For release on delivery

STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"THE CONSIDERATION OF REGULATORY RELIEF PROPOSALS"

BEFORE THE

COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 21, 2005

Chairman Shelby, Ranking Member Sarbanes, Senator Crapo and Members of the Committee: on behalf of the National Credit Union Administration (NCUA) I am pleased to be here today to present our agency's views on regulatory efficiency and reform initiatives being considered by Congress. Enacting legislation that will directly and indirectly benefit the consumer and the economy by assisting all financial intermediaries and their regulators perform the role and functions required of them is prudent.

REGULATORY RELIEF AND EFFICIENCY

In June of 2004 I testified before this Committee and presented several legislative proposals NCUA recommended for your consideration. NCUA continues to recommend these provisions as desirable components of regulatory reform:

- Permit federal credit unions to cash checks and money transfer services for individuals in their field of membership but not yet members. 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. The House of Representatives has taken this up as H.R. 749, amended it to include international remittances and passed the bill. Section 3 of S. 31, introduced by Senator Sarbanes and other Members of the Committee includes a similar provision;

- Increase the allowable maturity on federal credit union loans from 12 to 15 years. 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;

- Increase the investment limit in credit union service organizations (CUSO's) from one percent to three percent. 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;

- Safely increase options for credit unions to invest their funds by expanding authority beyond loans, government securities, deposits in other financial institutions and certain other very limited investments. The recommendation is to permit additional investments in corporate debt securities (as opposed to equity) and further establish specific percentage limitations and investment grade standards;

- Alleviate NCUA from the process now required that it consider a spin-off of any group of over 3,000 members in the merging credit union when two credit unions merge voluntarily. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns;

- Provide relief for credit unions from a requirement that they register with the SEC as broker-dealers when engaging in certain de minimums securities activities. The principle established by the present bank exemption, and a similar exemption sought by thrifts, is that securities activities of an incidental nature to the financial institutions do not have to be placed into a separate affiliate;

- Make needed technical corrections to the Federal Credit Union Act.

These NCUA recommendations are more fully described on the following pages.

NCUA has also reviewed the following additional credit union provisions included in the matrix circulated by Senator Crapo in anticipation of this hearing. 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: leases of land on federal facilities for credit unions; exclusion of member business loans to non-profit religious organizations; criteria for continued membership of certain member groups in community charter conversions; credit union governance provisions; providing NCUA with greater flexibility to adjust the federal usury ceiling for federal credit unions; and an exemption from the pre-merger notification requirements of the Clayton Act.

PRESERVING THE NET WORTH OF CREDIT UNIONS IN MERGERS

NCUA anticipates that the Financial Accounting Standards Board (FASB) will act in 2005 or 2006 to lift the current deferral of the acquisition method of accounting for mergers by credit unions thereby eliminating the pooling method and requiring the acquisition method beginning in 2007.[1] When this change to accounting rules is implemented it will require that, in a merger, the net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as "acquired equity," a term not recognized by the "Federal Credit Union Act" (FCUA).

This FASB policy has been in place since mid-2001 for most business combinations and the delay by FASB in implementing it for credit unions has allowed all of us to explore how credit unions could conform to the new financial reporting standards.

[1] 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).

Without the changes to the "Federal Credit Union Act," only "retained earnings" of the continuing credit union will count as net worth after a merger. This result would seriously reduce the post-merger net worth ratio of a federally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has adverse implications under the statutory "prompt corrective action" (PCA) regulation. This result will discourage voluntary mergers and on occasion make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF). Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost.

NCUA encourages this Committee to include language in legislation to allow NCUA to continue to recognize the "net worth" of the merging credit union for purposes of prompt corrective action. A solution has been referred to this Committee as H.R. 1042, the "Net Worth Amendment for Credit Unions Act."

REFORM OF PROMPT CORRECTIVE ACTION SYSTEM FOR FEDERALLY INSURED CREDIT UNIONS

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This mandate is good public policy and consistent with NCUA's fiduciary responsibility to the insurance fund. While NCUA supports a statutorily mandated PCA system, the current statutory requirements for credit unions are too inflexible and establish a structure based primarily on a "one-size-fits all" approach, relying largely on a high leverage requirement of net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to design a meaningful risk-based system.

Reform of capital standards is vital for credit unions as the other federal banking regulators explore implementation of BASEL II and other capital reforms for banks in the United States. While maintaining a leverage ratio, NCUA's PCA reform proposal incorporates a more risk-based approach to credit union capital standards consistent with BASEL I and II. In recognition of the inherent limitations in any risk-based capital system, our proposal incorporates leverage and risk-based standards working in tandem. The risk-based portion of the proposed tandem system uses risk portfolios and weights based on the BASEL II standard approach.

For the leverage requirement, NCUA supports a reduction in the standard net worth (i.e., leverage) ratio requirement for credit unions to a level comparable to what is required of FDIC insured institutions. The minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, compared to the threshold of 5% for FDIC-insured institutions. Our proposed new leverage requirement, while comparable, accounts for the 1% method of capitalizing the NCUSIF, and its effect on the overall capital in the Insurance Fund and the credit union system. The result is a leverage requirement for credit unions that averages 5.7% under our proposal, as compared to the 5% requirement in the banking system. There are important reasons why the leverage ratio for credit unions ratio should be lowered to work in tandem with a risk-based requirement.

First, credit unions should not be placed at a competitive disadvantage by being held to higher capital standards when they are not warranted to protect the insurance fund. For FDIC insured institutions, a 5% leverage requirement coupled with a risk-based system has provided adequate protection for their insurance fund. In comparison, the credit union industry has a relatively low risk profile, as evidenced by our low loss history. This is largely due both to the greater restrictions on powers of credit unions relative to other financial institutions and credit unions' conservative nature given their member-owned structure. In fact, our experience has shown that given economic needs and their conservative nature, the vast majority of credit unions will operate with net worth levels well above whatever is established as the regulatory minimum.

In addition, the current 7% leverage requirement is excessive for low risk institutions and overshadows any risk-based system we design, especially if you consider that under BASEL the risk-based capital requirement is 8% of risk assets. A meaningful risk-based system working in tandem with a lower leverage requirement provides incentives for financial institutions to manage the risk they take in relation to their capital levels, and gives them the ability to do so by reflecting the composition of their balance sheets in their risk-based PCA requirements. The current high leverage requirement provides no such ability or incentive and, in fact, it can be argued could actually contribute to riskier behavior to meet these levels given the extra risk isn't factored into the dominant leverage requirement.

As mentioned above, we recognize that achieving comparability between the federal insurance funds does require us to factor in the NCUSIF's deposit-based funding mechanism. Thus, our reform proposal incorporates a revised method for calculating the net worth ratio for PCA purposes by adjusting for the deposit credit unions maintain in the share insurance fund. However, our proposed treatment of the NCUSIF deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles, or NCUA's steadfast support of the mutual, deposit-based nature of the NCUSIF.

As for capitalization investments in corporate credit unions, these are not uniformly held by all credit unions. Indeed, not all credit unions even belong to a corporate credit union. Thus, these investments are appropriately addressed under the risk-based portion of PCA. Our reform proposal addresses capitalization investments in corporate credit unions consistent with BASEL and the FDIC's rules applicable to capital investments in other financial institutions.

For the risk-based requirement, our proposal tailors the risk-asset categories and weights of BASEL II's standard approach, as well as related aspects of the FDIC's PCA system, to the operation of credit unions. The internal ratings-based approach of BASEL II for the largest internationally active banks is not applicable to credit unions. However, it is our intention to maintain comparability with FDIC's PCA requirements for all other insured institutions and keep our risk based requirement relevant and up-to-date with emerging trends in credit unions and the marketplace.

As there are limitations in any regulatory capital scheme, NCUA's reform proposal also includes recommendations to address these other forms of risk under the second pillar of the supervisory framework, a robust supervisory review process. Through our examination and supervision process, NCUA will continue to analyze each credit union's capital position in relation to the overall risk of the institution, which may at times reflect a need for capital levels higher than regulatory minimums.

I would also point out that our reform proposal addresses an important technical amendment needed to the statutory definition of net worth. As mentioned earlier, NCUA anticipates that the Financial Accounting Standards Board (FASB) will act soon to lift the current deferral of the acquisition method of accounting for mergers by credit unions, thereby eliminating the pooling method and requiring the acquisition method. NCUA's PCA proposal includes a legislative solution to this problem, but if the issue is considered separately in Senate regulatory relief legislation before the expected FASB implementation date, that is a favorable outcome.

Enabling NCUA to adopt a PCA system that remains relevant and up-to-date with emerging trends in credit unions and the marketplace provides safety, efficiency, and benefits to the credit union consumer. I believe our reform proposal achieves a much needed balance between enabling credit unions to utilize capital more efficiently to better serve their members while maintaining safety and soundness and protecting the share insurance fund. 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 more fully risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

Net Worth Category Comparison - Current vs. Proposed PCA System
Number of Federally Insured Credit Unions (Excluding "New" Credit Unions)
December 31, 2004 Data

		Proposed System					
	PCA Classification	Well-capitalized	Adequately capitalized	Under-capitalized	Significantly under-capitalized	Critically under-capitalized	Total
Current System	Well-capitalized	8,753	0	12	0	0	8,765
	Adequately capitalized	89	0	17	0	0	106
	Undercapitalized	1	17	14	9	0	41
	Significantly undercapitalized	0	0	0	5	3	8
	Critically undercapitalized	0	0	0	0	7	7
	Total	8,843	17	43	14	10	8,927

The red fields represent a reduction in PCA category, the yellow fields represent no change in PCA category, and the green fields represent an increase in PCA category.

As the above table illustrates, the PCA category for the vast majority of credit unions, reflecting their already strong net worth levels, would remain unchanged. However, 107 credit unions would improve into a higher PCA category given their relatively low-risk profiles. At the same time 41 credit unions would experience a reduction in their net worth category, thus accelerating corrective action for these inadequately capitalized credit unions. In fact, almost all of the 29 downgrades from well or adequately capitalized to undercapitalized under the new system are due to the proposed new risk-based requirement, indicating the new system is better recognizing risk in relation to net worth levels. I would also point out that the proposed new tandem system is rigorous in respect to thinly capitalized credit unions as no significantly or critically undercapitalized credit unions are upgraded under the proposed system, and the overall level of critically, significantly, and undercapitalized credit unions increases.

EXPLANATION OF NCUA RECOMMENDED PROVISIONS FOR CONSIDERATION BY THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Check Cashing and Money Transfer Services Offered within the Field of Membership of the Credit Union

Current Law

Section 107 of the Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members.

Proposed Amendment

This amendment permits federal credit unions to offer these same services to persons eligible to be members of the credit union, defined as those that fall within the field of membership of the credit union.

Reasons for Change

- Congress and the Administration are asking financial institutions to do more to reach the "unbanked."
- Credit unions are constrained from extending the most basic financial transaction (check cashing) to those who have avoided traditional financial institutions.
- Expanding check cashing, wire transfer, and similar services to non-members within a credit union's field of membership would provide an introduction to reliable low-cost financial services which can provide a viable alternative to less savory practices while at the same time increase confidence in traditional financial organizations.
- With more and more credit unions adopting underserved areas, these services become especially important in reaching out to the underserved.

Eliminate the 12-year Limit on Term of Federal Credit Union Loans

Current Law

The Federal Credit Union Act imposes a 12-year loan maturity limit on most credit union loans. Principal residence loans have maturities up to 30 years, and principal mobile home loans have maturities of 15 years.

Proposed Amendment

The proposed amendment permits the NCUA Board to provide for maturity limits up to 15 years, or longer, as the NCUA Board may allow by regulation.

Reasons for Change

- The current restriction placed on federal credit unions is outdated and unnecessarily restricts a credit union's lending terms to its members.
- Members of Federal credit unions should be able to obtain loans for second homes, recreational vehicles, and other purposes in accordance with conventional maturities that are commonly accepted in the market today.

Increase in 1 percent Investment Limit in CUSOs

Current Law

The Federal Credit Union Act permits federal credit unions to invest in Credit Union Service Organizations (CUSOs)--organizations providing services to credit unions and credit union members. An individual credit union, however, may invest in aggregate no more than 1% of its shares and undivided earning in these organizations.

Proposed Amendment

The provision increases the permissible credit union investment in CUSO's from 1% to 3% of its shares and undivided earnings.

Reasons for Change

- CUSOs are frequently established by several credit unions to provide important services to credit unions, such as check clearing and data processing, which can be done more efficiently for a group.
- When these services are provided through a CUSO, any financial risks are isolated from the credit union while allowing the credit unions to retain quality control over the services offered and the prices paid by the credit unions or their members.
- An increase in the CUSO investment to 3% allows the CUSO to continue servicing its credit union members without having to bring services back in-house or engage outside providers. This controls risk and expense to the credit union.
- The 1% limit has not been updated since its inception in 1977.

Investments in Securities by Federal Credit Unions

Current Law

The Federal Credit Union Act authorizes federal credit unions to invest in loans, obligations of the United States, or securities fully guaranteed as to principal and interest by the U.S. government, deposits in other financial institutions, and certain other limited investments, such as obligations of federal home loan banks, wholly-owned government corporations, or in obligations, participations or other instruments issued by, or fully guaranteed by FNMA, GNMA, or FHLMC.

Proposed Amendment

This amendment would provide authority for federal credit unions to purchase and hold for their own account "investment securities" if they are in one of the four highest investment rating categories -- subject to further definition and qualification by NCUA rulemaking.

The amendment limits federal credit unions' investments in investment securities in two ways. First, a statutory "single obligor" percentage limitation is established, such that the total amount of investment securities of any single obligor or maker held by the federal credit union for the credit union's own account cannot exceed 10% of the net worth of the credit union. Second, the aggregate amount of investments held by the federal credit union for its own account cannot exceed 10% of the assets of the credit union.

Reasons for Change

- A number of private debt instruments such as highly rated commercial paper, corporate notes, and asset-backed securities would be appropriate investments for federal credit unions.
- Other federally regulated and state regulated financial institutions have a proven track record with these limited investments.
- Allowing such investments would give credit unions more asset liability management options.
- NCUA implementing regulations will further address appropriate investment gradings, possible minimum credit union net worth requirements, and other safety and soundness requirements.
- With a percentage limitation of 10% of net worth per single obligor, this modest increase in investment flexibility will not subject credit unions to undue risk.
- The 10% limitation language parallels the limitation applicable to national banks when applied to the "net worth" measurement for credit unions.
- The prohibition against investment in equity securities is maintained.

Voluntary Merger Authority

Current Law

Section 109 of the Federal Credit Union Act requires NCUA to engage in an analysis of every voluntary merger of healthy federal credit unions to determine whether a spin-off of any select employee group (SEG) of over 3,000 members in the merging credit union can be effectively accomplished.

Proposed Amendment

The recommendation is to eliminate the requirement that NCUA engage in an analysis of every voluntary merger to determine whether a select employee group over 3,000 can be spun-off into a separate credit union.

Reasons for Change

- Requiring NCUA to engage in an analysis of every voluntary merger of healthy federal credit unions to consider a spin-off from the merging credit union of any select employee group (SEG) of over 3,000 is cumbersome and provides little practical benefit or purpose. There are about 300 a year.
- When two healthy multiple bond credit unions pursue a merger, it increases their financial strength and member service is enhanced, as well as their long-term safety and soundness.
- Member employee (or other) groups over 3,000 are already included in a multiple group credit union in accordance with statutory standards.

Treatment of Credit Unions as Depository Institutions Under Securities Laws

Current Law

Section 201 and 202 of the Gramm Leach Bliley Act, enacted in 1999, created specific exemptions from broker-dealer registration requirements of the Bank Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisors Act of 1940. The principle established in these laws is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate and functionally regulated.

Proposed Amendment

This provision would provide a statutory exemption for credit unions similar to that already provided banks and allow credit unions, like banks, to avoid complicated filings with the Securities and Exchange Commission for incidental activities.

Reasons for Change

- Federal credit unions are empowered to engage in specific activities enumerated in the FCUA and any other activities incidental to the enumerated activities. Among the specific broker-related activities currently authorized are third-party brokerage arrangements, sweep accounts, safekeeping and custodial activities. Among the dealer-related activities are the purchase and sale of particular securities, including but not limited to municipal securities and "Identified Banking Products" for the credit union's own account.
- These incidental activities might trigger SEC registration if not exempted by law.
- This important regulatory relief and efficiency provision would reduce the cost and complication to credit unions having to approach the SEC on a case-by-case basis or through regulation – the only avenues now available to them for relief.
- While a federal or state chartered credit union might be granted authority to engage in otherwise lawful activities, the credit union might have to abandon the activity or outsource it to a third party at increased expense if this exemption is not provided.
- This exemption would not expand the types of securities activities that credit unions are authorized to engage in. It simply serves to provide parity with banks and thrifts regarding an exemption from SEC registration for the limited securities activities credit unions are authorized to engage in.

Technical Corrections to the Federal Credit Union Act

Explanation of Proposed Amendment

28 purely technical and clerical corrections to the Federal Credit Union Act have been identified as needed.

Reasons for Change

To make the Federal Credit Union Act accurate and correct.

Conclusion

Thank you, Mr. Chairman, Senator Sarbanes and Senator Crapo for the opportunity to appear before you today on behalf of NCUA to discuss the public benefits of regulatory efficiency for NCUA, credit unions and 84 million credit union members. I am pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.

###