

**WRITTEN TESTIMONY
OF
WILLIAM LAVAGE
PRESIDENT AND CEO
SERVICE 1ST FEDERAL CREDIT UNION
ON BEHALF OF
THE CREDIT UNION NATIONAL ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT**

MAY 20, 2009

Introduction

Chairman Gutierrez and Ranking Member Hensarling, thank you for inviting me to appear before the Subcommittee today on behalf of the Credit Union National Association to discuss H.R. 2351, the Credit Union Share Insurance Stabilization Act. I am William Lavage, President and CEO of Service 1st Federal Credit Union in Danville, Pennsylvania. My credit union has \$140 million in assets and we serve 18,000 members. Our original sponsor was Geisinger Medical Center in Danville. Today, Geisinger accounts for the vast majority of our members, even though we serve a number of additional select employee groups.

By way of background, CUNA is the nation's largest credit union advocacy organization, representing about 90% of our nation's approximately 8,000 state and federally chartered credit unions and their 92 million members.

We are grateful to long-time credit union champion Representative Paul Kanjorski (D-PA) for his leadership in introducing H.R. 2351. CUNA, its member credit unions, state credit union leagues, the Association of Corporate Credit Unions and others strongly

support this critical and timely legislation. We also appreciate that the House passed S. 896, the Helping Families Save Their Homes Act, yesterday. S. 896 includes the provisions of H.R. 2351. We look forward to the expeditious enactment of S. 896.

Why This Legislation is Needed

Most natural person credit unions are generally performing well. Unlike many other lenders, credit unions saw their loans rise by 7% to over \$575 billion in 2008, up about \$35 billion from the previous year. Meanwhile, banks in this country saw loans decline about \$31 billion in 2007, from \$7.9 to \$7.876 trillion, as reported in the Wall Street Journal March 19, 2009.

Still, no one is immune from the effect of the financial crisis and there are some natural person credit unions in states such as California, Florida, Arizona, Nevada and Michigan that are experiencing serious financial stresses, including net worth strains, primarily as a result of the collateral effects of their economic environment.

Within the credit union system, the corporate credit union network has been particularly hard hit, due in part to the impact of \$64 billion in mortgage-backed and asset-backed securities.

There are currently 28 corporate credit unions, which are owned by their natural person credit union members. Corporate credit unions are wholesale financial institutions that provide settlement, payment, liquidity, and investment services to their members. The powers of corporate credit unions differ from natural person credit unions. For example, the mortgage backed and asset backed securities that are permissible investments for corporate credit unions and not generally permissible for natural person credit unions.

For the most part, the problematic securities were tripled-A rated at the time the corporate credit unions purchased them. However, as a result of the impact of the economy on the securities, and the mortgages and other assets underlying the securities, the National

Credit Union Administration (NCUA) has projected substantial credit losses relating to these securities.

Since January 29, 2009, when it announced its Corporate Stabilization Plan, the NCUA has taken a number of steps to address the problems within the corporate credit union system. These actions have included a \$1 billion capital infusion into U.S. Central Corporate Federal Credit Union (U.S. Central), a National Credit Union Share Insurance Fund (NCUSIF) guarantee for uninsured shares in corporate credit unions, and programs to encourage credit unions to make, increase or maintain deposits in the corporate system. The most serious NCUA action to date has been the conservatorship of U.S. Central and Western Corporate Federal Credit Union (WesCorp), which began March 20, 2009. All of these steps have been funded through the NCUSIF, the costs of which must be borne by federally insured credit unions.

For my own credit union, I am facing potential NCUSIF costs this year of \$1.04 million and will need to set aside additional capital to restore the credit union's net worth to its previous level prior to the NCUSIF charges. These are funds that would otherwise have been used to help meet the consumer, home mortgage and small business borrowing needs of my credit union's members. Credit unions fully acknowledge that we will have to pay the eventual losses on the securities held by corporate credit unions. But, having to do so all in one year or two, at a time in which a severe recession is already stressing credit union income statements, will place unnecessary burdens on credit unions and their members.

In light of the corporate credit union problems and the toll that credit unions are facing to address these problems, we think it is imperative that NCUA have the statutory authority it needs to manage insurance costs both to facilitate operation of the NCUSIF, and to help credit unions handle their NCUSIF expenses, as H.R. 2351 would provide. More specifically, H.R. 2351 includes the following provisions.

Increased Agency Borrowing Authority

Currently, the NCUSIF may only borrow up to \$100 million. (This borrowing cap was established by Congress in 1970 when the NCUSIF was established.) Yet, the NCUSIF costs associated with NCUA's assistance to the corporate credit union are estimated by the agency to be \$5.9 billion, far exceeding the current borrowing cap. If the limit on agency borrowing is not increased, NCUA will not be able to amortize the NCUSIF costs and as a result, federally insured credit unions will have to fund unbudgeted assessments of approximately 100 basis points in a foreshortened time frame, dramatically reducing the net worth of federally-insured credit unions. More importantly, the lower net worth levels will make credit unions less able to lend to their members, and will require unnecessarily draconian measures to restore net worth.

To make it possible for NCUSIF costs to be amortized, H.R. 2351 would raise the agency's borrowing authority and create a new, temporary, Corporate Credit Union Stabilization Fund (CCUSF) within the U.S. Treasury to be operated by NCUA. NCUA would be authorized to borrow up to \$6 billion in the aggregate for the NCUSIF and the temporary CCUSF. In addition, NCUA would be authorized to borrow up to \$30 billion (an additional \$24 billion over the \$6 billion mentioned above) through December 31, 2010, for the NCUSIF and CCUSF combined.

The increased borrowing authority will allow NCUA to use the loan proceeds from the U.S. Treasury to fund the CCUSF and current NCUSIF costs associated with assisting corporate credit unions. Federally insured credit unions would still be obligated to repay all U.S. Treasury borrowings. However, rather than paying for them in a condensed time frame, which would be the case without the legislation, credit unions would be able to fund their NCUSIF and CCUSF charges over seven to eight years, as discussed in greater detail below.

H.R. 2351 provides several safeguards on the use of the borrowing authority. Under Section 2, Treasury loans of up to \$6 billion must be approved by the NCUA Board and under terms fixed by agreement between the Board and Treasury, as for the current borrowings. Any loan amounts that exceed the \$6 billion general borrowing cap would require a two-thirds vote for approval of the NCUA Board and Federal Reserve Board.

The Secretary of the Treasury, in consultation with the President, would also have to approve the additional borrowing. If the agency's borrowing exceeds \$6 billion, the agency must promptly provide a report to the House Financial Services Committee and Senate Banking Committee on the need for the additional funds and their intended uses.

We appreciate the leadership of Chairman Gutierrez, who originally offered an amendment during the full Committee consideration of H.R. 786 to increase the borrowing authority of the agency.

Spreading Out the Costs to Federally Insured Credit Unions of Assisting Corporate Credit Unions

Like the Federal Deposit Insurance Corporation, the NCUSIF provides account insurance, backed by the full faith and credit of the U.S. Government, to the institutions it covers. However, the NCUSIF differs from the FDIC in its structure and how it is funded. The FDIC is generally funded by assessing premiums to insured banks. The NCUSIF follows a somewhat different approach. The equity of the share insurance fund is comprised of two components, 1% of insured shares that all federally insured credit unions must maintain with the NCUSIF in the form of contributed capital and the 0.2 percent to 0.3 percent range of insured shares held in retained earnings that are funded through earnings on the fund and insurance premiums. Federally insured credit unions may be assessed an insurance premium, twice a year, to bring the NCUSIF to its normal operating level, which is set by the NCUA Board within a range of 1.2% to 1.3% of equity as a percentage of insured shares, as directed by the *Federal Credit Union Act*. The current operating level is 1.3% of insured shares. Absent passage of H.R. 2351, all of the assistance to the corporate credit unions must be provided through the NCUSIF.

As a result of NCUA's assistance to the corporate credit unions, the agency is estimating that all of the 0.3 percent retained earnings in the NCUSIF will be absorbed and must be replaced. Under current law, NCUA and federally insured credit unions replace the retained earnings in the calendar year; however, we note that S. 896 includes a provision

that permits NCUA and credit unions to replenish this component over as many as eight years.

This would be accomplished through the establishment by NCUA of a restoration plan to repay the retained earnings, if the equity ratio of the NCUSIF fund falls below 1.2%, or the NCUA Board projects that it will do so within 6 months. The restoration plan must permit federally insured credit unions to pay the insurance premium costs over 8 years (or longer if the NCUA Board determines there are extraordinary circumstances.) The restoration plan must be established within 90 days and must provide that the equity ratio of the NCUSIF will be restored to 1.2% before the end of the 8-year or longer period. And, within 30 days after the NCUA Board establishes the restoration plan, the agency must publish in the Federal Register a detailed analysis of the basis for its actions.

We appreciate the leadership of Representative Kanjorski who offered an amendment during the full Committee consideration of H.R. 786 to give credit unions the ability to replenish this component over multiple years.

Also as a result of its assistance to the corporate credit unions, NCUA is estimating that about 69 percent of federally insured credit unions' 1% of insured shares deposit (1% deposit) with the NCUSIF will be depleted, as a result of its assistance to the corporate credit unions.

Federally insured credit unions have an ownership interest in the 1% deposit and it is treated as an asset on their books. As a result, it is not possible under Generally Accepted Accounting Principles (GAAP) to amortize the costs to credit unions to write-down and replenish the 1% deposit because any known and estimable impairment to the NCUSIF's 1% of insured shares must be reflected in the same accounting period by federally insured credit unions.

Therefore, it is necessary to create a new mechanism that will repay the NCUSIF and spread out the costs to federally insured credit unions associated with restoring their 1% NCUSIF deposits.

H.R. 2351 would establish a new, temporary Corporate Credit Union Stabilization Fund (CCUSF) which would allow NCUA to spread out costs to federally insured credit unions associated with replenishing their 1% NCUSIF deposits.

NCUA would be able to borrow for the Stabilization Fund from the Treasury to make expenditures only in connection with the conservatorship, liquidation or threatened conservatorship or liquidation of a corporate credit union. The new CCUSF would repay all advances plus interest to the Treasury. NCUA would have seven years from the time of the first advance to repay Treasury, unless with Treasury's approval, it extends the final repayment date. At least 90 days prior to each prepayment to Treasury, the Board will determine the amount of the upcoming repayment and if the CCUSF has a deficit, it must assess each federally insured credit union an amount in the aggregate that is necessary to make the payment to Treasury. The charge will be stated as a percent of insured shares as represented on the credit union's previous call report and will be identical for each credit union. Credit unions that fail to make their payments will be subject to penalties.

The NCUSIF would be prohibited from paying dividends to federally insured credit unions while the CCUSF Fund has an outstanding advance from the Treasury. Instead, the NCUSIF would make the distribution to the CCUSF of the maximum amount possible as long as the NCUSIF equity rate is not reduced below the normal operating level and available assets of the NCUSIF do not fall below 1%. The CCUSF would be authorized to operate with a deficit for accounting purposes, as long as future repayments are planned and all deficits are resolved prior to the termination of the Fund. The Board must submit an annual report to Congress on the CCSUF. Within 90 days of the 7th anniversary of the first advance, the NCUA Board would be required to distribute any funds or assets in the CCUSF to the NCUSIF and close the Stabilization Fund.

CUNA feels strongly that the increased borrowing authority for NCUA and the new, temporary CCUSF are imperative in view of the significant costs NCUA estimates the NCUSIF will expend to assist the corporate credit unions and the impact of those costs on the credit union system.

For perspective, the FDIC is seeking an increase in its borrowing authority from \$30 billion to \$100 billion, with additional authority to borrow up to \$500 billion with the concurrence of the Federal Reserve Board, the Treasury Department and in consultation with the President. As credit unions continue to be affected by the economy, and in recognition of the \$250,000 insurance ceiling which may be extended thereby increasing the NCUSIF's exposure, we urge the Subcommittee to support an increase in the agency's borrowing authority and the establishment of a temporary CCUSF fund that will facilitate the ability of NCUA to manage the costs associated with the assistance to the corporate credit unions and allow credit unions to pay for those costs over time.

CUNA Supports Additional Tools for NCUA

I would also like to point out that CUNA supports enhanced authority for NCUA through its Central Liquidity Facility to provide liquidity to all member credit unions, including corporate credit unions. Currently, the CLF may provide loans to natural person credit unions for liquidity purposes, but is not authorized to lend directly to corporate credit unions. To address liquidity issues within the corporate credit unions, NCUA has developed programs such as the Credit Union System Investment Program (CUSIP) under which natural person credit unions borrow from the CLF at a favorable rate, and provide the proceeds to their corporate, also at a favorable rate. While this program has been beneficial, we feel it would also be useful for NCUA to have another mechanism to ensure there is sufficient liquidity within the corporate system, which would allow corporate credit unions to obtain short-term loans directly from the CLF. We urge the Subcommittee to consider this additional authority for the CLF.

In addition, CUNA supports systemic risk authority for NCUA, on a similar basis to that provided to FDIC. While we cannot imagine that Congress intended NCUA would not have such authority, the FDIC was able to point to specific provisions in its Act to provide unlimited deposit insurance coverage for non-interest bearing transaction accounts. These accounts are often held by small businesses. Without a specific systemic risk provision, NCUA believes it has not been able to provide such insurance coverage through the NCUSIF for these accounts at credit unions, creating a disadvantage for

credit unions in certain markets. Businesses often want to maintain their deposit accounts at the same institutions they receive loans. Because credit unions are not able to offer full insurance on these accounts, some small businesses have felt it necessary to turn elsewhere for their deposit and loan account needs. We urge the Subcommittee to look into this issue with NCUA.

We also note that limited assistance -- up to \$10 billion -- from the Treasury's Troubled Assets Purchase Program (TARP) to the NCUSIF and to a small number of individual credit unions could be extremely important in helping to blunt the impact of the insurance expenses on the credit union system. We believe such funding, which would be fully repaid by the credit union system in a reasonable amount of time, is appropriate under the circumstances.

Some banker groups have charged that credit unions' tax exemption would be threatened if we receive such funds. In our view, this should not be the case, because any funds from TARP would be reimbursed by credit unions. Further, the Treasury has developed a TARP program specifically for Subchapter S Banks, which receive very favorable tax treatment. No one is suggesting that this step undermines their generous tax benefits the Subchapter S banks receive from the federal government. We would welcome the Subcommittee's support of TARP assistance for some credit unions—and we appreciate the House passage of H.R. 384, which would permit credit unions to count certain forms of government assistance as capital for the purposes of prompt corrective action.

Ongoing Accounting Issues

While the focus of this hearing is not accounting issues, the impact of accounting rules regarding fair value and assets that have to be reported as “other than temporarily impaired” (OTTI) have placed a heavy burden on the credit union system, particularly for corporate credit unions. At the urging of Representative Kanjorski and others, the Financial Accounting Standards Board (FASB) issued new accounting rulings April 9, 2009 that, among other things, provide only credit losses for “other than temporarily impaired” assets have to be deducted from earnings. We sincerely appreciate these

efforts. However, FASB has not taken the additional step of allowing OTTI-classified assets to reflect any recovery on the assets prior to maturity or sale. We urge Congress to remain vigilant and keep the pressure on FASB to address these fair value accounting issues in a timely and effective manner.

NCUA's Actions to Assist Corporate Credit Unions

Because of the concerns of the credit union system, including my own, regarding the costs and other matters associated with the corporate credit union assistance, I want to raise a few issues about the process for handling the corporate credit unions' problems thus far and in the future. We feel it is appropriate and necessary to bring these concerns to your attention, consistent with the House Financial Services Committee's oversight role over the federal financial regulators.

Before addressing these concerns, I want to emphasize that CUNA supports rigorous supervision and balanced regulation for all credit unions to promote safety and soundness and the interests of credit union members. We also continue to support and urge Congress as it reviews regulatory reform to maintain NCUA as an independent regulatory agency for credit unions, for which House Financial Services Committee Chairman Barney Frank has indicated his support.

Even while we support NCUA's independence as the only regulatory framework to insure the unique cooperative nature of credit unions will be preserved, we also feel it is fair and appropriate to bring up to this Subcommittee the serious concerns federally insured credit unions have raised relating to the handling of the assistance for the corporate credit unions. I also want to be very clear that virtually all credit unions we have heard from understand there are critical problems within the corporate credit union system that must be addressed expeditiously. We want to work with NCUA in that endeavor.

Two major concerns of credit unions in NCUA's handling for the corporate stabilization thus far are the opaqueness of their process, and an apparent lack of creativity in seeking

ways to manage and minimize what has become the largest single shock ever to the share insurance fund. Credit unions face substantial future losses on investment securities held by corporate credit unions, and these losses may have to be absorbed by the share insurance fund. That much is certain. What is much less certain is the amount of those losses, and how they will be managed, minimized and borne. In this world of uncertainty, the more transparent NCUA's processes and actions, the better for all involved. So far that transparency has been lacking.

The NCUA initially engaged the bond firm PIMCO to analyze potential credit losses in the portfolio of securities held by corporate credit unions. PIMCO's loss estimates ranged from a low of around \$6 billion to a high of around \$16 billion with a "most likely" estimate of \$10.6 billion, which served as the basis for NCUA's judgment that the total costs to the share insurance fund of the corporate stabilization would be \$5.9 billion. The estimates are highly sensitive to assumptions pertaining to a number of details surrounding mortgage- and asset-backed securities such as default rates, prepayment rates, and loss severities which in turn depend on a variety of possible assumptions about the future course of the economy, interest rates, housing markets and housing finance. Credit unions do not believe that NCUA has been sufficiently forthcoming with enough details about the nature of the securities and the analysis given the magnitude of the implications for credit unions.

NCUA follows Generally Accepted Accounting Principles (GAAP), but has not shown sufficient flexibility in dealing with some of the shortcomings of GAAP. In particular, GAAP directs NCUSIF to record a single, exact figure on its financial statements for the cost of guaranteeing deposits in corporate credit unions, which cost depends on expected losses on the securities held by the corporate credit unions. That estimated cost is the \$5.9 billion figure I mentioned above. Although that may be the appropriate accounting treatment, in reality the actual losses will certainly be different from PIMCO's estimate, either higher or lower. Fully recognizing that the current expensed amount is just an estimate of an, as yet, unknown amount requires that the actions that follow from that assessment take into account the uncertain future. As I describe below, in the case of

dealing with credit unions' impaired capital in corporate credit unions, the Agency has not been sufficiently flexible or creative in dealing with these very complicated issues. Facing similarly trying circumstances, the Federal Deposit Insurance Corporation has shown greater creativity in responding to and managing the crisis in a responsible manner, and apparently in a manner that does not undermine accounting principles.

Going forward, CUNA encourages the Agency to provide more information to credit unions as it becomes available on the condition of the corporate credit unions under conservatorship, on the condition of the securities held by these credit unions, on how the agency is dealing with these issues and the implications those actions will have on credit unions.

We further request that the Subcommittee encourage the agency to develop a mechanism under which credit unions with capital accounts in WesCorp and U.S. Central that may soon be depleted have the possibility of recovering some of their absorbed capital in the event that the ultimate losses on the securities held by these corporate credit unions turn out to be significantly less than expected. Credit unions have no basis to evaluate the current estimates that require the depletion of their capital deposits in these corporate credit unions. Further, if the losses on the securities turn out to be sufficient to have warranted that depletion, credit unions do not expect any replenishment of their capital out of the general future earnings of the two corporate credit unions. However, in the event the actual, realized losses on the securities turn out to be small enough such that, had they been estimated accurately, the depletion of capital would not have been required, such depletion should be returned to the relevant credit unions. We are not suggesting that the estimates are intentionally misleading or inaccurate, but we are pointing out that the estimates are uncertain, and we encourage the Agency to arrange the transactions so that appropriate measures can be taken once the uncertainty has been resolved.

Another concern for the future is that the agency set in place mechanisms to ensure that the management of the portfolio of mortgage- and asset-backed securities is handled in such a manner so as to minimize losses on the portfolio. Currently, the expected losses

on the portfolio are driven by two factors: the eventual credit losses on the underlying securities, and market losses that would result from selling the securities before they mature or amortize. Currently, the market losses are likely the greater of these two components, and NCUA has insufficient reserves to sell the portfolio at current market values. The agency has assured credit unions that they have no intention of selling the securities in the near future.

However, in a few years, the market values of the securities are likely to move closer to the underlying credit losses. There is concern among credit unions that pressures will build on NCUA to sell the securities once the remaining market losses fall below the funds that the Agency has accumulated from credit unions to cover those losses. To address this issue, CUNA encourages NCUA to establish portfolio management guidelines that specify that the portfolios be managed with the goal of holding the securities for a long enough period that essentially only credit losses be incurred, and further to engage a portfolio manager to manage the portfolios under those guidelines.

CUNA's Recommendations to Transform the Corporate CU System

While CUNA is supporting additional resources for the NCUSIF and urging Congress to help with these and other issues, such as accounting concerns, that will have an impact on the credit union system including corporate credit unions, CUNA's Corporate Credit Union Task Force, which was created in 2008, has developed a range of structural and regulatory changes to the corporate credit union system. In response to NCUA's Advance Notice of Proposed Rulemaking on the corporate credit unions, CUNA filed a comment letter to the agency based on our Task Force's recommendations. Among the key principles regarding the corporate credit unions that CUNA advocates are:

- How the corporate credit union system can best meet the needs of natural person credit unions now and into the future must be the first priority in revamping the corporate credit union system.

- The core services of the corporate credit unions should focus on what natural person credit unions need the most: settlement, payment and liquidity services.
- As problems in the corporate have centered on investments, longer-term investments should be dramatically curtailed.
- Capital/net worth is a critical component in the successful operation of any credit union and federally insured corporate credit unions should maintain at least 4% net worth. If riskier activities are permitted, such as longer-term investments, there should be risk based capital requirements that support such additional activities.
- The number of corporate credit unions should be substantially reduced to a single digit number to achieve economies of scale, while promoting safety and soundness, but remain large enough to foster innovative services and service delivery.
- Corporate credit unions should have national fields of membership, which will also promote efficiency.
- Corporate governance issues are critical for all credit unions, including the corporate credit unions. To help promote effective corporate governance, corporate credit unions should be allowed to have up to 20% of their directors come from outside the credit unions system and be permitted to provide reasonable compensation to directors.

All of these changes are designed to prevent problems of the nature and magnitude that the credit union system is currently facing. We hope to work with NCUA as it develops a proposed and final regulation this year on corporate credit unions that will help minimize safety and soundness concerns but will allow corporate credit unions to operate without undue constraints that will undermine their ability to meet natural person credit unions' needs for settlement, payment and liquidity services. We hope this Subcommittee will

be mindful of the development of that regulation to encourage reasonable safeguards that do not unnecessarily limit the ability of corporate credit unions to operate and provide needed services to natural person credit unions.

Conclusion

In closing, Chairman Gutierrez, Ranking Member Hensarling and all the members of this Subcommittee, we appreciate your review of these issues today. Every day, credit unions reinforce their commitment to workers, small business owners and a host of others seeking to better their quality of life by providing loans on terms they can afford and savings rates that are favorable. We look forward to working with you to enact the provisions of H.R. 2351 and ensure the credit union system continues to be an important bulwark for the 92 million individuals and small businesses that look to their credit union for financial strength and support.