Prepared Testimony of George Reynolds
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Georgia Department of Banking and Finance
On behalf of the
National Association of State Credit Union Supervisors
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NASCUS History and Purpose

Good morning, Chairman Dodd, and distinguished members of the Senate Committee on Banking, Housing and Urban Affairs. I am George Reynolds, Senior Deputy Commissioner of Georgia Department of Banking and Finance and chairman of the National Association of State Credit Union Supervisors (NASCUS)[1]. I appear today on behalf of NASCUS, the professional association of state credit union regulators.

The mission of NASCUS is to enhance state credit union supervision and advocate for a safe and sound state credit union system. We achieve our mission by serving as an advocate for the dual chartering system, a system that recognizes the traditional and essential role of state governments in the national system of depository financial institutions.

[1] NASCUS is the professional association of the 47 state credit union regulatory agencies that charter and supervise the nation's 3,300 state-chartered credit unions.

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Thank you for holding this important hearing today to explore modernizing financial institution supervision and regulation. The regulatory structure in this country has been a topic of discussion for many years. The debate began when our country's founders held healthy dialogue about how to protect the power of the states. More recently, commissions have been created to study the issue and several administrations have devoted further time to examine the financial regulatory system. Most would agree that if the regulatory system were created by design, the current system may not have been deliberately engineered; however, one cannot overlook the benefits offered by the current system. It has provided innovation, competition and diversity to our nation's financial institutions and consumers.

In light of our country's economic distress, many suggest that regulatory reform efforts should focus, in part, on improving the structure of the regulatory framework. However, I suggest that it is not the structure of our regulatory system that has failed our country, but rather the functionality and accountability within the regulatory system.

A financial regulatory system, regardless of its structure, must delineate clear lines of responsibility and provide the necessary authority to take action. Accountability and transparency must also be inherent in our financial system. This system must meet these requirements while remaining sufficiently competitive and responsive to the evolving financial service needs of American consumers and our economy. Credit union members and the American taxpayer are demanding each of these qualities be present in the nation's business operations and they must be present in a modernized financial regulatory system.

These regulatory principles must exist in a revised regulatory system. This is accomplished by an active system of federalism, a system in which the power to govern is shared between national and state governments allowing for clear communication and coordination between state and

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federal regulators. Further, this system provides checks and balances and the necessary accountability for a strong regulatory system. I detail more about this system in my comments.

NASCUS Priorities for Regulatory Restructuring

NASCUS' priorities for regulatory restructuring focus on reforms that strengthen the state system of credit union supervision and enhance the capabilities of state-chartered credit unions. The ultimate goal is to meet the financial needs of consumer members while assuring that the state system is operating in a safe and sound manner. This provides consumer confidence and contributes to a sound national and global financial system.

In this testimony, I discuss the following philosophies that we believe Congress must address in developing a revised financial regulatory system. These philosophies are vital to the future growth and safety and soundness of state-chartered credit unions.

- Preserve Charter Choice and Dual Chartering
- Preserve States' Role in Financial Regulation
- Modernize the Capital System for Credit Unions
- Maintain Strong Consumer Protections, which often Originate at the State Level

My comments today will focus solely on the credit union regulatory system; I will highlight successful aspects and areas Congress should carefully consider for refinement.

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Preserving Charter Choice and Dual Chartering

The goal of prudential regulation is to ensure safety and soundness of depositors' funds, creating both consumer confidence and stability within the financial regulatory system.

Today's regulatory system is structured so that states and the federal government act independently to charter and supervise financial institutions. The dual chartering system for financial institutions has successfully functioned for more than 140 years, since the National Bank Act was passed in 1863, allowing the option of chartering banks nationally. It is important that Congress continue to recognize the distinct roles played by state and federal regulatory agencies.

Dual chartering remains viable in the financial marketplace because of the distinct benefits provided by charter choice and due to the interaction between state and federal regulatory agencies. This structure works effectively and creates the confidence and stability needed for the national credit union system.

Importance of Dual Chartering

The first credit union in the United States was chartered in New Hampshire in 1909. State chartering remained the sole means for establishing credit unions for the next 25 years, until Congress passed the Federal Credit Union Act (FCUA) in 1934.

Dual chartering allows an institution to select its primary regulator. For credit unions, it is either the state agency that regulates state-chartered credit unions in a particular state or the National Credit Union Administration (NCUA) that regulates federal credit unions. Forty-seven states have laws that permit state-chartered credit unions, as does the U.S. territory of Puerto Rico.

Any modernized regulatory restructuring must recognize charter choice. The fact that laws differ for governing state and federal credit unions is positive for credit unions and consumers. A key

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feature of the dual chartering system is that individual institutions can select the charter that will benefit their members or consumers the most. Credit union boards of directors and CEOs have the ability to examine the advantages of each charter and determine which charter matches the goals of the institution and its members.

Congress intended state and federal credit union regulators to work closely together, as delineated in the FCUA. Section 201 of the FCUA states, " … examinations conducted by State regulatory agencies shall be utilized by the Board for such purposes to the maximum extent feasible."[2] NCUA accepts examinations conducted by state regulatory agencies, demonstrating the symbiotic relationship between state and federal regulators.

Congress must continue to recognize and to affirm the distinct roles played by state and federal regulatory agencies. The U.S. regulatory structure must enable state credit union regulators to retain regulatory authority over state-chartered credit unions. This system is tried and it has worked for the state credit union system for 100 years. It has been successful because dual chartering for credit unions provides a system of "consultation and cooperation" between state and federal regulators.[3] This system creates the appropriate balance of power between state and federal credit union regulators.

A recent example of state and federal credit union examiners working together and sharing information is the bimonthly teleconferences held since October of 2008 to discuss liquidity in the credit union system. Further, state regulators and the NCUA meet in-person several times a year to discuss national policy issues. The intent of Congress was that these regulators share information and work together and in practice, we do work together.

[2] 12 US Code § 1781(b)(1).
[3] The Consultation and Cooperation With State Credit Union Supervisors provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).

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Another exclusive aspect of the credit union system is that both state and federal credit unions have access to the National Credit Union Share Insurance Fund (NCUSIF). Federally insured credit unions capitalize this fund by depositing one percent of their shares into the fund. This concept is unique to credit unions and it minimizes taxpayer exposure. Any modernized regulatory system should recognize the NCUSIF. The deposit insurance system has been funded by the credit union industry and has worked well for credit unions. We believe that credit unions should have access to this separate and distinct deposit insurance fund. A separate federal regulator for credit unions has also worked well and effectively since the FCUA was passed in 1934. NASCUS and others are concerned about any proposal to consolidate regulators and state and federal credit union charters.

Charter choice also creates healthy competition and provides an incentive for regulators (both state and federal) to maximize efficiency in their examinations and reduce costs. It allows regulators to take innovative approaches to regulation while maintaining high standards for safety and soundness.

The dual chartering system is threatened by the preemption of state laws and the push for a more uniform regulatory system. As new challenges arise, it is critical that the benefits of each charter are recognized. As Congress discusses regulatory modernization, it is important that new policies do not squelch the innovation and enhanced regulatory structure provided by the dual chartering system. As I stated previously, dual chartering benefits consumers, provides enhanced regulation and allows for innovation in our nation's credit unions.

Ideally, the best of each charter should be recognized and enhanced to allow competition in the marketplace. NASCUS believes dual chartering is an essential component to the balance of power and authority in the regulatory structure. The strength and health of the credit union

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system, both state and federal, rely on the preservation of the principles of the dual chartering system.

Strengths of the State System

State-chartered credit unions make many contributions to the economic vitality of consumers in individual states. Our current regulatory system benefits citizens and provides consumer confidence.

To begin, one of the strengths of the state system is that states operate as the “laboratories” of financial innovation. Many consumer protection programs were designed by state legislators and state regulators to recognize choice and innovation. The successes of state programs have been recognized at the federal level, when like programs are introduced to benefit consumers at the federal level. It is crucial that state legislatures maintain the primary authority to enact consumer protection statutes for residents in their states and to promulgate and enforce state consumer protection regulations, without the threat of federal preemption.

We caution Congress about putting too much power in the hands of the federal regulatory structure. Dual chartering allows power to be distributed throughout the system and it provides a system of checks and balances between state and federal authorities. A system where the primary regulatory authority is given to the federal government may not provide what is in the best interest of consumers.

Preserve States' Role in Financial Regulation

The dual chartering system is predicated on the rights of states to authorize varying powers for their credit unions. NASCUS supports state authority to empower credit unions to engage in activities under state-specific rules, deemed beneficial in a particular state. States should

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continue to have the authority to create and to maintain appropriate credit union powers in any new regulatory reform structure debated by Congress.

However, we are cognizant that our state systems are continuously challenged by modernization, globalization and new technologies. We believe that any regulatory structure considered by Congress should not limit state regulatory authority and innovation. Preemption of state laws and the push for more uniform regulatory systems will negatively impact our nation's financial services industry, and ultimately consumers.

Congress should ensure that states have the authority to supervise state credit unions and that supervision is tailored to the size, scope and complexity of the credit union and the risk they may pose to their members. Further, Congress should reaffirm state legislatures' role as the primary authority to enact consumer protection statutes in their states.

Added consumer protections at the state level can better serve and better protect the consumer and provide greater influence on public policy than they can at the federal level. This has proved true with data security and mortgage lending laws, to name a few. It is crucial that states maintain authority to pursue enforcement actions for state-chartered credit unions. Congress' regulatory restructuring efforts should expand the states' high standards of consumer protection.

Recently, Chairman Barney Frank (D, Mass.) of the House Financial Services Committee, said, "States do a better job," when referring to consumer protection. NASCUS firmly believes this, too.

Comprehensive Capital Reform for Credit Unions

The third principle I want to highlight is modernizing the capital system for credit unions. Congress should recognize capital reform as part of regulatory modernization. Capital sustains the viability of financial institutions. It is necessary for their survival.

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NASCUS has long supported comprehensive capital reform for credit unions. Credit unions need access to supplemental credit union capital and risk-based capital requirements; these related but distinctly different concepts are not mutually exclusive. The current economic environment necessitates that now is the time for capital reform for credit unions.

Access to Supplemental Capital

State credit union regulators are committed to protecting credit union safety and soundness. Allowing credit unions access to supplemental capital would protect the safety and soundness of the credit union system and provide a tool to use if a credit union faces declining net worth or liquidity needs.

A simple fix to the FCUA would authorize state and federal regulators the discretion, when appropriate, to allow credit unions to use supplemental capital.

NASCUS follows several guiding principles in our quest for supplemental capital for credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must preserve credit unions' tax-exempt status.[4] Finally, regulatory approval would be required before a credit union could access supplemental capital. We realize that supplemental capital will not be allowed for every credit union, nor would every credit union need access to supplemental capital.

Access to supplemental capital will enhance the safety and soundness of credit unions and provide further stability in this unpredictable market. Further, supplemental capital will provide an

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[4] State-chartered credit unions are exempt from federal income taxes under Section 501(c)(14) of the Internal Revenue Code, which requires that a) credit union cannot access capital stock; b) they are organized/operated for mutual purposes; and without profit. The NASCUS white paper, "Alternative Capital for Credit Unions … Why Not?" addresses Section 501(c)(14).

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additional layer of protection to the NCUSIF thereby maintaining credit unions' independence from the federal government and taxpayers.

Allowing credit unions access to supplemental capital with regulatory approval and oversight will enhance their ability to react to market conditions, grow safely into the future, serve their nearly 87 million members and provide further stability for the credit union system. We feel strongly that now is the time to permit this important change. Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings from net income. Since net income is not easily increased in a fast-changing environment, state regulators recommend additional capital-raising capabilities for credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness.

Supplemental capital is not new to the credit union system; several models are already in use. Low-income credit unions are authorized to raise uninsured secondary capital. Corporate credit unions have access, too; they have both membership capital shares and permanent capital accounts, known as paid-in capital. These models work and could be adjusted for natural-person credit unions.

Risk-Based Capital for Credit Unions

Today, every insured depository institution, with the exception of credit unions, uses risk-based capital requirements to build and to monitor capital levels. Risk-based capital requirements enable financial institutions to better measure capital adequacy and to avoid excessive risk on their balance sheets. A risk-based capital system acknowledges the diversity and complexity between financial institutions. It requires increased capital levels for financial institutions that choose to maintain a more complex balance sheet, while reducing the burden of capital

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requirements for institutions holding assets with lower levels or risk. This system recognizes that a one-size-fits-all capital system does not work.

The financial community continues to refine risk-based capital measures as a logical and an important part of evaluating and quantifying capital adequacy. Credit unions are the only insured depository institutions not allowed to use risk-based capital measures as presented in the Basel Accord of 1988 in determining required levels or regulatory capital. A risk-based capital regime would require credit unions to more effectively monitor risks in their balance sheets. It makes sense that credit unions should have access to risk-based capital; it is a practical and necessary step in addressing capital reform for credit unions.

Systemic Risk Regulation

The Committee asked for comment regarding the need for systemic risk regulation. Certainly, the evolution of the financial services industry and the expansion of risk outside of the more regulated depository financial institutions into the secondary market, investment banks and hedge funds reflect that further consideration needs to be given to having expanded systemic risk supervision. Many suggest that the Federal Reserve System due to its structural role in the financial services industry might be well suited to be assigned an expanded role in this area.

The Role of Proper Risk Management

During this period of economic disruption, Congress should consider regulatory restructuring and also areas where risk management procedures might need to be strengthened or revised to enhance systemic, concentration and credit risk in the financial services industry.

Congress needs to address the reliance on credit rating agencies and credit enhancement features in the securitization of mortgage-backed securities in the secondary market.

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These features were used to enhance the marketability of securities backed by subprime mortgages. Reliance on more comprehensive structural analysis of such securities and expanded stress testing would have provided more accurate and transparent information to market analysts and investors.

Further, there is a debate occurring about the impact of “mark-to-market” accounting on the financial services industry as the secondary market for certain investment products has been adversely impacted by market forces. While this area deserves further consideration, we urge Congress to approach this issue carefully in order to maintain appropriate transparency and loss recognition in the financial services industry.

Finally, consideration needs to be given to compensation practices that occurred in the financial services industry, particularly in the secondary market for mortgage-backed securities. Georgia requires depository financial institutions that are in Denovo status or subject to supervisory actions that use bonus features in their management compensation structure not to simply pay bonuses based on production or sales, but also to include an asset quality component. Such a feature will “claw back” bonuses if production or sales result in excessive volumes of problematic or non-performing assets. If such a feature were used in the compensation structure for the marketing of asset-backed securities, perhaps this would have been a deterrent to the excessive risk taking that occurred in this industry and resulted in greater market discipline.

Conclusion

Modernizing our financial regulatory system is a continuous process, one that will need to be fine-tuned over time. It will take careful study and foresight to ensure a safe and sound regulatory structure that allows enhanced products and services while ensuring consumer protections. NASCUS recognizes this is not an easy process.

To protect state-chartered credit unions in a modernized regulatory system, we encourage Congress to consider the following points:

- Enhancing consumer choice provides a stronger financial regulatory system; therefore charter choice and dual chartering must be preserved.
- Preserve states’ role in financial regulation.
- Modernize the capital system for credit unions to protect safety and soundness.
- Maintain strong consumer protections, which often originate at the state level.

It is important that Congress take the needed time to scrutinize proposed financial regulatory systems.

NASCUS appreciates the opportunity to testify today and share our priorities for a modernized credit union regulatory framework. We urge this Committee to be watchful of federal preemption and to remember the importance of dual chartering and charter choice in regulatory modernization. We welcome questions from Committee members.

Thank you.

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