likely to be continued to be merged than the larger banks.

One of the things that I certainly wonder about is how credit unions and the nature of credit unions are going to change over that period of time. So let me get each of you to comment very briefly on where you see the credit union industry in the next 10 years, and how you see that being affected by the bank consolidations we are witnessing right now.

Mr. LITTLE. I think it is fair to predict that there will be consolidation in the credit union movement as well. I think that is a natural economic consequence. With regard to the consolidation in the banking industry, I can give you a little perspective on what is happening in our State back in Michigan. Large banks are buying up small banks.

However, approximately 40 percent of our banks, State-chartered banks, have been chartered in the last 10 years. As banks are consolidated and purchased by larger banks, new community banks arise to fill the need. And, really, the consolidation just provides opportunities for capitalism to work on a local level and new banks to arise.

Mr. DAVIS. Let me ask you this question. Obviously, one of the things the chairman was alluding to and one of the things the banks regularly raise is whether or not there has been a change in market share. Certainly as you put it, Ms. Johnson, credit unions are certainly being very aggressive in terms of expanding the kinds of services they provide.

What I want to get a sense of is, are there any outer limits that the industry envisions? Is there a certain growth point that you would reach where you would think that beyond this point, we are dramatically changing the nature of what credit unions are? Have you looked at that question, whether you have any upper limits to what the arc should be?

Ms. JOHNSON. When I look at the mission that credit unions fulfill, I don't see any difference in their mission determined by their size. They are still to serve the needs of their members. We continue to see mergers and some consolidation as well.

I believe last year, 2003, we chartered 11 new credit unions. And I believe in the 2 years prior to that, combined, there were 11 new credit unions chartered. We don't see many new charters.

It is difficult to charter a credit union from the get-go, getting members to pool their money and to start a credit union from the very beginning. But the mission of credit unions continues to be the same regardless of whether they are a $1 million credit union or a larger credit union.

Mr. DAVIS. Let me ask you a question that kind of flows out of that assumption on your part, that the mission of credit unions is not different from the mission of banks, other than just being obviously a different scale of service. The banks' response to that is that if credit unions are going to assume a larger part of the mission and the space that banks have historically occupied, should the credit unions come under some of the burden, for example, of CRA compliance?

I know that is something that typically has been a subject of controversy in your industry. I presume that you are opposed to credit unions being covered by CRA. So let me ask a better question than that. Are there any circumstances or any trade-offs that the industry would be willing to accept to come under the purview of CRA?

What would credit unions need to garner if you had to talk to this body and treat us as a set of rulemakers or lawmakers that could affect your industry? What would you want this institution to do if it were ever going to provide CRA compliance rules for credit unions?

Ms. JOHNSON. Well, Congress decided as late as 1998 that the CRA requirements were not necessary for credit unions because they were meeting the needs of their members within the community. We have tried to facilitate that from a regulatory standpoint by facilitating and easing restrictions for credit unions to adopt underserved areas and to reach out to their communities more easily.

So I think I would rather look at it from a positive standpoint, of how can we facilitate reaching to the underserved; of being able to serve those who are unbanked and who are subject to predatory lending, et cetera.

So I think the focus is still the same, and I think we need to look for ways that we can help facilitate that movement into the neighborhoods.

Mr. DAVIS. I think my time has expired, but if the Chair will give me an additional 20 seconds or so, let me try to get a little more direct answer.

Is there anything that CRAs would be willing to accept or anything that you would require, maybe looking at it from that standpoint, if this body were ever to consider making credit unions fall under the purview of CRA? What would you require if that happened as a trade-off?

Mr. LITTLE. From a regulatory standpoint, we would require that the institutions follow whatever requirements were imposed. My understanding of CRA is that it was put in place to identify specifically identified problems in the banking industry. Absent such specifically identified problems in the credit union movement, I guess I would recommend that there not be that burden placed on the credit unions, unless there is a demonstrated need for it, which, to my knowledge, there is not.

Mr. ROYCE. [Presiding.] Thank you, Mr. Davis.

Chairman Johnson, one of the issues we have been discussing on this committee is following the money in terms of fighting terrorist financing and the efforts of credit unions and the NCUA have not been widely discussed in this debate at all. I would ask if you could elaborate today on efforts being taken in terms of implementing the Bank Secrecy Act and implementation of the PATRIOT Act. Can you tell us about your enforcement efforts on that front?

Ms. JOHNSON. Yes, sir. I had the opportunity to testify before the Senate Banking Committee on the Bank Secrecy Act hearings, and I was pleased to report at that time that we are working very hard with the other agencies to comply with all of the requirements.

At that time I did mention, however, there is one tool which we believe would help assist us further in this area, and that would be the ability to examine third-party vendors that serve federally insured credit unions. Currently, if a problem with a vendor is identified, we have to work through the credit union or voluntarily with the vendor in order to work through any problems. And we believe that, especially with money laundering, terrorism, other things that are foremost in the minds of those when we think about the Bank Secrecy Act, we believe this ability to go in and examine these third-party vendors, who may hold all of members' information, would be very helpful.

Mr. ROYCE. It is helpful for us to know that, and I thank you, and we will look into trying to provide you with that ability.

Ms. JOHNSON. Thank you.

Mr. ROYCE. I think most of us would agree that capital is a very good thing. At the same time, too much capital at times can be a detriment to economic growth. There certainly needs to be balance. So, in your view, is the credit union industry well capitalized and, perhaps, is it over capitalized?

Ms. JOHNSON. Well, the credit union community is well capitalized, and I believe the current average figure is 10.64 percent, which is indeed commendable. But it speaks to the conservative nature of credit unions and their risk-averse management style.

We believe that the risk basing the capital for PCA purposes really deserves a good hard look, and action, hopefully. We believe that the 7 percent minimum that is currently in place could be reduced to 5 percent. The excess capital could be put to better use to funding new services or reducing rates or fees on existing services.

It is time consuming to build capital, and so for most credit unions we believe they maintain a level higher than that 7 percent in order to have that cushion against unexpected growth.

Mr. ROYCE. Another question I have is, as you are aware, the legislation I co-authored would slightly increase credit unions' ability to make member business loans, and I was going to ask you if you can assure this committee that the NCUA has the expertise and has the resources at its disposal that would be necessary to oversee business lending at credit unions?

Ms. JOHNSON. Indeed, I can assure you of that. I believe we have a very good track record. Prior to, I believe, 1998, there was no top limit. Through the regulations that have been put into place, we know that credit unions are doing a very good job with their member business lending.

As I mentioned earlier, actually the percentage on defaults is less than for other member loans. We are proud of our member business lending regulation. We updated it this last year to better accommodate credit unions so they could better serve the business needs of their members, and we are working very hard to make sure it is done appropriately and with safety and soundness foremost.

Mr. ROYCE. Thank you for that response.

I think is it Mr. Sherman next, I believe.

Mr. SHERMAN. Thank you. Obviously, with regulatory relief, credit unions will be able to serve communities better. One of those areas is in the area of check cashing and remittances, where right now people in usually poorer communities have to turn to very expensive financial services. We really need much more competition in the area of check cashing, and especially in international remittances, particularly in the greater Pacoima area, I might add.

If we authorize Federal credit unions to engage in those two activities for anyone eligible to join the credit union, what can we expect of credit unions? Will they step forward and provide competition, particularly in lower-income communities?

Ms. JOHNSON. Absolutely. We feel having the opportunity to offer those services to anyone that is eligible will be that first opportunity to have individuals work with a financial institution and begin building a relationship. So I think this is the first way to get them in the door and begin building—most of these folks are unbanked with a Federally insured or with an insured institution. And we believe getting them in the door and beginning the relationship is very key. They will become, hopefully, good members and seek other services as well.

Mr. SHERMAN. Obviously, the bill we are focused on would redefine the net worth ratio to focus on risk assets and risk-based capital, so we would have a better calculation of the amount of capital that a particular credit union needs.

I am part of an entity called the U.S. Government, that got stung just a little bit when the thrifts didn't have enough capital. So I have become a real fan of capital. So in addition to calculating the amount of capital that a credit union should have, I am in favor of giving them all the tools to get as much capital as possible. It makes me sleep better at night.

What do you think of alternative capital, and what would that do both to allow credit unions to serve more financial services needs and also just to provide more capital to stand between the risks of their business and the U.S. taxpayer?

I might add, and this is unique to credit unions, it is not just the capital of that institution. If that institution goes under, all the other credit unions in the country also have to ante up to the full extent of their capital. So it is probably more likely that an undercapitalized credit union costs some of the folks in this room something rather than the Federal Government.

But either way, capital insulates other credit unions and, ultimately, the Federal Government, from risk, and what do we do to get more of it?

Ms. JOHNSON. Well, Congressman, I think the question on secondary capital has certainly been floating out there for about the last year and a half now. The discussions have stepped to the forefront. The jury is still out in a lot of people's minds. We at the agency continue to study the issue. So I don't have a definitive answer for you today.

Mr. SHERMAN. Can you think of a disadvantage to having more capital in the system?

Ms. JOHNSON. Well, I think the questions that arise in people's minds are more towards the structure of how to do it.

Mr. SHERMAN. Yes. I think it is obvious we cannot assign votes to those who provide alternative capital. It is one member, one vote. And we have to make sure alternative capital is sold in such a way so that there is not a single person who thinks they are getting a Federally insured deposit, when in fact they are getting a subordinated note.

Ms. JOHNSON. Yes. But I assume the discussions will continue.

Mr. SHERMAN. I look forward to hearing about those discussions and look forward to ending this one.

I yield back.

Mr. ROYCE. Mrs. Maloney of New York.

Mrs. MALONEY. Very briefly, because we have been called to a vote.

I would like to ask Mr. Little, because he thought that credit unions should be allowed to join home loan banks. Would you elaborate? What would be the advantage to members of the credit union and to the community?

Mr. LITTLE. Okay. What I specifically commented on was non-Federally insured credit unions. There are approximately 400 credit unions in the country that have a form of member deposit insurance other than that provided by the NCUA.

Federally insured credit unions can be and are members of the Federal Home Loan Bank. Privately insured credit unions cannot. The advantage to allowing that would be to provide the members of those credit unions the same access to affordable housing lending and the other types of services that the Federal Home Loan Bank system offers that are currently not available to that relatively small population of non-Federally insured credit unions.

As I mentioned, it certainly would not be a new precedent, as there are currently 86 insurance companies, none of which are federally insured, that are members of the home loan bank system.

Mrs. MALONEY. And I would like to ask both of the panelists, and I thank you for your testimony today, what are the two main things we could do on the Committee on Financial Services to improve the loan and savings services that credit unions provide to their members?

Ms. JOHNSON. Well, I believe you are taking a step forward with your Regulatory Improvements Act and reducing unnecessary burdensome regulation.

A couple of the things in this particular bill with the risk-based capital and the improvements to the member business lending are things that will really step forward to help members.

Mr. LITTLE. Yes. I would certainly agree on the member business lending. Removing the cap on business lending would be ideal. Certainly increasing it from the current level would be a good interim step.

As to what could be done on the savings side? Providing forms of alternative capital would be one way that members could invest in a different manner in their credit union. So I think we would be in harmony with the NCUA on those issues.

Mr. ROYCE. Well, thank you, Mr. Little.

At this point, we have a series of votes. Two votes on. After those votes, Chairman Bachus will be back from his meeting with Chairman Oxley and will reconvene this committee.

I want to thank our two witnesses for their testimony here today.

Before we recess here, I would just like to recognize and welcome a constituent of ours from California, Bill Cheney, to the committee this afternoon. Not only is he the President and CEO of Xerox Federal Credit Union, but equally importantly he is very involved in the financial services industry as an active voice on credit union issues at the State and national level. He serves as the Legislative Committee Chairman and an at-large director and Board Secretary for the National Association of Federal Credit Unions. He is a member of the Board of Directors of Western Corporate Federal Credit Union, WesCorp. He is a member of the Diversity Committee for the California Credit Union League, and, as I mentioned, he serves as Chairman of the Board of Xerox Federal Credit Union's Capital Corporation, a broker-dealer owned and controlled by 17 credit unions.

This is his second appearance here before this committee, and we look forward to his testimony.

We will stand in recess until after these votes are over.

[recess.]

Chairman BACHUS. Good afternoon. It is my understanding, Mr. Cheney, that Mr. Royce introduced you previously, so I would like to introduce and welcome Ms. Sharon Custer, President and CEO, BMI Federal Credit Union of Ohio, and representing the Credit Union National Association.

We also welcome Dr. William A. Jackson, III, Associate Professor of Finance and Economics at the University of North Carolina at Chapel Hill.

Ms. Custer has served as President and CEO of BMI Federal Credit Union in Columbus, Ohio, since 1986. Ms. Custer is a graduate of Franklin University, Columbus, Ohio, where she majored in business management and received her bachelor's in business administration. She is a member of the Credit Union National Association and a certified credit union executive.

Past activities include serving as a board member of the Credit Union Executive Society, the Credit Union Service Corporation, the Corporate One Federal Credit Union, the Member Mortgage Corporation, the World Computer Credit Union Association, and the Ohio Central Credit Union. And you are presently the Committee Chair of the Ohio Credit Union League.

Dr. Jackson is an associate professor of finance and economics at Kenan-Flagler Business School, University of North Carolina, Chapel Hill. He is a recognized expert in the area of financial intermediation and industrial economics. He earned his B.A. In economics and mathematics at Centre College, his MBA at Stanford University, and PhD at the University of Chicago.

He is the author of numerous articles, with the most recent publishing focused on issues related to small firms' access to credit markets, corporate governance, bank mergers, and risk management. He has published in many journals, held positions with the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of Chicago, the Federal Reserve Bank of Cleveland, the Federal Reserve Bank of Atlanta, Boston University, Jackson and Company, which is his consulting firm; is that right?

Mr. JACKSON. Yes, Mr. Chairman

Chairman BACHUS. Ernst & Young and your alma mater.

We welcome both of you to today's hearing.

Chairman BACHUS. And as is our custom, we will start from my left. Ms. Custer, welcome.

STATEMENT OF SHARON CUSTER, PRESIDENT AND CEO, BMI FEDERAL CREDIT UNION, REPRESENTING THE CREDIT UNION NATIONAL ASSOCIATION

Ms. CUSTER. Chairman Bachus, Ranking Member Sanders, and members of the subcommittee, on behalf of the Credit Union National Association, I appreciate the opportunity to express the Association's views on legislation to improve the regulatory environment in which credit unions operate. I also want to express our gratitude to Representatives Royce and Kanjorski, as well as LaTourette and Maloney, and all the other cosponsors of H.R. 3579, the Credit Union Regulatory Improvements Act.

I am Sharon Custer, President and CEO of BMI Federal Credit Union in Columbus, Ohio.

According to the U.S. Treasury, credit unions are clearly distinguishable from other depository institutions in their structure and operational characteristics. And despite the relative small size and restricted fields of membership, Federal credit unions operate under bank statutes and rules virtually identical to those of banks and thrifts. However, Federal credit unions have more limited powers than national banks and Federal savings associations.

My written statement catalogs and describes the more than 135 laws and regulations that apply to credit unions, including many unique restrictions that are far more stringent and limiting than laws applicable to other depository institutions. Given the limited time available this afternoon, however, I will devote the rest of my statement to describing a few exceptionally important issues for credit unions.

As part of our mission, credit unions are devoted to providing affordable services to all our members, including those of modest means. One provision pending in both the House and the Senate would better enable us to meet that goal. I am referring to legislation to permit credit unions to provide broader check cashing and remittance services.

Many of the individuals who would benefit from this change live from paycheck to paycheck and do not have established accounts. We know of members who join a credit union one day, deposit their necessary share balance, and come in the very next day and withdraw because they need the money. Sometimes a $5 withdrawal means the difference between eating or not.

Accomplishing our mission can also be greatly enhanced by revisiting two major components of the 1998-passed Credit Union Membership Access Act. With 6 years of experience, we have learned that what was thought to be good policy at the time actually created new problems that need to be resolved to assure that credit unions can continue to meet their mission.

The first of these issues is the current cap on member business loans. There was no safety and soundness reason to impose these limits, as the historical record is clear that such loans are not only safer than those in the banking industry, but also safer than other types over credit union loans. In fact, public policy argues strongly in favor of eliminating or increasing the limits from the current 12.25 percent to the 20 percent suggested in H.R. 3579, the Credit Union Regulatory Improvements Act.

Small business is the backbone of our economy and responsible for the vast majority of new jobs in America. Yet a February SBA study reveals that small businesses are having greater difficulty in getting loans in areas where bank consolidation has taken hold. The 1998 law severely restricts small business access to credit and impedes economic growth in America. Although few credit unions are currently bumping up against the cap, in a few years that is likely to change.

Then there is the case of many small credit unions. Investing in the expertise needed to run a member business lending operation is a very expensive proposition. With a 12.25 percent cap, they could not make up the cost needed to run such an operation. If the cap were increased to 20 percent, they could seriously consider entering into this line of lending.

Furthermore, the NCUA should be given the authority to increase the current $50,000 threshold, as proposed in CURIA, to $100,000. This would be especially helpful to smaller credit unions, as they would then be able to provide the smallest of these business loans without the expense of setting up a formal program.

Another critical issue is the prompt corrective action regulations governing credit unions. Credit unions have a higher statutory capital requirement than banks. But credit unions' cooperative structure creates a systemic incentive against excessive risk taking, so they may actually require less capital to meet potential losses than do other depository institutions.

Because of their conservative management style, credit unions generally seek to always be classified as "well" rather than "adequately" capitalized. To do that, they must maintain a significant cushion above the 7 percent level. PCA requirements provide a powerful incentive for credit unions to operate at "overcapitalized" levels.

CUNA believes that the best way to reform PCA would be to transform the system into one that is much more explicitly based on risk management. It would place much greater emphasis on ensuring that there is adequate net worth in relation to the risk a particular credit union undertakes.

Reforming PCA along the lines of a risk-based approach would preserve and strengthen the National Credit Union Share Insurance Fund. It would more closely tie a credit union's net worth requirements to exposure to risk. It would also free up more capital for making loans to members and putting resources into the economy.

Finally, I call your attention to two pending issues before the Financial Accounting Standards Board that raise serious concerns for credit unions. One involves the issue of the accounting treatment of credit union mergers. FASB's proposed change from the pooling method would have the unintended consequence of discouraging, if not eliminating, voluntary mergers that would be advantageous to credit union members.

The other issue relates to the accounting treatment of loan participations. They are used increasingly by credit unions to control interest rate risk, credit risk, balance sheet growth, and maintain net worth ratios.

In summary, Mr. Chairman, we strongly urge the subcommittee to act on this very important issue this year. Credit unions would benefit greatly from reducing unnecessary and costly regulatory burdens, especially those addressed in CURIA. And, more importantly, so would American consumers benefit from the savings that credit unions would pass along to their 85 million members.

Thank you.

[The prepared statement of Sharon Custer can be found on page 63 in the appendix.]

Chairman BACHUS. Mr. Cheney. Thank you, Ms. Custer.

STATEMENT OF BILL CHENEY, PRESIDENT AND CEO, XEROX FEDERAL CREDIT UNION, REPRESENTING NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. CHENEY. Good afternoon, Chairman Bachus, Ranking Member Sanders, and members of the subcommittee. My name is Bill Cheney. I am the President and CEO of Xerox Federal Credit Union located in El Segundo, California. I am here today on behalf of the National Association of Federal Credit Unions to express our views on the need for regulatory relief and reform for credit unions.

As with all credit unions, Xerox Federal Credit Union is a not-for-profit financial cooperative governed by a volunteer board of directors who are elected by our member-owners.

America's credit unions have always remained true to their original mission of promoting thrift and providing a source of credit for provident or productive purposes. A 2004 Filene Research Institute study entitled "Who Uses Credit Unions?" found that the average household income of those who hold accounts solely at a credit union was less than $43,000, while the average household income for those who solely hold accounts at a bank was almost $77,000.

NAFCU is pleased to report to you today that America's credit unions are vibrant and healthy and that membership in credit unions continues to grow, with credit unions serving over 85 million Americans. At the same time, it is important to note that while credit union membership is growing, over the past 23 years, credit unions have increased their market share only minimally. And, as a consequence, provide little competitive threat to other financial institutions. In fact, according to data obtained from the Federal Reserve Board, during the 23-year period from 1980 to 2003, the percentage of total household financial assets held by credit unions increased from 1.4 percent to only 1.6 percent.

Mr. Chairman, as your subcommittee considers regulatory relief issues for credit unions, we hope that you will consider supporting the Credit Union Regulatory Improvements Act. I would like to thank Mr. Royce and Mr. Kanjorski for introducing this vital legislation. The facts confirm that credit unions are more heavily regulated than other consumer financial services providers. Restrictions on the operations of credit unions limit not only who can avail themselves of credit union services, but also how credit unions can raise capital, an issue I know that has been of concern to certain members of this subcommittee, particularly Mr. Sherman.

As members over this subcommittee realize, neither NAFCU nor the credit union community at large hesitated from embracing the increased regulatory burden imposed upon us with the passage of the U.S.A. PATRIOT Act. We willingly and faithfully accepted those burdens necessary for our national security. The provisions of CURIA, while leaving in place the burdens imposed by the U.S.A. PATRIOT Act, would be a positive step in reducing the number of unnecessary or outdated regulatory burdens and restrictions currently imposed on Federal credit unions, some of which date to the very early days of the Federal Credit Union Act.

NAFCU is pleased to see the growing support in the House for CURIA. This legislation addresses additional key issues for credit unions not addressed in the House-passed Financial Services Regulatory Relief Act. As outlined in my written testimony, NAFCU supports the 12 credit union regulatory relief provisions included in both bills. There are additional provisions in CURIA not included in the regulatory relief bill I would like to highlight, as they are needed in the credit union community.

NAFCU urges you to modernize credit union capital requirements by redefining the net worth ratio to include risk assets. This would result in a new more appropriate measurement to determine the relative risk of a credit union's balance sheet, and improvement the safety and soundness of credit unions and our share insurance fund.

NAFCU also supports the provisions in CURIA to refine the member business loan cap established as part of the Credit Union Membership Access Act in 1998, replacing the current formula with a flat rate of 20 percent of the total assets of a credit union. We support revising the definition of a member business loan by giving NCUA the authority to exclude loans of $100,000 or less from counting against the cap. These provisions would facilitate member business lending without jeopardizing the safety and soundness of credit unions.

There is a lot of rhetoric on this issue, but I must note that a 2001 Treasury Department study entitled "Credit Union Member Business Lending" concluded that credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions.

Finally, if the subcommittee were to act on credit union regulatory relief legislation, we would urge you to include language that would address the strain that could be placed on merging credit unions when the Financial Accounting Standards Board changes merger accounting rules from the pooling method of accounting to the purchase method.

This can be done through a simple modification of the statutory definition of net worth in the Federal Credit Union Act to mean equity rather than the retained earnings balance of the credit union, as determined under GAAP. FASB has reviewed this proposed change and stated in an April 27 letter to NAFCU that, "While our primary concerns are not regulatory issues, we do have an interest in supporting an expedited resolution of this matter. The attached proposed amendment proposes a way to resolve this matter."

Mr. Chairman, I have a copy of the letter from FASB with me and would ask that it be included in the record with my testimony at this time.

[The following information can be found on page 171 in the appendix.]

In conclusion, the state of the credit union community is strong, and the safety and soundness of credit unions is unquestionable. Nevertheless, there is a clear need to ease the regulatory burden on credit unions as we move forward into the 21st century. NAFCU urges this subcommittee to support and pass the CURIA bill and the important credit union provisions we have outlined in this testimony. We look forward to working with you on this important matter and would welcome your comments or questions. Thank you.

[The prepared statement of Bill Cheney can be found on page 44 in the appendix.]

Chairman BACHUS. Thank you. Dr. Jackson.

STATEMENT OF WILLIAM E. JACKSON III, ASSOCIATE PROFESSOR OF FINANCE AND ECONOMICS, UNIVERSITY OF NORTH CAROLINA

Mr. JACKSON. Good afternoon, Chairman Bachus and other members of this subcommittee. I count it a great honor to have been invited to present a few ideas on the important topic of credit union regulation improvements before this distinguished subcommittee.

Chairman BACHUS. Mr. Jackson, if you could pull that mike a little closer, I think that will help.

Mr. JACKSON. Is that a little better?

Chairman BACHUS. Yes. I'm just a little worried about my hearing and the court reporter's.

I guess we're not actually in a court, though, are we?

Mr. JACKSON. I hope not, Mr. Chairman.

My name is William Jackson, and I am Associate Professor of Finance and Economics at the University of North Carolina at Chapel Hill, and this year I am a visiting research scholar at the Federal Reserve Bank of Atlanta where I conduct research on financial institutions and financial markets.

Also, let me mention that my views or my comments today do not represent or necessarily reflect the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System. They are my views and my views only. I am not sure if anyone is going to take credit for them beyond myself today after I present them.

Last year, a study that I authored was published by the Filene Research Institute. The title of that study was "The Future of Credit Unions: Public Policy Issues." It was a very broad-based study, but the major research question in the study was: Based on sound economic evidence, can we draw any conclusions about whether credit unions should receive some form of regulatory relief?

For my testimony here today, I would like to summarize the conclusions from that study and relate them to the proposed Credit Union Regulatory Improvements Act under consideration by this subcommittee.

The four main conclusions from my Filene study were that deregulation of banks, thrifts, and credit unions by Congress over the last 15, 20 years was the right thing to do. And today the U.S. financial system is much stronger because of that deregulation and other factors. Today, if you look at the U.S. financial system, by any reasonable measure it is the biggest and the best in the world. And I attribute a lot of the improvements in the financial system over the last 20 years to an active reevaluation of regulatory policy, and I am a fan of what Congress has done in that area.

My second conclusion was that credit unions received less deregulation than either banks or thrifts.

Thirdly, I concluded that more deregulation for credit unions would very likely have positive effects on our economy.

And fourth, and last, that the appropriate level of deregulation of credit unions is probably similar to that received by banks, adjusted for the special characteristics of credit unions.

Now, most of the specific areas of deregulation that I covered in my Filene study are addressed in the proposed Credit Union Regulatory Improvements Act. In general, I agree with those areas, especially the areas of member business lending and capital requirements, and my written testimony goes into more detail on those particular topics and other areas. But let me just speak for a moment or two about member business loans and about capital requirements.

To a large extent, credit union member business loans, looking at them from the outside as an economist, I see them more as personal loans for business purposes. And that appears to be the way that they should be categorized as opposed to the traditional small business loans that you would think of held in the loan portfolio of a commercial bank. Because of that, they have different risk characteristics. To a large extent, I think these loans are less risky than a typical commercial loan held in the portfolio of a commercial bank. And the idea of expanding the possibilities for credit unions to make more member business loans, I think, could possibly even reduce the overall riskiness of the credit union's loan portfolio through diversification effects. At worst, I would think it would not have a significant increase in the overall risk of the credit union industry.

Another issue that is obviously very important in terms of thinking about what happens when you expand the possibilities for more member business loans, is who receives these member business loans. The loans tend to be very, very small loans, very small businesses, and they tend to go to help improve the credit supply to very, very small businesses. Also, it appears from a recent Treasury study in the year 2001, that about one-fourth of member business loans made by credit unions actually go to low- and moderate-income individuals.

So the supply of very small business loans to very small businesses and the availability of credit to low- and moderate-income individuals could be improved by this particular relaxation of the current regulations, by allowing credit unions to increase the proportion of member business loans that they are currently making.

In terms of capital regulations, the idea of instituting a risk-based capital program makes a lot of sense. We have a good prototype from what has been developed in the banking industry. Obviously, that would have to be tweaked in certain ways to make it appropriate for credit unions, but I think that it allows for a good starting point.

One thing I would mention is that I think there is good theoretical and empirical evidence that would suggest that credit unions are probably less risky for given size and management profile than other types of depository institutions. So we might want to keep that in mind as we go through and think about how to develop the proper capital requirements, minimum net worth requirements, and the appropriate weighting system for credit union assets.

One of the other issues covered in CURIA that I would like to mention is nonmember services. I am really, really excited about allowing credit unions to get involved in the business of check cashing for nonmembers. And, hopefully, at some point, maybe getting more credit unions involved in payday lending. I like the idea of getting credit unions involved in those areas. One of the major credit unions in my State, the State Employees Credit Union of North Carolina, has been actively involved in those areas, and I can see that it is making a difference. I have some close friends that work with the credit unions and close friends that work with the banks too, and they tell me that programs like these are starting to make a difference.

To just wrap this up, I really think, looking at it from an economic theory standpoint, that what is being done in the proposed Credit Union Regulatory Improvements Act allows for the right approach to thinking about the optimal regulation of credit unions. And one thing that I will sum up and point to that I really think is appropriate is the idea of reducing legislative mandates and allowing the fine regulatory institution that oversees credit unions, the NCUA to have more authority and more flexibility to change its regulations in response to market changes as credit unions obviously have to respond to market changes.

Thank you very much.

[The prepared statement of William E. Jackson III can be found on page 120 in the appendix.]

Chairman BACHUS. Thank you, Dr. Jackson. I think my first question, I will actually pick up on what you have just talked about, and that is check cashing and what we might call payday lending. And I will ask any of the panelists.

Ms. Custer, you mentioned in your testimony, CUNA's support for the ability of credit unions to offer check cashing and, I think, remittance services to their members?

Ms. CUSTER. Yes.

Chairman BACHUS. How do credit unions use these basic banking services as an opportunity to educate the unbanked and the underserved members of the community of the services that are available to them in a credit union, including financial literacy programs sponsored by the credit unions?

That will be my first question. My follow up is: What are the statutory and regulatory impediments that prevent you from doing even more to serve the underserved or to make these payday loans or check cashing services or remittance services?

And I will just start with Ms. Custer and go down the line.

Ms. CUSTER. The statutory impediment that gives us the restrictions today is that we are limited to providing services to credit union members. This expands the ability to credit unions to provide these services to individuals who are in our field of membership, not just those individuals who have account relationships with us today.

This is important, because, for whatever reason, many people do not have banking accounts; they do not have relationships with financial institutions. By giving us the ability to provide these services to them, hopefully we can, along with the service, provide the incentive to have an account at the credit union and to educate them on financial literacy.

At BMI, I can speak to my own credit union, we have a program we call Second Chance Checking. And this is for individuals who have had checking accounts, and because they have had difficulty handling them in the past, we give them that second chance, and have a specific program for them to help them become acclimated to handling their personal finances.

I think credit unions have always been out in the forefront of providing financial education to their members and to nonmembers. We have in Columbus, Ohio, I think it is the second largest Somali population in the United States. We participate in the Somali Outreach Program. These are individuals who don't have account relationships at all and are just learning about the American financial system.

So giving us this ability helps us to provide even more services to those individuals that are learning to handle their own finances.

Chairman BACHUS. Okay, thank you.

Mr. Cheney, I mentioned, and I think you mentioned in your testimony too, that your institution has gone into four or five underserved areas?

Mr. CHENEY. Yes.

Chairman BACHUS. But I would invite your comment.

Mr. CHENEY. Sure. We have added underserved communities in four different locations where we had existing branches. We have not entered new markets, but we happened to have branches in those underserved areas, and allowing us to serve our entire field of membership in those areas would allow us, as Sharon was saying, to reach out to people who don't currently have accounts.

Often, that is an issue of trust. They have an issue of trust with a financial institution. So if we can bring them in and offer them services and offer them education on financial literacy, then it is an opportunity, as she said, to welcome them into our membership and to provide them with the full range of products and services. And today we are not allowed to serve nonmembers in any fashion.

Chairman BACHUS. All right. Mr. Jackson, or Dr. Jackson.

Mr. JACKSON. I think one of the impediments is the cost of actually making loans. There is a certain fixed cost associated with making any loan. And if the loan is too small, it is very difficult to institute a strategic plan that allows you to make the loan at any profit at all.

With payday lending, that is one of the issues that you run into in terms of the very small loans. And in some cases, I guess usury laws and regulations also prevent charging a rate or a fixed amount that will actually cover the cost of the loan. And kind of tweaking those things to allow for a small fee to be associated with making the loan, I think, would be very helpful.

Chairman BACHUS. Okay, thank you.

Ms. Custer, your testimony touched on the importance to many on this subcommittee and goes to the essence of what many of us feel is the mission of credit unions, the idea of providing services to members of modest means.

To many of us, modest means is another term for those who are poor and those who are underserved. We are aware of a recent GAO study—well, I tell you what, I am not going to ask that question.

In the interest of time, Mr. Cheney, NAFCU has been supportive in the past of a provision that is included in both H.R. 1375 and H.R. 3579 which gives federally insured credit unions the same exemption from premerger notification requirements imposed by antitrust laws that banks and thrifts already enjoy.

For those members who might question the wisdom of limiting the reach of these antitrust laws, can you explain why it is, in your view, that credit unions should be entitled to the same treatment as banks and thrifts in this instance? And I am a sponsor of that legislation and promoter of it, so I agree with you.

Mr. CHENEY. I am aware of that. Thank you very much.

Well, other insured financial institutions have been exempt for some time, and I can't prove it, but I wonder whether credit unions were left off merely as an oversight. I don't think that mergers of credit unions present consolidation issues in any markets.

Typically, as we said, credit unions as an industry hold 1.6 percent of all household assets. So I think it is just, more than anything, a technical correction, which would help with not only the cost of mergers, but also the paperwork and regulatory hurdles that credit unions have to go through when their members and boards members decide they want to merge. So we appreciate your leadership on that issue.

Chairman BACHUS. Okay. Let me go back to this question, which I have decided I will ask. I keep switching back and forth.

Ms. Custer, you are aware of the GAO study that suggested that you all might not be doing as good a job in the area of people of modest means as you could do?

Ms. CUSTER. Yes.

Chairman BACHUS. And in your testimony, you provide some interesting reasons for that. For the sake of just hitting that again and reemphasizing that, could you repeat those reasons?

Ms. CUSTER. In serving the individuals of modest means, or giving more data on supporting the fact that those are members of modest means, I do have some figures here that may be helpful to you, and this goes back to a study done by the Filene Research Institute. They show that the average credit union member is less affluent than the average bank customer. By race and ethnicity, African-American households are more likely to use a credit union than any other ethnic group and are more likely to do so as households overall.

It also shows that minority applicants and low-income households have a substantially higher likelihood of obtaining a first mortgage with a credit union. So I think these are all very consistent with the cooperative spirit and the fundamental philosophy of credit unions in helping all of our members.

Chairman BACHUS. Okay. Well, I applaud the credit unions for their outreach and successful efforts in serving those of modest means, which is something that I think members on both sides have urged all our financial institutions to do. And in that regard, credit unions have an enviable record of accomplishment.

I am going to ask this question. I really was going to talk to Ms. Johnson, but she, in her testimony, recommended that NCUA be given statutory authority to examine third-party vendors that provide data processing and other related services to insured credit unions. And I think this is actually probably a reversal of their position in the past. I will have to say that I am kind of skeptical of giving them this statutory authority.

Has the absence of that authority or the absence of their ability to do that created any problems that you all know of?

Ms. CUSTER. Not that I am aware of. I know that NCUA had the ability to look at third-party vendors in anticipation of Y2K. I think at this point, there would have to be more consideration to look at the whole issue, because I could not address it any more than that.

Chairman BACHUS. Yes, and that is the reason they were given that limited authority, and at that time, they assured us that would sunset and they would not ask that that be extended. I am curious to see what the reason is.

I didn't know if you all knew of some reason why they should have this authority; why maybe not having the authority has created a problem of safety and soundness; or is it something that the member institutions are asking them to do?

Chairman BACHUS. Do you have an opinion on that Mr. Cheney.

Mr. CHENEY. I am not aware of any credit unions that are asking NCUA for this authority, and I am not aware of any existing problems. Although I must say that this is an issue we haven't addressed—the NAFCU board has not addressed in some time, as we were certainly involved in support of the sunsetting of the authority, as you know, some time ago.

Chairman BACHUS. Right. And at least as chairman of the subcommittee I would—without seeing something substantial, I certainly wouldn't be in favor of granting them that authority.

I think that basically concludes—I want to ask Dr. Jackson one final question, and then we will conclude the hearing. In your testimony you express the view that excessive regulatory burdens are not just a minor nuisance for credit unions but have a significant impact on credit union customers and local economies. We have heard testimony that affirms that compliance burdens divert resources from customer service and community development. Can you elaborate on the impact that regulatory burdens on the credit unions have on the local economy?

Mr. JACKSON. In general, when I think about this, the notion of regulatory burdens, I usually think of it in a basic cost-benefit framework where, when you think of the benefits of regulation, for example, in capital regulation, the benefits would be reducing the risk of an event that might lead to taxpayers having to inject funds into the insurance system. But the whole idea of being able to maintain a safe and sound industry and having the regulations in place that focus on that issue and allow for that issue would definitely be a benefit in terms of regulation.

But in my way of thinking, in terms of credit unions, the regulations, the cost side of it in terms of restricting the credit union from providing products and services—financial products and services that the customers, their members, demand, it would outweigh the benefits from having a slight reduction in the risk of the adverse event for the deposit insurer.

So that was kind of my framework for thinking about the cost and benefits of regulation, and I think that the credit unions are basically—their insurance system over time has demonstrated that it is in good shape. It is very safe; and the idea of restricting innovation, restricting goods and services flowing to credit union members and not allowing them to have the same types of opportunities to utilize modern financial products is a very heavy cost.

That was kind of the general framework I was thinking of.

Chairman BACHUS. Thank you.

I think I do have one other question. Ms. Custer, you mentioned in your testimony you endorsed Mr. Royce's risk-based approach for determining capital; and I think, Mr. Cheney, you endorse that as well. And I actually think Dr. Jackson favorably endorsed that.

I know, Ms. Custer, do you—if my recollection serves me correct, you also talked about ability to raise secondary capital as maybe an appropriate way of addressing problems with a prompt, you know, corrective action. Are you—could you elaborate on that? Am I making myself clear?

Ms. CUSTER. I understand. As NCUA Chairman Johnson stated, NCUA had looked at the possibility of secondary capital for credit unions. It has been discussed within the industry. At this point in time, I think the general attitude is, at least with CUNA, who I represent at this hearing, is that the secondary capital was considered an option that was looked at. It was considered, still is being considered, still is being researched.

The reason that we have looked at risk-based capital as being a possibly more appropriate way of addressing the capital situation is because it is very fair and it walks or goes hand in hand with risk-based examination. NCUA went to risk-based examination a couple of years ago, putting more emphasis on the examination process where there are riskier elements within the credit union operation.

Risk-based capital does the same thing. If a credit union chooses to have more risk, allowable risk within their operation, then it is appropriate to have more capital required to cover that risk. Conversely, if a credit union has a more simplistic or less risky operation, then it would require less risk. So it simply seems to be a more appropriate way of addressing capital for credit unions.

Chairman BACHUS. Okay. Miss Custer or Dr. Jackson—I mean, I am sorry, Mr. Cheney or Dr. Jackson, do you have any comments on that?

You know, I certainly personally would prefer a risk-based approach; and I am wondering if there are any—I am not seeing any objection to that on the merits. I think that everyone agrees, at least I think your regulators, the institutions would say that a risk-based approach is really the—it is almost a nondebatable issue, that that is—is that a fair assumption?

Mr. CHENEY. Yes, I agree. NAFCU supports and I do, too, risk-based capital for credit unions. It makes a lot more sense than the current one-size-fits-all program that we have for the reasons that were just mentioned. NAFCU is looking at alternative sources of capital, and we support the concept, although we think there is more work that needs to be done on that issue before we would propose anything to this subcommittee.

Chairman BACHUS. And, Dr. Jackson, has there been any—in the academic world, or regulatory—among the regulatory bodies, is there a general consensus that risk-based approach makes more sense?

Mr. JACKSON. Mr. Chairman, I think the general consensus in the academic community is that it makes more sense, that if you think of capital as any other product that has a price and that it should be priced appropriately and if the insurance fund's purpose is to price risk and charge those who are imposing more risk on the insurance fund the appropriate fee, then there has to be some metric that allows you to assess the individual riskiness of each institution. So I think that is the way to go.

Most people would say that it is better than the alternative of a flat fee, that there are still problems even with the risk-based system. These problems are being worked on. But, we know much more about it now than we did before from banking research. A lot of that, I think, can be utilized for developing an appropriate system for credit unions.

Chairman BACHUS. All right. Thank you.

This concludes our hearing. I have to read some more words just for the record.

First of all, to both panels of witnesses, without objection, written statements will be made a part of the record and each of you will—your record will—I mean, your full statement will be put in the record.

The Chair notes that there may be some members that have additional questions to this panel. They may actually have just questions, as opposed to additional questions, for the panel, which they may wish to submit in writing; and, without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

The Chair asks unanimous consent that Mr. Paul, a member of the full committee who does not serve on this subcommittee, be permitted to submit a statement for inclusion in the hearing record. And without objection, hearing none, that is so ordered.

[The prepared statement of Hon. Ron Paul can be found on page 39 in the appendix.]

Chairman BACHUS. With that, this hearing will be concluded. So you witnesses are dismissed; and, again, I compliment the credit unions of this country for their service to the American public and meeting their financial needs. Thank you.

[Whereupon, at 4:55 p.m., the subcommittee was adjourned.]

A P P E N D I X

July 20, 2004

STATEMENT OF CHAIRMAN SPENCER BACHUS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
HEARING ON "CREDIT UNION REGULATORY IMPROVEMENTS"
July 20, 2004

The Subcommittee will come to order. I want to start by thanking the witnesses for being here today to discuss regulatory improvements to the credit union system. We extend a special welcome to National Credit Union Administration Chairman JoAnn Johnson, who is making her first appearance before this Subcommittee since taking over the leadership of the NCUA board earlier this year from former Chairman Dennis Dollar.

Credit unions are a vital part of our nation's financial services infrastructure. As nonprofit cooperatives managed by their members, credit unions excel at providing the services families and small businesses need most. I have had many constituents tell me how important their credit union has been in making it possible for them to afford their own home, obtain a loan to start a new business, or even attend college. Not surprisingly, the nation's almost 10,000 credit unions consistently rank high in customer satisfaction surveys, and play a particularly important role in expanding the financial alternatives available in historically underserved urban and rural areas.

Under Chairman Oxley's leadership, this Committee has been at the forefront of efforts to improve the regulatory environment in which credit unions operate, thereby enhancing their ability to meet the needs of their more than 80 million members nationwide. In addition to passing a deposit insurance reform bill out of the House that gives credit unions full parity with their bank and thrift counterparts, the Committee developed bipartisan legislation affording significant regulatory relief to credit unions, banks and thrifts. That bill, H.R. 1375, which was spearheaded by two Members of this Subcommittee, Mrs. Capito of West Virginia and Mr. Ross of Arkansas, passed the House last March with almost 400 votes, thanks in no small part to the enthusiastic support and grass-roots efforts of the credit union industry.

Among other provisions, H.R. 1375 expands credit unions' investment authority; increases the general limit on the maturity of credit union loans from 12 to 15 years; authorizes credit unions to provide check cashing and money transfer services to non-members, so long as they are within the credit union's field of membership; permits privately insured credit unions to join the Federal Home Loan Bank System; and excludes loans made to nonprofit religious organizations from the limits that otherwise apply to credit unions' commercial lending authority. The bill also includes a provision that I first offered as an amendment when the Judiciary Committee marked up the regulatory relief legislation in the 107th Congress, granting to credit unions the same exemptions from pre-merger notification requirements that banks and thrifts already enjoy under Federal antitrust law.

Last November, Congressman Royce and Congressman Kanjorski, two respected Members of the Subcommittee, introduced H.R. 3579, the Credit Union Regulatory Improvements Act, which mirrors in many respects the credit union provisions of H.R. 1375, but also includes several additional regulatory reforms. For example, H.R. 3579 would increase the aggregate level of commercial loans that a credit union could make to its members, from approximately 12 percent of total assets to 20 percent, as well as establish a risk-based approach for measuring credit union capital. While action this year on H.R. 3579 is unlikely – given the limited time remaining on the congressional calendar – today's hearing will allow the Subcommittee to hear the perspectives of credit union regulators and industry representatives on the legislation, and on other proposals for improving credit union regulation.

Today's hearing is also an appropriate "book-end" to a hearing that the Subcommittee held in May focusing on the crippling regulatory burdens faced by America's small community banks. Taken together, these hearings demonstrate this Committee's continuing commitment to identifying and eliminating outdated or unnecessary regulatory requirements, which will serve ultimately to benefit American consumers in the form of more innovative financial products and services offered at more competitive prices.

The chair now recognizes the Ranking Member of the Subcommittee, Mr. Sanders, for any opening statement that he would like to make.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
"Credit Union Regulatory Improvements"
July 20, 2004

I want to thank Chairman Bachus for calling this hearing to examine regulatory improvements to our nation's credit union system. Credit unions serve an important role in the U.S. financial services framework. I believe that Congress should work to ensure that the federal regulatory environment in which credit unions operate is one that encourages innovation while at the same time promoting safe and sound practices.

With total assets in excess of $610 billion and 82 million members, today's credit union system is growing and vibrant. Credit unions provide their members with a wide array of financial products, high quality services, and the unique opportunity to participate in an enterprise in which they have a common bond and ownership stake.

This Committee has taken the lead in promoting sensible regulation of depository institutions and encouraging efficiencies in the marketplace. Under the leadership of Representative Capito and Chairman Bachus, the Financial Services Committee crafted H.R. 1375, to alleviate unnecessary and outdated regulatory burdens for a wide range of financial services entities – including credit unions. The House approved this measure overwhelmingly by a vote of 392 to 25. Hope springs eternal that the other body will take up this important legislation before it adjourns later this year.

Representatives Royce and Kanjorski have drafted legislation, H.R. 3579, containing many of the important provisions included in H.R. 1375, as well as a number of other proposals that command broad support in the credit union industry. Today's hearing provides an opportunity to discuss these and other ideas for improving credit union regulation.

I would like to thank all of the witnesses who are here today to share their perspectives. I want to extend a particular welcome to NCUA Chairman JoAnn Johnson, who is making her first appearance before the Committee since taking over for Chairman Dennis Dollar earlier this year. I look forward to the testimony.

July 20, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
Hearing entitled, "Credit Union Regulatory Improvements"

Thank you, Mr. Chairman, for calling us here this afternoon to discuss regulatory challenges faced by credit unions and specifically HR 3579, the Credit Union Regulatory Improvements Act of 2003 or CURIA.

On March 18, 2004, I was happy to support HR 1375, the Financial Services Regulatory Relief Act, legislation that provided regulatory relief to all types of depository institutions. Specifically, title III of HR 1375 includes provisions:

1. expanding the investment authority of federal credit unions,
2. increasing the general limit on the maturity of federal credit union loans from 12 to 15 years,
3. authorizing federal credit unions to provide check cashing and money transfer services to non-members of the credit union so long as they are within its field of membership,
4. permitting privately insured credit unions to be eligible to join a Federal Home Loan Bank,
5. easing restrictions on voluntary mergers between healthy credit unions,
6. and giving federally insured credit unions the same exemption from certain pre-merger notification requirements that banks and thrifts already possess under federal antitrust law.

I look forward to our discussion of CURIA today but given the important provisions that are already included in HR 1375, do not support its consideration by this the Financial Services Committee this year.

I have strong concerns regarding the expansion of commercial lending opportunities contained in HR 3579:

1. the increase from 12.25% to 20% of a credit union's net worth available for member business loans,
2. the increased limit on loans exempt from this cap to $100,000 from $50,000,
3. the repeal of the restriction on undercapitalized credit union from making member business loans,
4. and the exemption of loans to nonprofit religious organizations from the member business loan cap.

These provisions would engender a rapid entry of credit unions into the commercial lending arena, moving away from the purpose of assisting the individuals of modest means they retain certain tax and regulatory advantages in order to serve.

In the House report that accompanied HR 1151, the Credit Union Membership Access Act, passed in 1998, legislation addressing the practice of commercial lending by credit unions, "reaffirms the continuing and affirmative obligation of insured credit unions to meet the financial services needs of persons of modest means, including those with low- and moderate- incomes, consistent with safe and sound operations."

Thank you again, Mr. Chairman, for holding this hearing and I look forward to a thorough debate.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
"CREDIT UNION REGULATORY IMPROVEMENTS"
JULY 20, 2004

Chairman Bachus and Ranking Member Sanders,

I want to thank you for holding this hearing to examine proposals that would provide additional regulatory relief for credit unions. This Committee provided them and other financial services institutions with regulatory relief in HR 1375, the "Financial Services Relief Act of 2003" that the House passed in March of this year.

I understand that we will also be discussing HR 3579, the "Credit Union Regulatory Improvements Act," otherwise known as "CURIA." This legislation contains a majority of the regulatory relief provisions for credit unions the House already granted them when it passed HR 1375 while adding four provisions not previously considered.

While it is prudent to provide regulatory relief to all financial institutions after considerable debate, I am a bit confused as to why we are considering providing additional regulatory relief to credit unions at this time when the "Financial Services Relief Act of 2003" remains in play. I hope that the witnesses will address this concern as well as one that I have concerning commercial lending limits.

I am researching how an increase in commercial lending limits would help improve the growth of the financial services marketplace and allow for competitors to allow equal access to capital.

Whatever action we take, if any, we must ensure that it levels the playing field for all of our financial institutions. Fair competition among our financial institutions is one of the keys to a successful economy.

I yield back the balance of my time.

RON PAUL
14TH DISTRICT, TEXAS

FINANCIAL SERVICES COMMITTEE
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VICE CHAIRMAN
OVERSIGHT AND INVESTIGATIONS
CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES
DOMESTIC MONETARY POLICY, TECHNOLOGY, AND ECONOMIC GROWTH

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Statement of Congressman Ron Paul
At the Subcommittee on Financial Institutions and Consumer Credit's hearings on
"Credit Union Regulatory Improvements"
Tuesday, July 20, 2004

Mr. Chairman, thank you for holding this hearing on "Credit Union Regulatory Improvements." Credit unions play a vital role in the United States financial services sector. During my time on the House Committee on Financial Services, I have had the opportunity to get to know many credit union employees. I have always been impressed with their commitment to serving their members and their communities. In many ways, credit unions exemplify the best of the free market system. Since credit unions are formed specifically to serve their members, credit unions put their depositors' interests first.

Relieving credit unions of unnecessary federal regulations and thus allowing them to expand the services they offer is one of my top priorities. This is why I am an original cosponsor of HR 3579, the Credit Union Regulatory Improvements Act. Among other things, this bill increases a credit union's business lending authority and authorizes credit unions to provide check cashing and money transfer services to non-members who are in the credit union's field of membership. I hope this hearing will soon be followed up by subcommittee and full committee mark-ups of HR 3579 so congress can pass, and the President can sign, this important bill before the 108th congress adjourns.

http://www.house.gov/paul/ • rep.paul@mail.house.gov

STATEMENT BY REP. BERNARD SANDERS AT CREDIT UNION HEARING

Mr. Chairman, thank you for holding this important hearing. I am a proud co-sponsor of H.R. 3579, the Credit Union Regulatory Improvement Act, and I applaud Congressmen Ed Royce and Paul Kanjorski for their leadership in introducing this legislation.

Mr. Chairman, America's credit unions are one of the most vital, one of the most democratic, institutions in America. Without the need to make a profit, without heavy advertising costs, without huge bonus packages to corporate executives, credit unions can provide loans at rates lower than other financial institutions. And credit unions can provide loans to those who might otherwise be turned away from conventional banking institutions.

I was pleased to be an original co-sponsor of the Credit Union Membership Access Act, and to work side-by-side with credit unions and their members during a long and contentious struggle in 1998. We were successful in that fight, and passed the law that preserved the right of consumers to join credit unions.

Today, I am pleased to report, credit unions are stronger than ever, and serving more people than ever. *There are over 9,000 credit unions in existence today. They serve nearly over 80 million people in our nation and they have $627 billion in assets.*

Now, Mr. Chairman, I know what the big banks are saying: my gosh, $627 billion in assets, that's a lot of money, we shouldn't be reducing the regulatory burdens for credit unions, we should tax them.

Wrong, Mr. Chairman. Keep in mind this one fact: J.P. Morgan Chase, the nation's largest bank, one bank, has the same amount of assets as the entire 9,400 credit unions in this country combined. In fact, banks have over $9 trillion in assets – 14 times more assets than credit unions.

While credit unions pay property taxes, sales taxes and payroll taxes, they are exempt from federal income taxes for good reasons, and not because anyone is doing them a special favor. Credit unions are tax-exempt because they are non-profits. Just like churches, hospitals, libraries, universities and other non-profit institutions, federal law exempts credit unions from federal taxes.

All over this country, the over 80 million Americans that belong to credit unions, including hundreds of thousands of Vermonters, benefit from this tax exempt status. Because credit unions are not motivated solely by profit, they are much more concerned about their members' financial needs than large banks. Credit union profits do not go to pay huge executive salaries. Instead, they are directed back to customers in the form of lower fees and higher rates of return.

On the other hand, as a group, big banks use the more than $300 billion they received in profits last year to pay their senior executives obscene levels of compensation. For example, while Citigroup made $17.85 billion in net profits in 2003 – more than any other company in history -- it paid its CEO Sanford Weill more than $500 million in total compensation over the past 5 years.

You will not see this outrageous level of compensation at any of the 9,400 credit unions across America, and that is a very good thing. And, here's another good thing: Because of the tax-exempt status of credit unions national credit card interest rates, personal loans, and ATM fees are lower at credit unions than big banks.

Yet, huge and highly profitable corporate banks are hard at work lobbying Congress to tax credit unions. The too-big-to-fail banking lobby even has the gall to question the safety and soundness of credit unions, even though it was the Savings and Loan industry, not credit unions, which had to be bailed out by taxpayers in the 1980s to the tune of $150 billion.

Still, banks hammer away and hammer away at their theme: 'It is unfair that credit unions are not taxed. They get a federal subsidy.'

Yet, big banks, unlike credit unions, have received hundreds of billions of dollars in corporate welfare over the past 15 years, courtesy of the American taxpayer. While big banks argue that it is bad for credit unions to receive a federal subsidy, these same banks successfully lobbied for a $19.2 billion taxpayer bailout for Chase Manhattan, Bank of America and CitiBank through the IMF for risky loans they made in South Korea, Indonesia and other Asian countries in 1998.

Big banks complain that it is unfair for credit unions to receive a federal subsidy, but rejoice when CitiBank and Bank of America received more than $1.4 billion in corporate welfare from the Overseas Private Investment Corporation since 1999, courtesy of the American taxpayer.

Big banks lobby Congress to tax credit unions, while the same big banks are busy setting up subsidiaries in tax havens like Bermuda, Barbados and the Cayman Islands to avoid U.S. taxes just like Enron did. For example, Morgan Stanley, Citigroup and Bank of America have established more than 240 offshore tax haven subsidiaries since 2003 all for the purpose of avoiding U.S. taxes, padding their bottom lines and enriching their CEOs.

And, while big banks are trying to convince small community banks that it is the credit union movement that is the cause of their demise they fail to mention that nine out of every ten bank mergers have eliminated a community bank. We must protect small community banks by opposing the massive consolidation in the banking industry, not by taxing credit unions.

Finally, consider this: according to the Institute on Taxation and Economic Policy, "[The] Wachovia [Bank] . . . . in 2002, even though it reported $4 billion in profits, reported that it didn't pay any taxes and, in fact, got a tax rebate from the government of about $160 million."

Mr. Chairman, this one bank earned $4 billion in profits in 2002, but paid no taxes. The entire credit union movement earned $5.9 billion in 2002.

And, according to another study, not only did J.P. Morgan Chase pay no federal income taxes at all in 1998, it received a $62.3 million tax rebate from Uncle Sam.

It is obvious why big banks want to tax credit unions – they want to drive them out of business. Without the presence of credit unions, banks would be free to further increase their surcharges for ATM transactions, increase interest rates on loans, lower interest rates on savings accounts and leave the American workers with no alternative.

This is wrong. For almost all of the past century, credit unions brought people together, allowed them to share their resources, and served the financial needs of their members in good times and bad.

I never make excuses for the fact that I am a strong supporter of credit unions. I want to see credit unions grow and flourish because I believe credit unions are good for the working people of Vermont and good for America. I thank the Chairman, and I look forward to this hearing.

NAFCU

Testimony of

Bill Cheney
President/CEO of Xerox Federal Credit Union

on Behalf of

The National Association of Federal Credit Unions

Regulatory Relief for Credit Unions

Before the

House Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

July 20, 2004

Introduction

Good afternoon, Chairman Bachus, Ranking Member Sanders and Members of the Subcommittee. My name is Bill Cheney and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President/CEO of Xerox Federal Credit Union, headquartered in El Segundo, California. Xerox FCU is a multiple common bond credit union with approximately 77,000 members and more than $760 million in assets. Xerox FCU serves employees of the Xerox Corporation and related companies nationwide through 17 credit union offices in eight states. My credit union has recently expanded to include underserved communities in Rochester, NY; Dallas, TX; St. Petersburg, FL; and Chicago, IL. I have a broad background in financial services, including more than 17 years working in the credit union industry. I joined Xerox FCU in 1997 after 10 years with Security Service Federal Credit Union in Texas.

I also serve as the Legislative Committee Chairman and a Director-at-Large and Board Secretary for the National Association of Federal Credit Unions; I am a member of the Board of Directors for Western Corporate Federal Credit Union (WesCorp), as well as a member of the Diversity Committee for the California Credit Union League. Finally, I am Chairman of the Board of XCU Capital Corporation, a broker/dealer owned and controlled by 17 credit unions.

I am also a Director and a member of the Executive Committee of the American Red Cross of Greater Los Angeles, and I volunteer with numerous charitable organizations such as Heal the Bay and the Boy Scouts of America. I earned my Bachelor of Business Administration degree from The University of Texas at Austin in 1982.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of more than 800 federal credit unions—member owned financial institutions across the nation—

representing approximately 25 million individual credit union members. NAFCU–member credit unions collectively account for approximately two-thirds of the assets of all federal credit unions. NAFCU and the entire credit union community appreciate this opportunity to participate in this discussion regarding regulatory relief for America's financial institutions and particularly its impact on federal credit unions.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created and has been recognized as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to fill a precise public need—a niche that credit unions fill today for over 85 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While over 70 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- Credit unions remain totally committed to providing their members with efficient, low cost, personal service; and,
- Credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 5,700 federally insured credit unions serve a different purpose and have a fundamentally different structure—existing solely for the purpose of providing financial services to their members—than banks that exist to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for profit stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit Unions have an unparalleled safety and soundness record. Credit unions—unlike banks and thrifts—have never cost the American taxpayer a single dime. Unlike the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loans Insurance Corporation (FSLIC) which were both started with seed money from the United States Treasury, every dollar that has ever gone into the National Credit Union Share Insurance Fund (NCUSIF) has come from the credit unions it insures. And unlike the thrift insurance fund that unfortunately cost American taxpayers hundreds of billions of dollars, credit unions have never needed a federal bailout.

Although not the subject of this hearing today, I would like to respond to comments made by several banker witnesses at a hearing before this subcommittee last May. At the hearing, a number of witnesses expressed some common misperceptions or "myths" about the credit union community and today I would like to cover what the reality really is:

Myth: Credit unions pay no taxes.

Reality: Credit unions pay many taxes and fees, among them payroll and property taxes, but Congress has determined that credit unions should be exempt from federal and state income tax. Congress granted this exemption in 1937, recognizing credit unions' unique differences from commercial banking institutions: chiefly, that credit unions are member-owned, not-for-profit institutions, and that taxing member-owned shares would place a "disproportionate and excessive" burden on credit unions. Congress reaffirmed its support for the tax exemption in 1998, and the Bush administration has endorsed continuing the exemption.

Myth: Credit unions have changed over the years and today are really no different than banks, which pay corporate income tax.

Reality: The defining characteristics of credit unions remain unchanged. Credit unions are not-for-profit cooperatives that serve defined fields of membership, generally have volunteer boards of directors and cannot issue capital stock. They are restricted in where they can invest their members' deposits; they are also subject to stringent capital requirements and a cap on business lending.

A key difference between credit unions and banks is that a credit union's shareholders are its members (and each member has one vote), while a bank is owned by its stockholders. A bank earns profits and distributes those profits to its stockholders; a credit union's "earnings" are returned to its members in the form of lower fees, higher dividends, better rates or more services.

Surprisingly, a large number of banks do not pay corporate income tax because they have converted to a Subchapter S corporation. As of December 2003, there were over 2,000 Sub S banks, with the largest at $9 billion.

Myth: Credit unions keep getting bigger and now compete head-to-head with banks.

Reality: Credit unions have grown steadily in members and assets, but in relative terms, they are quite tiny compared to banks. Federally insured credit unions had $610 billion in assets as of year-end 2003. By comparison, FDIC-insured institutions held $9.1 trillion in assets, and last year these institutions grew by an amount that exceeds the *total* assets of credit unions. The average size of a credit union is $65 million compared to just under $1 billion for banks. Over one-half of credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, just 1.6 percent as of June 2003.

Apparently credit union "competition" has not prevented banks from enjoying record profits. At the end of 2003, banks posted their fourth straight quarter and third straight year of record profits, with the return on assets for the nation's largest banks reaching a record level of 1.4 percent. Annual bank profits alone equaled nearly one-fifth of the total assets of credit unions. In addition, *Economist* magazine reported that banks and their subsidiaries earned one-third of all U.S. corporate profits in 2003.

Further, when the Department of Treasury studied potential credit union competition in the business lending arena, it concluded that, "Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions." What Treasury found, instead, was that banks had failed to penetrate many of the markets that credit unions typically serve.

Banks are free to switch to a credit union charter. However, to date, not a single shareholder-owned bank has done so, an indication that banks do not take the "threat" of credit unions very seriously.

Myth: The credit union tax exemption costs the Treasury billions of dollars in lost revenue while banks pay their fair share of income tax.

Reality: The government has calculated that the credit union tax exemption will reduce revenue receipts by $1.43 billion in FY 2005, but that figure is miniscule compared to projected total government receipts for 2005 of $2.04 trillion.

There is also a loss to the Treasury when banks convert to Subchapter S corporations. NAFCU calculates the annual loss of revenue from Subchapter S banks at roughly $600 million; however, if banks continue to grow at their current rate and the number of Subchapter S banks increases, this figure could rise dramatically over the next few years—to the point where the loss of revenue from Sub S banks is greater than the loss from credit unions.

The Consumer Federation of America, in its October 2003 study, "Credit Unions in a 21st Century Marketplace," concluded that "[t]he benefits that credit unions deliver to the public far exceed the costs, as measured by the tax exemption, through lower cost services and the payment of higher interest rates." That same study found that the value of tax breaks enjoyed by banks is "far greater, in absolute and relative terms, than the value of the credit union tax exemption."

Myth: It's the big credit unions—those over $1 billion in assets—that should be taxed.

Reality: Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and community. While credit unions have grown, their relative size is tiny when compared to banks. Even the world's largest credit union, with $20 billion in assets, is dwarfed by the nation's biggest banks with hundreds of billions in assets. (JP Morgan Chase Bank has $628.7 billion in assets.)

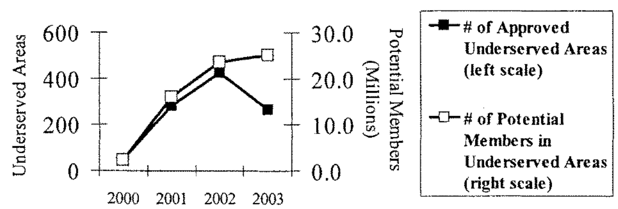
All credit unions are subject to higher capital standards than banks. Taxing the net income, which reduces the growth of retained earnings for a credit union, large or small, would thus have a very detrimental effect on its operations. In fact, the credit unions' regulator, NCUA, has warned for this very reason that credit union taxation could raise safety and soundness concerns.

Myth: Credit unions aren't regulated as well as banks.

Reality: Credit unions are highly regulated financial institutions, and their members' deposits enjoy identical protection to FDIC coverage (up to $100,000 per account) under the National Credit Union Share Insurance Fund. Credit unions also have the distinction of not costing the American taxpayer a penny in bailouts. By contrast, the S&L failures in the 1980s and '90s cost taxpayers approximately $124 billion. The Government Accountability Office (GAO), after completing a comprehensive study of credit unions in 2003, found that "[c]redit unions have a greater proportion of assets available to cover potential losses than banks and thrifts."

As you can see, America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the *Credit Union Membership Access Act* (CUMAA – P.L. 105-219). In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means ... [and it] continue[s] to fulfill this public purpose." Since the passage of CUMAA in 1998, federal credit unions have added over 1,000 underserved areas, resulting in low-cost financial services being made available to over 67 million people.

UNDERSERVED AREAS ADDED TO FEDERAL CREDIT UNIONS' MEMBERSHIP



Source: National Credit Union Administration

A 2004 Filene Research Institute study entitled "Who Uses Credit Unions" found that the average household income of those who hold accounts solely at a credit union was $42,664, while the average household income for those who only hold accounts at a bank was $76,923. For households that used multiple financial services providers, those that primarily used a credit union had an average income of $67,475. For households who used multiple financial services providers but primarily used a bank had an average income of $74,303. Credit unions also represent a very small portion of today's financial marketplace, holding only 1.6 percent of all household financial assets

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed with the resulting de-personalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided but also—and in many cases more importantly—to quality and cost. Credit unions are second to none in providing their members with quality personal service at the lowest possible cost. According to the 2003 American Banker/Gallup Consumer Survey, credit unions had the highest rated service quality of all surveyed financial institutions. This has held true each year since the survey was initiated.

Looking Beyond CUMAA

Credit unions have been the target of criticism by some in the banking industry for more than two decades, and the criticisms that the bankers are lodging today are nothing new. Over the past year, the banker attacks have intensified. The Supreme Court's decision in 1998 in the AT&T Family Federal Credit Union field of membership case followed by Congress' prompt passage of CUMAA in the summer of 1998, which was seen by many as a significant victory for credit unions, brought the issue to a head. The fact of the matter is that when CUMAA was signed into law it overturned in eight short months a decision that had encompassed eight years of costly litigation initiated by the banks.

CUMAA was a necessary piece of legislation for credit unions at the time of its enactment because it codified a number of fundamental credit union concepts embraced by both federal and state-chartered credit unions. In addition to the previously mentioned "Findings" section, these include:

- the multiple-group policy that NCUA had initiated in 1984;
- the "once a member, always a member" principle followed by virtually every credit union in the country; and,
- the "family member" concept followed by many credit unions.

Yet CUMAA came with some provisions that were not widely supported by the credit union community. These include:

- limitations on member business loans;
- imposition of a bank-like Prompt Corrective Action or "PCA" requirement that, given the structure of credit unions, serves in many respects as an overly restrictive constraint on growth; and
- various artificial and arbitrary limitations on growth.

Following the passage of CUMAA, NAFCU recognized the need for additional credit union legislation. As a result, NAFCU convened a task force of federal credit unions and former federal credit unions (that had converted to a state charter) to begin work on developing well-reasoned proposals to enhance the federal credit union charter and to ease the regulatory burdens of all credit unions.

This group met to discuss their concerns related to the federal charter in the post-CUMAA environment. Below are highlights of some of the comments NAFCU heard at that session and in subsequent meetings:

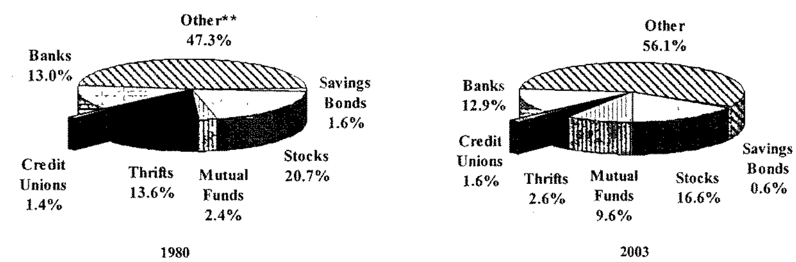
- NCUA should work to eliminate unnecessary and needless regulations and work with Congress to repeal laws which are only serving to drive small financial institutions out of business.
- Mergers seem to be a practical and necessary way of creating financially viable credit unions that can survive in today's financial marketplace.
- It is important that the regulatory environments allow for credit union growth and not impair the ability of credit unions to remain competitive.

As a result of these meetings, it became clear that both regulatory and legislative action was needed in the post-CUMAA environment.

The Current Situation

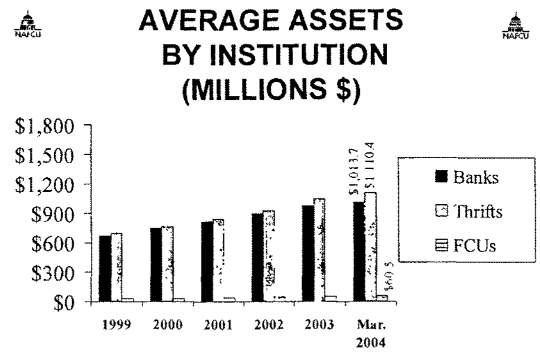
NAFCU is pleased to report to the Committee that credit unions today are vibrant and healthy. Membership in credit unions continues to grow with credit unions serving over 85 million Americans—more than at any time in history. At the same time, it is important to note that over the past 23 years credit unions have increased their market share only minimally and, despite what you may have heard at earlier hearings, provide little competitive threat to other financial institutions. According to data obtained from the Federal Reserve Board, during the 23 year period from 1980 to 2003 the percentage of total household financial assets held by credit unions increased from 1.4% to 1.6% or merely 0.2% over the course of 23 years.

HOUSEHOLD FINANCIAL ASSETS



****Other includes items such as life insurance reserves, pension fund reserves, mortgages, security credit, equity in noncorporate (e.g. farm) business, open market paper, and investments in bank personal trusts.**

The above chart only tells part of the story. Credit unions remain small financial institutions. The chart below indicates that the average credit union has $60.5 million in assets.



As you can see, a number of individual banks have total assets greater than the entire credit union community combined. The annual growth of the commercial bank sector in recent years is almost equal to the size of the entire credit union community—with banks growing in just one year by a magnitude that it took credit unions nearly a century to achieve.

As is the case with the banks and thrifts, there has been consolidation within the credit union community in recent years. The number of credit unions has declined by more than 59 percent over the course of the past 30 years, from an all-time high of 23,866 in 1969 to 9,709 at year-end 2003. Similar to the experience of all credit unions, the number of federal credit unions has declined by just about 56 percent over that same period, from a high of 12,921 in 1969 to 5,732 today.

Despite what you may hear, the reality is that credit unions are more heavily regulated than any other regulated consumer financial services provider. Restrictions on the operations of credit unions limit not only who can avail themselves of credit union services, but also how credit unions can raise capital—an issue that I know has been an interest to certain members of this Subcommittee and others on the full committee. While banks and their trade associations claim that about one-third of banks and thrifts have fewer than 25 employees, I must point out that over three-fourths of credit unions have fewer than 25 employees and almost two-thirds have fewer than ten employees.

As members of this Subcommittee realize, neither NAFCU nor the credit union community at large—which includes a number of credit unions serving parts of the federal government such as the military, the Federal Reserve, the FDIC and Members and staff of both the House and Senate among others—hesitated from embracing the increased regulatory burden imposed upon us with the passage of the USA Patriot Act and we willingly and faithfully accepted those burdens to benefit our national security.

NAFCU Meets with Policymakers to Enhance the Federal Charter

Over the past four years NAFCU has been working with former NCUA Board Chairman Dennis Dollar, current NCUA Chairman JoAnn Johnson, Board Member Deborah Matz and their staffs in a good faith effort to improve the regulatory environment for federal credit unions. We are pleased to see that these efforts have been fruitful in several respects.

On the legislative front, NAFCU has been meeting with legislators on both sides of the aisle to compile a package of initiatives to help credit unions better serve their members in today's sophisticated financial marketplace. An important part of that effort has involved identifying areas in which we believe Congress should provide what is now overdue regulatory relief. NAFCU has suggested a series of recommendations designed to enhance the federal charter, several of which are contained either in whole or in part within the House-passed *Financial Services Regulatory Relief Act of 2004*, H.R. 1375, and in the *Credit Union Regulatory Improvements Act* (CURIA), H.R. 3579, which has been introduced in the House. Both of these bills recognize the fact that today's credit unions exist in a very dynamic environment and that the laws and regulations dealing with credit union issues are currently in need of review and refinement.

***Financial Services Regulatory Relief Act of 2004* and CURIA**

NAFCU believes that the *Financial Services Regulatory Relief* is a positive step in addressing many of the regulatory burdens and restrictions on federal credit unions. We were pleased with the overwhelming bipartisan vote of support for this legislation when it passed the House on March 18, 2004, by a vote of 392-25.

NAFCU is also pleased to see the growing support in the House for CURIA, introduced last November by Representatives Ed Royce (CA) and Paul Kanjorski (PA). The provisions in CURIA, while leaving in place the necessary burdens imposed by the USA Patriot Act, would nevertheless be a positive step in reducing a number of other unnecessary or outdated regulatory constraints and restrictions currently imposed on federal credit unions, some of which date to the early days of the FCUA. In addition to having a number of credit union provisions that are also included in the Financial Services Regulatory Relief Act of 2004, CURIA addresses several new issues for credit unions that have not been previously addressed. We support this legislation and hope that the Subcommittee will consider and pass this bill.

Twelve provisions in particular that would ease the regulatory burden on credit unions have been included in both bills:

<u>Leases of land on federal facilities for credit unions</u>

NAFCU supports the effort to give credit unions land leases on federal property under the same terms and conditions as credit unions now are provided space allotments under the FCUA. Those that will be impacted by this change are defense (military) credit unions that have tried to expand their service to our men and women in uniform by building (and paying for) their own member service centers on military facilities. Many credit unions that have expanded their services by building their own facilities to serve military personnel have had their leases go from a nominal fee (e.g. $1.00 a year) to a "fair market value" rate of over $2,000 a month. For non-profit cooperative credit unions, this change in leasing costs will inevitably lead to higher fees and/or fewer services for the men and women they serve.

Investments in securities by federal credit unions

NAFCU supports this effort to increase investment options for federal credit unions by allowing certain limited investments in securities. The current limitations in the FCUA unduly restrict federal credit unions in today's dynamic financial marketplace and have the potential of adversely impacting both safety and soundness in the future. We believe that the track record of safe and sound performance by credit unions warrants expanded investment authority in accordance with regulations promulgated by the NCUA Board.

Increase in general 12-year limitation of term of federal credit union loans

NAFCU supports increasing the general 12-year limit on federal credit union loans to 15 years or longer as permitted by the NCUA Board. The current 12-year limit is outdated and does not conform to maturities that are commonly accepted in the market today. We believe that it is also important that the NCUA Board have the discretionary authority to extend this limitation beyond 15 years when necessary in order to appropriately address marketplace conditions.

Increase in one-percent investment limit in credit union service organizations

NAFCU supports this provision to increase the one percent investment limit in credit union service organizations (CUSOs). However, in lieu of just raising the limit to three percent, as found in both the *Financial Services Regulatory Relief Act of 2004* and CURIA. NAFCU recommends that Congress give the NCUA Board authority to establish an appropriate investment limit recognizing that as time goes on, that limit may legitimately warrant further adjustment.

Member business loan exclusion for loans to non-profit religious organizations

NAFCU supports this effort to exclude loans or loan participations by federal credit unions to non-profit religious organizations from the member business loan limit.

Check-cashing and money-transfer services offered to those within the credit union's field of membership

NAFCU supports efforts to allow federal credit unions to offer check-cashing and money-transfer services to anyone within the credit union's field of membership. We believe this new authority, which would be discretionary and not mandatory, will allow credit unions to help combat abuses by non-traditional financial institutions that prey on our nation's immigrants and others who live and work in underserved communities.

Voluntary mergers involving multiple common bond credit unions

Current law imposes a numerical limitation of 3,000 on the size of a group that can go forward with a credit union merger before considering spinning off the group and requiring it to form a separate credit union. There is no sound reason for this restriction and NAFCU believes the 3,000 limit is arbitrary. In addition, a credit union that converts to (or merges into) a community charter should be allowed to retain all employee groups in its field of membership at the time of conversion. Current law does not allow this, penalizing not only the credit union, but also those in its field of membership. In addition, we believe that the retroactive effective date of August 7, 1998 (the date of enactment of CUMAA), is an important part of this section and must be maintained.

Community charter conversions involving employee group credit unions

NAFCU supports efforts that give NCUA the authority to allow credit unions to continue to serve and add members from their select employee groups (SEGs) after a credit union converts to a community charter.

Credit union governance

The FCUA contains many antiquated "governance" provisions that, while perhaps appropriate in 1934, are outdated, unnecessary and inappropriate restrictions on the day-to-day operations and policies of a federal credit union. For example, credit unions are not allowed to expel disruptive or threatening members without a two-thirds vote of the membership. NAFCU supports other provisions in the House-passed *Financial Services Regulatory Relief Act of 2004* which would:

- allow credit unions to limit the length of service of members of the board of directors to ensure broader representation; and
- allow credit unions to reimburse volunteers on the board of directors for wages they would otherwise forfeit by participating in credit union-related activities.

In addition, NAFCU also believes that there are many more governance provisions in the *Federal Credit Union Act* that are out-of-date and that could be better addressed by the NCUA Board. These include:

- Allow the NCUA Board to set the amount at which the credit union board of directors must approve a loan to, or guaranteed by, a director or member of the credit union supervisory or credit committee (currently the Act sets it at $20,000); and,
- Allow the NCUA Board to determine policies for review of approved or pending applications for membership to the credit union (currently the Act stipulates that the Board must review approved or pending applications monthly).

<u>Providing NCUA with greater flexibility in responding to market conditions</u>
NAFCU supports the idea of giving NCUA the authority to adjust interest rates depending on market conditions. Under current law, federal credit unions are the only type of insured institutions subject to federal usury limits on consumer loans.

<u>Exemption from pre-merger notification requirement of the Clayton Act</u>
NAFCU supports the inclusion of this language which would exempt credit unions, just as banks and thrifts are already exempt, from the pre-merger notification requirements of the *Hart-Scott-Rodino Act*.

<u>Treatment of credit unions as depository institutions under securities laws</u>
Gramm-Leach-Bliley provided banks with registration relief from certain enumerated activities, and section 201 of the *Financial Services Regulatory Relief Act* provides

similar relief to thrifts. NAFCU supports providing credit unions regulatory relief along those same lines from the requirement that they register with the Securities and Exchange Commission as broker/dealers when engaging in certain activities.

There are also additional regulatory relief provisions included in CURIA that are not included in the *Financial Services Regulatory Relief* as it passed the House:

Risk-based capital

NAFCU supports this effort to modernize credit union capital requirements by redefining the net worth ratio to include risk assets. This would result in a new, more appropriate measurement to determine the relative risk of a credit union's assets and improve the safety and soundness of credit unions and the National Credit Union Share Insurance Fund.

Limits on member business loans

NAFCU supports elimination of the current asset limit on member business loans at a credit union from the lesser of 1.75 times actual net worth or 1.75 times net worth required for a well-capitalized credit union, and replacing it with a flat rate of 20 percent of the total assets of a credit union. NAFCU believes this provision would facilitate member business lending without jeopardizing the safety and soundness of participating credit unions. While the current cap was first imposed on credit unions as part of the *Credit Union Membership Access Act* in 1998, CUMAA also directed the Treasury Department to study the need for such a cap. In 2001, the Treasury Department released its study entitled "Credit Union Member Business Lending" in which it concluded that "credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions." That same study also found that over 50 percent of credit loans were made to businesses with assets under $100,000, and 45 percent of credit union business loans go to individuals with household incomes of less than $50,000. We would urge the Committee to review this study and give it the weight it deserves when considering these provisions. NAFCU also supports revising the current definition of a member business loan by giving the NCUA the authority to exclude loans of $100,000 or less as de minimus, rather than preserving the current threshold of $50,000.

Leasing space in buildings with credit union offices in underserved areas

NAFCU supports the provision in CURIA that enhances the ability of credit unions to assist distressed communities with their economic revitalization efforts. It would allow a credit union to lease space in a building or on property in an underserved area in which it maintains a physical presence to other parties on a more permanent basis. It would permit a federal credit union to acquire, construct, or refurbish a building in an underserved community, and lease out excess space in that building.

Should the Committee decide to consider CURIA, we would like to call the Committee's attention to some additional issues that we believe should be added to the legislation:

Modify the statutory definition of "net worth" to mean "equity" rather than the "retained earnings balance" of the credit union as determined under generally accepted accounting principles

Currently, credit union mergers are accounted for by using the "pooling method," meaning that the net worth of each merging credit union is combined to form the net worth of the surviving credit union: $5M (net worth of credit union A) + $5M (net worth of credit union B) = $10M (net worth of credit union AB). However, the Financial Accounting Standards Board (FASB) has proposed eliminating pooling and imposing the "purchase method" of accounting on credit union mergers. Using this method and the current definition of net worth which is "retained earnings" as required by PCA, the net worth of the surviving credit union is only $5M ($5M (net worth of credit union A) + $5M (net worth of credit union B) = $5M (net worth of credit union AB)). Therefore, under the purchase method of accounting, only the surviving credit union's retained earnings count as net worth for PCA purposes. As a result, the surviving credit union may have trouble meeting PCA requirements, unless credit union net worth is redefined to mean equity. It should also be noted that the FASB has reviewed this proposed amendment and has noted in a letter to NAFCU that they "have an interest in supporting an expedited resolution of this matter" and that this amendment "proposes a way to resolve this matter."

Relax the "reasonable proximity" requirement

This requirement imposes an undue burden on credit unions, requiring them to have a physical presence within a reasonable proximity of the location of a group that the credit union wants to add to its field of membership. In today's financial services marketplace, the increase in Internet and remote banking has rendered this requirement unnecessary.

We hope that the Committee will consider these issues as the bill moves forward in the legislative process.

Conclusion

NAFCU believes that the state of the credit union community is strong and the safety and soundness of credit unions is unquestionable. Nevertheless, there is a clear need for easing the regulatory burden on credit unions as we move forward into the 21st century financial services marketplace. We urge the Committee to consider the important provisions we have outlined in this testimony for any future effort to provide regulatory relief for credit unions. We look forward to working with you on this important matter and would welcome your comments or questions.

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WRITTEN TESTIMONY
OF
SHARON CUSTER
PRESIDENT & CEO, BMI FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
"CREDIT UNION REGULATORY IMPROVEMENTS"
BEFORE THE
HOUSE FINANCIAL INSTITUTIONS SUBCOMMITTEE

JULY 20, 2004

Table of Contents

WRITTEN TESTIMONY
OF
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PRESIDENT & CEO, BMI FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
"CREDIT UNION REGULATORY IMPROVEMENTS"
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Introduction

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, on behalf of the Credit Union National Association (CUNA), I appreciate this opportunity to come before you and express the association's views on the need to address legislation to help address regulatory improvements that would enable credit unions to improve service to their nearly 85 milllion members.

CUNA is the largest credit union advocacy organization, representing over 90% of our nation's approximately 9,400 state and federal credit unions and their 85 million members.

I am Sharon Custer, President and CEO of BMI Federal Credit Union in Columbus, Ohio. BMI FCU was chartered in 1936 to serve the employees of Battelle Memorial Institute, a private research facility, in Columbus, Ohio. Today BMI FCU has $210 million in assets and 27,000 members. The original sponsor, Battelle, still has 2,200 employees in Columbus, but BMI FCU now provides services to an additional 250 select employee groups. These select employee groups range from the 2,000-member Carpenters Local 200 to very small companies with less than 10 employees.

BMI FCU provides financial services through a variety of delivery channels, always keeping focused on its slogan "Technically Minded, People Driven". For members who want electronic service there is home banking with free bill-paying, e-statements and online loan applications. For members who want personal service, there are five locations accessible to all members and four branches within sponsor facilities. BMI FCU is also a member of the 1,400-location shared branch network and a surcharge-free credit union ATM network.

BMI FCU's most unique branch is within a retirement community, providing services to residents and employees of the community. After a year of operation, the branch has $8 million in deposits from members who are residents of the community, and over $1 million in deposits in the business account of the retirement community.

BMI FCU has made a commitment to supporting small businesses. The business services deposit program was implemented in 2002 to provide checking and savings services small business members. Business lending was added in the fall of 2003. To date, nearly $2 million has been made in small business loans, ranging from $51,000 to $400,000.

Two scholarship programs were developed to support education in our community. The Jack Deibert Memorial Scholarship provides $4,000 in scholarships to BMI FCU members each year. The Mary Jo Meinrad Memorial Nursing Scholarship provides $5,000 in nursing scholarships each year. The BMI FCU Community Relations Committee distributes an addition $20,000 in charitable contributions each year.

We are grateful to the Subcommittee and full Committee, as well as the House, for the passage of the H.R. 1375. As you know, however, the effort to pass a regulatory relief bill for all financial service institutions is currently stalled in the Senate.

Some might suggest that the Credit Union Membership Access Act (CUMAA) was the credit union version of regulatory relief. While that law did provide relief from an onerous U.S. Supreme Court decision, it also imposed several new, stringent regulations on credit unions, which, in spite of assertions to the contrary, are the most stringently regulated of insured financial institutions.

Credit Unions Are Distinct Financial Institutions

Among its numerous provisions, the Credit Union Membership Access of 1998[1] (CUMAA) required the U. S. Department of the Treasury to evaluate the differences between credit unions and other types of federally insured financial institutions, including any differences in the regulation of credit unions and banks.

The study, "Comparing Credit Unions with Other Depository Institutions," found that while "credit unions have certain characteristics in common with banks and thrifts, (e.g., the intermediation function), they are clearly distinguishable from these other depository institutions in their structure and operational characteristics."

[1] Pub. L. No. 105-219 Sec. 401; 112 Stat. 913 (1998); 12 USC 1752a note and 1757a note

These qualities, catalogued by the U.S. Treasury in its 2001 study, had been previously incorporated into the Congressional findings of the Federal Credit Union Act[2] when CUMAA was adopted in 1998.

Recognition and appreciation of such attributes is critical to the understanding of credit unions, as Congress made it clear when it amended the FCU Act in 1998 that it is these characteristics that form the foundation on which the federal tax exemption for credit unions rests. As Congress determined when it passed CUMAA:

"Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are:

1. member-owned,
2. democratically operated,
3. not-for profit organizations,
4. generally managed by volunteer boards of directors, and
5. because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means."

While other institutions, such as mutual thrifts, may meet one or two of these standards or display some of these differences, other credit union distinctions listed here do not necessarily apply. As Treasury noted in its study, "Many banks or thrifts exhibit one or more of ...(these) characteristics, but only credit unions exhibit all five together." [3]

[2] P. L. 105-219, Sec. 2, 112 Stat. 913
[3] U.S. Dept. of the Treasury, *Comparing Credit Unions with Other Depository Institutions, (Wash. DC: 2001.)*

Other 1998 congressional findings in the FCU Act also emphasize the unique nature of credit unions:

(1) "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.

(2) "Credit unions continue to fulfill this public purpose and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.

Since their inception, credit unions continue to share these unique attributes, separating them from other depository institutions. Despite the frequent attempts of detractors to present credit unions in a false light and label them just like other types of institutions, the distinct characteristics of credit unions have been recognized in the statute and in analytical reports from the U.S. Treasury and others. Further, despite repeated attempts, legal challenges brought by banking groups against NCUA's field of membership policies under the Credit Union Membership Access Act have not proved fruitful.

As distinct institutions, credit unions today stand distinctly in need of regulatory relief.

Credit Unions' Regulatory Burden Is *Real* And Relief Is Imperative

As cooperative financial institutions, credit unions have not been shielded from the mounting regulatory responsibilities facing insured depositories in this country. Recently, Federal Deposit Insurance Corporation (FDIC) Vice Chairman John M. Reich said in testimony before the House

Subcommittee on Financial Institutions and Consumer Credit, "regulatory burden is a problem for all banks." His statement is accurate as far as it goes.

Regulatory burden is an issue for all financial institutions generally, and credit unions in particular. Indeed, credit unions **are the most heavily regulated of all financial institutions.** This dubious distinction is the result of several factors, which include:

- Credit unions operate under virtually the same consumer protection rules, such as the Truth-Lending Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act, Truth-in-Savings Act, Expedited Funds Availability Act, USA Patriot Act, Bank Secrecy Act, safety and soundness regulations, including prompt corrective action regulations, and other rules that apply to banks. Credit unions will also have to comply with developing rules under the Fair and Accurate Credit Transactions (FACT) Act and the Check 21 statutory requirements. A list of the over 135 rules that federal credit unions must follow is attached.

(1) Credit unions are the only type of financial institution that have restrictions on whom they may serve;

(2) Federal credit unions are the only group of financial institutions that must comply with a usury ceiling;

(3) Credit unions may not raise capital in the marketplace but must rely on retained earnings to build equity;

(4) Credit unions are the only group of financial institutions that must meet statutory net worth requirements;

(5) Credit unions face severe limitations on member business lending;

(6) Credit unions have limitations on loan maturities;

(7) Credit unions have stringent limitations on investments;

(8) Credit unions have not been granted new statutory powers, as banks have under Gramm-Leach Bliley; and

(9) Credit unions' operations and governance are inflexible because many aspects are fixed in statute.

Most importantly for credit unions, time and other resources spent on meeting regulatory requirements are resources that would otherwise be devoted to serving their members – which is, after all, their primary objective.

With Few Exceptions, Credit Unions Must Comply with Virtually All Bank Rules

Despite unfounded banker charges to the contrary, federally insured credit unions bear an extraordinary regulatory burden that is comparable to that of banks in most areas and much weightier in others.

As the Treasury's 2001 study comparing credit unions with other institutions concluded, "Significant differences (in the general safety and soundness regulation of banks and credit unions, parenthesis added) have existed in the past, but have been gradually disappearing." The Treasury study cited prompt corrective action and net worth requirements for credit unions as a major regulatory difference that was removed in 1998.

Treasury further noted that their "relative small size and restricted fields of membership" notwithstanding, "federally insured credit unions operate under bank statutes and rules virtually identical to those applicable to banks and thrifts."

Credit Unions Must Comply With Substantial Requirements Banks Don't Have to Follow

In addition to following rules applicable to the banking industry, credit unions operate under considerable statutory and regulatory requirements that do not apply to other types of financial institutions.

As Treasury's study pointed out, credit union statutory net worth requirements direct federally insured credit unions to maintain a minimum of 6% net worth to total assets in order to meet the definition of an adequately capitalized credit union. Well-capitalized credit unions must meet a 7% net worth ratio. "(T)his exceeds the 4% Tier 1 level ratio applicable for banks and thrifts (and is statutory as opposed to regulatory)," Treasury stated. Complex credit unions have additional net worth requirements.

Treasury's analysis also pointed to the fact that **"federal credit unions have more limited powers than national banks and federal saving associations. Most notably, federal credit unions face stricter limitations on their (member business)** ...lending and securities activities. In addition, a usury ceiling prevents them from charging more than 18% on any loan, and the term of many types of loans may not extend beyond twelve years."

Credit unions also have statutory and regulatory restrictions as to whom they may serve. Federal credit unions' fields of membership must meet the common bond requirements that apply to an associational, occupational, multi-group or community credit union. Thus, unlike banks and thrifts, which may serve anyone regardless of where they live or work, a credit union may only offer its services to individuals within its field of membership.

Credit unions operate under heavily constrained investment authority as well. A federal credit union may invest in government securities and other investments only as provided under the Federal Credit Union Act and authorized by NCUA.

Credit unions also must comply with limitations on lending, including member business lending. A federal credit unions' member business loans may not exceed the lesser of 1.75 times its net worth or 12.25 percent of total assets, unless the credit union is chartered to make such loans, has a history of making such loans or has been designated as a community development credit union. By comparison, banks have no specific limits on commercial lending and thrifts may place up to 20% of their total assets in commercial loans.

It is useful to note that there are other limitations on credit unions' member business lending that do not apply to commercial banks. A credit union's MBLs must generally meet 12-year maturity limits and can only be made to members. Credit union MBLs have significant collateral requirements and while not required, often carry the personal guarantee of the borrower.

Commercial banks have a variety of mechanisms through which they can raise funds, including through issuing stock or borrowing funds in the capital markets. In marked contrast, credit unions may only build equity by retaining earnings. A credit union's retained earnings are collectively owned by all of the credit unions' members, as opposed to a bank that is owned by a limited number of stockholders or in some cases, by a finite number of individuals or family members.

Thus, a major distinction between credit unions and commercial banks is that credit unions operate under a number of specific, operational regulations that do not apply to banks. Bank trade associations attempt to mislead Congress when they erroneously argue that credit unions have evolved into banks. The restrictions on credit union operations and the limitations on their activities drive a stake into the heart of that argument.

Unlike Banks, Credit Unions Have Not Received New Statutory Powers

Not only have credit unions not received new statutory powers as banks have, severe regulatory constraints on member business lending and under prompt corrective action have been imposed on credit unions for the last several years.

An important study regarding the regulation of credit unions was published last year under the auspices of the Filene Research Institute and addresses the regulatory advantages banks have over credit unions.

Authored by Associate Professor of Economics William E. Jackson, III, Kenan-Flagler Business School, University of North Carolina at Chapel Hill and entitled, "The Future of Credit Unions: Public Policy Issues,"[4] the study looked at the efforts of Congress over the last two decades to provide regulatory relief for traditional depository institutions and whether more relief for credit unions is reasonable and appropriate.

[4] Jackson, III, William E., University of North Carolina-Chapel Hill. ***The Future of Credit Unions: Public Policy Issues, 2003.***

The study reviewed sources of funding, investments, and the ownership structure of banks, thrifts and credit unions and found that the operational differences among these types of institutions are "distinctive." It observed that since 1980, Congress has enacted a number of statutory provisions that have noticeably changed the regulatory environment in which banks and thrifts conduct business, such as by deregulating liabilities; removing restrictions on interstate branching; and expanding the list of activities permissible for financial holding companies.

Of particular note, the Gramm-Leach-Bliley Act of 1999 expanded the statutory definition of the kinds of products and services in which banks may engage. Under the Act, banking institutions may engage in activities that are merely "financial in nature" as opposed to those that are "closely related to banking." The bank regulators have the authority to determine what is permissible as "financial in nature." Credit unions were not included in this sweeping, statutory expansion of bank powers. However, while they received neither benefits nor new powers under the Gramm-Leach-Bliley Act, credit unions were included in the substantial requirements under the Act regarding privacy, including requirements to communicate their member privacy protection policies to members on an annual basis.

The Jackson study noted, "Credit unions face stricter limitations on their lending and investing activities" than other institutions bear. "In general, credit unions have received less deregulation than either banks or thrifts," the study concluded.

Pending Credit Union Regulatory Relief Legislation That CUNA Supports

CUNA strongly supports H.R. 3579, the Credit Union Regulatory Improvements Act (CURIA), which currently has 60 co-sponsors. CUNA has also endorsed of H.R. 1375, the House-passed Regulatory Relief Act, which was approved by the House of Representatives on March 18, 2004, by a vote of 392-25.

As previously mentioned, while CUNA is grateful for the House's action on H.R. 1375, we are particularly hopeful that this Subcommittee will act on H.R. 3579. CURIA represents a step forward in the effort to provide credit unions with significant relief.

H.R. 3579—The Credit Union Regulatory Improvements Act (CURIA)

In addressing the provisions in CURIA, let me first express the gratitude of the entire credit union movement to Rep. Royce, the original bill sponsor, along with Reps. Kanjorski, LaTourette, and Maloney, who were the bill's original co-sponsors, as well as all of the other co-sponsors. CURIA provides a sound foundation for this Subcommittee's consideration of some fundamental problems facing credit unions today, and we ask you to take a close look at these proposed changes.

H.R. 3579, THE CREDIT UNION REGULATORY IMPROVEMENTS ACT OF 2003–SECTION-BY-SECTION DESCRIPTION

TITLE I: Regulatory Flexibility

Section 102. Leases of land on federal facilities for credit unions

This provision would permit military and civilian authorities responsible for buildings on federal property the discretion to extend to credit unions that finance the construction of credit union facilities on federal land real estate leases at minimal charge. Credit unions provide important financial benefits to military and civilian personnel, including those who live or work on federal property. This amendment would authorize an affected credit union, with the approval of the appropriate authorities, to structure lease arrangements to enable the credit union to channel more funds into lending programs and favorable savings rates for its members.

Section 103. Investments in securities by federal credit unions

The Federal Credit Union Act limitations on the investment authority of federal credit unions are anachronistic and curtail the ability of a credit union to respond to the needs of its members. The amendment provides additional investment authority to purchase for the credit union's own account certain investment securities; that is, marketable obligations such as corporate bonds or debentures. The total amount of the investment securities of any one obligor or maker could not exceed 10 percent of the credit union's unimpaired capital and surplus. The NCUA Board would have the authority to define appropriate investments under this provision, thus ensuring that new investment vehicles would meet high standards of safety and soundness and be consistent with credit union activities. This provision would not authorize federal credit unions to invest in corporate stock.

Section 104. Increase in general 12-year limitation of term of federal credit union loans

Currently, federal credit unions are authorized to make loans to members, to other credit unions, and to credit union service organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a 12-year maturity limit that is subject to limited exceptions. This section would allow loan maturities up to 15 years, or longer terms as permitted by the National Credit Union Administration (NCUA) Board.

As a Federal credit union, my institution must comply with this limitation. We are very concerned that members seeking to purchase certain consumer items, may seek financing elsewhere in which they could repay the loan over a longer period of time than 12 years. While we would prefer for NCUA to have authority to determine the maturity on loans, consistent with safety and soundness, a 15-year maturity is preferable to the current limit. Such an increase in the loan limit would help lower monthly payments for credit union borrowers and benefit credit unions as well as their members.

Section 105. Increase in the one-percent investment limit in credit union service organizations

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than 1% of its shares and undivided earnings in these organizations, commonly known as credit union service organizations or CUSOs. The amendment raises the limit to 3% percent.

CUSOs provide a range of services to credit unions and allow them to offer products to their members that they might not otherwise be able to do, such as financial planning and retirement planning. Utilizing services provided through a CUSO reduces risk to a credit union and allows it to take advantage of economies of scale and other efficiencies that help contain costs to the credit union's members. Further, as federal credit union participation in CUSOs is fully regulated by NCUA, the agency has access to the books and records of the CUSO in addition to its extensive supervisory role over credit unions.

The current limit on CUSO investments by federal credit unions is out-dated and limits the ability of credit unions to participate with these organizations to meet the range of members' needs for financial services. It requires credit unions to arbitrarily forego certain activities that would benefit members or use outside vendors in which the credit union has no institutional stake. While we feel the 1% limit should be eliminated or set by NCUA through the regulatory process, we appreciate that the increase to 3% will provide credit unions more options to invest in CUSOs to enhance their ability to serve their members.

CUNA also would support raising the borrowing limitation that currently restricts loans from credit unions to CUSOs to 1 percent. We believe the limit should be on par with the investment limit, which under this bill would be raised to 3 percent.

Section 106. Member business loan exclusion for loans to non-profit religious organizations

This section, first introduced as a separate bill by Rep. Royce, excludes loans or loan participations by federal credit unions to non-profit religious organizations from the member business loan limit contained in the Federal Credit Union Act, which is 12.25% of the credit union's total assets. It would offer some relief in this area by allowing federal credit unions to make member business loans to religious-based organizations without concern about the statutory limit that now covers such loans. While the limit would be eliminated, such loans would still be subject to other regulatory requirements, such as those relating to safety and soundness.

We believe that this is really a technical amendment designed to correct an oversight during passage of the Credit Union Membership Access Act. The law currently provides exceptions to the member business loan caps for credit unions with a history of primarily making such loans.

Congress simply overlooked other credit unions that purchase parts of these loans, or participate in them. This provision would clarify that oversight and ensure that these organizations can continue meeting the needs of their members and the greater community at large, and ensure that loans are available for religious buildings as well as their relief efforts.

Section 107. Check-cashing and money-transfer services offered within the field of membership

Federal credit unions are currently authorized to provide check cashing services to members and have limited authority to provide wire transfer services to individuals in the field of membership under certain conditions. The amendment would allow federal credit unions to provide check cashing and wire transfer services to anyone eligible to become a member.

This amendment is fully consistent with President Bush's and Congressional initiatives to reach out to underserved communities in this country, such as some Hispanic neighborhoods. Many of these individuals live from pay check to pay check and do not have established accounts, for a variety of reasons, including the fact that they do not have extra money to keep on deposit. We know of situations where members join one day, deposit their necessary share balance and come in the very next day and withdraw because they need the money. This is not mismanagement on their part. They just do not have another source of funds. And sometimes, a $5.00 withdrawal means the difference between eating or not.

If we are able to cash checks, sell negotiable checks such as travelers checks, and provide remttance services to eligible members, we could accomplish two things: save our staff time and effort opening new accounts for short term cash purposes which are soon closed, and gain the loyalty and respect of the potential member so that when they are financially capable of establishing an account, they will look to the credit union, which will also provide financial education and other support services.

Rep. Joe Baca has introduced legislation, H.R. 4348, the Financial Services For All Act, that is supported by CUNA and would provide similar authority but also permit credit unions the ability to offer these services on a wider basis.

Section 108. Voluntary mergers involving multiple common bond credit unions

In voluntary mergers of multiple bond credit unions, NCUA has determined that the Federal Credit Union Act requires it to consider whether any employee group of over 3,000 in the merging credit union could sustain a separate credit union. This provision is unreasonable and arbitrarily limits the ability of two healthy multiple common bond federal credit unions from combining their financial resources to serve their members better.

The amendment is a big step forward in facilitating voluntary mergers, as other financial institutions are permitted to do. It provides that the numerical limitation does not apply in voluntary mergers.

Section 109. Conversions involving common bond credit unions

This section allows a multiple common bond credit union converting to or merging with a community charter credit union to retain all groups in its membership field prior to the conversion or merger. Currently, when a multiple group credit union converts to or merges with a community charter, a limited number of groups previously served may be outside of the boundaries set for the community credit union. For instance, a new employee of a group now outside of a community federal credit union's boundaries is ineligible for service from that community credit union. The amendment would allow the new community credit union to provide service to all employees of groups previously served.

Section 110. Credit union governance

This section would give federal credit union boards flexibility to expel a member who is disruptive to the operations of the credit union, including harassing personnel and creating safety concerns, without the need for a two-thirds vote of the membership present at a special meeting as required by current law. Also, federal credit unions would be authorized, but not required, to limit the length of service of their boards of directors to ensure broader representation from the membership. Finally, this section would allow, but not require, federal credit unions to reimburse board of director volunteers for wages they otherwise forfeit by participating in credit union affairs.

Credit unions should have the right to limit the length of service of their boards of directors as a means to ensure broader representation from the membership. Credit unions, rather than the federal government, should determine term limits for board members. Providing credit unions with this right does not raise supervisory concerns and should not, therefore, be denied by the federal government.

Credit unions are directed and operated by committed volunteers. Given the pressures of today's economy on many workers and the legal liability attendant to governing positions at credit unions, it is increasingly difficult to attract and maintain such individuals. Rather than needlessly discourage volunteer participation through artificial constraints, the Federal Credit Union Act should encourage such involvement by allowing credit unions to determine whether to reimburse wages lost when carrying out their board representation. Whether or not a volunteer attends a meeting or training session is sometimes determined by whether or not that volunteer will have to miss work and not be paid.

Section 111. Providing NCUA with greater flexibility in responding to market conditions

Under this section, in determining whether to lift the usury ceiling for federal credit unions, NCUA will consider rising interest rates or whether prevailing interest rate levels threaten the safety and soundness of individual credit unions.

Section 112. Leasing Space in Buildings with Credit Union Offices in Underserved Areas

This section, proposed previously by Rep. Kanjorski, enhances the ability of credit unions to assist distressed communities with their economic revitalization efforts. It would allow a credit union to lease space in a building or on property in an underserved area on which it maintains a physical presence to other parties on a more permanent basis. It would permit a federal credit union to acquire, construct, or refurbish a building in an underserved community, then lease out excess space in that building.

Section 113. Credit Union Conversion Voting Requirements

This section would change the Federal Credit Union Act which now permits conversions after only a majority of those members voting approve a conversion, to require a majority vote of at least 20 percent of the membership to approve a conversion.

Time and time again, Congress has made clear its support for credit unions, in order to assure consumers have viable choices in the financial marketplace. Yet, banking trade groups and other credit union detractors have indicated they would like to encourage credit union conversions, particularly those involving larger credit unions, in order that they may control the market, thereby limiting consumers' financial options.

In February, the National Credit Union Administration adopted new regulatory provisions to require credit unions seeking to change their ownership structure to provide additional disclosures to their members to insure they are adequately informed regarding the potential change and are fully aware of the consequences of such action. CUNA strongly supported this action because we feel members should know that their rights and ownership interests will change, particularly if the institution converts to a bank. In such a situation the institution would "morph" from one in which the members own and control its operations to an institution owned by a limited number of stockholders.

CUNA likewise supports the agency's ongoing efforts to ensure members are provided sufficient disclosures and opportunities to present opposing views in relation to a possible conversion.

Congress addressed conversions in the Credit Union Membership Access Act and reinforced that a credit union board that desires to convert must allow its members to vote on its conversion plan. CURIA would require a minimum level of participation in the vote -- at least 20% of the members -- for a conversion election to be valid. Currently, there is a requirement that only a majority of those voting approve the conversion. The legislation would prevent situations in which only a very small number of an institution's membership could successfully authorize such a conversion.

Earlier this year, CUNA's Governmental Affairs Committee developed a resolution that was adopted by our Board relating to credit union ownership, and we want to share its provisions with the Committee.

- The credit union charter presents the best vehicle for serving the financial needs of consumers;
- Credit unions considering changing ownership structure to a bank or thrift charter should decide solely on the basis of what is best for the members of the credit union--not for the management or directors;
- The credit union system should identify and recommend ways to keep the credit union's net worth in the hands of its members;
- Credit unions should provide plain language, full disclosure of all relevant information--including the pros and cons--of a change in the ownership and governance of the credit unions;
- Ensure that credit union senior management and directors are not unjustly enriched, and that appropriate penalties will be imposed for noncompliance with disclosure and other requirements designed to protect the interests of the members; and
- CUNA is rededicated to the improvement of the credit union charter.
- CUNA will continue to look for ways, working with Congress and regulators, to insure a credit union's membership is fully aware of the consequences of a conversion prior to any membership vote.

Section 114. Exemption from pre-merger notification requirement of the Clayton Act

This section gives all federally insured credit unions the same exemption as banks and thrift institutions already have from pre-merger notification requirements and fees of the Federal Trade Commission.

Section 115. Treatment of credit unions as depository institutions under securities laws

This section gives federally insured credit unions exceptions, similar to those provided to banks, from broker-dealer and investment adviser registration requirements.

Title II: Member Business Lending

Section 201. Limits on Member Business Loans

This section eliminates the current asset limit on member business loans at a credit union from the lesser of 1.75 times actual net worth or 1.75% times net worth required for a well-capitalized credit union and replaces it with a flat rate of 20 percent of the total assets of a credit union. This provision therefore facilitates member business lending without jeopardizing safety and soundness at participating credit unions.

Section 202. Definition of Member Business Loans

This section would amend the current definition of a member business loan to facilitate such loans by giving the NCUA the authority to exclude loans of $100,000 or less as de minimus, rather than the current limit of $50,000.

Section 203. Restrictions on Member Business Loans

This section would modify language in the Federal Credit Union Act that currently prohibits a credit union from making any new member business loans if its net worth falls below 6 percent. This change will permit the NCUA to determine if such a policy is appropriate and to oversee all member business loans granted by an undercapitalized institution.

Having described briefly how CURIA would address this issue, I would like to provide the Committee with a detailed rationale for these needed changes.

HELPING SMALL BUSINESS

Title II, Section 203 of the Credit Union Membership Access Act of 1998 (CUMAA) established limits on credit union member business loan (MBL) activity. There were no statutory limits on credit union member business lending prior to1998. The CUMAA-imposed limits are expressed as a 1.75 multiple of net worth, but only net worth up to the amount required to be classified as well capitalized (i.e., 7%) can be counted. Hence the limit is (1.75 x .07) or 12.25% of assets for practically all federally insured credit unions.

NEED FOR REFORM OF CREDIT UNION MBL LIMITS

Small businesses are the engine of economic growth – accounting for about one-half of private non-farm economic activity in the U.S. annually. Their ability to access capital is paramount. But this access is seriously constrained by the double-whammy of banking industry consolidation and the CUMAA-imposed limitations on credit union MBLs. Recent research published by the Small Business Administration reveals that small businesses receive less credit on average in regions with a large share of deposits held by the largest banks. Federal Deposit Insurance Corporation statistics show that the largest 100 banking institutions now control nearly two-thirds of banking industry assets nationally. In 1992 the largest 100 banking institutions held just 45% of banking industry assets. Thus, CUMAA severely restricts small business access to credit outside the banking industry at a time when small firms are finding increasing difficulty in accessing credit within the banking industry.

Basic problems with the current MBL limits are:

- **THE LIMITS ARE ARBITRARY AND UNNECESSARILY RESTRICTIVE.** Insured commercial banks have no comparable business lending portfolio concentration limitations. Other financial institutions, savings and loans, for example, have portfolio concentration limitations, but those limitations are substantially less restrictive than the limits placed on credit unions in CUMAA.

- **THE 12.25% LIMIT DISCOURAGES ENTRY INTO THE MBL BUSINESS.** Even though very few credit unions are approaching the 12.25% ceiling, the very existence of that ceiling discourages credit unions from entering the field of member business lending. Credit unions must meet strict regulatory requirements before implementing an MBL program, including the addition of experienced staff. Many are concerned that the costs of meeting these requirements cannot be recovered with a limit of only 12.25% of assets. For example, in today's market, a typical experienced mid-level commercial loan officer would receive total compensation of approximately $100,000. The substantial costs associated with hiring an experienced lender, combined with funding costs and overhead and startup costs (e.g., data processing systems, furniture and equipment, printing, postage, telephone, occupancy, credit reports and other operating expenses) make member business lending a very unpractical option at most credit unions given the current

12.25% limitation. In fact, assuming credit unions could carry salary expense of 2% of portfolio, 76% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum. Alternatively, assuming credit unions could carry salary expense of 4% of portfolio, 63% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum.

- **THE LIMITS ARE NOT BASED ON SAFETY AND SOUNDENSS CONSIDERATIONS.** There is no safety and soundness reason that net worth above 7% cannot also support business lending. If all net worth could be counted, the actual limit would average between 18% and 19% of total assets rather than 12.25% of total assets.

- **THE MBL DEFINITIONS CREATE DISINCENTIVES THAT HURT SMALL BUSINESSES.** The current $50,000 threshold for defining an MBL is too low and creates a disincentive for credit unions to make loans to smaller businesses because they have to set up a formal member business lending program in compliance with all the requirements of Section 723 of the NCUA's regulations. Compliance with these requirements is very expensive and not cost effective for making loans of such a small amount. Thus, permitting the threshold to rise to $100,000 would open up a significant source of credit to small businesses. These "small" business purpose loans are so small as to be unattractive to many larger lenders. Simply adjusting the $50,000 threshold for inflation would result in an approximate 33% increase in the threshold to over $65,000. The $50,000 threshold was initially established in 1993 and hasn't been adjusted since that time. In fact, the NCUA was poised to adopt a $100,000 threshold by regulation in 1998 until CUMMA incorporated the $50,000 regulatory definition into statute that year.

Some bankers call credit union member business lending "mission creep." This is simply a preposterous fiction. Credit union member business lending is not new. Since their inception, credit unions have offered business-related loans to their members. Moreover, credit union member business lending shows a record of safety. According to a U.S. Treasury Department study, credit union business lending is more regulated than commercial lending at other financial institutions. In addition, the Treasury found that:

> "...member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and the loans generally must be fully collateralized. Ongoing delinquencies – for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due – are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent)."

Not surprisingly, the Treasury also concluded that member business lending "does not pose material risk to the" National Credit Union Share Insurance Fund.

Updated statistics from full-year 2000 through 2003 indicate that the favorable relative performance of MBLs reported in the Treasury study has continued in recent years. Credit union MBL net chargeoffs have averaged just 0.08% over the four-year period since the Treasury study, while the comparable average net chargeoff rate at commercial banks was 1.28% and at savings institutions was 1.11%. MBLs have even lower loss rates than other types of credit union lending, which themselves have relatively low loss experience.

Credit union member business lending represents a small fraction of total commercial loan activity in the United States. At year-end 2003, the dollar amount of MBLs was less than one-half of one percent of the total commercial loans held by U.S. depositories. Credit union MBLs represent just 2.5% of the total of credit union loans outstanding, and only 17.5% of U.S. credit unions offer MBLs. According to credit union call report data collected by the National Credit Union Administration, the median size of credit union MBLs granted in 2003 was $81,125.

An almost two-thirds increase in credit union MBL limits (from 12.25% to 20% of assets, equivalent to the business lending limit for savings institutions) would not cause these numbers to change dramatically.

Raising the current MBL limits would help small business. As noted earlier, small businesses are the backbone of the nation's economy. The vast majority of employment growth occurs at small businesses. And small businesses account for roughly half of private non-farm gross domestic product in the U.S. each year.

Small businesses are in need of loans of all sizes, including those of less than $100,000, which many have said banks are less willing to make.

Moreover, large banks tend to devote a smaller portion of their assets to loans to small businesses. The continuing consolidation of the banking industry is leaving fewer smaller banks in many markets. In fact, the largest 100 banking institutions accounted for 42% of banking industry assets in 1992. By year-end 2003, the largest 100 banking institutions accounted for 65% of banking industry assets – a 23-percentage point increase in market share in just eleven years.

This trend and its implications for small business credit availability are detailed in a recently released Small Business Administration paper. The findings reveal "credit access has been significantly reduced by banking consolidation…we believe this suggests that small businesses, especially those to which relationship lending is important, have a lower likelihood of using banks as a source of credit."

In reforming credit union MBL limits Congress will help to ensure a greater number of available sources of credit to small business. This will make it easier for small businesses to secure credit at lower prices, in turn making it easier for them to survive and thrive.

Title III: Capital Levels

Section 301. Amendment to Net Worth Categories

This section modernizes credit union capital requirements by redefining the net worth ratio to include risk assets, as defined by the NCUA Board, thereby instituting a new measurement to determine the relative risk of a credit union's assets and improving the safety and soundness of credit unions and the safety of the National Credit Union Share Insurance Fund.

The following is a detailed discussion of the problem and the need for such reform.

REFORMING PROMPT CORRECTIVE ACTION

The Prompt Corrective Action (PCA) section of the Credit Union Membership Access Act of 1998 (CUMAA) established for the first time "capital" or "net worth" requirements for credit unions. Prior to that time, credit unions were subject only to a requirement to increase their regular reserves depending on the ratio of these reserves to "risk-assets" (then defined as loans and long-term investments). The purpose of Section 1790d (Prompt Corrective Action) of the Act is "to resolve the problems of insured credit unions at the least possible long-term loss to the Fund." The CUMAA instructs the National Credit Union Administration (NCUA) to implement regulations that establish a system of prompt corrective action for credit unions that is consistent with the PCA regime for banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) but that takes into account the unique cooperative nature of credit unions.

REASONS TO REFORM CREDIT UNION PCA

The legislative creation of credit union Prompt Corrective Action in 1998 was a significant first step in establishing capital requirements for credit unions. Indeed, during the first two full years of PCA's existence, the number of seriously undercapitalized credit unions has declined substantially, while the costs of resolving failed credit unions have remained modest. However, capital requirements were not the original purpose of the CUMAA. The genesis of the Act was the

Supreme Court's field of membership decision of 1998 that prohibited the NCUA from approving credit union fields of membership comprising more than one group. Most of Congress' attention at the time was necessarily devoted to resolving the field of membership issue. Therefore, it is not surprising that there should be a need for some modifications to PCA now that the NCUA and the credit union movement have some experience with it.

Basic problems with the current PCA system are:

- **HIGH BASIC CREDIT UNION CAPITAL REQUIREMENTS.** Credit unions have higher capital requirements than do banks, even though the credit union share insurance fund has an enviable record compared to other federal deposit insurance funds. Indeed, because credit unions' cooperative structure creates a systemic incentive against excessive risk taking, it has been argued that credit unions actually require less capital to meet potential losses than to other depository institutions.

- **NET WORTH RATIOS HARD-CODED INTO LAW.** Bank and thrift regulatory agencies are empowered to establish the capital ratios that place institutions into the various capitalization categories: well capitalized, adequately capitalized, inadequately capitalized, etc. In the case of credit unions, the actual numerical values for these ratios are specified in the law. This denies the NCUA the opportunity to establish net worth ratios based on its informed understanding of potential threats to the National Credit Union Share Insurance Fund.

- **LACK OF ACCESS TO CAPITAL MARKETS.** Credit unions may only use retained earnings to build net worth. They are currently not permitted any form of secondary capital, which could be used to augment retained earnings in protecting the share insurance fund and meeting capital requirements.

RISK-BASED SYSTEM COULD BE IMPROVED. In one way, the risk-based net worth requirements for credit unions under PCA represent an improvement over banks' Basel-type risk based capital requirements. The credit union system explicitly accounts for both interest-rate and credit risk. The current Basel system considers only credit risk. However, the Basel system's method of applying different risk weights to assets permits a more precise accounting for risk than does the credit union system, which focuses on concentrations of assets in the balance sheet.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that those credit unions with net worth ratios well below those required to be adequately capitalized should be subject to prompt and stringent corrective action. There is no desire to shield such credit unions from PCA. They are indeed the appropriate targets of PCA. However, the pernicious effects of PCA have been on those credit unions that have more than enough capital to operate in a safe and sound manner, but that feel constrained by potential future reductions in their net worth ratios that can result from growth in member deposits. The law stipulates that a credit union with a 6% net worth ratio is "adequately" capitalized. Considering the risk exposure of the vast majority of credit unions, 6% is indeed a completely adequate level of net worth. However, because of PCA, a very well run, very healthy, very safe and sound credit union cannot feel comfortable operating with just a 6% net worth ratio. This is because of the effect of potential growth on a credit union's net worth ratio. Without access to capital markets, a spurt of growth brought on by members' desire to save more at their credit union can quickly lower a credit union's net worth ratio, even if the credit union maintains a healthy net income rate.

This effect goes far beyond those credit unions that are close to the 6% cutoff for being considered adequately capitalized. Again because of the conservative management style that is the product of their cooperative structure, most credit unions wish to be always classified as "well" rather than "adequately" capitalized. In order to do that, they must maintain a significant cushion above the 7% level required to be "well" capitalized so as not to fall below 7% during a period of rapid growth. A typical target is to have a 200 basis point cushion above the 7% standard. Thus, in effect, the PCA regulation, which was intended to ensure that credit unions maintain a 6% capital ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50% higher than that level. The PCA regulation in its present form thus incents credit unions to operate at "overcapitalized" levels. This reduces the ability of credit unions to provide benefits to members and to grow.

There are two ways to resolve these problems. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the share insurance fund and does not upset the unique cooperative ownership structure of credit unions. Secondary capital could come either from members in the form of uninsured shares, or from nonmembers in the form of subordinated debt or trust preferred securities. There would likely be limits on the extent to which a credit union could rely on secondary capital to meet net worth requirements. For example, secondary capital might be limited to no more than 50% of total capital for purposes of meeting net worth requirements. That said, the rest of this section of the testimony deals with reforming basic PCA requirements rather than with secondary capital.

The other solution would be a reform of PCA requirements themselves. Reform of prompt corrective action should have two primary goals. First, it should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized. This will maintain the very strong incentives for credit unions to avoid becoming seriously undercapitalized. This is essential to achieving the purpose of minimizing losses to the share insurance fund. Second, a reformed PCA should not induce well-capitalized credit unions to feel the need to establish such a large buffer over minimum net worth requirements that they feel required to become overcapitalized.

CUNA believes that the best way to reform PCA consistent with these two requirements would be to transform the system into one which is much more explicitly based on risk measurement. Because of the variety of risk exposures a credit union could come under for a given level of assets, the riskiness of those assets should be given greater consideration in determining capital adequacy.

Such a reform could be achieved by modifying the definition of the "net worth ratio" for PCA as contained in the Act. Specifically, the current definition "the ratio of the net worth of the credit union to the total assets of the credit union" would be changed by inserting "risk" between "total" and "assets." The Act would further authorize NCUA to establish a system for determining risk assets based on its knowledge of credit union balance sheets and in a fashion designed to minimize losses to the share insurance fund.

A conversion to a risk based system would also need to incorporate a minimum core leverage requirement to ensure that an undercapitalized credit union that held primarily non-risk assets would not be inappropriately shielded from PCA. To that end, in addition to maintaining the stipulated level of net worth to total risk assets, a credit could be required to maintain a ratio of net worth to total assets of at least 4% to be considered adequately capitalized. Further, any credit union with a ratio of net worth to total assets of less than 3% or 2% would be considered significantly or critically undercapitalized respectively, regardless of its net worth ratio.

Under this proposal, a credit union's PCA capitalization classification would be determined as follows:

	Ratio of Net WorthTo Risk Assets*		Ratio of Net WorthTo Total Assets*
Well Capitalized	Over 7%	&	5% and above
Adequately Capitalized	6% and above	&	4% and above
Undercapitalized	4% and above	&	3% and above
Significantly Undercapitalized	2% and above	&	2% and above
Critically Undercapitalized	Under 2%	or	Under 2%

*If a credit union's net worth ratio falls into different categories by risk and total assets, the lower classification would apply.

This reform proposal involves improving the risk-based components of PCA and placing greater emphasis on the risk-based measures, while lowering the pure net worth ratio requirements to be classified as adequately capitalized. It also maintains a basic 4% net worth requirement regardless of risk (compared to the current 6% requirement) to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the net worth levels to be classified as well- or adequately-capitalized is justified for the following reasons:

1. One of the original justifications for higher credit union net worth requirements (higher than for banks) is the 1% NCUSIF deposit. However, the 1% NCUSIF deposit is a systemic, as opposed to an individual credit union issue. The purpose of PCA is to minimize losses to the Share Insurance Fund. It does this in two ways. First, it creates a powerful incentive for individual credit unions to maintain net worth ratios above those required by the regulation. Second, it requires the NCUSIF to take mandatory supervisory corrective action whenever an individual credit union's net worth ratio falls below certain levels. These corrective actions are designed to restore the credit union to an adequately capitalized level, or to force liquidation before that individual credit union's net worth is completely depleted, reducing losses to the Share Insurance Fund. The systemic issue of the 1% deposit really has nothing to do with the level of net worth at which NCUSIF might need to take corrective action with respect to any individual credit union, or to the level of net worth that an individual credit union should aspire to so as to comply with the rule. The only time the 1% issue would come into play in the context of PCA is if huge numbers of credit unions failed

concurrently, so that individual credit unions were required to write-down part of their 1% deposits. Given the strong capitalization of credit unions that PCA itself incents, and the existence of PCA to force corrective action at individual credit unions before failure, such a systemic meltdown is extremely unlikely. Therefore, one might ask why does each credit union have to be overcapitalized compared to a similarly situated bank, to guard against the extremely unlikely event that huge numbers of credit unions fail simultaneously? The answer is they should not be. Establishing credit union PCA with a higher net worth requirement than for banks because of this systemic issue is tantamount to solving the same problem twice.

2. Another reason given for credit unions' higher net worth requirements is their lack of access to capital markets. Credit unions' only source of net worth is the retention of earnings, which is a time consuming process. The idea is that since credit unions cannot access capital markets, they should hold more capital to begin with so that they have it available in time of need. There is some merit to this notion, but a problem with this logic is that is suggests that a poorly capitalized institution can easily access the capital markets. However, if an institution's net worth ratio falls substantially due to losses, investors are likely to be wary of providing additional capital. Thus lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from other depository institutions as much as it might appear. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. The other reason that a credit union's net worth ratio might fall – rapid asset growth – also should not require a higher net worth requirement for credit unions. Asset growth (which comes from savings deposits) can be substantially influenced by a credit union's dividend policies. Lowering dividend rates creates the dual effects of retarding growth and boosting net income, both of which raise net

worth ratios compared to not lowering dividend rates. A credit union should be allowed to protect a reasonable net worth ratio with aggressive dividend rate cutting rather than being required to hold additional capital. Also, a credit union could maintain a 4% net worth ratio earning 1% of assets (an earnings level consistent with the highest CAMEL rating of 1 and close to the credit union average net income ratio over the past two decades) and still grow by as much as 30% per year. Therefore, lack of access to net worth from sources other than retained earnings does not justify a higher net worth requirement for credit unions.

3. There is substantial evidence that credit unions require **less** net worth than do for-profit financial institutions for purposes of providing protection to the deposit insurance system. Credit unions, because of their very cooperative nature, take on less risk than do for-profit financial institutions. Because credit union boards and management are not incented by stock ownership and options, the moral hazard problem of deposit insurance has much less room for play in credit unions than in other insured depository institutions. Evidence of the effects of this conservative financial management by credit unions is found in the fact that average credit union ratios for net worth, net income and credit quality have shown dramatically less volatility over that past two decades than comparable statistics for banks and thrifts. Similarly, the equity ratio of the NCUSIF has been remarkably stable between 1.2% and 1.3% while other federal deposit funds have seen huge swings and even insolvency. This is hardly evidence supporting the need of more capital in credit unions than in banks and thrifts.

Reforming PCA along the lines of the risk-based approach suggested here would preserve and strengthen the essential share-insurance fund protection of PCA. It would more closely tie a credit union's net worth requirements to exposure to risk – the reason for holding net worth in the first place. It would also permit adequately and well-capitalized credit unions to operate in a manner devoted more to member service and less to unnecessary capital accumulation.

Additional legislative amendments CUNA supports

- **Allow credit unions to make MBLs unless they are significantly undercapitalized at 4% or less.**

Under prompt corrective action, credit unions are not allowed to continue making member business loans if they are undercapitalized, that is have net worth of less than 6%. When this provision was included in the FCU Act, the Treasury had not yet conducted its study of MBLs for credit unions. That study concluded that MBLs within the credit union system are subject to more safeguards and are less risky than such lending at banks. The small business community is in great need of these kinds of business loans, generally for amounts of less than $100,000, which banks are often not willing to make. This change would facilitate the continuation of MBL lending while a credit union works to bring its net worth back to the adequate level of 6%.

- **Allow credit unions to serve underserved areas with an ATM.**

The legislative history to the Credit Union Membership Access Act indicates that federal credit unions should establish a brick and mortar branch or other facility rather than establishing an ATM to serve an underserved area. This directive makes it far less affordable for a number of credit unions to reach out even more to underserved areas. While credit unions serving underserved areas through an ATM should be as committed to the area as a credit union with another type of facility, this change would facilitate increased service to underserved areas.

- **Eliminate the requirement that only one NCUA Board member can have credit union experience.**

Currently, only one member of the NCUA Board may have credit union experience. Such a limit does not apply to any of the other federal regulatory agencies and denies the NCUA Board and credit unions the experience that can greatly enhance their regulation. This limitation should be eliminated, or at a minimum, the law should be changed to permit **at least one** person with credit union experience on the NCUA Board.

- **From H.R. 1375: Section 301. Privately insured credit unions authorized to become members of a Federal Home Loan Bank.**

This provision would permit privately insured credit unions to apply to become members of a Federal Home Loan Bank. Currently, only federally insured credit unions may become members. This provision is drafted so that the state regulator of a privately insured credit union applying for Federal Home Loan Bank membership would have to certify that the credit union meets the eligibility requirements for federal deposit insurance before it would qualify for membership in the Federal Home Loan Bank system.

FINANCIAL ACCOUNTING STANDARDS BOARD ISSUES

Two pending issues from the Financial Accounting Standards Board have raised serious concerns for credit unions. One involves the issue of the accounting treatment of credit union mergers. Currently, credit unions may use the pooling method under which the retained earnings of the merging credit union are included in the retained earnings of the continuing credit union. FASB permits this treatment under a delay in the effective date of its Statement of Financial Accounting Standards No. 141, Business Combinations, which requires the acquisition method of accounting for mergers and acquisitions. Under the acquisition method, the retained earnings of the merging credit union must be reflected as "acquired equity" and, although included in GAAP net worth, would not be included in net worth under prompt corrective action of the continuing credit unions. That is because, for purposes of prompt corrective action, net worth is statutorily defined as "retained earnings" as determined under GAAP and does not include "acquired equity," which will be included in GAAP net worth. In other words, regulatory net worth would be more strictly defined than GAAP net worth. It is our understanding that FASB intends to apply the standard to credit unions beginning in early 2006, following a comment period beginning later this year.

Such a change, we believe will have the unintended consequence of discouraging, if not eliminating, voluntary mergers that, absent FASB's policy, would be advantageous to credit union members involved. In addition, FASB's application of SFAS No. 141 to credit unions will mean that a credit union's net worth would typically be understated by the amount of the fair value of the merging credit union's retained earnings.

This result is not in the public interest. That is why CUNA, along with the National Credit Union Administration and others, supports a technical correction that would amend the Federal Credit Union Act to make it clear that net worth is equity, including acquired earnings of a merged credit union as determined under GAAP, and as authorized by the National Credit Union Administration Board. Senior legal staff at FASB has indicated support for a legislative approach, and we urge the Committee to likewise support such an effort, well in advance of the effective date of SFAS 141 so credit unions will have certainty regarding the accounting treatment of mergers.

FASB's business combinations proposal is equally problematic for other types of cooperatives, such as farmer-owned and electric cooperatives, which also tend toward mergers of equals rather than acquisitions. CUNA is working with other cooperatives on this issue, all of which oppose the purchase method for member-owned cooperatives.

The other issue relates to the accounting treatment of loan participations. Many of our members currently engage in loan participations, either as the originating institution or as an investor, and FASB's project to review FASB Statement (FAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, is of great concern to us. Other financial institution groups, as well as federal financial regulators, have likewise raised serious questions about the need for and advisability of the proposed guidance.

For a variety of reasons, participations can be important financial and asset liability management tools. They are used increasingly by credit unions, as well as by other institutions, to control interest rate risk, credit risk, balance sheet growth, and maintain net worth ratios. Participations enable credit unions to utilize assets to make more credit available to their membership than they would be able to do without the use of loan participations.

FASB states that it is concerned that in a loan participation, in which the borrower has shares or deposits at the originating institution, if that institution is liquidated, the participating institution would not be able to recover its pro rata portion of the members' shares/deposits within the originating institution that are "claimed" by the originating institution to setoff the portion of the debt owed to it. This outcome is highly unlikely, and we are not aware that it has ever occurred in a credit union.

Nonetheless, FASB is considering amendments to Statement of Financial Accounting Standard 140 that would expressly state that because the right of setoff between the originating institution and the member/depositor/borrower exists (setting up the potential that the participating institution would not have any claim against the member/depositors' funds in the originating institution) the loan transaction does not meet the isolation requirements of FAS 140. Because of this concern, instead of transferring the portion of the loan participated off of its books as a sale, the transaction would be reflected on the originating credit union's financial statements and records as a secured borrowing.

In order for participations to continue being treated as sales for accounting purposes, the amendments would further change the existing accounting standards by requiring an institution to transfer participations through a qualified special purpose entity (QSPE). This is a needless and costly expense that would make it difficult for credit unions to use participation loans as a management tool. Further, it would drastically limit the ability of credit unions to provide low-cost, economical financing for their membership through loan participations.

There are sufficient safeguards already in place that address FASB's concerns about isolating the loan participation asset from the reach of the originating credit union and its creditors in liquidation, without the need for changes to FAS 140 of the nature FASB is contemplating.

CUNA strongly opposes the changes FASB has signaled it is considering because they are unnecessary and would render the use of loan participations impracticable. While we commend FASB for requesting comments on this issue and holding roundtable discussions in which CUNA, the NCUA, and the FDIC participated last week, we remain concerned about the scope of the problems its contemplated guidance could create if adopted. We urge the Committee to communicate with FASB and encourage the Board to withdraw this unnecessary, potentially devastating guidance.

Credit Union Tax Exemption

While we recognize that the topic of this hearing is on credit union regulatory improvements, we feel compelled to use this opportunity to respond to attacks on the credit union tax-exempt status by the banking industry, both during the recent hearing in this Subcommittee and by the overall bank strategy here in Washington and around the country.

Bankers claim that credit unions are no longer the same types of organizations they were in 1917 and 1937 when the federal income tax exemptions were granted to state and federal credit unions respectively, and because of this credit unions should now be taxed. They point to the evolution and expansion of credit union fields of membership and the addition of a wider range of financial services as evidence that the tax exemption is no longer warranted.

Interestingly, the original justification for credit unions' tax exemption had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Field of membership restrictions were included in the original Federal Credit Union Act as a device to support the operations of small, volunteer-run credit unions. Since lending was to be crucial to credit union operations, the idea was to ensure that credit unions knew to whom they were lending in the days before comprehensive credit reports. Second, when credit unions were first established, the range of financial services to consumers was very limited. It is true that credit unions did not then offer their members credit cards, money market accounts, and a wide range of share certificates in the 1930's. But, of course neither did banks. These services had not yet been invented. Today, they are part of the normal portfolio of consumer financial services. **Both credit unions and banks have expanded their service offerings over the past seven decades as consumer demand and technological advances have combined to create new products and services.**

Rather, the original reason for the tax exemption had everything to do with the cooperative structure of credit unions. As the Treasury Department describes in its January 2001 report, *Comparing Credit Unions and Other Depository Institutions,* the rationale for the 1937 granting of the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937):

> (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members . . ." Thus, the tax exemption was based primarily on the organizational form of credit unions..." (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)

Credit unions continue to operate as democratically controlled mutual institutions, serving only their members, on a non-profit basis, consistent with the rationale for the tax exemption. The net income of a credit union is not distributed among stockholders. Instead, that portion not returned to members in lower loan rates and fees, or higher yields on savings, is retained by the credit union to build net worth and ensure safety and soundness. These retained earnings are not accumulated for the benefit of management or stockholders. They exist only for the benefit of members in the future by providing for the stability of the credit union.

Congress recently reaffirmed the logic behind the tax treatment of credit unions in the findings to the Credit Union Membership Act of 1998:

> The Congress finds the following: . . .
>
> (4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

Despite what bankers say, the reasons for the credit union tax exemption today are the same as they were 70 years ago. Credit unions remain true cooperatives, operating for the benefit of their members. Credit unions also take seriously their role to serve all their members, including those of modest means.

Credit unions have a proven record of serving those of modest means who fall within their fields of membership. A recently published report on *Who Uses Credit Unions (Third Edition)* by the Filene Research Institute found that: "Households that use a bank only have higher median incomes than those who use a credit union only." And, "Among households that use both a bank and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily." (page 15). The source for this analysis was the Federal Reserve's *Survey of Consumer Finances*.

Credit unions are not as great a presence the financial lives of those at the very lowest end of the income distribution as they are for those in the middle-income and lower-middle-income groups. Credit union membership is highest in the $30,000 to $80,000 range of household income. At higher and lower income levels, credit union membership is lower. Upper income households are more likely to be bank customers; lower income households are more likely to be unbanked.

The lower membership rates in the very lowest income groups do not mean credit unions have avoided their responsibilities. Credit unions in the U.S. have a 70-year history of serving primarily occupational fields of membership. There have always been a few community credit unions in some parts of the country, but the overwhelming character of credit union fields of membership has been occupational. As such, credit unions have developed into powerful forces of financial betterment in the lives of working people all over the country. The move to serve select employee groups (SEGs) over the past two decades has extended the availability of credit union service to more Americans, but this membership expansion has been largely restricted to occupational fields.

Those at the very lowest end of the income distribution are less likely to be employed, particularly at the larger employers where credit unions have historically had the greatest presence. Indeed, research shows that "unbanked" households tend to be headed by a person who isn't working. Therefore, the reason credit unions might not show up in statistics as heavily serving the lowest end of the income distribution is because those households are least likely to have in the past been eligible to join traditional, occupationally based credit unions.

It's important to note that credit unions didn't choose the occupational field of membership model as a way of excluding potential members. In fact, just the opposite has been the case. Many credit unions have for much of their history, especially in the past two decades, been doing what they can to expand fields of membership. Yet the bankers attack credit unions when we try to branch out in this way as well.

In summary, restricted by law and regulation that defined fields of memberships, including on occupational grounds, credit unions have performed very well in serving those of modest means who fell within those fields. With recent field of membership expansions, especially the move to more community based fields of membership, we expect the provision of credit union service to those at the lower end of the income distribution to increase in the coming several years. Evidence of credit union interest in this area is found to the extent to which credit unions have added underserved areas to their fields of membership under the NCUA's Access Across America program. Since the beginning of 2003, almost 65 million potential members from underserved areas have been added to credit union fields of membership. Although it will take some time for credit unions to reach out to and serve members in these communities, it is instructive to note that in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth of over three times that of other credit unions (17.4% vs. 5.2% over the three year period).

There are other good public policy reasons to retain the credit union tax exemption. Substantial, tangible benefits accrue to members because of the cooperative operation of the credit union. Precisely because of their cooperative structure, credit unions produce benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over $6 billion a year. That is the additional amount that credit union members would pay if they were to conduct all the business they do with credit unions at banks instead. That is about four times the roughly $1.5 billion that credit unions would pay in federal income tax.

The reason the tax exemption is so leveraged for the benefit of credit union members is directly due to the cooperative structure of credit unions. When comparing banks to credit unions, more important than the tax exemption is the fact that banks must pay dividends to stockholders. In addition, credit unions pay very little in the form of compensation to directors, with the savings passed on to members. Finally, credit unions expense ratios compare very favorably to banks of similar size. Their efficiency of operations, supported by lower compensation for senior staff and lower loan losses, also benefits members.

The tax exemption plays an important role in maintaining the cooperative structure of credit unions. As is pointed out elsewhere in this testimony, credit unions are more heavily regulated than are other financial institutions. The restrictions on the operations of a credit union are severe: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than throwing off the restrictions by converting to a bank charter. Continuing as credit unions maintains the source of cooperative benefits to 85 million credit union members.

The credit union tax exemption is also a very important element in the structure that supports the safety and soundness of the credit union share insurance fund, thus protecting the general taxpayer from obligation. In its history, the U.S. has had three federal deposit insurance systems: the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the National Credit Union Share Insurance Fund (NCUSIF). A decade and a half ago, FSLIC failed at a cost of almost $200 billion, borne by the taxpayer. At the same time, FDIC teetered on the brink of insolvency, which could have cost the taxpayer plenty. At the same time, NCUSIF easily maintained its ratio of insurance fund balance to insured shares in the normal operating range of 1.2% to 1.3%.

There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Indeed, the whole purpose of prompt corrective action is to minimize losses to the deposit insurance funds by ensuring there is sufficient capital in insured depositories. Because credit unions have no access to the capital markets, their only source of capital is the retention of earnings. A tax on net income, the only source of credit union capital, would thus undermine credit unions in building retained earnings, weakening protection for NCUSIF. It is worth noting that the cost to the taxpayer of FSLIC's losses far exceeded the total of all federal income taxes paid by FSLIC-insured institutions prior to FSLIC's failure.

Second, as described in more detail in the section above on reforming PCA, as cooperatives credit unions have a systemic inclination to avoid risky activities. This is an especially beneficial trait for federally insured depository institutions. Again, to the extent the tax exemption is an important part of the reason credit unions remain cooperatives, it serves to protect taxpayers from losses to the National Credit Union Share Insurance Fund.

Finally, the bankers have suggested that large credit unions should be subjected to income taxation. There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Large credit unions are democratically controlled, not-for-profit cooperatives in every way that smaller credit unions are. The boards of directors of large credit unions are volunteers just as they are at small credit unions. Because of its size, a large credit union is likely offer a broader array of services, and be a greater presence in a local market, but that makes it no less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say that the American Heart Association should lose its tax exemption simply because of its size while a local health clinic that serves the indigent should not.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs geared to and benefiting low- and moderate-income households. In the February 2003 CUNA study "Serving Members of Modest Means," when asked how many of up to 18 services geared to low/moderate income households were offered, only 6% of credit unions with assets below $20 million offered at least half of the services. Resources are often the issue. Yet, fully 42% of credit unions with assets over $500 million offered nine or more of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/moderate income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program. Finally, many small credit unions benefit from the assistance they receive from larger credit unions, whether from donated equipment or free training. This is the cooperative spirit in its purest form.

The significance of the credit union tax exemption is well understood by key public officials. Both President Bush and Senator Kerry, as well as many Members of Congress, have written letters or issued statements affirming their appreciation for the important service that credit unions provide to their 85 million members, and indicating their support for the continuation of credit unions' tax exemption.

COMMERCIAL BANK TAX STATUS

Subchapter S Elections and Other Considerations

The commercial banking industry has increasingly attacked the current credit union tax status. Historically, these attacks generally focused on credit union size and/or breadth of service offerings. As explained earlier, the credit union tax status has nothing to do with size or types of services offered.

More recently, as state and federal government budgets have come under pressure, banker attacks have focused on the revenue implications of the credit union tax status. However, the hypocrisy of the banking industry's new-found concern for government tax receipts is clearly seen in the industry's zealous pursuit of Subchapter S status.

Subchapter S status was originally created to provide federal tax relief to small business owners, and to allow small businesses to incorporate without incurring a tax penalty. Before 1997, banks were prohibited from organizing as S corporations, and therefore were organized and taxed as C corporations. The Small Business Job Protection Act of 1996 allowed certain banks to elect Subchapter S status, beginning January 1, 1997.

An annual average of nearly 300 commercial banking firms (banks and savings & loans) have elected Subchapter S status since that time. According to Federal Deposit Insurance Corporation statistics, a total of 2,020 active Subchapter S banking institutions existed at year-end 2003 and an additional 117 have been added to that total in the first quarter of 2004. This brings the March 2004 total number of Subchapter S banking institutions to 2,137. Overall, 24% of commercial banking firms now hold Subchapter S status.

These Subchapter S banking institutions have $306 billion in total assets – an amount that is equal to 47% of the total assets in the credit union movement. The two largest Subchapter S institutions each has more than $9 billion in total assets, and the third largest has more than $7 billion in total assets.

Subchapter S banking institutions recorded $6.3 billion in annualized net income in the first three months of 2004. This amount is roughly equal to the annualized dollar amount of net income recorded by all U.S. credit unions in the same period.

While Subchapter S status is not the same as the credit union tax status, it results in significant loss of both state and federal government revenue. Collectively, Subchapter S election is estimated to have totaled $626 million in foregone revenue to the U.S. Treasury in 2003 and a total of $3.5 billion in foregone revenue since 1997. These estimates are based upon the fact that Subchapter S shareholders pay tax on their banking institutions income whether it is distributed in the form of dividends or not.

Moreover, the banking industry has lobbied tirelessly for Subchapter S expansion. If successful, such an expansion will add millions to the foregone Treasury revenue totals cited above. While the exact costs are difficult to measure (in part because there is no convenient way of identifying the number of shareholders individual banks have), conservative estimates put Subchapter S expansion costs at roughly $1.2 billion over ten years. Overall, 54% of this total foregone revenue would likely arise from raising the shareholder threshold from 75 to 100, 31% from allowing IRA shareholders, 12% form allowing director-qualifying stock, and 5% from counting family members as one shareholder.

The credit union movement does not oppose Subchapter S status for banking institutions, nor the expansion of Subchapter S status. Yet banking industry attacks on the credit union tax status continue at a torrid pace.

OTHER BANK TAX ISSUES

The use of other tax breaks and tax shelters within the banking industry are well known and widely documented. Like Subchapter S status, these too, result in substantial revenue losses to the Treasury.

One particularly egregious example of this activity was reported on the February 2004 PBS Frontline broadcast "Tax Me if You Can". In this program, Bob McIntyre, Director, Institute on Taxation and Economic Policy, cited the case of one large bank. McIntyre said: "...amazingly, in

2002, even though it reported $4 billion in profits, (the bank) reported that it didn't pay any taxes, and in fact, got a tax rebate from the government of about $160 million."

Of course, the IRS filings of individual corporations are confidential and unavailable to investors, so there is no way to know how widespread this activity is in banking circles. However, the Frontline report suggests it is more prevalent than commonly believed.

Regardless of the exact magnitude of banking industry tax avoidance, it is worth reiterating that the single banking institution cited in the Frontline broadcast earned $4 billion in 2002 profits but paid no taxes. The entire U.S. credit union movement earned $5.9 billion in 2002.

At the state level, in a number of states, banks have set up shell subsidiaries to avoid paying state taxes. For example, a recent study found that 80% of banks in Wisconsin commonly set up subsidiaries in Nevada and transfer their income-earning securities to the Nevada companies to avoid paying Wisconsin taxes. Since Nevada has no corporate income tax, the banks don't pay taxes. Eleven of the 15 largest banks in the state paid no corporate income tax.

While the banking industry professes deep concern about government tax revenue, it is directly responsible for revenue losses that total many times the value of the credit union tax exemption. Increasing government tax revenues would thus be best accomplished by closing banking industry tax loopholes rather than by imposing new taxes on credit unions and their 85 million member-owners.

Facts and Fallacies

Finally, as an additional appendix, I am attaching a report by CUNA entitled *Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends*. This report addresses many of the inaccurate statements made by the banking industry and provides evidence that credit unions deserve their place in the market and consumers and small businesses deserve to have them as a choice for their financial needs.

Conclusion

In summary, Mr. Chairman, we are grateful to the Subcommittee for holding this important hearing. We strongly urge the Subcommittee to further act on this very important issue this year. Credit unions would benefit greatly from reducing unnecessary and costly regulatory burdens, especially those addressed in CURIA. And more importantly, so too would American consumers benefit from the additional savings that credit unions would pass along to their 85 million members.

Appendix 1: List of Rules Credit Unions Follow

Appendix 2: Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends

Appendix 3: Frequently Requested Credit Union/Bank Comparison

Written Testimony of William E. Jackson III, PhD

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On

"Credit Union Regulatory Improvements"

Before the

House Subcommittee on Financial Institutions and Consumer Credit

July 20, 2004

Introduction

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, thank you for offering me this opportunity to provide a few comments today on the important subject of "Credit Union Regulatory Improvements".

My name is William Jackson, and I am an associate professor of finance and economics at the Kenan-Flagler Business School of the University of North Carolina at Chapel Hill. The University of North Carolina at Chapel Hill is the flagship university of the great state of North Carolina. And, I have had the pleasure of teaching courses on financial institutions and financial markets (as well as other subjects) at this fine institution for about twelve years. Currently, I am on professional leave from the University of North Carolina while I serve as a Visiting Research Scholar at the Federal Reserve Bank of Atlanta where I conduct research on several topics related to the behavior of financial institution and financial markets.

By any reasonable measure, the U.S. financial system is the biggest and the best in the world. With over 80 million members and over $600 billion in assets, credit unions are an integral part of the U.S. financial system. I believe that the proposed Credit Union Regulatory Improvement Act (CURIA) represents significant progress in the economic regulation of federally insured credit unions. It is my opinion that the changes proposed in CURIA will help the U.S. financial system by allowing credit unions to become more efficient members of our dynamic financial services marketplace. It will do this by providing more flexibility, where appropriate, for both credit unions and their regulator, the National Credit Union Administration.

I base this opinion on a recent research study that I was chosen to conduct for the Filene Research Institute (Filene). The research study was published in early 2003. My agreement with Filene was that as part of my study I would prepare an independent evaluation the question: *should* credit unions receive regulatory relief? Thus, the issue of credit union deregulation was central to my study just as it is to the proposed Credit Union Regulatory Improvements Act currently under consideration by this Subcommittee. I am here today to provide a brief summary of my recent research study and to demonstrate that the proposed Credit Union Regulatory Improvements Act is supported in general, and in several specific instances, by my recent Filene research study.

The remainder of my testimony is organized into three sections. In the first section, entitled "The Logic of Credit Union Deregulation", I provide a summary of my Filene research study. In the second section I discuss several specific topics that are both part of the proposed CURIA and discussed in my Filene research study. These topics will include member business lending, capital requirements, general lending restrictions, investing restrictions, incidental powers restrictions, and nonmember services restrictions. In the third section I offer a brief conclusion to my testimony.

The Logic of Credit Union Deregulation

My Filene research study was entitled, "The Future of Credit Unions: Public Policy Issues." The main question addressed in my study was whether state and federal chartered credit unions should be deregulated. Obviously, this is a very broad and complex question. And, I was both honored and challenged when Filene chose me to conduct this study. To address the question of whether credit unions should be deregulated, or receive regulatory relief, I decide I needed to develop a systematic analytical framework. This framework provided a reasonable and rational approach to address this complex question. The approach was based on six steps.

In the first step, I presented some background information on the operations and current trends for the three types of depository institutions (i.e., commercial banks, thrifts, and credit unions). In the second step, I addressed the general question of why Congress and State Legislatures deregulated the depository institutions industry. This step allowed me to develop a general framework for evaluating the dynamics of recent federal and state regulatory policy toward depository institutions. In step three, after establishing a rationale for their deregulation, I briefly summarized the major acts of Congress that codified the deregulation of depository institutions. Next, in step four, I focused in more detail on the recent credit union deregulations initiated by Congress (e.g., CUMAA). Also, in step four, I compared bank and thrift deregulation to credit union deregulation to evaluate whether credit unions had received more or less deregulation than banks or thrifts. The next step, step five, was the most important part of my report. In step five, I investigated those areas where deregulation has been different for credit unions relative to banks or thrifts. This investigation included an evaluation of whether a differential deregulatory treatment of credit unions was reasonable. And, the criteria for judging reasonableness was based on similarities and differences of banks, thrifts, and credit unions in their role as depository institutions, or financial services providers, in the overall U.S. financial system. To be more succinct, I addressed the question: When are good reasons for deregulating banks and thrifts also good reasons for deregulating credit unions? Finally, in step six, I summarized and synthesized the issues presented in the first five steps in order to provide some general guidelines for thinking about the optimal regulation of credit unions. In particular, I addressed two questions in step six. First, what should be the objectives of optimal credit union regulation? And, second, are there unique characteristics of credit unions that would suggest that they need more or less regulation relative to banks or thrifts?

What did I conclude?

The conclusions of my research report were fairly straightforward. First, I concluded that the reason depository institutions were deregulated was that Congress and State Legislatures rightly recognized that the entire financial services industry had fundamentally changed. And, because the industry had changed, the laws and regulations governing the depository institutions had to also change to reflect the new competitive realities facing commercial banks, thrifts, and credit unions. For example, consider how dramatic the changes in the structure and operations of depository institutions have been over the last two decades. To a large degree, these changes can be traced to three factors. These factors, while significant individually, when combined created a "Perfect Storm" of change for the depository institutions industry. The first (and most powerful) of these three factors was advancements in technology. The second was increases in market competition. And, the third factor was financial innovations and new product creation. It was my contention that these three factors were the driving forces behind the need for the deregulation of the depository institutions industry.

My second conclusion was that a significant amount of financial deregulation had occurred over the last twenty years. My third conclusion was that credit unions had been deregulated less than commercial banks or thrifts. My fourth conclusion was that the same factors that reasonably support the deregulation of other depository institutions also reasonably support the deregulation of credit unions. And, my fifth conclusion was that the degree of deregulation recently experienced by the banking industry is very likely to approximate the appropriate degree of deregulation that should be applied to credit unions.

In my opinion, public policy toward depository institutions should not attempt to provide a legislative mandate that universally restricts the set of operational choices available to credit unions, banks, or thrifts. Rather, public policy should seek to provide a broad framework in which operational differences are determined by the strategic choices of these institutions themselves, given their different structures and forms of organization. Of course, these strategic choices will be subject to the discipline of a competitive marketplace; and should be subject to the oversight of a well-informed and prudent regulatory institution. And, the inherent differences in risks associated with different types of financial operations must be carefully considered in developing the optimal principles for regulating our depository institutions. I firmly believe that the legislation codifying these principles must be broad enough to allow the respective regulatory and supervisory agencies to adapt to their industries as their industries adapt to a changing competitive marketplace. Of course, these regulatory and supervisory agencies must be provided adequate resources and incentives to meet these challenges.

Additionally, I believe that good public policy dictates that our regulatory framework be adjusted whenever the costs of regulatory restrictions exceed their benefits. It seems very likely that the current costs of regulatory restrictions on credit unions, greatly exceeds any reasonable measure of their current benefits. In the final analysis, the regulation of credit unions (as well as other depository institutions) should seek to provide as much consumer choice as possible, while insuring a safe and sound financial system. It appears to me that some of our current laws and regulations are unnecessarily limiting credit unions' ability to provide the financial products and services that their members demand. But, I believe that the Credit Union Regulatory Improvements Act currently under consideration by this Subcommittee goes a long way toward improving the level of legislative oversight for credit unions.

In my Filene research report I suggested that credit unions should receive deregulatory relief in several areas. Five of these areas that coincide with issues addressed in the proposed Credit Union Regulatory Improvements Act are: (1) member business lending, (2) capital requirements, (3) investing restrictions, (4) the provision of incidental financial services, and (5) non-member services. I briefly address each of these five areas in the next section of my testimony.

Some Specific Topics addressed in my Filene Research Study

MEMBER BUSINESS LENDING

Current regulations place severe limitations on the member business lending activities of federally insured credit unions. For examples, consider the following four typical limitations. First, a credit union's member business lending is limited to the lesser of either 1.75 times net worth or 12.25 percent of total assets. Second, credit unions' loans can only be made to credit union members. Third, the loans generally require the personal guarantee of the borrower. And, fourth, the member business loans generally must be fully collateralized.

These are very restrictive regulations. In this section I argue that the costs of these restrictions on our financial system are more than their benefits. I make this argument by simply addressing the question: What would happen if we relaxed one of the four restrictions listed above? In particular, I address the likely outcome of relaxing the requirement limiting a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets (note: similar outcomes would likely result from relaxing some of the other restrictions).

Reducing the limitations on member business lending will allow more potential for credit unions to diversify their asset portfolios. This diversification benefit may serve to reduce the overall risk of credit unions' loan portfolios. Furthermore, reducing the limitations on member business lending may well allow credit unions to serve business clients that would otherwise not receive credit. To investigate this latter possibility I provide some evidence below on the current business clientele serviced by credit union member business lending. In particular, I offer evidence to suggest that those who will benefit from an increase in credit union member business lending are small businesses and low- to moderate-income individuals.

Small Business Credit and Member Business Lending

A study published by the U.S. Department of the Treasury in 2001 reported that 59 percent of credit union member business loans had balances less than $50,000 and that only two percent had balances greater than $500,000. These loans amounted to 14 percent and 17 percent, respectively, of the total outstanding principal balance of all U.S. credit union member business loans reported. For all member business loans reported, over half were collateralized with non-agricultural real estate, and another 23 percent were collateralized with taxicab medallions. Agricultural collateral backed 12 percent of the loans.

Additionally, over 50 percent of the member business loans reported were made to businesses with assets under $100,000. And, about 86 percent of all loans were made to businesses with total assets less than $500,000. Loans to service-oriented businesses and for rental property made up nearly 55 percent of the total number of loans.

Looking at the total dollar value of member business loans outstanding, the survey showed that over 70 percent went either to service providers (38.8 percent) or for rental properties (32.9 percent). It appears that the figures for service providers largely reflect the loans made for taxicab medallions. Nearly half of the unpaid principal balance of member business loans outstanding was to businesses with total assets between $100,000 and $500,000. Cumulatively, almost 70 percent of the value of member business loans was made to businesses with total assets less than $500,000.

As might be expected, the vast majority of credit union member business lending goes to small businesses. And, thus, policies that increase credit union member business lending are likely to increase available credit to small business borrowers.

Meeting the Needs of Low- and Moderate-Income Individuals

An interesting question is: To what extent does member business lending help to meet the financial services needs of low- and moderate-income individuals?

The Treasury study also reported that 25 percent of credit unions' member business loans were made to members with household income of less than $30,000. In dollar terms, these loans totaled about 13 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balance) went to households with incomes reported to be between $30,000 and $50,000. Thus, it appears that about 45% (28% in dollar terms) of all credit union member business lending goes to low and moderate-income individuals. And, thus, policies that increase credit union member business lending are likely to increase available business credit to low and moderate-income individuals.

Member Business Loans may be Less Risky

Credit union member business loans are generally loans to individuals for business purposes. Because an individual (or group of individuals) is personally liable for the debt, member business loans tend to be smaller and less risky than typical business loans made by banks and thrifts. Indeed, credit union member business loans share many characteristics of consumer loans. That is, these loans are generally smaller and fully collateralized, and borrower risk profiles are more easily determined. As a result, the credit risk associated with member business loans may be less than that for most banks and thrifts commercial loans.

Because credit union member business loans are likely to be less risky than comparable loans at banks or thrifts, increasing member business lending at credit unions will not likely increase risk in the overall financial system as much as the risk associated with increases in bank or thrift business lending. Reducing the restrictions on member business lending, however, will likely lead to a higher level of average risk in the member business loan portfolios of credit unions. But, given the cooperative philosophy and culture of credit unions this increase in risk is still likely to be less than the risk associated with increases in bank or thrift business lending.

Thus, reducing the restrictions on credit union member business lending is likely to lead to more lending to small businesses, more lending to low- and moderate-income individuals, without adding any significant additional risk into the U.S. financial system.

CAPITAL REQUIREMENTS

With the passage of The Credit Union Membership Access Act of 1998 (CUMAA), federally insured credit unions became subject to similar prompt corrective action regulations as commercial banks. These new regulations formed the basis for the current capital requirements that apply to most credit unions. The capital requirements for credit unions were set at a significantly higher level than those for banks. The rationale for setting a higher capital requirement for credit unions was based (in part) on the inability of credit unions to quickly raise capital by issuing securities, as banks are able to do.

Capital requirements and net worth requirements exist to ensure that potentially troubled institutions do not reach insolvency and impose costs on the deposit insurer and taxpayers. To obtain that goal in the case of undercapitalized credit unions, (1) restrictions may be placed on the choices and activities available to management, (2) management may be replaced, or (3), if necessary, the institutions may be closed. However, under current capital and net worth requirements, faced with profitable opportunities and low capital ratios, commercial banks find it easier than credit unions to simultaneously expand and reach their capital targets.

Banks may, on relatively short notice, issue common stock, subordinated debt, or a variety of debt-equity hybrids that qualify towards their capital requirements. In contrast, credit unions have no flexibility on the choice of instruments that may be used to meet net worth requirements. In effect, current regulations limit the ability of credit unions to serve their members on a timely basis, if their net worth ratios approach their net worth requirements. Several proposals have been made over the last few years, seeking to correct this situation. As might be expected, these proposals seek to expand the range of instruments that credit unions may use to meet their net worth requirements.

Credit union net worth requirements may have been set too high on a risk-adjusted basis

CUMAA codified the net worth requirements for credit unions at a level higher than the corresponding requirements for banks. However, for purposes of providing protection to their respective deposit insurance system, credit unions may actually require a lower net worth mandate than commercial banks of similar size and risk-profile. This is because credit unions are likely to take on less risk than profit-seeking financial institutions because credit unions are nonprofit cooperatives. For example, credit union boards of directors and senior managers do not receive stock or stock options in their credit unions. Thus, the moral hazard and other principal-agent problems associated with deposit insurance are not as problematic in credit unions relative to other types of insured depository institutions.

I suggest that this is an area that needs to be revisited by Congress. I recommend that the minimum net worth requirements from the CUMAA be eliminated. And, that the NCUA, with guidance from Congress, be given the authority to establish and maintain the minimum net worth requirements for federally insured credit unions. I believe a significant amount of guidance in this area has been developed in the proposed Credit Union Regulatory Improvement Act (CURIA). In particular, I believe that the risk-based capital approach contained in CURIA is a step in the right direction toward improving the capital regulation of credit unions.

Optimal regulatory policy must continually weigh the costs and benefits of its restrictions on the operating policies of those regulated. And, when the costs of the restrictions exceed their benefits, it is time to reconsider the regulatory policy. The costs of the current CUMAA based minimum net worth requirements for credit unions are probably higher than their corresponding benefits. Thus, this policy should be reconsidered.

INVESTING RESTRICTIONS

In order to be competitive in the marketplace, credit unions should have a wide range of investment alternatives available to them. The current statutory and regulatory constraints on credit unions' allowable investment products are shocking. In most cases, credit unions can only invest in U.S. government securities and the deposits of other depository institutions, while commercial banks and thrift may choose from a very wide variety of investment products.

Credit unions should be permitted to invest in a wider range of high quality securities, such as, asset-backed securities; corporate debt securities (e.g., commercial paper, notes and bonds); non-agency mortgage-backed securities; and real estate investment trusts. Additionally, credit unions should be allowed to invest in an expanded array of securities that aid credit unions in developing more effective risk management processes.

The proposed Credit Union Regulatory Improvements Act before this Subcommittee would allow for a broader array of alternative investments for credit unions. This is in complete agreement with the conclusions in my Filene research study on investing restrictions. And, I believe it moves public policy in the right direction.

INCIDENTAL POWERS RESTRICTIONS

The Gramm-Leach-Bliley Act of 1999 (GLBA) expanded the principles for determining the permissible activities of a bank from "closely related to banking" to "financial in nature". Activities specifically determined as "financial in nature" are securities brokerage and underwriting, insurance agency and underwriting, and the ability to make merchant capital investments. Additionally, GLBA provided the federal bank regulators with the ability to designate additional activities as "financial in nature." GLBA did not however expand the permissible set of activities for credit unions. Credit unions should be allowed to offer new financial products and services to their members because other depository institutions will be allowed to do so for their customers. Simply put, credit unions should be given parity with other federally insured financial institutions in the areas of incidental powers. Credit union members should have the same access to consumer financial services as customers of other depository institutions.

The proposed Credit Union Regulatory Improvements Act will allow for an expanded set of available financial services to credit union members by increasing the allowable investment limit for credit unions in CUSOs. I believe that this is a move in the right direction.

NON-MEMBER SERVICES

Optimal regulatory policy would imply that credit unions should be encouraged to offer services, even to nonmembers, whenever such services served a recognized social policy objective. Two services that meet such criteria are check-cashing and payday lending services. Both payday lending and check-cashing services seem to fit the culture of credit unions. Many lower-income households – those who can least afford it – pay high fees for these types of financial services in the alternative financial sector. Credit unions can provide most of these services at lower cost, while charging fees consistent with their long-term financial well-being. By reaching out to these households, credit unions can introduce them to products and services that will help them build financial savings, reduce debt burdens, and clean up impaired credit records. Credit unions, working together, can make an enormous contribution to the financial well-being of thousands of lower-income households by offering these non-member services.

The proposed Credit Union Regulatory Improvements Act will allow federal credit unions to provide check-cashing services to non-members as long as those non-members are within the scope of the credit union's field of membership. I believe that this is a good start in the right direction.

Conclusions

When addressing the issue of deregulating credit unions, at the end of the day, we still return to this basic question. Do the costs of the regulatory limitations currently in place for credit unions outweigh their benefits? Here we can consider the benefits of regulatory limitations as enhancing the safety and soundness of the U.S. credit union industry. And, we can consider the costs of regulatory limitations as the detrimental impact on consumer choice caused by the restrictions on financial innovation associated with such limitations. Optimal public policy dictates that the regulatory limitations on credit unions be adjusted whenever their costs exceed their benefits.

Currently, those costs appear to greatly exceed any reasonable measure of their benefits. Recall that the regulation of credit unions should seek to provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace, while insuring a safe and sound financial system. The current deregulatory legislation proposed in the Credit Union Regulatory Improvement Act is a start in the right direction toward removing the restrictions that limit credit unions' ability to provide the products and services that their members' need and demand.

As this Subcommittee continues its good work on the proposed Credit Union Regulatory Improvements Act, it is my belief that it would be appropriate for the Subcommittee to continue to emphasize the option to authorize the National Credit Union Administration to address as many of these important issues as possible from a regulatory basis as opposed to detailed legislative mandates. Such an approach would make it possible for the regulator to adjust, where appropriate, to changing competitive conditions in the marketplace. And, it would allow the regulator to adjust to evolving safety and soundness considerations without the need of statutory revisions.

This concludes my testimony. And, again, I thank you for the honor and privilege of offering comments on this important regulatory issue.

Short Biography for William E. Jackson III, PhD

Dr. William E. Jackson III, an associate professor of finance and economics at the Kenan-Flagler Business School, is a recognized expert in the areas of financial intermediation and industrial economics. During the 2004-2005 academic year Dr. Jackson will be a Visiting Research Scholar at the Federal Reserve Bank of Atlanta where he will continue his current research. Professor Jackson's research centers on the role financial markets and financial institutions play in making the modern economy more efficient and productive. Specific areas of research include corporate governance, small firm finance, monetary policy and macroeconomics, industrial economics, financial markets and institutions, corporate finance, financial literacy, and public policy.

Dr. Jackson earned his BA in economics and applied mathematics at Centre College, his MBA in finance at Stanford University, and his Ph.D. in economics at the University of Chicago. The author of many articles published in major academic and practitioner journals, Dr. Jackson's most recent published work focuses on issues related to small firms access to credit markets, corporate governance and bank mergers, the optimal level of service quality in the financial services industry, and risk management at financial institutions. Dr. Jackson's current research agenda also includes topics related to the comparative consumer deposit pricing behavior of banks and credit unions, small firm finance and public policy interventions in credit markets, executive compensation and commercial bank risk, mergers and acquisitions, private equity markets, and financial markets in emerging economies.

Dr. Jackson's research has been published in the leading academic journals in the areas of empirical economics, management, and banking. His articles have appeared in such journals as, the *Journal of Money Credit and Banking*, the *Review of Industrial Organization,* the *Journal of Banking and Finance, Management Science*, and the *Review of Economics and Statistics*. Dr. Jackson is currently on the Editorial Advisory Board of one of the premier small firm research journals, the *Journal of Small Business Management.*

Dr. Jackson has held positions with the Board of Governors of the Federal Reserve System, The Federal Reserve Bank of Chicago, The Federal Reserve Bank of Cleveland, The Federal Reserve Bank of Atlanta, Boston University, Jackson and Company (his consulting firm), Ernst and Young, and Centre College. Recently, Dr. Jackson provided expert testimony before the Michigan Senate on the deregulation of credit unions.

STATEMENT

OF

THE HONORABLE JOANN JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

ON

"CREDIT UNION REGULATORY IMPROVEMENTS"

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 20, 2004

Chairman Bachus, Representative Sanders, and Members of the Subcommittee: thank you for inviting me to appear before you today. On behalf of the National Credit Union Administration (NCUA) I am pleased to provide information on the condition of the credit union industry and the National Credit Union Share Insurance Fund, as well as present our agency's views on regulatory efficiency initiatives originating here on Capitol Hill, and from NCUA.

CONDITION OF THE CREDIT UNION INDUSTRY

I am pleased to report to the Subcommittee that the state of the credit union industry remains strong and healthy. All indicators show that credit unions, which serve nearly 83 million Americans, are safe and sound and well positioned for continued strength and vitality in our nation's financial marketplace.

These indicators include key ratios and trends compiled from call report data submitted to NCUA by all federally insured credit unions as of March 31, 2004.

- The average net worth-to-assets ratio of all federally insured credit unions remains extremely strong at 10.64 percent, notwithstanding share growth of 15.27 percent in 2001, 10.77 percent in 2002, and 9.11 percent in 2003, and 11.31 percent (annualized) as of March 2004. Such strong share deposit growth would bring about a significant decrease in the net worth ratio, but for the fact that, credit unions are managing these increased shares effectively and continuing to build net worth. For example, in the first quarter of 2004, credit union net worth, which is built solely from retained earnings, has increased in total dollars at an annualized rate of 8.35 percent. This growth in actual dollars of net worth results in the highest level in history of total industry net worth, currently at $66.8 billion as of March 31, 2004.
- Return on average assets (ROA) is 0.90 percent. Considering the combined effects of the recent low interest rate environment and historically high growth in credit union share accounts, this compares favorably with recent ROA trends (0.99 percent in 2003 and 1.07 percent in 2002).
- Asset growth was 11.20 percent and share growth was 11.31 percent annualized as of March 2004.
- Loan growth slowed to 4.28 percent (annualized) in the first quarter of 2004. At the same time, share growth increased reducing the loan-to-share ratio to 69.97percent, from 71.2 percent in 2003. Total loans to credit union members totaled $380.2 billion, up $108.6 billion since year-end 1999.
- Credit unions' overall delinquency ratio fell to 0.68 percent and is lower than the ratios recorded in the previous two years (0.77 percent in 2003 and 0.80 percent in 2002), demonstrating effective risk management in the loan portfolios during a period of economic downturn in many industries and communities.

- Savings grew to $543.3 billion in 2004, an annualized increase of 11.31 percent. Due to the slower rate of loan growth, much of the increased savings are placed in the conservative investment options available to credit unions under applicable federal and state laws and regulations. Total assets grew to an all-time high of $627.2 billion, an annualized increase of 11.20 percent.
- First mortgage real estate loans grew at an annualized rate of 4.94 percent to $119 billion as of March 2004, thus continuing the growth of credit unions as a source of access to the American dream of home ownership for millions of their members.
- New auto lending increased 6.72 percent to 64.8 billion in 2004. Used auto loans increased by 4.60 percent to $82.1 billion.

The ratios and trends presented above are not unexpected in the present economic and marketplace environment; however, taken as a whole, they are indeed indicative of a healthy and robust industry.

CONDITION OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

The National Credit Union Share Insurance Fund (NCUSIF) provides federal share insurance coverage on credit union accounts generally up to $100,000 per member in a single federally insured credit union. As with FDIC coverage of deposits in banks and thrifts, there is an opportunity to structure separate account coverage under the NCUSIF based on the number and nature of the accounts established.

As of December 31, 2003, there were $479 billion in insured funds covered by the $6.163 billion NCUSIF, with a 1.27 percent equity ratio. As of May 31, 2004, the equity ratio in the NCUSIF was 1.29 percent.

Under the Federal Credit Union Act (FCUA), the NCUA Board has the authority to determine the annual operating level of the fund between the statutorily prescribed parameters of 1.2 and 1.5 percent. This year, as in the last several years, the Board has set the operating level at 1.3 percent. If, at the end of the calendar year, the NCUSIF equity level is above 1.3 percent, the Board may declare a dividend. If it is below 1.3 percent, the Board may assess a premium. If the equity ratio falls below 1.2 percent, the FCUA requires a premium be assessed. However, based upon the limited number of losses in federally insured credit unions, history has proven that in most years the fund level can be maintained without the assessment of a premium through the combination of the one percent of insured funds required deposit plus earnings on those deposits.

Since the NCUSIF was capitalized in 1985, only one insurance premium has been assessed. That single premium assessment took place in 1992 when the problems in New England area credit unions and in the real estate markets resulted in significant losses to the NCUSIF. Other than in that extraordinary situation, no premium assessments have been required. In fact, effective management of the NCUSIF and minimal credit union losses have resulted in the end-of-year equity ratio being above the required operating level in an amount sufficient to allow the NCUA Board to declare dividends to insured credit unions for six consecutive years beginning in 1995. As a result of the combined effects of the high rate of share growth in 2001, 2002 and 2003 and declining rates of return on the NCUSIF investment portfolio of U.S. Treasury securities, the Fund ended each of those years just below the 1.3 percent operating level and dividends were not paid.

There are two primary factors influencing the NCUSIF and its equity ratio at this time. First, as noted above, the low interest rate environment of recent years has reduced the investment income to the NCUSIF. In December 2003 gross income was $10.6 million, while in December 2002 gross income was $16.2 million. Gross income for May 31, 2004 was $10.9 million. Investment earnings have been significantly reduced since many of the fund's older investments which yielded over six percent have matured over the past several years. The funds are now being reinvested in Treasury Notes of similar maturities with yields of two to three percent. During this same period, the yield of the NCUSIF has fallen over 300 basis points to 2.02 percent for December 31, 2003. The NCUSIF yield for May 31, 2004 is 2.05 percent.

Second, in July 2002 the NCUA Board adopted a policy of building its reserves for losses to the NCUSIF by transferring $1.5 million a month to the reserve account for incurred losses not specifically identified, in addition to reserves for specific cases and a pool for CAMEL Code 4/5 credit unions. The final $1.5 million transfer was made as of December 31, 2003 to the reserve account for incurred losses not specifically identified.

Earnings on the fund principal have been sufficient to keep the NCUSIF appropriately funded into the future absent extraordinary losses, but dividends to insured credit unions that are allowable by statute when the fund equity level exceeds the established operating level are not likely to return until interest rates rise sufficiently to allow earnings to return to historical levels.

Based on the above discussed financial trends and indicators, and as a result of our ongoing programs of examination and supervision of federally insured credit unions, we expect that losses will remain low and we do not anticipate any extraordinary lass cases.

As of May 31, 2004 there are 245 problem credit unions, up from 217 at year-end 2003. This number has remained relatively constant over the last four years. For purposes of comparison, there were 338 problem credit unions in 1999 and, for a 10-year indication, there were 319 in 1994.

For 2003, NCUA was called upon to provide assistance to liquidate, merge or arrange a purchase and assumption for 13 federally insured credit unions. This number is significantly lower than the average of 27.8 such cases over the last ten years.

REGULATORY RELIEF AND EFFICIENCY

Mr. Chairman, this Subcommittee has been taking the lead in the 107th and 108th Congress in many areas of interest to consumers, financial institutions, credit unions and their members. The "Financial Institutions Regulatory Relief Act of 2004," H.R. 1375, is a significant bipartisan achievement that NCUA greatly appreciates and enthusiastically supported as it moved through the House of Representatives. I also strongly supported it in testimony I presented before the Senate last month.

The introduction of the "Credit Union Regulatory Improvements Act of 2003," H.R. 3579 (CURIA), includes many of the same credit union provisions you included in H.R. 1375. Additionally, it addresses some of the most compelling issues being discussed within the credit union industry today. These issues need your attention and I welcome the opportunity to explain their importance. Thank you for demonstrating determination to bring these matters to the attention of your colleagues and the public.

Effective regulation, not excessive regulation is my guiding principle as a federal regulator. Before I discuss the new regulatory reform issues, I would like to comment on the progress NCUA is making under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and report to you on what we are doing through our own annual review of regulations.

EGRPRA AND NCUA ANNUAL REVIEW OF REGULATIONS

NCUA is participating with the other four federal financial institution regulatory agencies in the review project mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). We will soon be publishing our third request for public comment on ways in which we might improve or eliminate regulations that are burdensome or unnecessary. NCUA is carefully coordinating with the other agencies. However, because of the unique nature of credit unions and their differences from other financial institutions, NCUA is publishing separate notices.

We are also coordinating the EGRPRA effort with our own internal regulatory review process. Annually, we scrutinize one-third of our entire body of existing regulations to find ways to simplify or improve any regulation that is outdated or in need of revision. This internal process, which NCUA has had in place for a number of years, has brought about important regulatory reform for credit unions, including complete overhaul and modernization of NCUA's rules on lending, share accounts and incidental powers.

We expect that both EGRPRA and our internal review will continue to further a critical and strategic initiative of reducing or eliminating unduly burdensome regulation on the credit union system, and that the EGRPRA effort will result in additional recommendations for legislative reform as we work to complete the EGRPRA review by the 2006 statutory deadline.

NEW LEGISLATIVE RECOMMENDATIONS

Since the passage by the House of Representatives of the "Financial Institutions Regulatory Relief Act of 2004" and the introduction of CURIA, two issues have come to my attention for which NCUA is suggesting legislative solutions.

Accounting Treatment of Net Worth in Credit Union Mergers

A time-sensitive recommendation involves an expected Financial Accounting Standards Board (FASB) decision coming later this year with a January 2006 effective date. The issue arises from the interface between the statutory definition of "net worth" in the Federal Credit Union Act and the accounting treatment of net worth in credit union mergers. This issue is important separate and apart from the question of converting to a system of risk-weighted net worth requirements addressed elsewhere in NCUA's testimony.

The Credit Union Membership Access Act of 1998 established a statutory system of capital standards and prompt corrective action (PCA) for federally insured institutions. Capital, or the term "net worth" for credit unions, is defined as being limited to their retained earnings as determined in accordance with generally accepted accounting principles (GAAP). In the context of credit union mergers, where the "pooling method" of accounting has traditionally been used, the retained earnings of the two credit unions are pooled and the sum of these retained earnings become the net worth of the combined credit union. This is a logical result that facilitates the ability of credit unions to merge when it is in the best interests of their members.

A proposed change to the accounting standards for credit union mergers that FASB expects to implement as early as January 1, 2006, will dramatically alter this treatment of retained earnings and net worth in a manner that will make it difficult or impossible for many credit unions to consider combining their strengths through merger. Specifically, FASB's proposed change to accounting rules will require, in a merger, that the retained earnings of one credit union be carried over as "acquired equity" rather than retained earnings. Thus, only the retained earnings of the remaining credit union will count as net worth after the merger. This seriously reduces the post-merger net worth ratio, because that ratio is the retained earnings stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has serious adverse implications under the statutory PCA scheme, and it is this result that will strongly discourage voluntary mergers and, on occasion, make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF).

To follow the new FASB rule, while still allowing the capital of both credit unions to flow forward as regulatory capital for purposes of PCA, an amendment to the Federal Credit Union Act is sought.

The FASB has indicated it supports a legislative solution and that such a solution will not impact their standard-setting activities. The amendment redefines net worth for PCA purposes as equity, rather than just retained earnings. NCUA has suggested statutory language, as well as report language, clarifying the very limited purpose of this amendment, and they are attached for the Subcommittee's consideration.

Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other related services to insured credit unions. Statutory authority did previously exist for NCUA, but under a temporary provision that expired in 2001. We are currently required to work through credit unions to obtain vendor information or seek voluntary cooperation from vendors. We do not have direct examination authority nor related powers to enforce full disclosure and cooperation in a case where that might become necessary.

We believe that in these times, when privacy, money laundering and financing of terrorism are issues of such paramount national interest, as well as safety and soundness concerns, NCUA should have direct examination authority over those vendors providing services to federally insured credit unions. Direct examination authority would provide NCUA parity with other financial regulators with respect to examinations and would eliminate the need for us to approach the matter indirectly through credit unions, thus providing some measure of regulatory relief. NCUA requests only direct examination authority, and not rulemaking authority, with respect to vendors.

I should also note that the Government Accounting Office (GAO), in its October 2003 report on credit unions stated:

> To improve oversight of third-party vendors, Congress may wish to consider granting NCUA legislative authority to examine third-party vendors that provide services to credit unions and are not examined through FFIEC. (GAO-04-91)

Attached for the Committee's consideration are suggested legislative and report language to accomplish this recommendation.

"CREDIT UNION REGULATORY IMPROVEMENTS ACT OF 2003"

CURIA addresses three prominent issues being discussed in the credit union industry today; adjusting Prompt Corrective Action (PCA) standards for federally insured credit unions based on the risk profile of the institution; member business loan limitations for federally insured credit unions; and conversions of federally insured credit unions to mutual savings banks.

Prompt Corrective Action: Risk-Based Net Worth

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This principle is consistent with our fiduciary responsibility to the insurance fund. However, the current statutory net worth structure establishes a system based largely on net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to incorporate behavioral incentives related to higher risk activities.

Section 301 of CURIA would address these inequities by establishing a risk-based system for PCA. NCUA strongly supports such a risk-weighted system. A well-designed risk-based system would alleviate regulatory concerns by not penalizing low risk activities and by providing credit union management with the ability to manage their compliance through adjustments to their assets and activities. A PCA system that is risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

Since first advocating the idea of a risk-based PCA system, NCUA has envisioned a system similar to that currently employed in the banking system where assets are weighted by risk. However the Basel accords do not appropriately apply to credit unions as not-for-profit financial cooperatives that can only build net worth through retained earnings. In addition, unlike the current bank PCA system, which is intended only to address credit risk, we believe a risk-based credit union PCA system should be designed to address all relevant and material risks.

While NCUA supports a statutorily mandated PCA system, the system should contain a statutory definition of net worth with NCUA provided the ability through regulation to exclude certain accounts as necessary from what qualifies as net worth. The system should also establish statutory thresholds based on risk-assets defined by the NCUA Board for all of the net worth classifications, and a minimum leverage component (net worth in relation to total, non-weighted assets) either for all classifications or for the critically undercapitalized and well capitalized classifications.

While NCUA is continuing to develop its specific recommendations we suggest that the leverage ratio below which a credit union is critically undercapitalized remain at its current 2 percent, and that the minimum leverage ratio for a well-capitalized credit union be set at 5 percent.

Although the minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, there are important reasons why that ratio should be lowered. First, our experience tells us that the vast majority of credit unions will operate at a range well above whatever is established as the minimum. This is due to the conservative nature of credit unions (as member-owned cooperatives) and their recognition of the time it takes to rebuild from any unexpected decline in their net worth ratio. The practical result is a "one-size-fits-all" system with capital ratios at levels that are well above those needed and that limit the ability of credit unions to use their capital to improve member services and to manage changes in their assets associated with normal swings in the economy.

We are well aware of the primary argument for a 7 percent leverage ratio, namely that it is comprised of a 5 percent ratio (the ratio banks that wish to take advantage of full powers under the Gramm-Leach-Bliley Act) plus an additional 2 percent to reflect credit union investments in the National Credit Union Share Insurance Fund and in corporate credit unions. These investments are assets, however, under Generally Accepted Accounting Principles and like any asset, have value to individual credit unions. The NCUSIF capitalization deposit is returned to a credit union that leaves the Fund, it is available to cover losses in a failed credit union, and it is protected from the risk of a write-down by virtue of the fact that NCUA is required to assess insurance premiums as necessary to maintain the NCUSIF ratio at a minimum level of 1.2 percent. Capitalization investments in corporate credit unions are not uniform, indeed not all credit unions even belong to a corporate, and those investments would be better addressed on the risk-based side of the PCA system.

All financial assets carry some risk. Indeed, many carry far greater risk than the insurance deposit and corporate capitalization deposits. It is inappropriate to single out these assets and impose a dollar-for-dollar capitalization requirement.

For the remaining elements of the risk-based PCA system, NCUA should be provided with the authority to set risk-based net worth levels and corrective actions by regulation. This will enable us to ensure the system remains relevant and up-to-date with emerging trends in credit unions and the marketplace.

Member Business Lending

Federal credit unions have been authorized since 1934 to make member business loans and have had a successful record of meeting the small business loan needs of their members. NCUA issued regulations establishing safety and soundness standards for member business lending as a result of some losses on business lending beginning in the early 1980's. Those regulations, which apply to all federally insured credit unions, have been successful in ensuring that credit union business lending is carried out in a safe and sound manner that does not present undue risk to the NCUSIF. In fact, since the time that NCUA issued its regulation, defaults for member business lending have consistently been lower than the ratios for member loans generally.

Nonetheless, Congress in 1998, as part of the Credit Union Membership Access Act, established an aggregate cap on member business lending. The cap, 12.25 percent of total assets for well-capitalized credit unions and lower for those with less capital, has had two detrimental effects. First, for those credit unions with successful business programs, they must shut down their programs once they reach the cap, and they are prevented from providing needed and valuable services to their members. Second, the cap discourages other credit unions from entering the program because of the difficulties in operating a successful and economically viable program within the limits of the cap.

To address these concerns, Section 201 of CURIA would: (1) raise the cap to 20 percent of total assets, and (2) increase the threshold, below which an individual loan is not treated as a business loan for purposes of the cap, from the current $50,000 level to the new level of $100,000.

In view of the historical success of NCUA's regulatory and supervisory efforts in ensuring that business loans are made in a safe and sound manner and at no increased risk to the Insurance Fund, NCUA continues to believe, as it did in 1998, that a cap on business lending is unwarranted and hampers the ability of individual credit unions to meet the varying needs of their memberships. The increases proposed by CURIA are, however, a vast improvement over the current limitations, and NCUA therefore strongly supports these initial changes.

Credit Union Conversions to Mutual Savings Bank Charter

Prior to the enactment of CUMAA, NCUA rules required that a majority of all members of a federal credit union approve a conversion to a mutual savings bank charter. That rule was intended to ensure full democratic control of a federal credit union's capital and its future by its member owners. CUMAA, however, restricted NCUA's authority over these conversions and provided that a majority of those members who choose to vote will determine the outcome of a conversion proposal. The post CUMAA record of conversions is clear in demonstrating that these conversions are often motivated in part by the ability of officials to enrich themselves, that the voting process is often structured to minimize member turnout, and that disclosures are designed to obfuscate the facts related to loss of democratic ownership and control of the institution.

Section of 113 of CURIA addresses these concerns to a limited extent by conditioning conversion to a savings bank charter on a vote in which least 20% of the members cast their ballot. While a better solution would be to encourage even greater member participation in a vote of this importance, Section 113 is an improvement over the current law, and for that reason we support it.

Authorizing Credit Unions to Lease Space in Credit Union Office Buildings in Underserved Areas

Current NCUA rules permit federal credit unions to lease space to third parties, but only in commercial space the credit union intends to fully occupy at a later time.

Section 112 of CURIA proposes to expand leasing authority by allowing federal credit unions to lease space indefinitely to third parties, so long as the building is in an "underserved area" and the building is "purchased or constructed by the credit union for a credit union office or credit union operations..." The credit union would not plan to use all of the space for its own use, but would be free to lease the remainder to a third party. NCUA is provided necessary rulemaking responsibility to ensure the safety and soundness of the credit union.

The section uses and defines the term "underserved area" differently than the same term is currently defined in the FCUA. NCUA prefers the use of the term "underserved area" as it is currently defined at Section 109(c)(2) of the FCU Act (12 U.S.C. 1759(c)(2)), that is based on an area qualifying as an investment area under the Community Development Financial Institutions Act (CDFI Act).

NCUA current policy and practice with regard to federal credit unions adopting underserved areas is to require them to establish a "bricks and mortar" presence in the underserved area in order to encourage active relationship development (ATM's and electronic kiosks won't do). While a building purchased or constructed in an underserved area meets the "bricks and mortar" policy, language might be added to specify that "any building purchased be staffed to provide service to credit union members in that underserved area." This could also be accomplished through regulations implementing Section 112.

OTHER PROVISIONS OF CURIA RECOMMENDED BY NCUA AND INCLUDED IN HR 1375

Check Cashing, Wire Transfer and Other Money Transfer Services

The Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members (12 USC 1757(12)). To reach the "unbanked," federal credit unions should be authorized to provide these services to anyone eligible to become a member. This is particularly important to federal credit unions in furthering their efforts to serve those of limited income or means in their field of membership. These individuals, in many instances, do not have mainstream financial services available to them and are often forced to pay excessive fees for check cashing, wire transfer and other services. Allowing federal credit unions to provide these limited services to anyone in their field of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations.

The Twelve-Year Maturity Limit on Loans

Federal credit unions are authorized to make loans to members, to other credit unions and to credit union organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a twelve-year maturity limit that is subject to only limited exceptions (12 USC 175(5)). This maturity limit should be eliminated. It is outdated and unnecessarily restricts federal credit union lending authority. Federal credit unions should be able to make loans for second homes, recreational vehicles and other purposes in accordance with conventional maturities that are commonly accepted in the market today. It is our view that NCUA should retain the rulemaking authority to establish any maturity limits necessary for safety and soundness.

Increase One Percent Investment Limit in CUSOs to Three Percent

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations (12 USC 1757(7)(I)). These organizations, commonly known as credit union service organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risks are isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the NCUSIF, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation. Increasing the CUSO investment limit from 1 percent to 3 percent, as proposed in CURIA, is an improvement over the current limit, and NCUA supports the change.

Expanded Investment Options

The Federal Credit Union Act limits the investment authority of federal credit unions to loans, government securities, deposits in other financial institutions and certain other very limited investments (12 USC 1757(7)). This limited investment authority restricts the ability of federal credit unions to remain competitive in the rapidly changing financial marketplace. The Act should be amended to provide such additional investment authority as approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state chartered credit unions or other financial institutions. Section 303 of H.R. 1375, as passed by the House of Representatives, appropriately addresses the issues NCUA has presented in our recommendation, limits additional investment to corporate debt securities (as opposed to equity) and further establishes specific percentage limitations and investment grade standards.

Voluntary Merger Authority

The Federal Credit Union Act, as amended by the Credit Union Membership Access Act, allows voluntary mergers of healthy federal credit unions, but requires that NCUA consider a spin-off of any group of over 3,000 members in the merging credit union (12 USC 1759(d)(2)(B)(i)). When two healthy federal credit unions wish to merge, and thus combine their financial strength and service to their members, they should be allowed to do so. There is no reason to require in connection with such mergers that groups over 3,000, or any group for that matter, be required to spin off and form a separate credit union. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns. These groups are already included in a credit union in accordance with the statutory standards, and that status should be unaffected by a voluntary merger.

Regulatory Relief from SEC Registration Requirements

NCUA is seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker-dealers when engaging in certain de minimus securities activities.

The Gramm Leach Bliley Act, enacted in 1999, created exemptions from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisers Act of 1940. The principle established by these exemptions is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate.

Section 313 of HR 1375, and Section 115 of CURIA, would provide similar exemptions for federally insured credit unions. NCUA supports these exemptions. Because of significant differences between broker-dealer capital requirements and depository institution capital requirements, it is virtually impossible for depository institutions, including credit unions, to register as a broker-dealer and submit to broker-dealer requirements. Without an exemption credit unions may find that although they are authorized under their chartering statutes to engage in particular securities-related activities, their inability to register as a broker-dealer would keep them from engaging in these activities.

Recently, the Securities and Exchange Commission proposed a rule that would exempt credit unions from the definition of broker and dealer for a few of the activities exempted for banks under Gramm Leach Bliley, including third party brokerage arrangements and sweep account arrangements. NCUA supports the SEC proposal. We believe, however, that the SEC's proposal does not go far enough, and we continue to support legislative relief.

The relief sought for credit unions would be more limited in scope and application than that which is available to banks and requested by thrifts. Credit union powers are limited by their chartering statutes, and credit unions do not have certain powers, such as general trust powers, that are available to banks and thrifts. The requested parity relief for credit unions would apply only to those activities otherwise authorized for credit unions under applicable credit union chartering statutes, currently including third-party brokerage arrangements, sweep accounts, and certain safekeeping and custody activities.

ADDITIONAL CREDIT UNION PROVISIONS IN CURIA

I would also like to take this opportunity to comment on credit union provisions not originating from NCUA, but included in CURIA and H.R. 1375 as passed by the House of Representatives.

NCUA has reviewed all of the additional credit union provisions included in H.R. 3579 and the agency has no safety and soundness concerns with these provisions. Among these are provisions which address leases of land on Federal facilities for credit unions (Section 102); member business loans for non-profit religious organizations (Section 106); criteria for continued membership of certain member groups in community charter conversions (Section 109); credit union governance changes (Section 110); and revising the economic factors the NCUA Board must use when considering adjustments to the statutory 15% interest rate that can be charged by federal credit unions on loans (Section 111). Again, though we recognize these issues as statutory in nature and therefore a public policy decision only the Congress can make, we have carefully examined each and have determined that these provisions present no safety and soundness concerns for the credit unions we regulate and/or insure. Also, Section 114 of H.R. 3579 provides for an exemption from pre-merger notification requirements of the Clayton Act. We have likewise reviewed this provision, and have no objections and actually see benefit from a safety and soundness perspective.

Conclusion

As we implement regulatory reforms through our own annual review of regulations, through the EGRPRA process or through any legislative improvements the Congress ultimately chooses to enact, effective regulation, not excessive regulation, should be the basis of fulfilling our mission and ensuring the safety and soundness of our nation's credit unions.

The additional legislative proposals I have presented here are consistent with the mission of credit unions and the principles of safety and soundness. The credit union provisions of H.R. 1375 and H.R. 3579 will benefit credit union members and have a positive impact on credit unions by lowering the cost of doing business and complying with regulations and the Federal Credit Union Act.

I would be pleased to assist your further deliberations on these in any way I can.

Thank you.

ADDENDUM TO CHAIRMAN JOHNSON'S TESTIMONY

Proposed Language to the Federal Credit Union Act Regarding Mergers and Net Worth

Proposed technical correction to Section 216 of the Federal Credit Union Act (12 USC 1790d(o)(2)(A)):

(2) **Net Worth**.---The term 'net worth'--

(A) with respect to any insured credit union, means equity as determined under generally accepted accounting principles and as authorized by the Board; and

(B) with respect to a low income credit union, includes secondary capital accounts that are---

(i) uninsured; and
(ii) subordinate to all other claims against the credit union, including claims of creditors, shareholders, and the Fund.

Draft Report Language

This amendment to Section 216 of the Federal Credit Union Act (FCU Act) (12 USC 1790d(o)(2)(A)) redefines the term "net worth" for PCA purposes by replacing the phrase "retained earnings balance" with the phrase "equity" and by inserting the phrase "and as authorized by the Board" (i.e., NCUA Board) where indicated. The amendment is necessary to cure the unintended consequence of business combination accounting rules the Financial Accounting Standards Board (FASB) is intending to apply to the combinations of mutual enterprises (e.g., credit unions).[1]

[1] In June 2001, the FASB adopted Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations*, requiring the acquisition method for business combinations and effectively eliminating the pooling method. The pooling method has typically been used by credit unions to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001. Paragraph 60 of the standard deferred the effective date for mutual enterprises (i.e., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

When FASB lifts the paragraph 60 deferral of the acquisition method that credit unions have enjoyed, this will eliminate the practice of accounting for mergers as a pooling of interests. The acquisition method would require the valuation of the target credit union at fair value; the recognition of identifiable intangibles (e.g., core deposit intangibles and/or goodwill), when relevant; and the application of a market-based acquisition model to a non-bargained transaction. The FASB intends to expose a statement for public comment in the 2nd quarter of 2004 and to finalize the standard in the 2005 with an effective date in early 2006.

Currently, under the FCU Act, a credit union's capital is measured based on the retained earnings balance as determined under GAAP. The FASB is preparing to revise GAAP in relation to the combination of mutual enterprises (i.e., credit unions) with the effective result that the interplay between the capital definition in the FCU Act and FASB's new rules will create a disincentive to otherwise desirable credit union mergers. Additionally, the change will make it more difficult for the NCUA to carry out its responsibilities to protect the public interest in managing and minimizing losses to the National Credit Union Share Insurance Fund (NCUSIF) through the merger option. The FASB has expressed support for a legislative solution and has indicated that a legislative redefinition of capital (net worth) will not affect their standards-setting activities. The remedy needed is an expanded definition of capital in the FCU Act in advance of the FASB rule effective date (expected January 2006) to mitigate this unintended result. Banks and their insurers do not have the same concerns because their existing capital definition under relevant law is broader.

This amendment is intended to address a narrow and technical accounting issue and in the process remove the unintended disincentive to credit union mergers that FASB's imminent action will create.

The "as authorized by the Board language" has the limited effect of allowing the Board comparable authority as federal banking regulators to exclude items within the capital structure that do not have value to the insurance fund in a liquidation scenario, e.g., core deposit intangibles, goodwill, etc., thus not "overvaluing" resulting post-merger capital. The "as authorized" language does not provide the Board any other authority to either limit the definition of net worth or alter the PCA net worth categories. The authority would be exercised only after due deliberation and public comment through a federal register notice and rulemaking process.

Unlike FDIC-insured financial institutions, credit unions are permitted by law to count as capital only their "retained earnings" as determined under GAAP. The law excludes all other equity components. Federally-insured credit unions are required to comply with a Congressionally-mandated system of minimum regulatory capital standards known as "prompt corrective action." 12 U.S.C.§1790d. A credit union's "net worth ratio" determines its classification among five statutory net worth categories. The lower the category, the more supervisory actions the credit union must comply with and implement. The denominator of the net ratio is the balance of a credit union's total assets. The numerator of the ratio is narrowly limited by law to the "retained earnings" component of equity. 12 U.S.C.§1790d(o)(2)(A). In contrast, the numerator of an FDIC-insured financial institution's equivalent "leverage ratio" may include virtually all GAAP equity components.

Under FASB's expected approach, however, a combination between credit unions would cause the acquiring credit union's capital ratio to *decline* in most cases. Potential acquiring credit unions would naturally find the prospect of being demoted to a lower net worth category, and potentially subject to more supervisory actions, too high a price to pay to merge with another credit union. In contrast, the expected approach would not inflict this problem on acquiring banks and thrifts because they are allowed to include virtually all components of equity in their capital.

The adverse impact on an acquirer's post-merger capital level will be a disincentive to otherwise desirable credit union mergers. In turn, it will be much more difficult for NCUA to carry out its responsibility to protect the public interest. Fewer potential merger partners will come forward to rescue a troubled credit union when they realize that the reward for doing so is a reduction in post-merger capital. This also will undermine the purpose of "prompt corrective action" which is to resolve the problems of credit unions while minimizing losses to the NCUSIF. Fewer willing merger partners mean fewer opportunities to avert losses to the NCUSIF by merging a troubled credit union. Credit union mergers have traditionally been effective in accomplishing both objectives while preserving the continuity of credit union service to the target credit union's members. We have no doubt that Congress neither intended nor expected to discourage mergers when it adopted GAAP retained earnings as the definition of credit union capital.

Proposed Amendment to the Federal Credit Union Act Regarding Vendor Examinations.

The Federal Credit Union Act, (12 U.S.C. §1752 et seq.) is amended by deleting existing Section 206A, 12 U.S.C. §1786a, and adding the following new section:

§1786a

Examination of credit union service providers -

(a) If an insured credit union causes to be performed for itself, by contract or otherwise, any service that provides information systems support, technology services, data processing services, loan services or other services related to the credit union's operations (as those terms are defined by the Board, by regulation) such service shall be subject to examination by the Board to the same extent as if such services were being performed by the insured credit union itself on its own premises.

(b) Administration by the Board – The Board may issue such regulations and orders as may be necessary to enable it to carry out examinations under this Section.

Draft Report Language on Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other services to federally insured credit unions. This statutory authority did previously exist for NCUA, but under a sunset provision that expired in 2001. Indeed, the authority that expired in 2001 allowed NCUA to examine and regulate all third-party service providers, and was thus broader than the authority now being requested by NCUA.

As of December 2003 approximately 25% of all federally insured credit unions contract with outside vendors to perform many of their automated back room accounting processes. Another 70% use vendor supplied software and data processing programs that rely upon vendor servicing and maintenance to function effectively. These services may include such things as electronic money transfers, check clearance, transactional internet services, and varying levels of internal controls to assist credit unions in identifying and reporting suspicious activity. Other third-party vendors provide processing and support services in areas such as loan processing and overdraft protection.

This heavy and increasing reliance on vendors by credit unions for many critical functions makes it essential for NCUA to have the authority to examine and evaluate vendor operations. The General Accounting Office in October 2003 recommended that Congress consider giving NCUA the authority to examine third-party vendors. NCUA's ability to timely identify weaknesses and require their correction is critical to our ability to assure credit unions operate in a safe and sound manner.

NASCUS

An Umbrella Organization

Testimony of Roger W. Little
Deputy Commissioner, Credit Unions
Michigan Office of Financial and Insurance Services
On behalf of the
National Association of State Credit Union Supervisors
Before the Subcommittee on
Financial Institutions and Consumer Credit
Financial Services Committee
United States House of Representatives
July 20, 2004

NASCUS History and Purpose

Good afternoon, Chairman Bachus, and distinguished members of the Financial Institutions and Consumer Credit Subcommittee. I am Roger W. Little, Deputy Commissioner of Credit Unions for the Office of Financial and Insurance Services of the state of Michigan. I appear today on behalf of the National Association of State Credit Union Supervisors (NASCUS). NASCUS represents the 48 state and territorial credit union supervisors and the NASCUS Credit Union Council is composed of more than 600 state-chartered credit unions dedicated to defending the dual chartering system for credit unions.

The mission of NASCUS is to enhance state credit union supervision and regulation and advocate policies to ensure a safe and sound state credit union system. We achieve those goals by serving as an advocate for a dual chartering system that recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the introduction of proactive credit union legislation that provides regulatory relief, advances credit union efforts to promote economic growth and modernizes capital standards while ensuring a safe and sound environment for credit unions and the consumers they serve. We appreciate the opportunity to provide the Subcommittee with our comments on the Credit Union Regulatory Improvements Act of 2003, H.R. 3579, and look forward to the successful passage of this Act.

H.R. 3579 includes almost all of the credit union provisions that were included in H.R. 1375, Regulatory Relief legislation, favorably passed by the full House of Representatives in March of this year. It adds several new credit union powers or provisions that make daily operations easier and provide greater flexibility for credit unions to serve their members.

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In this testimony, I offer both insights about the provisions contained in all three Titles of H.R. 3579 as well as other NASCUS priorities for regulatory relief.

Title III—Capital Reforms

NASCUS has studied the risk-based capital reform proposal outlined of H.R. 3579 and supports a risk-weighted capital regime for credit unions.

The term net worth ratio in Section 216 of the Federal Credit Union Act would be changed from the ratio of credit union net worth to total assets to the ratio of net worth to risk assets of a credit union. In effect, this establishes a risk-based, net-worth ratio system for credit unions. The existing PCA/net worth numerical categories in the statute would remain unchanged. However, NCUA would establish the new risk weighting categories, hopefully similar to those used by banks and thrifts.

The risk-weighted capital reform should be flexible, and NASCUS believes that the regulations should be progressive and not designed to "regulate to the lowest common denominator."

State regulators would assist NCUA in crafting these regulations. The existing Credit Union Membership Access Act requires the NCUA to consult and cooperate with state regulators in the crafting of PCA and MBL regulations. This cooperation between the federal and state agencies ensures a safe and sound method for determining the risk weighting categories.

Alternative Capital for Credit Unions

The proposed bill does not change the definition of net worth to permit credit unions to count alternative capital as a part of net worth for PCA purposes. NASCUS strongly supports alternative capital for credit unions. We believe it is complementary to a risk-based capital regime, and in no way conflicts with the proposals outlined in H.R. 3579.

NASCUS supports alternative capital reform beyond risk-based, net worth requirements. The combination of PCA requirements established by Congress for credit unions in 1998 and significant deposit growth has created a financial and regulatory dilemma for many state-chartered credit unions. As noted above, the FCUA defines credit union net worth as retained earnings. The NCUA has determined it lacks the regulatory authority to broaden that net worth definition to include other forms of capital as a part of PCA calculations. Thus, credit unions will require an amendment to the FCA to rectify this statutory deficiency.

To continue to meet the financial needs of their members for additional services such as financing home ownership and providing financial education and credit counseling, many state-chartered credit unions will not be able to rely solely on retained earnings to meet the capital base required by PCA standards.

With the economic downturn and the flight to safety from the stock market, credit union member savings are growing rapidly and many credit unions are reporting reduced net worth ratios as earnings retention lags growth in assets.

As a regulator, it makes no business sense to deny credit unions the use of other forms of capital that improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this nation's credit union system.

Recently, the Filene Research Institute published a study on the feasibility of allowing credit unions to count subordinated debt toward their federal PCA capital requirements. The study was prepared by Professor James A. Wilcox of the Haas School of Business, University of California-Berkeley. He concluded that permitting credit unions to issue subordinate debt, as many state statutes now allow, and count it as a part of net worth would be beneficial for credit unions and would achieve important public policy objectives.

The study, *Subordinated Debt for Credit Unions,* is lengthy and detailed and I will not submit it for the record, but will make copies available for the Subommittee staff and any Members who would like a copy.

In summary, we believe H.R. 3579 should be amended to allow other forms of capital to be counted as part of net worth for PCA purposes for federally insured credit unions. We urge this Subcommittee to consider and approve this revision of the definition of net worth for credit unions.

FASB Rules Affect Credit Union Mergers

NASCUS also supports amending the definition of net worth to cure the unintended consequences for credit unions of business combination accounting rules the Financial Accounting Standards Board (FASB) intends to apply to combinations of mutual enterprises. The new rules may cause significant dilution of net worth in credit union merger transactions if the definition of net worth continues to be limited solely to retained earnings.

In June 2001, the FASB adopted Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations*, requiring the acquisition method for business combinations and effectively eliminating the pooling method. The

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pooling method has typically been used to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001.

Paragraph 60 of the standard deferred the effective date for mutual enterprises (e.g., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

The FASB is likely to lift the paragraph 60 deferral of the acquisition method for mutual enterprises, thus eliminating the practice of accounting for credit union mergers as a pooling of interests. The acquisition method would require the valuation of the target credit union at fair value; the recognition of identifiable intangibles (i.e., core deposit intangibles and/or goodwill), when relevant, and the application of a market-based acquisition model to a non-bargained transaction. The retained earnings of the merging institution could no longer be combined with those of the continuing credit union, creating a potentially significant dilution of statutory net worth and an unintended impediment to credit union mergers, thereby adding additional regulatory risk. We urge the Subcommittee to support amending net worth to resolve the unintended consequences of FASB's rules. FASB supports such an amendment.

Title II—Expanding Member Business Lending Authority

Title II of H.R. 3579 focuses on member business loans (MBLs). Credit unions should be given greater authority to meet their member business lending needs. It is important for both economic development and to meet the growing needs of entrepreneur members.

NASCUS supports Section 201 of H.R. 3579, which expands the member business lending (MBL) provisions from 12.25% to 20% of total assets of a credit union. This provision facilitates member business lending without jeopardizing safety and soundness at participating credit unions.

In addition, Section 202 of the bill amends the current definition of a member business loan to facilitate such loans by granting NCUA the authority to exempt loans $100,000 or less. This increases the definition of business loans subject to the current cap of $50,000 to $100,000. H.R. 1375 similarly expanded lending authority for federal savings institutions. We urge that the statutory definition of a credit union MBL be changed from the current $50,000 limit contained in the FCUA. In fact, we support redefining credit union MBLs as those that exceed the Fannie/Freddie conforming loan limit, approximately $322,000, a safe and sound, well established and readily understandable index that has served lenders and the public interest well for many years.

Title I: Regulatory Flexibility

NASCUS supports Section 106 of H.R. 3579 revising member business lending restrictions in the Federal Credit Union Act, thus lifting the restrictions on member business lending to nonprofit religious organizations for federally insured, state-chartered credit unions.

This is a win-win for everyone involved. The credit union has the ability to expand its member business offerings and members involved with non-profit religious organizations have greater ability to offer lending products benefiting the entire community.

Additionally, NASCUS supports Section 114 of H.R. 3579 giving all federally insured credit unions the same exemptions as banks and thrift institutions from pre-merger notification requirements and fees of the Federal Trade Commission. In fact, we believe it should be expanded to include all state-chartered credit unions, not just those that are federally insured.

H.R. 3579 provides regulatory relief for federally insured credit unions with regard to SEC broker/dealer registration and investment advisor requirements. These are similar exceptions to those provided to banks in Gramm-Leach-Bliley and we support this provision of the legislation (Section 115).

Our major concern is that, unless state-chartered credit unions are accorded the same SEC treatment as commercial banks and savings institutions, the powers granted credit unions by state legislatures and state regulators will be unnecessarily preempted by SEC regulation. Section 115 will provide regulatory relief to credit unions from redundant and costly examination.

Section 113 of H.R. 3579 calls for more rigorous charter conversion requirements. The bill requires that at least 20 percent of the membership of a federally insured credit union vote to approve a proposal to convert its charter. NASCUS believes the process for converting a state-chartered credit union to another financial institution charter is a matter that should be determined by state law and regulation rather than by the federal deposit insurer.

Expanding H.R. 3579

NASCUS supports other regulatory relief priorities beyond those found in H.R. 3579.

NASCUS believes non-federally insured credit unions should be eligible to join the Federal Home Loan Banks (FHLBs). This provision is contained in

Section 301 of H.R. 1375 and we believe H.R. 3579 should be amended to include a similar provision.

At this time, all credit unions do not operate with access to the same benefits. Federally insured credit unions now have access to the FHLBs, while privately-insured credit unions do not have the same access.

Today, there are approximately 375 credit unions that are non-federally insured. All of these credit unions are regulated and examined by state regulatory agencies to assure they are operating in a safe and sound manner. Regulatory functions are a primary determinant of the safety and soundness of the credit union system. The function of the credit union regulator is to assure consumers that their deposits are safe. The credit union regulator performs this mission by:

- issuing rules to assure safe and sound financial practices in credit unions;
- ensuring that violations of those safety and soundness rules are corrected;
- performing safety and soundness examinations of credit unions under their supervision;
- requiring correction of financial and operational deficiencies identified during the examination process; and
- taking enforcement actions to assure that financial remedies are implemented by the credit union (including letters of understanding and agreement, closure of the credit union, etc.).

To protect credit union shareholders both federal and private share insurance systems have been established. To manage and price insurance risk, each share insurer relies significantly on the examination reports of the institution's primary regulator. Most state credit union agencies use the NCUA/AIRES examination platform when they examine state-chartered credit unions for safety and soundness purposes. NASCUS agencies participate in the development and testing of NCUA's examination program and procedures. In short, there is an excellent working relationship with NCUA and there are substantially similar examination standards for both federally and state-chartered credit unions. The private insurers, primarily American Share Insurance in the United States and a cooperative insurance fund in Puerto Rico, have established additional solvency standards to minimize risks in their insured credit unions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a series of safety and soundness requirements both for entities that offer private deposit insurance to credit unions and for credit unions which opt for private deposit insurance.

FDICIA also requires that privately insured credit unions must be certified to meet eligibility requirements for federal deposit insurance. Specifically, the Act states that no depository institution which lacks federal deposit insurance may use "the mails or any instrumentality of interstate commerce to receive or facilitate receiving deposits, *unless* the appropriate supervisor of the State in which the institution is chartered has determined that the institution meets all eligibility requirements for Federal deposit insurance ... ." (Emphasis added) As a practical matter, this requirement applies to every state-chartered, privately insured credit union, as every such credit union uses some instrumentality of interstate commerce or the mails.

FDICIA also spells out the manner and extent to which institutions choosing for private deposit insurance are required to fully disclose that their deposits are privately insured. Therefore, there should be no concern that these credit unions are not operated in a safe and sound manner.

Attached to our testimony is a comparative analysis of the financial performance of federally-chartered, state-chartered federally insured and state-chartered non-federally insured credit unions. The data shows the financial performance and safety and soundness of all three groups of credit unions are substantially equivalent.

Permitting non-federally insured institutions to join the FHLBank System would not establish a new membership principle for the system. More than 50 insurance companies, chartered and regulated by state governments with no federal oversight or insurance, are now members of these Banks. Allowing FHLBank membership to privately-insured credit unions to provide additional opportunities for housing finance will not inflict any new or unusual exposure on the Bank System.

Moreover, an additional layer of financial discipline will be introduced. Each Federal Home Loan Bank has a sophisticated credit screening system to assure that any borrower, federally insured or not, is credit worthy. In addition, every advance is secured by marketable collateral. Indeed, even during the savings and loan debacle, we understand that no Federal Home Loan Bank suffered a loss on advances extended to their members.

In the past, Congress has expanded the membership eligibility for the Bank system as a mechanism to help local financial institutions meet the housing and home ownership needs of their communities. The inclusion of this provision, enabling state-chartered, privately insured credit unions to be eligible to join the FHLBank System, is merely one more step in bringing home ownership opportunities to these credit union members.

We would appreciate your support by including this proposal in H.R. 3579 and urge the Subcommittee to approve this provision which will help achieve our nation's housing and home ownership goals.

Federal Preemption of State Regulation of Consumer Protection Practices

Lastly, as credit union regulators, we have a significant stake in the growing controversy between the Office of the Comptroller of the Currency (OCC) and the National Governors' Association, the National Association of Attorney's General, the Conference of State Bank Supervisors, the National Conference of State Legislatures and others over the issue of expanding federal preemptions of state laws and regulations.

As a matter of policy NASCUS does not take public positions on issues that only affect the commercial banking industry, but we are concerned about the contagion impact on the credit union dual chartering system if the powers of the state banking regulators are significantly curtailed by these actions of the OCC.

Recent regulations of the OCC will have a broad impact on the dual chartering system for commercial banks and could open the door to similar actions by the federal credit union regulator, the National Credit Union Administration (NCUA), unless Congress intervenes to rein in additional federal preemption powers that the OCC has implemented.

Determining the extent to which such additional federal banking powers should be granted by the OCC is an important matter for those who support the dual chartering system for all depository institutions. The importance of this matter dictates that the Congress should resolve these conflicts rather than delegate this fundamental issue to the federal financial institution regulators to determine.

The states, through the dual chartering system, have long served as laboratories for experimentation in the financial services business. State governments have pioneered in providing depository institutions new powers that enhance the earnings of those financial institutions and provide consumers innovative new financial services. Later, after a period of experimentation in the state sector, such new powers often were granted to federal financial institutions either by statute or regulation.

In the case of credit unions, almost all innovations in new powers were initiated by the states, and later imitated by the federal credit union regulator after successful experience in the state sector. In this way, the dual chartering system for both commercial banks and credit unions has provided our economy with two very effective financial engines that drive our nation's economic change and growth. We applaud these dynamic results of the dual chartering system for depository institutions.

But now, when the issue becomes one of consumer protection, some are demanding that the federal banking authorities preempt state consumer protection initiatives in the name of establishing an exclusive national standard for regulating almost all aspects of consumer lending practices.

Historically, states have established predatory lending and other consumer protection statutes that are applicable to both state and federal depository institutions. In general, the rule has been that national banks are subject to such state statues to ensure the same level of protection for citizens of the state opting to use the services of a federally-chartered financial institution.

NASCUS is not comfortable with such federal rulemaking. What the OCC has adopted will override state law and concentrate regulatory power at the federal level. The Governors similarly oppose these rules. The National Conference of State Legislatures has expressed its concerns about the impact of these rules on state law. The Conference of State Bank Supervisors has opposed these rules. Consumer groups have opposed federal preemptions that would vitiate hard won victories in state legislatures that provide additional protection to all consumer borrowers in their states.

Given the widespread, significant and expert opposition to these federal rules, we encourage Congress to intervene and block such precipitous federal actions. Congress should decide if these proposals are consistent with the Riegle-Neal Act which protects state laws regulating activities of commercial banks in several specific areas, or decide to overturn the Riegle-Neal principles on the application of federal and state law to the commercial banking industry.

Conclusion

In conclusion NASCUS strongly supports the following provisions of H.R. 3579 and other priorities for regulatory relief:

- NASCUS supports Title II of H.R. 3579 that focuses on member business lending. Section 201 expands member business lending provisions from 12.25% to 20% of total assets of a credit union, furthering the goal of providing loans for consumer members.

- NASCUS supports Section 202 of Title II of H.R. 3579 that amends the current cap of a member business loan from $50,000 to $100,000.

- NASCUS supports the risk-weighting capital reform provisions outlined in Title III of H.R. 3579. Section 216 of the Federal Credit Union Act would be changed from the ratio of credit union net worth to total assets to the ratio of net worth to risk assets of a credit union.

- NASCUS supports alternative capital reform beyond risk-weighted alternatives and believes credit unions should be permitted to issue alternative capital.

- NASCUS supports amending the definition of net worth to cure the unintended consequences for credit unions of business combination accounting rules the FASB intends to apply to combinations of mutual enterprises.

- NASCUS supports the regulatory flexibility provisions in Title I of H.R. 3579. Section 106 lifts the restrictions on member business lending to nonprofit religious organizations for federally insured, state-chartered credit unions.

- NASCUS supports Section 114 of H.R. 3579 giving all federally insured credit unions the same exemptions as banks and thrift institutions from pre-merger notification requirements and fees of the Federal Trade Commission. In fact, we believe it should be expanded to include all state-charted credit unions.

- NASCUS supports Section 115 that provides regulatory relief to savings associations and credit unions with regard to SEC broker/dealer registration and investment advisor requirements.

- NASCUS strongly believes non-federally insured credit unions should be eligible to join the FHLBs.

- We encourage Congress to intervene to block continuing OCC preemption of state laws.

NASCUS appreciates the opportunity to testify today on the Credit Union Regulatory Improvements Act of 2003 and we welcome further participation in the discussion and deliberation. We urge this Subcommittee to protect and enhance the viability of the dual chartering system for credit unions by acting favorably on the provisions we have discussed in our testimony.

Competitive Analysis
Credit Unions
As of March 31, 2004

	SCU	PISCU	FCU
Member Growth *	.65%	1.63%	.43%
Share Growth*	2.68%	4.73%	3.03%
Loan Growth*	1.28%	1.73%	.90%
Delinquency	.69%	.66%	.68%
Loans/Shares	71.92%	65.43%	68.16%
Loans/Assets	62.40%	58.07%	59.01%
Return on Assets**	.87%	.95%	.93%
Net Worth	10.56%	10.66%	10.71%

* = First Quarter Only
** = Annualized Data

SCU—State-Chartered Credit Unions
PISCU—Privately Insured, State-Chartered Credit Unions
FCU—Federally Insured Credit Unions

SCU and FCU data are derived from call reports from all federally insured CUs. PISCU information is derived from American Share Insurance.

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Fax: 203-849-9714

April 27, 2004

Fred R. Becker, Jr.
President and CEO
National Association of Federal Credit Unions
3138 10th Street
North Arlington, VA 22201-2149

Dear Mr. Becker:

Re: Proposed Amendment to the Federal Credit Union Act

The purpose of this letter is to respond to your request for comment on the impact of a proposed amendment to § 1790d(o)(2)(A) of The Federal Credit Union Act (12 U.S.C. § 1790d(o)(2)(A)) (the "Act") on the activities of the Financial Accounting Standards Board ("FASB"). We understand that your organization has drafted and is considering pursuing with Members of Congress a proposed amendment to the Act redefining the term "net worth" as described in the attachment. We believe that it is vital that our comments are considered within the perspective of a shared understanding of the mission and role of our organization. Our view is based solely on the FASB staff's review of the attached proposed amendment and the related accounting literature.

The mission of the FASB is to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The National Credit Union Administration, an independent agency of the U.S. government, charters, regulates, supervises and insures federal credit unions. That supervision includes assessing the financial safety and soundness of credit unions, in part based on regulatory capital guidelines established by the Act. As indicated in § 1790d(b)(1)(B), those guidelines include assessing the capital adequacy of credit unions, taking into account that credit unions do not issue capital stock and must rely on retained earnings to build capital.

The proposed amendment seeks to revise the definition of net worth solely for the purpose of assessing regulatory capital adequacy of credit unions pursuant to the Act. An amendment to the capital adequacy ratio in no way influences the creation and improvement of general-purpose standards of financial accounting and reporting. As such, the attached proposed amendment *does not* propose to establish or change general-purpose standards of financial accounting and reporting. Therefore, the proposed amendment has no impact on the standard setting activities of the FASB.

April 27, 2004
Page 2 of 2

While our primary concerns are not regulatory issues, we do have an interest in supporting an expedited resolution of this matter. The attached proposed amendment proposes a way to resolve this matter. Therefore, if there is any additional assistance we can offer from a financial accounting and reporting perspective, please let us know. If you have any questions on this matter, please contact me directly at (703) 243-9085.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
Counsel to the Chairman

Attachment

cc: Dennis E. Dollar, Chairman, National Credit Union Administration
Dan Mica, President and CEO, Credit Union National Association, Inc.

Attachment

National Association of Federal Credit Union's Proposed Amendments to Section 1790(o)(2)(A) of the Federal Credit Union Act ("Act")

MAY 2004

The proposed technical corrections below suggest revisions to the definition of net worth in §1790d(o)(2)(A) of the Act. Net worth is used to assess the capital adequacy of credit unions for regulatory purposes.

The FASB plans to propose changes to standards of financial accounting and reporting for general-purpose financial statements that, consistent with existing standards for other entities, might require a direct addition to the capital (or equity) base of the acquiring credit union in a business combination. That addition to capital (or equity) as defined for general-purpose financial reporting would not, however, be classified as part of retained earnings; thus, it would not be included in capital as it is currently defined for regulatory purposes. Therefore, changes to the credit union regulatory requirements are proposed below to correspond to the proposed financial accounting changes.

Proposed technical correction to Section 1790(o)(2)(A) of the Act:

> ...with respect to any insured credit union, means ~~retained earnings balance~~ the equity of the credit union, as determined under generally accepted accounting principles and as authorized by the Board;...

Questions Submitted for the record by Chairman Bachus
Subcommittee on Financial Institutions and Consumer Credit Hearing on
"Credit Union Regulatory Improvements"
July 20, 2004

Questions for Sharon Custer, representing Credit Union National Association (CUNA)

1. **HR 1375 includes a section expanding the lending authority of credit unions from 12-year maturity limitations to 15-years. This seems to me a common sense provision that would make it much easier for consumers to comparison shop for loans. Could you discuss this provision and others like it that just lead to common sense improvements to the financial services those credit unions provide their members?**

The 12-year maturity is out of date and out of sync with the marketplace. This limit, along with others such as the 1% limit on loans to or investment to CUSOs, sets artificial impediments that prevent credit unions from serving their members and their communities as fully as they could otherwise. Also, in the case of the 12-year limit, a longer maturity would help consumers because they could have lower monthly payments if the maturity is extended.

The governance provisions in Title I of CURIA are another example of statutory micromanagement...credit union boards, not statutes, should determine the procedures for expelling unruly members or whether boards should want term limits. And there are provisions in CURIA that give credit unions the same exemptions that other financial institutions have from filing requirements in the broker/dealer area and for anti-trust purposes. These were obvious oversights that need to be fixed.

2. **In your testimony, you mention a Small Business Administration paper that states, "Access to credit has been significantly reduced by banking consolidation." Prior to the Credit Union Membership Access Act of 1998 (CUMAA), credit unions had few restrictions on their member business lending authority. How has CUMAA affected your ability to make Member Business Loans?**

   My credit union only started a member business lending program within the last year. We are lucky that we have the resources to start up this program. But regrettably, there are many credit unions that I know of that do not have this ability. Here is one major problem. The National Credit Union Administration regulates MBLs for federally insured credit unions, including state chartered credit unions whose states have not received a waiver. NCUA requires by regulation that credit unions have on staff or utilize the services of a lending officer who has expertise in the area of MBLs for at least two years. It is expensive for credit unions to procure this expertise and no sooner do they acquire it then they have reached their cap. We understand the need for MBL expertise at credit unions and are not opposed to this requirement. But the 12.25% limit creates a real barrier to the development of an ongoing MBL program, in large part because of the interplay between the regulatory requirement and the limit.

3. **I understand that only roughly 16% of credit unions are engaged in member business lending (MBL) today, which is only a one percent increase in the last decade. If this is so, then why are credit unions so supportive of eliminating the cap on MBL loans? Doesn't it seem that there is plenty of room for growth under the current guidelines?**

   There are 2 problems that are not apparent when you look at the statistics. As mentioned, the cost of setting up an MBL program is very expensive. For many credit unions, this expense is enough to discourage them from ever entering this line of lending...they figure, why bother if they can't make up the start-up costs. Also, while there are quite a few credit unions that are not in that market now, they may wish to be in the future...a change in the law now will make it easier for them to do that later.

4. **In your testimony you mention CUNA's support to expand check-cashing and remittance services. Could you detail for the Subcommittee how credit unions use this and other services as an opportunity to educate unbanked and underserved members of your community of services that are available to them, particularly financial literacy programs?**

Absolutely! Our hope is that if we are given this additional authority that we can reach out to people who now have only been able to rely upon check cashers, payday and predatory lenders, and high cost wire transfer services. If we can provide these services as an initial point of contact, by offering fairer prices and more personal services, it is our hope that we can persuade them to become credit union members and benefit from all our services, including financial counseling and education.

5. **It is my understanding that current Prompt Corrective Action (PCA) rules force credit unions to maintain capital levels higher than what may be necessary to protect the National Credit Union Share Insurance Fund. This reduces the amount of funds that credit unions can devote to member loans and other services that support the economy. If a risk-based approach to credit union capital is adopted instead, how significantly would this affect local communities? Would the amount of loans credit unions are able to provide make a difference?**

Adopting a risk-based PCA system would have the overall impact of freeing up a considerable amount of capital in credit unions, and all within the bounds of safety and soundness. This extra capital, in turn, could be used to provide higher rates of return on savings, lower interest rates on loans, an increase in the number of loans, and an increase in services to members, including those in lower income areas. Local communities that include both community and other chartered credit unions would be the beneficiaries by providing increased savings and more access to capital. It is difficult to calculate the actual dollar amount of this impact, but it would be significant for those individual beneficiaries at the very least.

6. **What are the two main things we can do here as part of the Financial Services Committee to improve the loan and savings services you provide to credit union members?**

Remove or increase the limits on member business lending and change PCA to require more reliance on a risk based system than the current approach provides. These changes would be the most useful to credit unions now and into the future.

7. **If a Risk Based PCA approach is adopted, will this pose any risk to the safety and soundness protections of the share insurance fund?**

No, it will enhance safety and soundness. Here is why. Under risk-based PCA, credit unions would maintain net worth (capital) based in greater proportion to the risk of the activities they engage in, rather than based on some arbitrary net worth goal that may not be that appropriate for a particular credit union's portfolio and activities. Such an approach is also fully consistent with the risk-focused examination process that NCUA and the other federal regulators adopted several years ago in which the exam provides the greatest scrutiny to those areas that pose the greatest risk to the credit union and the Share Insurance Fund.

8. **It is my understanding that credit unions lack access to capital markets, meaning that, unlike banks and thrifts, they cannot issue stock to raise additional capital when necessary. When members are concerned about the economy or financial markets, or if a credit union grows because of a merger or conversion to a community charter, the ratio of net worth to assets can fall**

substantially even for healthy, well-managed credit unions. How will a risk based approach to PCA change this?

A risk-based approach to PCA will recognize the nature of this growth and either reward a credit union or punish it based on the quality of its risk portfolio. For the overwhelming majority of credit unions, the result will be a positive one in which they will be able to use excess capital to the benefit of their members.

9. **With all the claims of the significant advantages that credit unions have over banks in taxes and regulation, it follows that the credit union charter should be a very attractive one for banks, resulting in a significant number of conversions of banks to credit unions. Can you tell me how many banks have converted to credit unions in recent years? To what do you attribute these figures?**

That's easy...we are not aware of any banks that have converted to credit unions. Why? Because they would have to give up their huge salaries, their enormous stock benefits, their retirement investment when they sold the bank, either for themselves or their families; their board members would have to give up tens of thousands of dollars in fees; and their shareholders would be out of an investment. In addition, they would have establish a field of membership that would restrict who they could serve, would be limited in their lending ability, and would have stricter PCA...just to mention some of the so-called advantages of a credit union.

10. **As in all industries, there seems to have been a growth in mergers and consolidations in the credit union industry. This has in part undoubtedly contributed to the growth in the number of credit unions with over $1 billion in assets that offer many of the same products and services banks do. Do credit unions of that size exceed what Congress envisioned when they were created and given their special status?**

Not at all. A credit union is not determined by its size nor the products and services it offers. Regardless of either of these, the structure is identical for all credit unions, and the structure is what defines a credit union. Congress reinforced the definition of a credit union in 1998: It is member-owned, democratically operated, not-for-profit, generally managed by a volunteer board of directors, and has the specified mission of meeting the credit and savings needs of consumers, especially those of modest means. That's what credit unions of all sizes were in the early 20th century, what they were in 1998, and what they are now.

11. **Your testimony touches on a topic of importance to many on this Subcommittee and goes to the essence of what many of us feel is the mission of credit unions--the idea of providing service to members of modest means. To many of us, "modest means" is another term for those who are poor and those who are underserved. We are aware of recent studies that suggest that credit unions might not be doing as good a job in this area as they could be.**

You suggest as much in your testimony and provide some interesting and convincing reasons for that. Please elaborate.

I want to be sure the Subcommittee understands that credit unions provide a tremendous benefit to their communities and to all of their members as well. A high percentage of credit unions offer "lifeline" products and services to their lower income members; many provide free financial counseling; are active in providing school children with financial literacy training, are partners with the National Child Program, often members can take advantage of products that provide an alternative to payday and predatory lenders, whether in the housing area or for international remittances. Data shows that a minority is more likely to get a loan from a credit union than from a bank. Credit unions will still make loans for a tv or refrigerator.

Having said all that, we recognize that there is always room for improvement. Credit unions were formed originally almost exclusively for employees, ie., people with jobs and affiliated with a particular employer-sponsor. Only within the last several years has there been an increase in the number of community chartered credit unions. These community charters are still limited to serving only those within their community that actually join the credit union. And for many of them, reaching out to the entire community to attract membership is a new challenge that they are only now beginning to understand. It will take several years to develop this new approach to membership. And even then, the great majority of credit union members remain with credit unions through their employment.

12. **Your testimony endorsed the risk-based approach in CURIA, yet it also suggests that giving credit unions the ability to raise secondary capital may be an appropriate way to address problems with PCA. I recall that you supported previous efforts to have the Subcommittee look at this option and as a result there is a pending GAO study on this issue. Could you tell me why you now appear to prefer the risk-based approach over secondary capital?**

Our concern has always been with problems associated with problems related to the one-size-fits-all approach for credit union Prompt Corrective Action. When we first approached the possibility of finding a legislative fix, secondary capital is an approach that we explored and thought could work. While we still think it could work, we recognized that there were concerns both within and outside the credit union movement. So, with the help of former NCUA Chairman Dennis Dollar, we began to focus on the risk-based approach to fixing PCA. We believe that adopting this approach would work for the overwhelming majority of credit unions.

The Honorable Judy Biggert
U.S. House of Representatives
Washington, D.C. 20515

VIA E-MAIL

Dear Representative Biggert:

I have received your letter of August 18, 2004 and I would be pleased to respond to your request to provide reasons why the National Credit Union Administration (NCUA) supports restoring this agency's authority to examine vendors of federally insured credit unions.

Let me begin by saying that Congress was judicious in previously granting NCUA temporary examination and regulatory authority with regard to credit union vendors in preparation for an anticipated temporary critical event – the transition to Y2K. That has now passed, but the critical events we now face are different and the following observations have led this agency to recommend that Congress consider reinstating only vendor examination authority to NCUA for the following reasons:

1. Three of the federal financial institution regulators (Federal Reserve Board, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation) received examination authority over third party service providers in 1982. 12 U.S.C. §1867. For the reasons explained below, NCUA and the Office of Thrift Supervision were given both examination and regulatory authority over third party vendors in 1998. 12 U.S.C. §§1786a(c), 1464(d)(7)(D). However, only NCUA's grant of that authority included a "sunset" provision," under which the authority lapsed on December 31, 2001. 12 U.S.C. §1786a(f). Today NCUA, alone among federal financial institution regulators, lacks the authority to examine the third party vendors who serve the industry it regulates.

2. The primary reason why Congress gave NCUA vendor examination authority in the first place—the impending Y2K transition—has been overtaken by an even more critical concern—national security. In 1998, Congress was concerned with preparing federally-insured financial institutions for the impending Y2K computer software transition to the new millennium. Because the Y2K transition was a temporary, one-time event, it warranted a grant of vendor examination authority that was temporary and would lapse by itself. But today we face a risk far more pervasive and unpredictable than Y2K—the threat to national security that has emerged since September 11, 2001. As reflected in the USA PATRIOT Act, this threat demands heightened vigilance by financial institution regulators to secure the nation's financial network.

3. The other two reasons why Congress gave NCUA vendor examination authority in 1998 are even more compelling today. First, credit unions today rely more than ever on outside information technology and computer systems vendors to perform mission-critical functions. As of December 2003, approximately 25 percent of all federally-insured credit unions contract with outside vendors to perform automated

accounting functions. Another 70 percent use vendor-supplied software and data processing programs that must be serviced and maintained by the vendor to function effectively. Second, the greater involvement of third party vendors in the critical operations of credit unions has introduced new and greater risks to their safety and soundness and, in turn, to that of the nation's financial network. Among these are risks associated with consumer privacy, money laundering and the financing of terrorism. Thus, unlike the "sunset" provision that ended NCUA's original vendor examination authority, the sun clearly has *not* set on the original reasons why vendors should be subject to examination.

4. When it is necessary to obtain information from a vendor about the services it provides, especially a vendor that serves multiple credit unions, NCUA is forced to approach individual credit unions and work with them to persuade their vendor(s) to voluntarily provide the information NCUA seeks. Plainly, it would be far more efficient and less burdensome for credit unions if NCUA had the authority to unilaterally go directly to the source—the vendors themselves—to seek the needed information.

5. Since its original authority to examine vendors lapsed in 2001, voluntary cooperation from vendors has been uneven and, more importantly, impossible to verify. In one instance a vendor completely denied NCUA access to its premises. In other instances, NCUA has had on-site access to conduct an examination, but vendors have withheld relevant information specifically requested by the examiners—something that typically is not discovered until after the examination is completed. Because vendor examinations are voluntary in the first place, NCUA really has no way of knowing whether it is getting full disclosure from vendors.

6. Because vendor examinations are voluntary, vendors who have been examined have the opportunity to object to distribution of NCUA's report of its observations about the vendor to the vendor's credit union clients who are most affected by them. When this happens, NCUA's only recourse is to instruct those credit unions to enhance their due diligence of the vendor, without identifying specific risks.

7. NCUA has neither the intention nor the resources to regularly conduct examinations of vendors that do business with credit unions. This is reflected in the approach I have suggested for the Subcommittee's consideration: to reinstate NCUA's *examination* authority over third party vendors, but not the *regulatory* authority originally granted NCUA that expired on December 31, 2001. *See* 12 U.S.C. §1786a(a)(1). This will facilitate the limited purpose of selectively examining vendors when in individual cases where it is necessary to get to the facts and assess their impact on credit unions. In addition, vendors' awareness that NCUA's authority to examine them is mandatory will encourage full cooperation and full disclosure by the vendors.

I trust these observations clarify the need for restoring the vendor examination authority NCUA once had. Please let me know if I can provide any additional information on this issue. I look forward to continuing to work with you on this and other issues of vital concern to NCUA and credit unions that are before the Subcommittee.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman

AMERICAN BANKERS ASSOCIATION ®

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Memo

World-Class Solutions, Leadership & Advocacy Since 1875

Date: July 15, 2004

To: Members of the House Financial Services Subcommittee on Financial Institutions and Consumer Credit

From: Edward L. Yingling, Executive Vice President, ABA

RE: Credit Union Charter Expansion Hearing on July 20, 2004

In anticipation of the hearing on July 20, 2004, I am writing to express the American Bankers Association's opposition to H.R. 3579, "The Credit Union Regulatory Improvements Act of 2003," introduced by Representatives Ed Royce (R-CA) and Paul Kanjorski (D-PA).

This legislation would, among other things, greatly expand credit union commercial lending authority while at the same time undercut the regulation of capital levels at federally-insured credit unions. Taken together, these changes would fuel even more aggressive growth within an ever-increasing segment of the credit union industry comprised of credit unions that are virtually indistinguishable from commercial banks. Today, 89 credit unions have grown to over ***$1 billion*** in assets, with the largest credit union holding $21 billion. These institutions dwarf the typical community bank that, with a median asset size of $99 million, historically has helped serve the varied financial needs of individuals and local businesses.

This new breed of credit unions is aggressively entering business lending. Their current tax-exempt status and lack of equivalent regulation have created huge competitive inequities in the local marketplace. Unfortunately, H.R. 3579 would further exacerbate these competitive inequities, as well as raise safety and soundness concerns. Specifically, the bill would increase credit unions' business lending authority to 20 percent of total assets. In addition, the bill ***excludes*** business loans under $100,000 from the business lending limit, up from $50,000 under current law, further masking the true amount of commercial lending engaged in by credit unions. Taken together these changes would ***grant credit unions more expansive commercial lending authority than tax-paying federal savings associations***, which are subject to a flat 20 percent of total assets limitation, but do not have the benefit of excluding certain loan amounts from that cap.

The current limits, as stated in the Senate Report to the implementing Credit Union Membership Access Act of 1998, "...are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through the emphasis on consumer rather than business loans."[1] How many loans to low- and moderate-income individuals could be made instead of 20 percent of all assets being devoted to business loans in excess of $100,000? Simply put, the focus on "people of small means" that was clearly enunciated in the preamble to the Federal Credit Union Act would be even further diminished – but the tax exemption for credit unions would not.

There is already plenty of evidence that business lending by credit unions is often focused on larger loans to businesses that do not deserve tax-subsidized loans:

- Less than one year after commencing operations, CU Business Group, LLC (a consortium of four large corporate credit unions) said it has processed more than $50 million in credit union business loans – with the average-sized loan over $600,000.

- The average business loan made at California's Arrowhead Credit Union is $225,000; at Telesis Credit Union, it is $783,000.

- Coastal Federal Credit Union (NC) with $1.33 billion in assets advertises on its web site that business loans are available up to $2 million – hardly a micro loan.

- OmniAmerican CU (TX) has established a $10.5 million line of credit and $2 million for working capital to Wide Open Spaces LLC for a real estate development project.

- Whitefish Credit Union (MT) made a $7 million loan to Clark Fork Valley Memorial Hospital to finance the expansion of the hospital's services and facilities.

- Citizens Equity First Credit Union (IL) made a commitment to finance a $2.6 million loan to Stonebridge Hospitality for a property located in Cayce, South Carolina.

These are loans for which any bank would compete.

But the credit union story does not stop here – the safety and soundness of these loans is an open question. A Pennsylvania banker reports losing a $2 million shopping center loan to $1.4 billion Visions FCU (NY). The reason: the bank wanted covenants in place to protect itself against an anchor store owned by a company in bankruptcy – the credit union did not seek the added protection ***and*** made the loan at a lower rate. Congress worried about this very thing when it enacted the current limitations: "The Committee action will prevent significant amounts of credit union resources from being allocated to large commercial loans that may present additional safety and soundness concerns for credit unions and that could potentially increase the risk of taxpayer losses

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1 Senate Report 105-193, May 21, 1998, pp.9-10

through the National Credit Union Share Insurance Fund."[2] Moreover, by raising the exclusion for business loans to $100,000, even more loans would no longer be subjected to special regulatory requirements for business lending, such as loan-to-value limitations and using experienced business-loan officers.

To make matters worse, H.R. 3579 would weaken capital standards by changing the definition of net worth ratio in a manner that would artificially inflate the capital cushion purported to be available. It does so by eliminating the minimum capital "leverage ratio" requirement. The current capital system was developed by Congress in 1998 because, in the words of the Treasury Department during the debate on the bill, NCUA's "...relevant statutes, regulations, and policies fall short of providing a system of prompt corrective action for credit unions. The NCUA has no regulations or even formal guidelines for taking corrective action regarding a troubled credit union...."[3] Moreover, the current capital rules were specifically imposed by Congress in order that credit unions would have the same type of capital requirements that were given to commercial banks and savings institutions in the aftermath of the savings and loan crisis. To remove the leverage ratio requirement would be to forget the lessons of the savings and loan crisis about the importance of a minimum mandatory capital requirement.

In sum, expanding commercial lending powers for credit unions, while simultaneously reducing capital levels, raises significant safety and soundness concerns. Moreover, the credit union lobby's efforts to obtain such expanded authority will primarily benefit the new breed of credit unions that are indistinguishable from banks and a far cry from traditional credit unions. The reality is that these morphed credit unions have out-grown their tax-exempt status and should be treated like any other full service financial services provider, including subjecting such institutions to taxation and bank-like regulation.

For these reasons, we oppose H.R. 3579. ABA thanks you for considering our views on this important issue.

Cc: House Financial Services Committee Chairman Mike Oxley

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2 ibid.

3 Credit Unions, United States Department of the Treasury, 1997, p. 76

Statement of

America's Community Bankers

on

Credit Union Regulatory Improvements

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

of the

U.S. House of Representatives

on

July 20, 2004

America's Community Bankers
Washington, DC

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee on Financial Intuitions and Consumer Credit, America's Community Bankers is pleased to submit a statement for the hearing on regulatory improvements for credit unions. America's Community Bankers is the member driven association representing the nation's community banks. ACB members, whose aggregate assets total more than $1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities. Our members believe that a discussion on the regulatory structure of credit unions is both timely and necessary, and we thank you for holding today's hearing.

ACB also is the primary representative of mutual savings banks and associations. These institutions share a cooperative structure similar to that of credit unions. However, there is one major difference. Just over 50 years ago, Congress declared that mutual savings banks actively competed with commercial banks. The tax-free treatment accorded mutual savings banks was determined to be discriminatory and was revoked. Today, many credit unions are more like banks than mutuals were 50 years ago, however, they still operate without meeting tax obligations.

Credit unions, as an industry, have $623 billion in assets and they compete with community banks to offer a broad array of financial services to consumers. Credit unions engage in activities ranging from traditional services such as checking and savings accounts to more diverse financial services products, including commercial loans, money market accounts, brokerage services, mutual funds, and insurance products. While many credit unions still meet the purposes for which they were originally established, which is to serve those with limited means or provide financial services to groups with a common bond, some have evolved into large, complex, bank-like entities serving large geographic areas and offering a diverse array of services. These institutions are professionally staffed, operate from large facilities, and often have extensive branch networks. A list of current credit union products is attached as appendix 1 to this testimony.

Despite their aggressive product offerings and profitability, this new breed of credit union does not pay federal, state, or local income taxes. As a result, these credit unions and community banks compete for the same customers on an unlevel playing field. The preferential tax treatment given to credit unions amounts to a government subsidy that provides a distinct pricing advantage when community banks are saddled with a combined tax rate of approximately 40 percent. H.R. 3579 would exacerbate this inequity because it would further hinder the ability of the nation's community banks to compete with credit unions in the financial services marketplace. Without accompanying tax legislation, H.R. 3579 would also further erode the tax base on which state and local governments depend, and widen the federal budget deficit.

Community banks are important to our communities and local economies. They provide needed financial services and are an integral part of the tax base. ACB members make loans to first time homebuyers, meet consumer credit needs, help families pay college tuition, sponsor financial literacy programs, help budding entrepreneurs establish their own businesses, promote community development, and pay taxes. It is truly inequitable that community banks are forced to compete head-to-head with a new breed of banks operating as tax-exempt credit unions. Our economy is built on free and fair competition. However, the free market is being disrupted by tax subsidies provided to large, complex credit unions.

Congress first permitted the chartering of federal credit unions in 1934 as tax-exempt financial service cooperatives to serve persons of modest means. This federal model was drawn from the successful state credit union model. At that time, credit unions also had meaningful restrictions on their fields of membership. Since then, credit unions have evolved into complex financial institutions. Some credit unions have fields of membership encompassing entire states and others have strayed from their mission of serving the underserved. For example, an October 2003 General Accounting Office (GAO) report indicates that "credit unions served a slightly lower proportion of low-and moderate-income households than banks." Moreover, credit unions are not required to comply with the Community Reinvestment Act. It is ironic that community banks are placed at a disadvantage because they are paying taxes and complying with the Community Reinvestment Act, while giant credit union conglomerates are exempt from both and can engage in such lines of business as aircraft lending and commercial property loans. We do not believe that credit unions should be granted expanded powers until they pay taxes like all other financial service providers and have community reinvestment responsibilities.

Under H.R. 3579, credit unions' commercial lending authority would be doubled to 20 percent of assets, and loans written for under $100,000 would not count against the limit. This is very troubling. The Home Owners' Loan Act limits the commercial lending of federal savings associations to 20 percent of an association's assets, provided that amounts in excess of 10 percent of total assets may be used only for small business loans. H.R. 3579 would, in effect, permit tax-exempt credit unions to exceed the commercial lending authority of taxpaying federal savings associations.

Furthermore, ACB is concerned about the safety and soundness impact of the regulatory changes being requested by credit unions. The new authority sought for credit unions would:

- Increase from 12 to 15 years the maturity limit for loans made by federal credit unions;
- Permit credit unions to cash checks for non-members;
- Permit voluntary mergers and conversions involving multiple common bond credit unions without numerical limitation; and
- Permit the use of secondary capital.

These activities require new levels of risk management and sophistication for credit unions. Banks and their regulators have decades of experience with the underwriting and risk management requirements required by managing debt instruments and business lending. Permitting credit unions to engage in these activities would not only divert them from their core mission, but it would dramatically and unnecessarily increase their risk profile. If credit unions desire to become major business lenders or undertake other bank activities then they should become banks, which they can do without changing their cooperative status.

ACB also believes that recent rulemakings by the National Credit Union Administration ("NCUA") have been inappropriate. NCUA policy has encouraged the growth of large, unbridled credit unions by:

- Expanding the community charter by liberalizing the definition of "local community;"
- Repealing the Community Action Plan, which would have imposed community reinvestment requirements;
- Ignoring Treasury's concern that liberalized business lending regulations disregard the Credit Union Membership Access Act's 12.25 percent cap; and
- Rejected Treasury's request to establish a credit-risk weighted capital requirement for corporate credit unions.

The NCUA's recent policy decisions have continued to eliminate the distinctions between credit unions substantially similar to tax paying banks of all charter types and organizational structures. ACB reiterates our opposition to expanding the powers of credit unions until credit unions and community banks compete on a level playing field. Thank you again for allowing ACB to submit a statement for this hearing. We appreciate the opportunity to share our views on this important issue. We look forward to working with you on issues relating to credit unions.

INDEPENDENT COMMUNITY BANKERS of AMERICA

July 19, 2004

Honorable Spencer Bachus, Chairman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U. S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the nearly 5,000 community bank members of the Independent Community Bankers of America (ICBA), I am writing to express strong opposition to H.R. 3579, the Credit Union Regulatory Improvements Act of 2003 (CURIA), which will be the subject of a hearing in your subcommittee this week. I respectfully request that this letter be made part of the permanent hearing record.

The bill substantially increases credit unions' commercial lending powers and makes a number of additional changes that undermine safety and soundness and are inconsistent with credit unions' historic mission and favored tax status.

The bill would substantially expand credit union commercial lending authority, permit credit unions to make investments in securities for their own accounts; increase the maturity date on credit union loans to 15 years, up from 12 under current law, or longer as the NCUA may allow; permit credit unions to offer money transfer instruments, including electronic fund transfers, to anyone eligible for credit union membership, regardless of whether they are actual members; repeal the mandate that regulations for complex credit unions include a risk-based net worth requirement; and increase the aggregate investment limit in CUSOs to 3%, from 1%, of the total paid in and unimpaired capital and surplus.

The ICBA has serious concerns about each of the provisions in this legislation, but will limit our remarks in this letter to the expansion of commercial lending powers under the bill.

Expands Commercial Lending Powers

H.R. 3579 expands commercial lending opportunities for credit unions by raising the cap on "member business loans" to 20% of a credit union's net worth, up from 12.25% under

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current law; raising the limit on loans exempt from this cap to $100,000, up from $50,000 under current law; repealing the restriction on undercapitalized credit unions from making member business loans, leaving that decision to the discretion of the NCUA; and exempting loans to nonprofit religious organizations from the member business loan cap.

Commercial Lending Should Be Incidental Service

The ICBA has consistently expressed concerns about the rapid entry of credit unions into the commercial lending arena, so long as credit unions remain tax-exempt. Credit unions were created by Congress, and given certain tax and regulatory advantages, for the purpose of serving individuals of modest means. It is doubtful that Congress, in passing the Federal Credit Union Act of 1934, ever envisioned credit unions making commercial loans.

Indeed, H.R. 1151, the Credit Union Membership Access Act ("CUMAA"), which first codified the practice of commercial lending, actually imposed a limit on member business loans. The Senate Banking Committee report on this bill stated clearly that Congress intended that business lending by credit unions be incidental to, and not the main focus of, the services provided to their customers. The reasoning behind this concern was sound -- commercial lending is a highly specialized business, and it is questionable whether credit unions have the experience or staff to ensure the safety and soundness of their business lending operations.

Credit Unions Pursuit of Expanded Powers Extends Beyond Congress

The current restrictions on member business loan activity is, in our view, more than sufficient for any credit union to make member business loans as an incidental service. Still, the credit union industry has been relentless in its pursuit of expanded commercial lending powers in circumvention, in our view, of the statutory limitation on commercial lending:

- They have asked the NCUA to make regulatory changes to facilitate a greater involvement in small business services (the NCUA has historically been open to credit union expansion).
- They pressed the SBA to open its 7 (a) small business loan program to more credit unions (SBA loans are not covered by the limitation on "member business loans").
- They are seeking increased access to the Federal Home Loan Bank System (to circumvent statutory limitations on capital).
- And they have proposed an expansion the types of loans that would be exempt from the "member business loan" cap (effectively raising the cap).

This agenda demonstrates the aggressive nature of the credit union industry's expansion plans. This kind of an agenda is not consistent with credit unions' safe and sound operations, their historic mission, or their favored tax status.

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Safety and Soundness Concerns

ICBA questions whether or not the credit union industry has the management expertise and experience to properly and safely underwrite commercial loans. As stated earlier, commercial lending is a highly specialized and risky business. Even the GAO, Congress's investigative arm, recently cited the need for greater risk management because of the growing concentration of industry assets in large credit unions. Credit unions should be reducing their risk portfolio, not increasing it.

Credit Unions Commitment to Statutory Mission Questioned

Indeed, the continued pursuit of expanded commercial lending powers calls into question the credit union industry's commitment and ability to serve the needs of lower income and un-banked populations. The Woodstock Institute, a Chicago-based nonprofit that promotes access to capital and credit, issued a report[1] showing that credit unions do not live up to their statutory mission of serving people of small means. Based on surveys of about 3,000 respondents in the Chicago metropolitan area, the report refuted claims by the credit union industry and its regulator, the NCUA, that credit unions had achieved the goal of serving low-income people (the NCUA earlier withdrew a requirement that credit unions document their service to low-income areas, arguing that the industry had already met this goal).

The press release accompanying the report said, "Woodstock's report shows the claim to be false and damaging to the challenge of bringing low-income people into the financial mainstream." The fact is that credit unions get tax benefits, estimated to reach $6 billion by 2003, in part because, "they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means," according to the Federal Credit Union Act.

Indeed, the House Report on H.R. 1151 ("CUMAA") states: "Section 204 reaffirms the continuing and affirmative obligation of insured credit unions to meet the financial services needs of persons of modest means, including those with low- and moderate-incomes, consistent with safe and sound operations."[2] We question whether H.R. 3579, expanding the commercial lending powers of credit unions, is consistent with this mandate.

Unfair Competition

It has been clear for some time that there is a strong trend in the credit union industry, routinely enabled by NCUA actions, away from the statutory mandate to serve people of small means and towards direct competition with tax-paying commercial banks for customers in the general population for all product and service lines. For example, some credit unions are now making commercial loans and are involved in electronic bill

[1] "Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low-Income People," Woodstock Institute, Chicago, IL, February 14, 2002.
[2] House Report 105-472, page 21

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payment and presentment, trustee and custodial services, finder activities, certification services, marketing activities and financial counseling. Some even offer "smart cards." The legislation to expand the commercial lending opportunities for credit unions promotes that trend.

Adoption of H.R. 3579 would exacerbate the already growing competitive disparity between community banks and credit unions. Credit unions have a decided funding advantage over community banks because of their tax exemption and exclusion from CRA. This may have been justifiable when the scope of credit unions was limited by the obligation to serve people with a "common bond." However, it is difficult to justify today as credit unions have expanded their scope to serve the general population through community charters. This makes their aggressive pursuit of expanded commercial lending opportunities all the more troubling.

Competition in the marketplace is healthy, provided the competition is fair. When one competitor pays taxes and the other does not, that constitutes unfair competition. If credit unions want to maintain their tax-exempt status, they should be required to focus on their statutory mission.

Conclusion

H.R. 3579 will promote the trend of large, multi-bond credit unions to move into commercial activities and raises serious safety and soundness concerns as well as concerns about increasing the risk to the industry's insurance fund.

The ICBA believes that if credit unions want to be the functional equivalent of banks and thrifts and compete with banks and thrifts on these expanded product and service lines in an open market, they should be willing to comply with the same laws and regulations as banks and thrifts, and that includes the obligation to comply with the Community Reinvestment Act (CRA) and pay taxes.

Thank you for this opportunity to express the view of our nation's community bankers.

Sincerely,

Camden R. Fine

Camden R. Fine
President and CEO

CC: Members, House Financial Services Committee

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