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
Committee of Housing, Banking & Urban Affairs
United States Senate
June 22, 2004

NASCUS History and Purpose

Good morning, Chairman Shelby, and distinguished members of the Committee. 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 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 the National Association of State Credit Union Supervisors (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

National Association of State Credit Union Supervisors (NASCUS)
1655 North Fort Myer Drive, Suite 300
Arlington, Virginia 22209
(703) 528-8351 • (703) 528-3248 Fax
E-mail: offices@nascus.org

recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the Committee's continued commitment to providing ongoing regulatory relief that ensures a safe and sound environment for credit unions and the consumers they serve. We appreciate the opportunity to provide the Committee with our legislative priorities for the regulatory relief package that the Committee is now preparing.

NASCUS supports the amendments to the Federal Credit Union Act (FCUA) that are included in H.R. 1375 which has been favorably passed by the House of Representatives, by a vote of 392 – 25 on March 18, 2004. Those amendments will provide regulatory relief for credit unions, both federal and state, and enhance the value of the credit union charter. NASCUS recognizes that a viable dual chartering system requires credit unions continue to be empowered to serve their members' changing financial needs.

NASCUS Priorities for Regulatory Relief

NASCUS priorities for regulatory relief legislation are focused on the reforms that will strengthen the state system of credit union supervision and enhance the capabilities of state-chartered credit unions to meet the financial needs of their members while assuring that the state system is operating in a safe and sound manner. Some priorities are contained in H.R. 1375. Other priorities NASCUS supports in this testimony are beyond the scope of H.R. 1375.

Provisions NASCUS Supports in H.R. 1375

NASCUS supports Section 306 in H.R. 1375 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 312 in H.R. 1375 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.

Another provision in H.R. 1375 that NASCUS supports is Section 313. This provision provides federally insured credit unions and savings institutions parity of treatment with commercial banks with regard to exemptions from SEC registration requirements that banks were provided in the Gramm-Leach-Bliley Act.

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. Unless appropriate regulatory relief is provided, credit unions offering these services may be subject to redundant and costly examination. We urge that credit unions be accorded similar regulatory treatment in the Senate bill.

Privately-Insured Credit Unions Should Be Eligible to Join Federal Home Loan Banks (FHLBs)

NASCUS supports Section 301 in H.R. 1375 that will permit non-federally insured credit unions to be eligible to join the FHLBs.

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 and 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 would 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 opting 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.

National Association of State Credit Union Supervisors (NASCUS)
1655 North Fort Myer Drive, Suite 300
Arlington, Virginia 22209
(703) 528-8351 • (703) 528-3248 Fax
E-mail: offices@nascus.org

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 would not inflict any new or unusual exposure on the Bank System.

Moreover, an additional layer of financial discipline would 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 the Regulatory Relief legislation and urge the Committee to approve this provision which will help achieve our nation's housing and home ownership goals.

Other NASCUS Legislative Priorities

In addition to provisions NASCUS supports in H.R. 1375, we also support the following priorities outside the scope of H.R. 1375.

Expanding PCA Provision of the Federal Credit Union Act (FCUA)

NASCUS strongly urges the Committee to amend the Prompt Corrective Action (PCA) provision of the FCUA to obligate federally insured credit unions to include all forms of capital when calculating the required net worth ratio. Under the current federal statute, credit union net worth is defined as and limited to retained earnings. This exclusive reliance on retained earnings limits a credit union's ability to implement new programs or expand services that meet the changing needs of its membership.

More importantly, though, the failure to obligate these credit unions to include all forms of capital in their PCA net worth calculation distorts the credit union's actual financial position.

Additionally, NASCUS supports federal legislation that would substitute a risk-based capital concept for the current NCUA federal PCA/net worth requirement. NCUA has indicated their support for a risk-based capital regime for credit unions. In addition, legislation has been introduced in Congress on a bipartisan basis, H.R. 3579, that would reform credit union capital requirements by redefining the net worth ratio to include risk-weighted assets rather than total assets.

NASCUS has studied the risk-based capital reform proposal outlined in H.R. 3579 and supports a risk-weighted capital regime for credit unions. We believe that supplemental capital authority and a risk-based system are complementary capital reforms.

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 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 resulting in regulatory risk. We urge the committee to support amending net worth to resolve the unintended consequences of FASB's rules. FASB supports such an amendment.

Alternative Capital Authority for Credit Unions

NASCUS supports alternative capital reform beyond the risk-weighted capital and FASB merger fix. 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 Act 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.

National Association of State Credit Union Supervisors (NASCUS)
1655 North Fort Myer Drive, Suite 300
Arlington, Virginia 22209
(703) 528-8351 • (703) 528-3248 Fax
E-mail: offices@nascus.org

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 Committee staff and any Members who would like a copy.

NASCUS understands that permitting other forms of capital to be counted as part of net worth for PCA purposes for federally insured credit unions may be beyond the scope of this regulatory relief package. However, we urge that this Committee consider and approve this revision of the definition of net worth for credit unions when other omnibus financial institutions legislation is considered by this Committee later in this Congress.

Expanding Business Lending Authority

H.R. 1375 expands business lending authority for federal savings associations. NASCUS urges the Committee to include a similar expansion of credit union member business lending (MBL) authority in the new bill. Raising the statutory basket for such credit union loans from 12.25% to 20% of total assets, as the House bill provides for savings institutions, would provide equivalent regulatory relief for credit unions. We also urge that the statutory definition of a credit union MBL be changed from the current $50,000 limit contained in the FCUA. One approach to achieve this purpose would be to redefine 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.

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 were 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 now intends to implement.

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 all 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 would 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 issues for regulatory relief:

- NASCUS supports Section 301 in H.R. 1375 that will permit non-federally insured credit unions to be eligible to join the Federal Home Loan Banks.

- NASCUS supports Section 306 in H.R. 1375 revising member business lending restrictions in the Federal Credit Union Act, thus lifting the restrictions on member business lending for federally insured, state-chartered credit unions.

- NASCUS supports Section 312 in H.R. 1375 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.

- H.R. 1375 provides regulatory relief to savings associations and credit unions with regard to SEC broker/dealer registration and investment advisor requirements. We urge that credit unions be accorded the similar regulatory relief treatment in the Senate bill.

- NASCUS urges the Committee to amend the PCA provision of the FCUA to obligate federally insured credit unions to include all forms of capital when calculating the required net worth ratio.

- NASCUS supports federal legislation that would substitute a risk-based capital concept for the current NCUA federal PCA/net worth requirement.

- NASCUS supports amending the definition of net worth to cure the unintended consequences for credit unions of business combination accounting rules FASB intends to apply to combinations of mutual enterprises.

- Raise the statutory definition of a credit union MBLs from 12.25% to 20% of total assets, as the House bill provides for savings institutions, providing equivalent regulatory relief for credit unions.

- We encourage Congress to intervene to block continuing OCC preemption of state laws.

NASCUS appreciates the opportunity to testify today on the pending regulatory relief legislation and we welcome further participation in the discussion and deliberation. We urge this Committee 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.

National Association of State Credit Union Supervisors (NASCUS)
1655 North Fort Myer Drive, Suite 300
Arlington, Virginia 22209
(703) 528-8351 • (703) 528-3248 Fax
E-mail: offices@nascus.org

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.