



CUNA & Affiliates

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**WRITTEN TESTIMONY
OF
JOE MCGEE, PRESIDENT & CEO
LEGACY COMMUNITY FEDERAL CREDIT UNION,
BIRMINGHAM, ALABAMA
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION ON
“THE CONSIDERATION OF REGULATORY RELIEF PROPOSALS”
BEFORE THE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE**

March 1, 2006

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Chairman Shelby, Ranking Member Sarbanes, Senator Crapo, and other members of the Committee, I am Joe McGee, President and CEO of the Legacy Community Federal Credit Union in Birmingham, Alabama. I appreciate the opportunity to represent the Credit Union National Association (CUNA) at this hearing to address legislation to help alleviate the regulatory burden under which all federally insured depository institutions operate today. CUNA is the largest credit union advocacy organization, representing over 90% of our nation’s approximately 8,800 state and federal credit unions and their 87 million members.

Legacy Community Federal Credit Union, originally University FCU serving UAB, has recently converted to a community charter, serving 7 counties in Alabama. At Legacy Community Federal Credit Union, our motto is “Your Life, Your Legacy.” We aim to treat all of our members with respect and dignity and we offer honest, fair deals to all members at all times. We deliver a wide range of low cost products and services to the diverse economic and social make-up of our members and potential members and always look out for better ways to reach out to the under served within our field of membership.

At Legacy, we put forth every effort to enable our members to become financially self-sufficient and successful. We place a high priority on consumer education and the teaching of financial thrift as demonstrated through our home buyer and financial planning seminars, free financial planning services, web site, consumer education library and consumer credit counseling programs.

I am extremely proud to speak on behalf of the nation’s credit unions today because credit unions benefit America. We are the only financial institutions that are run solely for the benefit of the

people who use their services—not for the benefit of stockholders, or the board of directors, or the institution itself. We operate without paying a dime to most of our boards of directors, and without providing stock options to our senior management. We do this because of the devoted efforts of tens of thousands of selfless volunteers for whom credit unions are not just a business, but a cause. We do this “not for charity, not for profit, but for service.” That attitude makes us unique. Now we are asking for Congress’s help in continuing the not-for-profit, people-oriented, cooperative work we do.

CREDIT UNIONS ARE UNIQUE DEPOSITORY INSTITUTIONS

CUNA is pleased that the Senate Banking Committee is moving forward with this initiative to provide America’s financial institutions with well needed regulatory relief of costly and outdated burdens. Some might mistakenly believe that the Credit Union Membership Access of 1998 (CUMAA, Pub. L. No. 105-219)) was the credit union version of regulatory relief. While that law did provide relief from an onerous 1998 U.S. Supreme Court decision severely restricting fields of membership of federal credit unions, it also imposed several new, stringent regulations on credit unions, which are most severely regulated group of all insured financial institutions.

Congress in CUMAA directed the U.S. Department of the Treasury to evaluate the differences between credit unions and other types of federally insured financial institutions, including any differences in the regulation of credit unions and banks. The 2001 Treasury study, “Comparing Credit Unions with Other Depository Institutions,” found that while “credit unions have certain characteristics in common with banks and thrifts, (e.g., the intermediation function), they are clearly distinguishable from these other depository institutions in their structure and operational characteristics.”

When Congress amended the Federal Credit Union Act with the passage of CUMAA in 1998, it included a preamble which enumerated the characteristics that differentiate credit unions from other depository institutions and from the foundation on which the federal tax exemption for credit unions rests. The preamble states:

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

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

Other 1998 Congressional findings in CUMAA also emphasize the unique nature of credit unions:

- (1) “The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.”
- (2) “Credit unions continue to fulfill this public purpose and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.”

Recognition and appreciation of these fundamental attributes are critical to understanding credit unions. As Treasury stated in its study, “Many banks or thrifts exhibit one or more of ... (these) characteristics, but only credit unions exhibit all five together.”

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

CREDIT UNIONS’ REGULATORY BURDEN IS *REAL* AND RELIEF IS IMPERATIVE

Regulatory burden is an issue for all financial institutions in general, and for credit unions in particular. Indeed, **credit unions are the most heavily regulated of all financial institutions.** Credit unions are, for instance, subject to the same consumer protection laws as other financial

institutions (such as Truth-Lending, Equal Credit Opportunity, Fair Credit Reporting Act, Home Mortgage Disclosure, Real Estate Settlement Procedures Act, Truth-in-Savings, and the Expedited Funds Availability Act), the ever-increasing requirements of the Bank Secrecy Act, and a broad array of safety and soundness rules. In addition, credit unions have an extensive list of unique operating restrictions, including the following:

- (1) Credit unions are the only type of financial institution that have field of membership restrictions on whom they may serve.
- (2) Credit unions may not raise capital in the marketplace but must rely on retained earnings to build equity.
- (3) Credit unions are the only group of financial institutions that must meet statutory net worth requirements under the prompt corrective action (PCA) provisions.
- (4) Credit unions face severe limitations on member business lending.
- (5) Federal credit unions have a federal usury ceiling, limitations on loan maturities, and stringent limitations on their investment options.
- (6) Federal credit unions' governance practices are inflexible because many aspects are fixed in statute.

As discussed in detail below, there are two major areas of concern that CUNA asks be addressed by this Committee in regulatory relief legislation: The prompt corrective action (PCA) provisions in Section 216 of the Federal Credit Union Act (12 USC §1790d); and the member business loan cap in Section 107A (12 USC §1757a) of the Act. These provisions were added to the law in 1998 as part of the CUMAA legislation.

The unnecessarily inflexible PCA requirements were imposed on federally insured credit unions in 1998, not because of any problems with credit unions, but simply because PCA had been imposed on banks and thrift institutions several years earlier and some in Congress and the Treasury Department felt credit unions and its regulator should be subject to similar standards. However, as formulated in 1998, the credit union PCA standards are not, in fact and application, similar. The statutory net worth requirements direct federally insured credit unions to maintain a minimum of 6% net worth to total assets in order to meet the definition of an adequately capitalized credit union. Well-capitalized credit unions must meet a 7% net worth ratio. “[T]his exceeds the 4% Tier 1 level

ratio applicable for banks and thrifts (and is statutory as opposed to regulatory),” Treasury noted in its 2001 study. “Complex” credit unions have additional net worth requirements.

The member business loan cap imposed in 1998 is also unnecessarily restrictive and arbitrary in nature. Treasury’s 2001 analysis pointed to the fact that “federal credit unions have more limited powers than national banks and federal saving associations. Most notably, federal credit unions face stricter limitations on their (member business) ...lending and securities activities.”

A federally insured credit union’s member business loan (MBL) aggregate portfolio may not exceed the lesser of 1.75 times its net worth or 12.25 percent of total assets, unless the credit union is chartered to make such loans, has a history of making such loans or has been designated as a community development credit union. By comparison, banks have no specific limits on commercial lending, and thrifts may place up to 20% of their assets in a combination of small business loans and other commercial loans. There are other limitations on credit unions’ member business lending that do not apply to commercial banks. For instance, a federal credit union’s member business loan is generally limited to a 12-year maturity and can only be made to members.

Unlike banks, credit unions have not received new statutory powers for many years. In 2003 the Filene Research Institute published a study by Professor William E. Jackson III of the University of North Carolina at Chapel Hill, which looked at the efforts of Congress over the last two decades to provide regulatory relief for traditional depository institutions and whether more relief for credit unions is reasonable and appropriate.

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

Most recently, the Gramm-Leach-Bliley Act of 1999 expanded the statutory definition of the kinds of products and services in which banks may engage. Under the Act, banking institutions may engage in activities that are merely “financial in nature” as opposed to those that are “closely related

to banking.” The bank regulators have the authority to determine what is permissible as “financial in nature.” Credit unions were not included in any sweeping, statutory expansion of powers, but they were included in the substantial requirements under the Act regarding privacy, including requirements to communicate their member privacy protection policies to members on an annual basis.

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

CUNA endorsed the regulatory relief legislation that was passed by the House of Representatives in 2004, and supports H.R. 3505, the Financial Services Regulatory Relief Act, which has been approved by both the House Financial Services Committee and the House Judiciary Committee. This bill contains a number of amendments to the Federal Credit Union Act advocated by CUNA. However, the legislation does not include two key provisions that we urge this Committee to make a high priority for inclusion in its regulatory relief bill, provisions found in H.R. 2317, the Credit Union Regulatory Improvements Act (CURIA), which has garnered notable bi-partisan support in the House.

PROMPT CORRECTIVE ACTION REFORM

CUNA strongly supports amending the system of prompt corrective action for credit unions by establishing a dual ratio requirement: a pure leverage ratio and a net worth to risk-asset ratio. The resulting system would be comparable to the system of PCA in effect for FDIC-insured institutions while taking into account the unique operating characteristics of cooperative credit unions.

History of the PCA Provisions

Net worth requirements were not the original purpose of the CUMAA. The genesis of the 1998 Act was the Supreme Court’s field of membership decision that prohibited NCUA from approving federal credit union fields of membership comprising more than one group. Since its adoption eight

years ago, NCUA and credit unions have had sufficient time to experience PCA requirements. Therefore, it is not surprising that there should be a need for some modifications to PCA now that the NCUA and the credit union movement have been operating under PCA for several years.

The PCA section of CUMAA established for the first time “capital” or “net worth” requirements for credit unions. Prior to that time, credit unions were subject to a requirement to add to their regular reserves, depending on the ratio of those reserves to “risk-assets” (then defined as loans and long-term investments). The purpose of PCA section of the Act (Section 1790d) is “to resolve the problems of insured credit unions at the least possible long-term loss to the Fund.” The CUMAA instructs the NCUA to implement regulations that establish a system of PCA for credit unions that is consistent with the PCA regime for banks and thrifts under the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) but that takes into account the unique cooperative nature of credit unions.

There are, however, a number of ways that credit union PCA under CUMAA differs from PCA as it applies to banks and thrifts under FDICIA. Key differences are:

- The net worth levels that determine a credit union’s net worth classification are specified in the Act rather than being established by regulation as is the case for banks and thrifts.
- The levels of the net worth ratio for a credit union to be classified “well” or “adequately” capitalized are two percentage points (200 basis points) above those currently in place for banks and thrifts, even though credit unions’ activities are far more circumscribed than those of banks.
- The system of risk-based net worth requirements for credit unions is structured very differently from the Basel-based system in place for banks and thrifts. For example, the Basel system is credit-risk based while credit union risk-based net worth requirements explicitly account for the difficult-to-quantify interest rate risk. In PCA as implemented under FDICIA, interest rate risk at banks and thrifts is instead dealt with through examination and supervision.

The Need for PCA Reform

There are two basic problems with the current credit union PCA system:

- **There are unnecessarily high basic credit union capital requirements.** Credit unions have significantly higher capital requirements than do banks, even though the National Credit Union Share Insurance Fund (NCUSIF) has an enviable record compared to other federal deposit insurance funds. Indeed, because credit unions' cooperative structure creates a systemic incentive against excessive risk taking, it has been argued that credit unions actually require less capital to meet potential losses than do other depository institutions.
- **The current risk-based PCA system is imprecise.** The current system of risk-based net worth requirements for credit unions provides an imprecise treatment of risk. It is only when a portfolio reaches a relatively high concentration of assets that it signals greater risk and the need for additional net worth. This system weakens the measurement of the NCUSIF's exposure to risk, and provides blurred incentives to credit unions on how to manage their balance sheets so as to minimize risk. A Basel-type method of applying different weights to different types of assets based on the asset's risk profile would permit a more precise accounting for risk than does the current credit union PCA system, thus improving the flow of actionable information regarding net worth adequacy to both regulators and credit unions.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that any credit union with a net worth ratio well below those required to be adequately capitalized should be subject to prompt and stringent corrective action. There is no desire to shield such credit unions from PCA -- they are indeed the appropriate targets of PCA. Because credit unions themselves fund the NCUSIF, they are keenly aware that they are the ones that pay when a credit union fails. Therefore, CUNA strongly supports a rigorous safety and soundness regulatory regime for credit unions that is anchored by meaningful and appropriate net worth requirements which drive the credit union system's PCA requirements.

Under the current system of PCA, however, there are many credit unions that have more than enough capital to operate in a safe and sound manner but feel constrained in serving their members

because potential reductions in their net worth category can result from growth in member deposits, even when not induced by the credit union. The current law stipulates that a credit union with a 6% net worth ratio is “adequately” capitalized. Considering the risk exposure of the vast majority of credit unions and the history of their federal share insurance fund, 6% is more than adequate net worth.

As a result of the effect of potential growth on a credit union’s net worth ratio under the present system of PCA, a very well run, very healthy, very safe and sound credit union feels regulatory constraints operating with a 6% net worth ratio. Without access to external capital markets, credit unions may only rely on retained earnings to build net worth. Thus, a spurt of growth brought on by members’ desire to save more at their credit union can quickly lower a credit union’s net worth ratio, even if the credit union maintains a healthy net income rate.

Any credit union can be hit with sharp and unexpected increases in member deposits, which are the primary source of asset growth for credit unions. This can happen whenever credit union members face rising concerns either about their own economic or employment outlook (as in a recession) or about the safety of other financial investments they may hold (as when the stock market falls). A recent example is the influx of funds by members of certain Gulf Coast credit unions who deposited insurance payments as a result of Hurricane Katrina. The resulting deposit building translates into large swings in deposit inflows without any additional effort by the credit union to attract deposits. As an example, total credit union savings growth rose from 6% in 2000 to over 15% in 2001 despite the fact that credit unions lowered their savings dividend rates sharply throughout the year. The year 2001 produced both a recession and falling stock market, and was topped off with the consumer confidence weakening effects of the September terrorist attacks.

Credit union concern about the impact of growth triggered by external factors on net worth ratios goes far beyond those credit unions that are close to the 6% cutoff for being considered adequately capitalized. Because of the conservative management style that is the product of their cooperative, volunteer-run structure, most credit unions seek always to be classified as “well” rather than “adequately” capitalized. In order to do that, they must maintain a significant cushion above the 7% level required to be “well” capitalized so as not to fall below 7% after a period of rapid growth. A typical target is to have a 200 basis point cushion above the 7% standard. Thus, in effect, the PCA

regulation, which was intended to ensure that credit unions maintain a 6% adequately capitalized ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50% higher than that level, far in excess of the risk in their portfolios. The PCA regulation in its present form thus drives credit unions to operate at “overcapitalized” levels, reducing their ability to provide benefits to their members, and forcing them instead to earn unnecessarily high levels of net income to build and maintain net worth.

There are two ways to resolve the problems with the current system of PCA. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the NCUSIF and does not upset the unique cooperative ownership structure of credit unions. Although CUNA believes that credit unions should have greater access to such secondary capital, this is not something CUNA is advocating as part of regulatory relief legislation.

The preferable solution is to amend the PCA requirements. PCA reform should have two primary goals. First, CUNA believes any reform should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized, maintaining the very strong incentives for credit unions to avoid becoming undercapitalized. This is essential to achieving the purpose of minimizing losses to the NCUSIF. Second, PCA requirements should not force well-capitalized credit unions to feel the need to establish a large buffer over minimum net worth requirements so that they become overcapitalized.

CUNA advocates reforming PCA in a manner consistent with these two requirements by transforming the system into one with net worth requirements comparable to those in effect for FDIC-insured institutions, and that is much more explicitly based on risk measurement by incorporating a Basel-type risk structure.

Specific PCA Amendments

CUNA strongly urges amendments to the Federal Credit Union Act so that a credit union’s PCA capitalization classification would be determined on the basis of two ratios: the net worth ratio and the ratio of net worth to risk assets. The net worth ratio would be defined as net worth less the credit union’s deposit in the NCUSIF, divided by total assets less the NCUSIF deposit. The ratio of

net worth to risk assets would be defined as net worth minus the NCUSIF deposit divided by risk assets, where risk assets would be designed in a manner comparable to the Basel system in effect for banks of similar size to credit unions.

Specifically, CUNA urges the Committee to include in regulatory relief legislation provisions to change the PCA requirements for credit unions (Section 216 of the Federal Credit Union Act, 12 USC §1790d) as follows:

1. Amend the net worth categories: The Federal Credit Union Act specifies net worth ratios that, along with a risk-based net worth requirement, determine a credit union's net worth category. The Act should continue to specify net worth requirements, but at levels more appropriate for credit unions and comparable to those currently in effect for banks and thrift institutions. See the chart below for the proposed categories for net worth ratios.

2. Amend the risk-based net worth categories: Currently, federally insured credit unions that are considered "complex" must meet a risk-based net worth requirement. The Act should require all credit unions to meet a risk-based net worth requirement and should direct the NCUA Board to design the risk-based requirement appropriate to credit unions in a manner more comparable to risk standards for FDIC-insured institutions. The right column in the chart below provides information on appropriate ratios of net worth to risk assets.

3. Provide NCUA with the flexibility to address other risk criteria: Current risk-based net worth requirements for credit unions incorporate measures of interest-rate risk as well as credit risk. The comparable standards for risk-based capital requirements for FDIC-insured institutions deal only with credit risk. The NCUA Board should have the authority to delegate to NCUA's regional directors the authority to lower by one level a credit union's net worth category for reasons of interest rate risk only that is not captured in the risk-based ratios.

4. Amend the definitions relating to net worth: Net worth, for purposes of PCA, is currently defined as a credit union's retained earnings balance under generally accepted accounting principles. The Financial Accounting Standards Board (FASB) is finalizing guidance, expected to be effective in 2007, on the accounting treatment of mergers of cooperatives that would create a

new component of net worth, in addition to retained earnings, after a credit union merger. The unintended effect of the FASB rule will be to no longer permit a continuing credit union to include the merging credit union's net worth in its PCA calculations. FASB's application of its proposal to credit unions will mean that a credit union's PCA net worth would typically be understated by the amount of the fair value of the merging credit union's retained earnings, i.e., part of GAAP net worth would be excluded from regulatory net worth. This anomaly must be addressed by including a definition of net worth for purposes of PCA to include the new component for post-merger credit unions.

Without an amendment to the PCA definition, the FASB pronouncement will have the unintended consequence of discouraging, if not eliminating, voluntary mergers that, absent FASB's policy, would be advantageous to credit union members involved. In addition, FASB's application of its proposal to credit unions will mean that a credit union's net worth would typically be understated by the amount of the fair value of the merging credit union's retained earnings. This result is not in the public interest. That is why CUNA, along with the NCUA and others, supports a technical correction that would amend the Federal Credit Union Act to make it clear that net worth equity, including acquired earnings of a merged credit union as determined under GAAP, and as authorized by the NCUA Board, would be acceptable for calculating PCA ratios.

Senior legal staff at FASB has indicated support for a legislative approach, and we urge the Committee to address this problem, well in advance of the effective date, so credit unions will have certainty regarding the accounting treatment of mergers. The House of Representatives approved by voice vote on June 13, 2005 a bill specifically solving this problem, H.R. 1042, the "Net Worth Amendment of Credit Unions Act."

Several other changes in the PCA-related definitions are needed. The definition of secondary capital for low-income credit unions needs to address certain limitations on its use by those credit unions. The definition of the net worth ratio also needs to be modified to exclude a credit union's National Credit Union Share Insurance Fund (NCUSIF) deposit from the numerator and denominator of the ratio; the ratio of net worth to risk-assets must also exclude a credit union's NCUSIF deposit from the numerator.

5. Amend the net worth restoration plan requirements: The NCUA Board should have the authority to permit a marginally undercapitalized credit union to operate without a net worth restoration plan if the Board determines that the situation is growth-related and likely to be short term. The law should also authorize the Board to issue an order to a critically undercapitalized credit union and possibly shorten the timing of the period before appointment of a liquidating agent. CUNA would also like to see an amendment clarifying the coordination requirement with state officials in the case of state-chartered credit unions.

How the PCA Amendments Would Work

The table below shows the ratio cutoff points for the various net worth classifications CUNA advocates. A credit union would have to meet both ratio classifications, and if different, the lower of the two classifications would apply. For example, a credit union classified as “well capitalized” by its net worth ratio, but “undercapitalized” by its ratio of net worth to risk assets, would be considered undercapitalized.

Net Worth Categories	Net Worth Ratio	Ratio of Net Worth to Risk Assets
Well Capitalized	5% or greater	8% or greater
Adequately Capitalized	4% to < 5%	8% or greater
Undercapitalized	3% to < 4%	6% to 8%
Significantly Undercapitalized	2% to < 3%	< 6%
Critically Undercapitalized	<2%	NA

The proposed net worth cutoff points are substantially similar to those currently in effect for FDIC-insured institutions. Nevertheless, the ratios would have the effect of being more stringent on credit unions for two reasons. First, not all of an individual credit union’s net worth would be included in the numerator of the ratio -- the NCUSIF deposit would first be subtracted. Second, a portion of banks’ net worth can be met by secondary or Tier II capital. All but low-income credit unions have no access to secondary capital, so all credit union net worth is equivalent to banks’ Tier I capital, which has more characteristics of pure capital than does Tier II.

In the PCA reforms CUNA envisions, NCUA would have to design a risk-based net worth requirement based on comparable standards applied to FDIC-insured institutions. The outlook for those standards as they will apply to banks is currently under review by the federal banking regulators. Federal banking regulators have indicated that if Basel II takes affect for the very largest U.S. banks (approximately 25 banks and thrifts), some modifications to Basel I for all other U.S. banks will be implemented.

The exact nature of the changes to Basel I for the vast bulk of U.S. banks and thrifts is as yet unclear, although U.S. banking regulators have stated they do not intend to permit smaller U.S. banks to be disadvantaged compared to the largest banks if Basel II lowers net worth requirements for the very large institutions. Thus, it is likely that any modified version of Basel I in place for smaller banks would be the standard under which NCUA would construct a risk-weighting system for credit unions. Since it would be Basel-based, it would focus on credit risk, leaving the treatment of interest rate risk to the supervisory process (our third recommendation). This kind of reformed credit union risk-based system would provide a much more precise measure of balance sheet risk than the current risk-based net worth requirement.

The PCA reform plan will improve the risk-based components of PCA and place greater emphasis on the risk-based measures, while lowering to the same level in effect for banks the pure net worth ratio requirements for a credit union to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the pure net worth levels to be classified as well- or adequately-capitalized is justified for the following reasons:

1. *We proposed subtracting out the 1% NCUSIF deposit in calculating the net worth ratio.* One of the original justifications for higher credit union PCA net worth requirements (higher than for banks) was the 1% NCUSIF deposit. While FASB and NCUA have both affirmed that the 1% NCUSIF deposit is an asset and thus part of net worth, as a result of the unique credit union funding mechanism of the NCUSIF, the 1% deposit appears on the books of both the NCUSIF and insured credit unions. We propose to address this issue by defining the net worth ratio as “net worth less the 1% NCUSIF deposit divided by assets less the 1% deposit.” Thus, to be adequately capitalized, a credit union must hold net worth equal to about 5.7% (on average) of its assets to meet

the 5% net worth requirement. This means that the discretionary and mandatory supervisory actions of PCA will be applied when a credit union is at higher level of individual capital than for a similarly situated bank or thrift.

2. *Although credit unions can't access capital markets, banks experiencing problems are unlikely to have ready access to capital markets.* Another reason given for credit unions' higher-than-banks net worth requirements is their lack of access to capital markets. Credit unions' only source of building net worth is through the retention of earnings, which is a time-consuming process. Since credit unions cannot access capital markets, drafters of the PCA requirements thought credit unions should hold more capital to begin with so that they have it available in time of need. There is some merit to this notion, but a problem with this logic is that it suggests that a poorly capitalized bank can easily access the capital markets. However, if a bank's capital ratio falls substantially due to losses, investors are likely to be wary of providing additional capital to it. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. Thus, the lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from banks or other depository institutions as much as it might appear.
3. *Credit unions have some control over growth by the dividends paid on savings.* A credit union's net worth ratio might fall due to rapid asset growth, but this shouldn't require higher net worth requirements for credit unions. Asset growth, which comes from savings deposits, can often be substantially influenced by a credit union's dividend policies. Under the current PCA system, lowering dividend rates creates the dual effects of retarding growth and boosting net income, both of which raise net worth ratios. Our plan would permit a credit union to protect a reasonable net worth ratio with appropriate dividend rate cutting rather than being required to hold additional net worth.
4. *There is substantial evidence that credit unions actually require less net worth than do for-profit financial institutions in order to provide protection to the deposit insurance system.* Credit unions, because of their very cooperative nature, take on less risk than do for-profit financial institutions. Because credit union boards and management are not

enticed to act by stock ownership and options, the moral hazard problem of deposit insurance has much less room for play in credit unions than in other insured depository institutions. Evidence of the effects of this conservative financial management by credit unions is found in the fact that average credit union ratios for net worth, net income and credit quality have shown dramatically less volatility over that past two decades than comparable statistics for banks and thrifts. Similarly, the equity ratio of the NCUSIF has been remarkably stable, between 1.2% and 1.3%, of insured shares while other federal deposit funds have seen huge swings, and even insolvency. This is hardly evidence supporting the need of more capital in credit unions than in banks and thrifts.

Reforming PCA as outlined by our testimony would preserve and strengthen the essential share-insurance fund protection of PCA and would more closely tie a credit union's net worth requirements to its exposure to risk – the reason for holding net worth in the first place. It would also permit adequately and well-capitalized credit unions to operate in a manner devoted more to member service and less to the unnecessary accumulation of net worth.

CHANGES IN MEMBER BUSINESS LOAN STATUTORY REQUIREMENTS

Some mistakenly believe that credit unions first obtained authority to lend to businesses with the passage of the Credit Union Membership Access Act in 1998. On the contrary, CUMAA imposed statutory limits on credit union member business lending for the first time; until then, NCUA addressed business lending activities of credit unions through supervision and regulation. The CUMAA-imposed limits are expressed as a 1.75 multiple of net worth, but only net worth up to the amount required to be classified as well capitalized (i.e., 7%) can be counted. Therefore, the limit is (1.75×7) or 12.25% of assets for most federally insured credit unions.

Credit unions are not major players in business lending, although there are some credit unions which feel they have a field of membership and expertise that would allow them to provide more businesses with more competitive options than currently permitted by the Federal Credit Union Act. At mid-year 2005, the dollar amount of credit union member business loans was less than one percent of the total commercial loans held by all U.S. depository institutions. Credit union MBLs

represent just 3.8% of the total of credit union loans outstanding, and only one in five U.S. credit unions offer MBLs. The average size of credit union MBLs granted in the first six months of 2005 was \$166,506.

Looking at Alabama credit union statistics, 34 credit unions out of a total of 159 in Alabama offer MBLs to their members. The average size of an Alabama MBL is \$144,283. The total amount of business lending by credit unions in Alabama is \$105.3 million, while banking institutions in Alabama make \$76.3 billion in business loans. In Alabama, credit unions represent 0.14% of the market share for business lending, while banking institutions represent 99.86%; and, while credit union business loans represent only 0.98% of credit union assets, banking institutions' business loans represent 35.52% of bank assets.

Need for Reform of Credit Union Member Business Loan (MBL) Limits

Small businesses are the engine of economic growth, accounting for about one-half of private non-farm economic activity in the U.S. annually. Their ability to access capital is paramount. Their access is seriously constrained by the double-whammy of banking industry consolidation and the CUMAA-imposed limitations on credit union MBLs. FDIC statistics show that the largest 100 banking institutions now control over 70% of banking industry assets nationally – in 1992, the 100 largest banks held about 45% of total banking industry assets.

Recent research published by the Small Business Administration reveals that small businesses receive less credit on average in regions with a large share of deposits are held by the largest banks. The findings reveal “credit access has been significantly reduced by banking consolidation...we believe this suggests that small businesses, especially those to which relationship lending is important, have a lower likelihood of using banks as a source of credit.” CUMAA's member business restrictions on credit unions severely restrict small business access to credit outside the banking industry at a time when small firms are finding it increasingly difficult to obtain credit from the banking industry.

Basic problems with the current MBL limit include the following:

- **The limit is arbitrary and unnecessarily restrictive.** Insured commercial banks have no comparable business lending portfolio concentration limitations. Thrift institutions have portfolio concentration limitations, but those limitations are substantially less restrictive than the limits placed on credit unions in CUMAA. There is no safety and soundness reason that net worth above 7% cannot also support business lending. If all net worth could be counted, the actual limit would average between 18% and 19% of total assets rather than 12.25% of total assets.
- **The 12.25% cap discourages credit unions from entering into business lending.** Even though very few credit unions are approaching the 12.25% ceiling, the very existence of that limitation discourages credit unions from opening business lending departments. Credit unions must meet strict regulatory requirements before implementing an MBL program, including the addition of experienced staff. Many are concerned that the costs of meeting these requirements cannot be recovered with a limit of only 12.25% of assets. For example, in today's market, a typical experienced mid-level commercial loan officer would receive total compensation of approximately \$100,000. The substantial costs associated with hiring an experienced lender, combined with funding costs and overhead and startup costs such as a data processing system to support this type of lending, present a serious barrier at most credit unions given the current 12.25% limitation.
- **The MBL threshold definition creates a disincentive that hurts small businesses.** The current \$50,000 threshold for defining an MBL is too low and creates a disincentive for credit unions to make loans to smaller businesses. Permitting the threshold to rise to \$100,000 would open up a significant source of credit to small businesses. The NCUA Board was on the verge of revising its regulations to move the threshold to \$100,000 when Congress incorporated the then \$50,000 regulatory definition into the 1998 law. Even business purpose loans up to \$100,000 are so small as to be unattractive to many larger commercial lenders. A simple inflation adjustment of the \$50,000 threshold, which was initially established by regulation in 1993, would result in a threshold figure of \$65,000.

Since their inception, credit unions have offered business-related loans to their members. Moreover, credit union member business lending shows a record of safety. According to a 2001 U.S. Treasury Department study entitled “Credit Union Member Business Lending,” credit union business lending is more regulated than commercial lending at other financial institutions. In addition, in comparing delinquencies on business loans, Treasury found credit union delinquencies (business loans more than 60 days past due) were lower than those of banks and thrifts (business loans more than 90 days past due). Not surprisingly, the Treasury also concluded that member business lending “does not pose material risk” to the National Credit Union Share Insurance Fund. The trends continue today, and MBLs have even lower loss rates than other types of credit union lending, which themselves have relatively low loss experience.

CUNA’s Regulatory Relief Recommendations for Economic Growth

In reforming credit union MBL limits in Section 107A of the Federal Credit Union Act (12 USC §1757a), Congress will help to ensure a greater number of available sources of credit to small businesses throughout the country. This will make it easier for small businesses to secure credit at lower prices, in turn making it easier for them to survive and thrive.

CUNA urges that the following provisions be included in the Committee’s regulatory relief bill:

1. Increase the limit on member business loans: Congress should eliminate the current asset limit on MBLs at a credit union (the lesser of 1.75 times actual net worth or 1.75 times net worth required for a well-capitalized credit union, or 12.25%) and replaces it with a flat rate of 20 percent of the total assets of a credit union. This provision would facilitate member business lending without jeopardizing safety and soundness at participating credit unions.

2. Increase the threshold of which business purpose loans are defined as member business loans: Congress should amend the current definition of a MBL to give NCUA the authority to exclude loans of \$100,000 or less as de minimus, rather than the current limit of \$50,000. Loans below the threshold do not apply against the cap, but more importantly, credit unions that are not in a position to open business lending departments that have to comply with NCUA’s extensive MBL regulations can still help small businesses with smaller dollar loans.

3. Provide NCUA with the authority to address member business lending by undercapitalized credit unions: The Federal Credit Union Act currently prohibits a credit union from making any new MBLs if its net worth falls below 6 percent. NCUA should have the authority to determine how to address business lending by any undercapitalized credit union.

4. Exclude from the definition of member business loans to non-profit religious organizations: The law currently provides exceptions to the MBL caps for credit unions with a history of primarily making such loans. Credit unions serving religious organizations were instrumental in persuading Congress to include this exception in the 1998 law. We believe that, when passing CUMAA, Congress simply overlooked the situation that other credit unions purchase parts of these loans (“participate in them”). We propose that the Act be amended to exclude from the MBL limit loans to or loan participations involving non-profit religious organizations. While these types of loans would not be subject to the limit, such loans would still be subject to other regulatory requirements, such as those relating to safety and soundness.

5. Authorize federal credit unions to lease space in credit union offices located in underserved areas: While not directly related to business lending, CUNA also supports an amendment to Section 107 of the Federal Credit Union Act (12 USC §1757), but adding new authority which would enhance the ability of credit unions to assist distressed communities with their economic revitalization efforts. A federal credit union maintaining a presence in an underserved area should be allowed to lease space in its building or on its property to third parties on a more permanent basis. This change would allow a federal credit union to acquire, construct, or refurbish a building in an underserved community, then lease out excess space in that building which should assist in community development.

CUNA urges the Committee to include amendments to the member business lending provisions in the Federal Credit Union Act in its regulatory relief bill.

OTHER AMENDMENTS TO THE FEDERAL CREDIT UNIONS ACT

In addition to seeking amendments to the Federal Credit Union Act relating to prompt corrective action and member business loans, there are a number of other amendments to the Act that CUNA urges the Committee to include in its regulatory relief legislation. These are:

1. Leases of land on federal facilities for credit unions

We support an amendment to Section 124 of the Federal Credit Union Act (12 USC §1770) which would permit military and civilian authorities responsible for buildings on federal property the discretion to extend real estate leases at minimal charge to credit unions that finance the construction of credit union facilities on federal land. Credit unions provide important financial benefits to military and civilian personnel, including those who live or work on federal property. This amendment would authorize an affected credit union, with the approval of the appropriate authorities, to structure low cost lease arrangements which would enable the credit union to channel more funds into lending programs and favorable savings rates for its members.

2. Investments in securities by federal credit unions

The Federal Credit Union Act's limitations on the investment authority of federal credit unions are anachronistic. CUNA supports an amendment to Section 107 of the Federal Credit Union Act (12 USC §1757) to provide additional investment authority for credit unions to purchase for their own accounts certain investment securities. The NCUA Board should have the authority to define appropriate investments under this provision, thus ensuring that new investment vehicles would meet high standards of safety and soundness and be consistent with credit union activities. The total amount of the investment securities of any one obligor or maker should not exceed 10 percent of the credit union's unimpaired capital and surplus

3. Increase in the general 12-year maturity limit applicable to federal credit union loans

Currently, federal credit unions are authorized to make loans to members, to other credit unions, and to credit union service organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a 12-year maturity limit that is subject to exceptions for certain types of loans, such as mortgage loans. The Federal Credit Union Act (Section 107(5), 12 USC §1757(5)) should allow loan maturities up to 15 years, or longer terms as permitted by the NCUA Board. While we would prefer that loan maturities be completely removed from the statute, leaving NCUA with the authority to determine the maturity on loans consistent with safety and soundness, a

15-year maturity is preferable to the current limit. Such an increase in the loan limit would help lower monthly payments for credit union borrowers.

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

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in the aggregate no more than 1 percent of its total paid-in and unimpaired capital and surplus in these organizations, commonly known as credit union service organizations (CUSOs). CUNA asks the Committee to include an amendment to raise the limit in Section 107(7)(I) (12 USC §1757(7)(I)) to 3 percent.

CUSOs provide a range of services to credit unions and their members. Some services directly support credit union operations such as data processing, record retention and debt collection. Other services directly benefit members such as financial planning, retirement planning and shared branching. Utilizing services provided through a CUSO reduces risk to a credit union and allows it to take advantage of economies of scale and other efficiencies that help contain costs to the credit union's members. Further, a federal credit union's participation in CUSOs is regulated by NCUA, and the agency has access to the books and records of the CUSO.

The current limit on CUSO investments by federal credit unions is out-dated and limits the ability of credit unions to support CUSOs to meet the range of members' needs for financial services. This limit results in federal credit unions having to either forego certain opportunities that would benefit members or use outside vendors in which the credit union has no ownership stake. While CUNA would prefer to see the 1 percent limit eliminated or set by NCUA through the regulatory process, an increase to 3 percent in the statute would provide credit unions more options to investment in CUSOs to enhance their ability to serve their members.

CUNA also would support raising the 1 percent borrowing limitation (Section 107(5)(D), 12 USC §1757(5)(D)) that currently restricts loans from credit unions to CUSOs. We believe the limit should be on par with the investment limit, which we hope the Committee will support raising to 3 percent.

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

Federal credit unions are currently authorized to provide check-cashing services only to members and have very limited authority to provide wire transfer services to individuals in the field of membership under certain conditions. CUNA urges the Committee to support an amendment to Section 107(12) of the Federal Credit Union Act (12 USC §1757(12)) to allow a federal credit union to provide check-cashing services and money transfer services to anyone eligible to become a member of the credit union. Such services would include the authority to sell travelers checks and money orders, and send and receive international and domestic funds transfers.

This proposed amendment is fully consistent with the initiatives of President Bush and Congress to reach out to underserved communities in this country. Many of these individuals live from pay check to pay check and do not have established accounts for a variety of reasons, including the fact that they do not have extra money to keep on deposit. We know of members who join one day, deposit their necessary share balance and come in the very next day and withdraw because they need the money. This is not financial mismanagement on their part. They just do not have another source of funds.

If federal credit unions are permitted to cash checks, sell negotiable checks, and facilitate transfers of funds, we could accomplish two things: Save our staff time and effort opening new accounts for short term cash purposes which are soon closed; and gain the loyalty and respect of potential members so that when they are financially capable of establishing an account, they will look to the credit union, which can also provide financial education and other support services.

Legislation that includes similar provisions is pending in both the House and Senate on this issue: the International Consumer Protection Act, introduced in the House (H.R. 928) by Representative Gutierrez and in the Senate (S. 31) by Senator Sarbanes. Additionally, the Expanded Access to Financial Services Act (H.R. 749), introduced by Representatives Gerlach and Sherman, contains identical language to this provision, and passed the House of Representatives on April 26, 2005 by voice vote. CUNA strongly supports all legislative efforts to enact this provision and is grateful to Ranking Member Sarbanes for the introduction of his bill.

6. Voluntary mergers involving multiple common bond credit unions

In voluntary mergers of multiple bond credit unions, NCUA has determined that the Federal Credit Union Act requires it to consider whether any employee group of over 3,000 in the merging credit union could sustain a separate credit union. This provision is unreasonable and could occasionally limit the ability of two healthy multiple common bond federal credit unions from efficiently combining their financial resources to serve their members better. CUNA urges that Section 109(d)(2) of the Federal Credit Union Act (12 USC §1759(d)(2)) be amended to eliminate this requirement for voluntary mergers.

7. Conversions involving common bond credit unions

CUNA supports an amendment to Section 109(g) of the Federal Credit Union Act (12 USC §1959(g)) to allow a multiple common bond federal credit union converting to or merging with a community federal credit union to retain all groups in its membership field prior to becoming a community credit union. Currently, when a multiple group credit union converts to or merges with a community charter, a limited number of groups previously served may be outside of the boundaries set for the community credit union. Thus, new members within those groups would be ineligible for service from that federal credit union. The amendment would allow the community credit union to provide service to all members of groups previously served by the multiple group credit unions.

8. Credit union governance

CUNA strongly believes that credit union boards should have more authority in making their own decisions. We are proposing three specific amendments for the Committee's consideration for inclusion in its regulatory relief bill. First, federal credit union boards must be given flexibility to expel a member who is disruptive to the operations of the credit union, including harassing personnel and creating safety concerns, without the need for a two-thirds vote of the membership present at a special meeting as required by current law (Section 118(b) of the Act, 12 USC §1764(b)). Second, federal credit unions should have the ability in their by laws to limit the length of service of individual members of their boards of directors (amending Section 111(a) of the Act, 12 USC §1761(a)). Third, federal credit unions should have the ability, if they choose to do so, to reimburse volunteers for wages they would otherwise forfeit by participating in credit union affairs (Section 111(c) of the Act, 12 USC §1761(c)).

Some federal credit unions have occasionally faced situations where there was a need to expeditiously expel a member for just cause, particularly for instances of harassing –or threatening - - credit union staff. The boards of these credit unions should have the ability to quickly act, without having to call a special membership meeting.

Federal credit unions should have the right to limit the length of service of their boards of directors, which should help to assure broader representation from the membership. This would be a permissive, not mandatory, authority. Providing credit unions with this right does not raise supervisory concerns and should not, therefore, be determined by the federal government.

Credit unions are directed by committed volunteers. Given the pressures of today's economy on many workers and the legal liability when holding governing positions at credit unions, it is increasingly difficult to attract and maintain such individuals. Rather than needlessly discouraging volunteer participation through artificial constraints, the Federal Credit Union Act should encourage such involvement by allowing volunteers serving on the federal credit union's board or any of its committees to recoup wages they would otherwise forfeit by participating in credit union affairs. The decision on whether to reimburse for lost wages should be left to individual credit unions, not a mandatory requirement.

9. Providing NCUA with greater flexibility in responding to market conditions

Section 107(5)(A)(vi) of the Federal Credit Union Act (12 USC §1757(5)(A)(vi)) provides the authority for the NCUA Board to establish a federal usury ceiling above 15% under certain circumstances up a period not to exceed 18 months. CUNA feels that it is important that NCUA be given greater flexibility in evaluating the market place by looking at interest rates in the preceding six months or (rather than the current “and”) whether prevailing interest rate levels threaten the safety and soundness of individual credit unions.

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

CUNA believes that it is very important to give federally insured credit unions the same exemption that banks and thrift institutions already have from pre-merger notification requirements and fees of

the Federal Trade Commission. Therefore we request that the Committee include in its regulatory relief bill an amendment to Section 7A(c)(7) of the Clayton Act (15 USC §18a(c)(7)).

11. Treatment of credit unions as depository institutions under securities laws

CUNA requests that Section 3(a)(6) of the Securities and Exchange Act of 1934 (15 USC §78c(a)(6)) and Section 202(a)(2) of the Investment Advisers Act of 1940 (12 USC §80b-2(a)(2)) be amended to give federally insured credit unions exceptions, similar to those provided to banks, from broker-dealer and investment adviser registration requirements.

12. Privately insured credit unions authorized to become FHLB members

Currently, only federally insured credit unions may become members of the Federal Home Loan Bank System. A privately insured credit union should be permitted to apply to become a member of a Federal Home Loan Bank. The state regulator of a privately insured credit union applying for membership could certify that the credit union meets the eligibility requirements for federal deposit insurance in order to qualify for membership in the Federal Home Loan Bank system.

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

CUMAA added a provision to the Federal Credit Union Act (Section 102(b)(2)(B), 12 USC §1752a(b)(2)(B)) stating that only one member of the NCUA Board may have recent credit union experience. A similar experience limit does not apply to any other federal regulatory agency. And the restriction denies the NCUA Board and credit unions the expertise that can greatly enhance their regulatory and supervisory systems. This restriction should be stricken from the statute. The law should be changed to state **at least one** person on the NCUA Board should have recent credit union experience.

**AMENDMENTS TO OTHER FEDERAL LAWS THAT CUNA URGES THE COMMITTEE
INCLUDE IN REGULATORY RELIEF LEGISLATION**

The “Matrix of Financial Services Regulatory Relief Proposals” prepared by Senator Crapo’s staff is certainly a comprehensive listing of regulatory relief provisions across a broad array of banking and consumer disclosure regulations. CUNA’s support for a number of amendments to laws other than the Federal Credit Union Act is noted in the Matrix. We would like to highlight several provisions that we urge the Committee to include in its regulatory relief bill. Where appropriate, we note by number where the proposal is found in the Matrix.

- **Monetary reserve requirements:** CUNA hopes that any regulatory relief passed by Congress includes authority for the Federal Reserve Board to pay interest on the reserves that credit unions have to maintain in compliance with the Fed’s Regulation D (#1). While we support the provision recommended by the Fed (#2 of the Matrix), which would give the Fed greater flexibility to set the transaction account reserve level as low as 0 percent, we think that it is important that the Committee make the basic inquiry to the Fed on whether monetary reserves are even needed in 2006 for carrying out the nation’s monetary policy.

The current six transfers a month restrictions on savings accounts is a tremendous regulatory burden on depository institutions. The requirement is impossible to logically explain to consumers, is challenging to support by data processing systems, and we really question if monetary reserves help the Fed carrying out its monetary policy today. The banking industry seeks (#113) to expand the number of permissible transfers from savings deposits from 6 to 24 per months, which would maintain a line, albeit a thin line, between savings and transaction accounts. We support #113 if this is the only change possible, but we urge the Committee to review the need for monetary reserves in this modern electronic age. We certainly want the Committee to understand that there is a major operational burden in having to count transfers per month and warn consumers about the consequences of exceeding the arbitrary number of transfers.

- **Annual privacy notices:** CUNA supports the elimination of the annual privacy notice provision in the Gramm-Leach-Bliley Act (#63 and others). Financial institutions that do not share personal financial information or have not changed their policy should not have to send out these notices every year. A credit union should be required to give new members its privacy notice, provide all members with a revised privacy notice when its privacy policy

has changed, post its privacy notice on its website if it maintains a website, and make a copy of its privacy notice available upon request. This approach would be more useful to consumers than annually sending out another piece of paper that goes unread.

- **Bank Secrecy Act and the requirements of the Office of Foreign Assets Control (OFAC):** Compliance with the Bank Secrecy Act is taking up a tremendous amount of time and resources for credit unions as well as banks and thrift institutions right now, as the agencies and regulated financial institutions work through new compliance expectations. Any further guidance on suspicious activity monitoring would be especially welcomed, as suggested in #180. We certainly support the ideas offered by the Independent Community Bankers of America in #106 about reviewing the currency transaction reporting thresholds, and reporting, retention and exemption procedures.

We saw nowhere mentioned in the Matrix a related burden, the various OFAC compliance requirements. Simply put, OFAC has certain requirements, with potentially high penalties, that are impossible to comply with – unless we want to bring the nation’s payments system to a screeching halt. We ask the Committee will help identify the appropriate place to review the regulatory burdens and concerns created by certain OFAC requirements.

CONCLUSION

In summary, Mr. Chairman, we are grateful to the Committee for holding this hearing. Credit unions’ ability to continue serving the financial needs of our current members and our potential members who need access to our services in Alabama and across the country will be significantly reduced without the regulatory relief this Committee is addressing. We strongly urge the Committee to act on this very important issue this year. And, we strongly urge the Committee to include the many amendments we have suggested to the Federal Credit Union Act, particularly on prompt corrective action reform and member business lending restrictions, and the provisions we cite in other federal laws that are unnecessarily burdensome.

I thank you for the opportunity to present these proposals on behalf of CUNA, and I look forward to your questions.