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.

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 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. 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.

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.