Testimony of Jerrie J. Lattimore
Administrator, Credit Union Division
North Carolina
on behalf of the
National Association of State Credit Union Supervisors
before the
Subcommittee on Financial Institutions and Consumer Credit
House Financial Services Committee
March 27, 2003

NASCUS History and Purpose

Mr. Chairman and members of the Subcommittee, my name is Jerrie Jay Lattimore. I am the North Carolina regulator for state-chartered credit unions and Chairman of the National Association of State Credit Union Supervisors (NASCUS). I was appointed by then Governor Jim Hunt as the North Carolina regulator seven years ago, and prior to that, served as Assistant General Counsel for NationsBank, now Bank of America.

NASCUS has been in existence since 1965 and represents all 48 state and territorial credit union supervisors who regulate more than 4,300 state-chartered credit unions, almost 50% of all credit unions in the United States. In addition, our Credit Union Council membership consists of nearly 800 CEOs of state-chartered credit unions that have a keen interest in protecting and enhancing the dual system for chartering and supervising credit unions.

Like my 47 counterparts in state government, the North Carolina Credit Union Division is committed to carrying out its mission through efficient and effective chartering, regulation and supervision of state-chartered credit unions within the statutory requirements and prudent industry safety and soundness standards. We serve the public through responsible regulation, effective administration and the vigorous enforcement of state laws and many federal laws as well.

Provisions of the Bill Affecting Federal Credit Unions and Other Institutions

NASCUS is supportive of your efforts to reduce the regulatory burden on all depository institutions and I appear, today, to comment on those aspects of H.R. 1375, The Financial Services Regulatory Relief Act of 2003 that directly impact the state credit union system.

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

NASCUS endorses your efforts to reduce regulatory burdens on financial institutions and, in general, supports the statutory improvements that this legislation would provide for federally chartered credit unions. We believe that a viable and healthy dual chartering system requires that the charter for federal credit unions should be modernized to meet competitive demands and credit union member needs.

Our specific testimony on this legislation addresses the issues in the pending regulatory relief legislation that would directly impact state-chartered and regulated credit unions. NASCUS, also, would suggest some further revisions to the Federal Credit Union Act that would strengthen the state credit union charter. All of these recommendations to the Committee were outlined in our letter to Chairman Oxley dated January 23, 2003.

Specific Provisions Affecting State-Chartered Credit Unions

There are two provisions contained in the regulatory relief bill that NASCUS would like to address today. The first provision would authorize state-chartered privately-insured credit unions to be eligible for membership in the Federal Home Loan Banks.

NASCUS strongly supports the provisions contained in the regulatory relief legislation that would authorize state-chartered privately insured credit unions to be eligible for membership in the Federal Home Loan Banks.

Today, there are approximately 365 credit unions that are non-federally insured. All of these credit unions are regulated and examined by agencies of state governments to ensure that they are operating in a safe and sound manner. Sound management and effective regulatory oversight are the primary determinant of the safety and soundness of a credit union.

To protect credit union members, 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. In the case of state-chartered credit unions, that supervision and examination function is performed by the state credit union regulator. Privately insured state-chartered credit unions are examined by their primary safety and soundness regulator, the state credit union supervisor, in exactly the same manner as federally insured state-chartered credit unions.

In short, privately insured credit unions and federally insured credit unions are required to meet and maintain the same standards of financial performance by state regulators.

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With regard to privately insured credit unions, it is important to note that the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a series of safety and soundness requirements both for entities that would 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.

NASCUS is aware that the Appropriations Committees have not provided funding to the Federal Trade Commission for these purposes and the last appropriations legislation directed the General Accounting Office (GAO) to determine which agency should enforce these private insurance disclosure requirements of FDICIA. That report from the GAO was directed by Congress to be completed within six months. So, the issue of consumer disclosure enforcement for private share insurance should be resolved shortly.

Permitting non-federally insured institutions to join the FHLBank System would not establish a new membership principle for the System. Insurance companies, chartered and regulated by state governments, are eligible to be members of these Banks. At the end of last September the number of non-federally insured state regulated insurance company members had grown to more than 70.

Thus, allowing FHLBank membership for these credit unions that wish to expand housing finance opportunities for their members would not subject the FHLBank System to any new or unusual financial risk or exposure. 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 fully secured by marketable collateral. Indeed, we understand that no Federal Home Loan Bank has 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

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credit unions to be eligible to join the FHLBank System, is merely one more step in bringing additional home ownership opportunities to these credit union members.

We urge the Committee to approve this provision in the bill that would help achieve our nation's housing and home ownership goals.

Exemptions from Broker-Dealer Registration Rules

Another provision of the regulatory relief package would give 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 by the Gramm-Leach-Bliley Act.

NASCUS supports provisions that would permit state-chartered credit unions to be accorded similar regulatory relief treatment. We understand that the NCUA has endorsed provisions of this bill that would grant this parity of treatment to all federal and state, federally insured credit unions and has previously submitted language to the Committee to achieve these purposes.

Our major concern is that, unless state-chartered credit unions, both federally-insured and privately insured, are accorded the same SEC treatment as commercial banks and savings institutions, the powers granted credit unions by state legislatures and by 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 and oversight.

It should be clearly understood that this proposed provision specifically extends only to those activities that state-chartered credit unions are authorized to engage in under relevant chartering statutes and does not create any new powers for state-chartered credit unions.

Other NASCUS Legislative Priorities

There are two other legislative issues that NASCUS would like the Committee to address.

The first is relief from restrictive member business loan constraints that were added by the Senate to the Credit Union Membership Access Act of 1998.

The second is to permit credit unions to count supplemental capital as a part of the "net worth" definition included in the Federal Credit Union Act for PCA purposes.

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Revising Member Business Lending Restrictions in the Federal Credit Union Act

Historically, many credit unions have provided members with loans for business purposes. In recent years, particularly during the consolidation of the banking industry, credit union members have sought small business financing from their credit unions. Member business lending by community based institutions, credit unions in this case, not only meets the credit needs of members but also serves as a valuable source of financing for community development and local job creation. Credit unions are not in the business of lending to foreign corporations or governments. Their business loans are made locally and the funds recycle throughout the local community. At a time when small businesses are closing and jobs are being lost in many local communities, permitting credit unions greater flexibility to help meet local small business lending needs of their members would be sound public policy.

Until the Credit Union Membership Access Act was enacted by Congress in 1998, the authority of state-chartered credit unions to engage in business lending to their members was a matter to be determined by state statute and regulation. That Act imposed a severe limit on the member business lending activities of all federally insured credit unions, whether chartered and regulated by the States or by the National Credit Union Administration. That restriction on state chartered credit unions was not contained in the House version of the bill. It was added by the Senate Banking Committee and the House later accepted the Senate version of the bill. In short, there was no opportunity to eliminate, or even reach a workable compromise, on this new restriction on state credit union powers through a Conference Committee process.

NASCUS would urge, as a matter of principle, that the restrictions on member business lending be removed from the Federal Credit Union Act and, for state-chartered credit unions and returned to the State legislatures and credit union supervisors to regulate.

If that solution is not acceptable to the Committee, then NASCUS would urge that credit unions be granted business lending authority substantially equivalent to that proposed for federal savings institutions in this bill.

Last year, during the markup of the predecessor regulatory relief bill, federal savings institutions, without dissent, were granted a substantial expansion of business lending authority by this Committee. That bill eliminated any limitation on small business loans (those, we understand, of $1M or less in size) and an increase in the limit on larger business loans from 10% to 20% of assets for federally chartered savings associations.

NASCUS has raised no objections to this expansion of business lending powers for the savings institution industry. That industry understands the additional powers they require to remain competitive in the marketplace.

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NASCUS would propose to the Committee a two step legislative solution that would provide credit unions with roughly equivalent regulatory relief in the business lending area.

First, the asset limitation contained in the Federal Credit Union Act for credit union member business loans should be raised from 12.25% to the same percentage, 20%, as proposed for federal saving associations. Secondly, "micro" member business loans, those of less than the Fannie Mae/Freddie Mac ceiling (roughly $322,000), should be excluded from the member business loan cap of each federally insured credit union.

In fairness, the reform of business lending authority for the savings and loan industry and credit union community should be authorized by simultaneous and comparable federal legislative relief.

Supplemental Capital Authority for Credit Unions

The combination of PCA requirements established by Congress for credit unions in 1998 and subsequent rapid deposit growth has created a financial and regulatory dilemma for many state-chartered credit unions. The Federal Credit Union Act defines credit union "net worth" as retained earnings. The NCUA has determined that they do not have the regulatory authority to broaden that "net worth" definition in the Federal Credit Union Act to include credit union supplemental capital as a part of PCA calculations. Thus, credit unions will require an amendment to the Federal Credit Union 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.

As a result of the flight to financial safety by their members, many credit unions have rapidly growing "deposit" bases and face the following strategic choices:

- Constrict membership service (and growth) and live with capital generated from current earnings, the only source of capital, currently, for most credit unions to meet PCA requirements (apply growth constraints because supplemental capital sources are not available).
- Convert to a stock form of a depository institution. (Twenty-one credit unions have converted to other charters in recent years.) We would argue that there should be no need to give up the credit union charter to gain access to additional capital. All other types of depository institutions have supplemental forms of capital available.

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- Remain a credit union and raise supplemental or alternative capital from either members or external sources. (as corporate credit unions and low-income credit unions are now permitted to do by the Federal Credit Union Act) However, for most credit unions, this remedy would require an amendment to the Federal Credit Union Act since the NCUA has determined that they cannot include supplemental capital in "net worth" for PCA purposes without specific statutory language broadening the definition of credit union "net worth"

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 showing reduced "net worth" ratios.

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.

Representatives Brad Sherman (CA) and Robert Ney (OH) introduced amendments to the regulatory relief bill in the last Congress to expand the definition of "net worth" in the Federal Credit Union Act. However, these amendments were withdrawn since they were opposed by other segments of the depository institution community and the Committee had held no hearings on this issue.

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. His conclusion was that permitting credit unions to issue subordinate debt, (as many state statutes now permit), and count it as a part of "net worth" would be beneficial for credit unions and would achieve important public policy objectives.

As Committee members may be aware, Dr. Wilcox was chief economist for the Office of the Comptroller of the Currency, senior economist for the President's Council of Economic Advisors and an economist for the Federal Reserve. The study 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 supplemental capital to be counted as a part of "net worth" for PCA purposes for federally insured credit unions may be beyond the scope of this regulatory relief package. However, we would 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.

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GAO Study of Credit Union Safety and Soundness and Regulatory Structure

Last August, as this Committee may be aware, the Senate Banking Committee requested that the General Accounting Office undertake a study of credit union safety and soundness and the organization and structure of regulation and supervision by the NCUA and State regulatory agencies. The last major review by GAO of the credit union industry and regulatory structure was in 1991. State credit union regulators welcome the opportunity to inform and educate GAO staff about the major improvements in supervision and regulation undertaken by States since the 1991 study. NASCUS has held three meetings with GAO staff to provide them with information about the state segment of the credit union system and GAO staff have held telephone or "in person" meetings with State credit union regulators.

Unfortunately, the letter to the GAO from the Chairman of the Senate Banking Committee describing the purposes of this study has not been made public. In short, even though state regulators are being interviewed and asked to fill out surveys from the GAO, they do not know the exact purpose and scope of this GAO study. NASCUS hopes that this Committee will provide them with a copy of the letter request to the GAO from the Congress.

Without the benefit of a full description of the scope of this congressionally mandated study, NASCUS assumes that the GAO will evaluate the performance and structure of the NCUA as the 1991 study did. We assume that the GAO will evaluate the responsibilities of NCUA for supervising and regulating federal credit unions and providing share insurance to both federal and state-chartered and regulated credit unions.

When the GAO study is completed and oversight hearings are held by the Congress, NASCUS may wish to submit recommendations to this Committee for changes in the organization and structure of NCUA to delineate, clearly, the two functions NCUA performs; first, the regulatory agency for federal credit unions; and secondly, the federal insurance agency for both federal and state-chartered credit unions.

Safety and Soundness of State Credit Union Sector

NASCUS regularly reviews key financial performance characteristics of the federally chartered and state-chartered credit unions. The current data indicates that, in every essential safety and soundness category, the financial performance of state-chartered credit unions is as sound as that of federally chartered institutions. The current key indicators of financial health for the two sectors of the industry show the following.

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At the end of 2002:

- The capital ratio of federal credit unions was 11.48%.
- The capital ratio of state-chartered credit unions was 11.27%.

In short, their capital ratios were roughly the same.

- The Return on Average Assets (ROAA) for federal credit unions was 1.08%.
- The ROAA for state-chartered, credit unions was 1.06%.

In short, their ROAA ratios were roughly the same.

Finally, the data demonstrates that all of the major asset quality indicators for these two groups of credit unions are roughly the same.

Moreover, the recent expansion of fields of membership for both federal and state-chartered credit unions has diversified geographical risks for many credit unions, enhancing the safety and soundness of these institutions. Credit unions with more diversified membership bases are growing more rapidly than credit unions with narrow fields of membership, often tied to employees of a single or a few local employers, and this diversification results in a stronger and safer system.

We should not forget some important lessons of commercial banking history. As financial analysts have pointed out, most of the commercial bank failures in the 1920's and 1930's occurred in "unit" banking states where commercial banks were not permitted to diversify geographically and were "prisoners" of the local economy. As a result, many of these banks with highly restrictive customer bases failed because their safety and soundness was severely impacted by the economic misfortunes of their local economies while banks with more diversified customer bases survived and thrived.

By enacting the Reigle-Neal Act in the 1995, Congress recognized that permitting geographic diversification of the customer bases for banks would improve the safety and soundness of the commercial banking system

In the state-chartered credit union system, which began in the early 1900s, state legislatures were in the forefront in permitting credit unions to diversify their fields of membership. "Community" was the original basis for credit union membership. Today, regulators at both the federal and state level understand that there is "safety and soundness value" in diverse fields of membership for credit unions.

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Conclusion

NASCUS appreciates this opportunity to testify today on the pending regulatory relief legislation. 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.

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