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WRITTEN TESTIMONY
OF
MARILYN JAMES
PRESIDENT & CEO, NEPCO FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
"CONSIDERATION OF REGULATORY REFORM PROPOSALS"
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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Chairman Shelby, Ranking Member Sarbanes, Senators Crapo, Allard and other members of the Committee, on behalf of the Credit Union National Association (CUNA), I appreciate this opportunity to come before you and express the association's views on legislation to help alleviate the regulatory burden under which all insured financial institutions operate today.

CUNA is the largest credit union advocacy organization, representing over 90% of our nation's approximately 9,400 state and federal credit unions and their 85 million members.

I am Marilyn James, President and CEO of NEPCO Federal Credit Union in Pueblo, Colorado. NEPCO, a relatively small credit union with $20 million is assets, is an acronym for Northeast Pueblo County. We have a geographic field of membership that incorporates approximately 1/5th of the city and 1/4th (inclusive of each other) of the county and was designed in 1976 so that it included our original FOM, the Pueblo Army Depot (now the Pueblo Chemical Depot). We serve anyone who lives or works in the area or has a relative who is eligible.

The Pueblo City/County population is approx. 124,000 and is 36% Latino or Hispanic, 61% White and 3% other (according to the most recent census). 25% are under age 18, 15% are over age 65

with the remaining 60% between 18-64. Two trends seem to be the future of our area: Increasing elderly and increasing Latino/Hispanic. The median income has shown a slight decline in comparison to both the State of Colorado and the U.S. This is counterbalanced by a low cost of living compared to both the State and the U.S. The average annual wage is $27,100.

While we do not track our membership specifically by ethnic origin, I would say that NEPCO's membership somewhat reflects the local community with a slightly larger percentage of Latino/Hispanic members, probably closer to 45%. The age breakdown of our members also deviates from the City/County: 6% are under age 18, 22% are over age 65 and 72% are between the ages of 18 and 65.

NEPCO offers the usual services: All types of secured and unsecured consumer loans including line of credit, VISA credit cards and overdraft protection and mortgage loans; regular share accounts (including Life Savings Insurance), money market shares, vacation & Christmas savings, share drafts with VISA debit/ATM cards, IRAs and CDs. We are one of the few institutions in town where you can still open a savings account with $5.00 and a checking account with as little as $50.00. There is no monthly service charge on our checking accounts and the only fees incurred by our members are the cost of check forms and fees for such things as NSF, stop payment, etc. These fees are approximately 35% lower than corresponding fees at local banks. We also offer free instruction to members opening a draft account (at the member's request) as well as free consultation for members who have trouble balancing their accounts.

While we do not have "Life Line Checking" per se, we have many members who have opened a $5.00 share account for the specific purpose of receiving direct deposit of social security and/or

other recurring payments. There is no fee attached to these transactions. In addition, we offer members check cashing services either for free (requires a savings balance of more than $100, or a loan account) or at a nominal fee of $1.00 per $100. This fee is 50% less than the cheapest check cashing service in town and 100% or more less costly than most. This is one service that could be provided to the underserved in our community and give us the opportunity to educate consumers eligible for membership regarding other services beneficial to consumers of modest means.

CUNA is especially pleased that the Committee is considering a new effort to provide regulatory relief of unneeded and costly burdens, since the last two regulatory relief bills that Congress passed did not include provisions specific to credit unions. Some might suggest that the Credit Union Membership Access Act (CUMAA) was the credit union version of regulatory relief. While that law did provide relief from an onerous Supreme Court decision, it also imposed several new, stringent regulations on credit unions, which, in spite of assertions to the contrary, are the most stringently regulated of insured financial institutions.

Credit Unions Are Distinct Financial Institutions

Among its numerous provisions, the Credit Union Membership Access of 1998[1] (CUMAA) required 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 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

[1] Pub. L. No. 105-219 Sec. 401; 112 Stat. 913 (1998); 12 USC 1752a note and 1757a note

function), they are clearly distinguishable from these other depository institutions in their structure and operational characteristics."

These qualities, catalogued by the U.S. Treasury in its 2001 study, had been previously incorporated into the congressional findings of the Federal Credit Union Act[2] when CUMAA was adopted in 1998.

Recognition and appreciation of such attributes is critical to the understanding of credit unions, as Congress made it clear when it amended the FCU Act in 1998 that it is these characteristics that form the foundation on which the federal tax exemption for credit unions rests. As Congress determined when it passed CUMAA:

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

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

While other institutions, such as mutual thrifts, may meet one or two of these standards or display some of these differences, other credit union distinctions listed here do not necessarily apply. As

[2] P. L. 105-219, Sec. 2, 112 Stat. 913

Treasury noted in its study, "Many banks or thrifts exhibit one or more of …(these) characteristics, but only credit unions exhibit all five together." [3]

Other 1998 congressional findings in the FCU Act 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.

Since their inception, credit unions continue to share these unique attributes, separating them from other depository institutions. Despite the frequent attempts of detractors to present credit unions in a false light and label them as other types of institutions, the distinct characteristics of credit unions have been recognized in statute and in analytical reports from the U.S. Treasury and others. Further, despite repeated attempts, legal challenges brought by banking groups against NCUA's field of membership policies under the Credit Union Membership Access Act have not proved fruitful.

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

[3] U.S. Dept. of the Treasury, *Comparing Credit Unions with Other Depository Institutions, (Wash. DC: 2001.)*

<u>Credit Unions' Regulatory Burden Is *Real* And Relief Is Imperative</u>

As cooperative financial institutions, credit unions have not been shielded from the mounting regulatory responsibilities facing insured depositories in this country.

Last month, Federal Deposit Insurance Corporation (FDIC) Vice Chairman John M. Reich said in testimony before the House Subcommittee on Financial Institutions and Consumer Credit, "regulatory burden is a problem for all banks." His statement is accurate as far as it goes.

Regulatory burden is an issue for all financial institutions generally, and credit unions in particular. Indeed, credit unions **are the most heavily regulated of all financial institutions.** This dubious distinction is the result of several factors, which include:

- Credit unions operate under virtually the same consumer protection rules, such as Truth-Lending, Equal Credit Opportunity, Home Mortgage Disclosure, Real Estate Settlement Procedures Act, Truth-in-Savings, Expedited Funds Availability Act, USA Patriot Act, Bank Secrecy, safety and soundness including prompt corrective action regulations reviewed by Treasury, and other rules that apply to banks. Credit unions will also have to comply with developing rules under the Fair and Accurate Credit Transactions (FACT) Act and the Check 21 statutory requirements. A list of the 137 rules that federal credit unions must follow is attached.

(1) Credit unions are the only type of financial institution that have restrictions on whom they may serve;

(2) Credit unions are the only group of financial institutions that must comply with a federal usury ceiling;

(3) Credit unions may not raise capital in the marketplace but must rely on retained earnings to build equity;

(4) Credit unions are the only group of financial institutions that must meet statutory net worth requirements;

(5) Credit unions face severe limitations on member business lending;

(6) Credit unions have limitations on loan maturities;

(7) Credit unions have stringent limitations on investments;

(8) Credit unions have not been granted new statutory powers, as banks have under Gramm-Leach Bliley; and

(9) Credit unions' operations and governance are inflexible because many aspects are fixed in statute.

Most importantly for credit unions, time and other resources spent on meeting regulatory requirements are resources that would otherwise be devoted to serving their members – which is, after all, their primary objective.

With Few Exceptions, Credit Unions Must Comply with Virtually All Bank Rules

Despite unfounded banker chargers to the contrary, federally insured credit unions bear an extraordinary regulatory burden that is comparable to that of banks in most areas and much more restrictive in others.

As the Treasury's 2001 study comparing credit unions with other institutions concluded, "Significant differences (in the general safety and soundness regulation of banks and credit unions, parenthesis added) have existed in the past, but have been gradually disappearing." The Treasury

study cited prompt corrective action and net worth requirements for credit unions as a major regulatory difference that was removed in 1998.

Treasury further noted that their "relative small size and restricted fields of membership" notwithstanding, "federally insured credit unions operate under bank statutes and rules virtually identical to those applicable to banks and thrifts."

Credit Unions Must Comply With Substantial Requirements Banks Don't Have to Follow

In addition to following rules applicable to the banking industry, credit unions operate under considerable statutory and regulatory requirements that do not apply to other types of financial institutions.

As Treasury's study pointed out, credit union 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 stated. Complex credit unions have additional net worth requirements.

Treasury's analysis also 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. In addition, a usury ceiling prevents them from charging more than 18% on any loan, and the term of many types of loans may not extend beyond twelve years."

Credit unions also have statutory and regulatory restrictions as to whom they may serve. Federal credit unions' fields of membership must meet the common bond requirements that apply to an associational, occupational, multi-group or community credit union. Thus, unlike banks and thrifts, which may serve anyone regardless of where they live or work, a credit union may only offer its services to individuals within its field of membership.

Credit unions operate under heavily constrained investment authority as well. A federal credit union may invest in government securities and other investments only as provided under the Federal Credit Union Act and authorized by NCUA.

Credit unions also must comply with limitations on lending, including member business lending. A federal credit unions' member business loans 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 total assets in commercial loans.

It is useful to note that there are other limitations on credit unions' member business lending that do not apply to commercial banks. A credit union's MBLs must generally meet 12-year maturity limits and can only be made to members. Credit union MBLs have significant collateral and while not required, often carry the personal guarantee of the borrower.

Commercial banks have a variety of mechanisms through which they can raise funds, including through deposit-taking or borrowing funds in the capital markets. In marked contrast, credit unions

may only build equity by retaining earnings. A credit union's retained earnings are collectively owned by all of the credit unions' members, as opposed to a bank that is owned by a limited number of stockholders or in some cases, by a finite number of individuals or family members.

Thus, a major distinction between credit unions and commercial banks is that credit unions operate under a number of specific, operational regulations that do not apply to banks. Bank trade associations attempt to mislead Congress when they erroneously argue that credit unions have evolved into banks. The restrictions on credit union operations and the limitations on their activities drive a stake into the heart of that argument.

Unlike Banks, Credit Unions Have Not Received New Statutory Powers

Not only have credit unions not received new statutory powers as banks have, severe regulatory constraints on member business lending and under prompt corrective action have been imposed on credit unions for the last several years.

An important study regarding the regulation of credit unions was published last year under the auspices of the Filene Research Institute and addresses the regulatory advantages banks have over credit unions.

Authored by Associate Professor of Economics William E. Jackson, III, Kenan-Flagler Business School, University of North Carolina at Chapel Hill and entitled, "The Future of Credit Unions: Public Policy Issues,"[4] the study looked at the efforts of Congress over the last two decades to

[4] Jackson, III, William E., University of North Carolina-Chapel Hill. ***The Future of Credit Unions: Public Policy Issues, 2003.***

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.

For example, 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 this sweeping, statutory expansion of bank powers. However, while they received neither benefits nor new powers under the Gramm-Leach-Bliley Act, credit unions 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.

<u>Pending Credit Union Regulatory Relief Legislation That CUNA Supports</u>

CUNA strongly supports H.R. 3579, the Credit Union Regulatory Improvements Act (CURIA), which currently has over fifty co-sponsors and is awaiting a hearing before the House Financial Services Committee. CUNA has also endorsed of H.R. 1375, the House-passed Regulatory Relief Act, which was approved by the House of Representatives on March 18, 2004, by a vote of 392-25. In our view, these bills provide an excellent starting point for the Senate Banking Committee as it considers real reforms that will provide regulatory relief to credit unions and other institutions.

While CUNA also supports other statutory changes, we first want to focus on amendments to the Federal Credit Union Act that are contained in H.R. 3579 and Title III of H.R. 1375.

<u>H.R. 3579—The Credit Union Regulatory Improvements Act (CURIA)</u>

Although a comparable bill has not been introduced in the Senate, it nevertheless provides a sound foundation for this Committee's consideration of some fundamental problems facing credit unions today and we ask you to take a close look at these proposed changes as incorporated in CURIA.

H.R. 3579, THE CREDIT UNION REGULATORY IMPROVEMENTS ACT OF 2003--SECTION-BY-SECTION DESCRIPTION

TITLE I: Regulatory Flexibility

<u>Section 102. Leases of land on federal facilities for credit unions</u>

This provision would permit military and civilian authorities responsible for buildings on federal property the discretion to extend to credit unions that finance the construction of credit union facilities on federal land real estate leases at minimal charge. 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 lease arrangements to enable the credit union to channel more funds into lending programs and favorable savings rates for its members.

Section 103. Investments in securities by federal credit unions

The Federal Credit Union Act limitations on the investment authority of federal credit unions are anachronistic and curtail the ability of a credit union to respond to the needs of its members. The amendment provides additional investment authority to purchase for the credit union's own account certain investment securities. The total amount of the investment securities of any one obligor or maker could not exceed 10 percent of the credit union's unimpaired capital and surplus. The NCUA Board would 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.

Section 104. Increase in general 12-year limitation of term of 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 limited exceptions. This section would allow loan maturities up to 15 years, or longer terms as permitted by the National Credit Union Administration (NCUA) Board.

As a Federal credit union, my institution must comply with this limitation. We are very concerned that members seeking to purchase certain consumer items, such as a mobile home, may seek

financing elsewhere in which they could repay the loan over a longer period of time than 12 years. While we would prefer for NCUA to have 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 and benefit credit unions as well as their members.

Section 105. Increase in 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 aggregate no more than 1% of its shares and undivided earnings in these organizations, commonly known as credit union service organizations or CUSOs. The amendment raises the limit to 3% percent.

CUSOs provide a range of services to credit unions and allow them to offer products to their members that they might not otherwise be able to do, such as check clearing, financial planning and retirement planning. 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, as federal credit union participation in CUSOs is fully regulated by NCUA, the agency has access to the books and records of the CUSO in addition to its extensive supervisory role over credit unions.

The current limit on CUSO investments by federal credit unions is out-dated and limits the ability of credit unions to participate with these organizations to meet the range of members' needs for financial services. It requires credit unions to arbitrarily forego certain activities that would benefit

members or use outside vendors in which the credit union has no institutional stake. While we feel the 1% limit should be eliminated or set by NCUA through the regulatory process, we appreciate that the increase to 3% will provide credit unions more options to investment in CUSOs to enhance their ability to serve their members.

CUNA also would support raising the borrowing limitation that currently restricts loans from credit unions to CUSOs to 1 percent. We believe the limit should be on par with the investment limit, which under this bill would be raised to 3 percent.

Section 106. Member business loan exclusion for loans to non-profit religious organizations

This section excludes loans or loan participations by federal credit unions to non-profit religious organizations from the member business loan limit contained in the Federal Credit Union Act, which is 12.25% of the credit union's total assets. This amendment would offer some relief in this area by allowing federal credit unions to make member business loans to religious-based organizations without concern about the statutory limit that now covers such loans. While the limit would be eliminated, such loans would still be subject to other regulatory requirements, such as those relating to safety and soundness.

We believe that this is really a technical amendment designed to correct an oversight during passage of the Credit Union Membership Access Act. The law currently provides exceptions to the member business loan caps for credit unions with a history of primarily making such loans. Congress simply overlooked other credit unions that purchase parts of these loans, or participate in them. This provision would clarify that oversight and ensure that these organizations can continue meeting the needs of their members and the greater community at large and ensuring that loans are available for religious buildings as well as their relief efforts.

Section 107. Check-cashing and money-transfer services offered within the field of membership

Federal credit unions are currently authorized to provide check cashing services to members and have limited authority to provide wire transfer services to individuals in the field of membership under certain conditions. The amendment would allow federal credit unions to provide check cashing services to anyone eligible to become a member.

This amendment is fully consistent with President Bush's and Congressional initiatives to reach out to other underserved communities in this country, such as some Hispanic neighborhoods. 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 have had members 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 mismanagement on their part. They just do not have another source of funds. And sometimes, a $5.00 withdrawal means the difference between eating or not.

If we are able to cash checks and sell negotiable checks such as travelers checks, 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 the potential member so that when they are financially capable of establishing an account, they will look to the credit union, which will also provide financial education and other support services. This is especially so in Pueblo, which attracts migrant workers who live in our area for several months each year, many who return year after year. It has been our experience that this particular group is taken advantage of because of the language barrier. We have developed a group of bi-lingual members who are

willing to act as translators when needed and several successful membership relationships have resulted.

Legislation that includes similar provisions is pending in the Senate on this issue: S. 1359, the "International Remittance Services Enhancement and Protection Act;" and S. 1344, the "Money Wire Improvement and Remittance Enhancement Act," or the "Money WIRE Act." The latter, introduced by Senator Corzine, is cosponsored by several other members of the Committee, including Sens. Bayh and Schumer.

Section 108. 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 arbitrarily limits the ability of two healthy multiple common bond federal credit unions from honing their financial resources to serve their members better.

The amendment is a big step forward in facilitating voluntary mergers, as other financial institutions are permitted to do. It provides that the numerical limitation does not apply in voluntary mergers.

Section 109. Conversions involving common bond credit unions

This section allows a multiple common bond credit union converting to or merging with a community charter credit union to retain all groups in its membership field prior to the conversion or merger. 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 credit union. The amendment would allow the new or continuing community credit union to provide service to all members of groups previously served.

Section 110. Credit union governance

This section gives federal credit union boards 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. Federal credit unions are authorized to limit the length of service of their boards of directors to ensure broader representation from the membership. Finally, this section allows federal credit unions to reimburse board of director volunteers for wages they would otherwise forfeit by participating in credit union affairs.

There has been more than one occasion when we would have liked to have had the ability to expel a member for just cause. It is relatively rare that things occur that would cause us to use such a provision. However, the safety of our personnel may be at stake. One instance involves a member who seems to have a fixation on one of our employees and who has made inappropriate comments. Another involves an older member who refuses to take no for an answer from one of our young tellers whom he persistently asks to date. We have heard an example at another credit union when one member actually told one of the tellers he would punch her if he ever saw her out in public. Most cases are not quite that extreme; however, we have had our share of unruly members who seem to enjoy causing a ruckus.

Credit unions should have the right to limit the length of service of their boards of directors as a means to ensure broader representation from the membership. Credit unions, rather than the federal government, should determine term limits for board members. Providing credit unions with this

right does not raise supervisory concerns and should not, therefore, be denied by the federal government.

Credit unions are directed and operated by committed volunteers. Given the pressures of today's economy on many workers and the legal liability attendant to governing positions at credit unions, it is increasingly difficult to attract and maintain such individuals. Rather than needlessly discourage volunteer participation through artificial constraints, the Federal Credit Union Act should encourage such involvement by allowing volunteers to recoup wages they would otherwise forfeit by participating in credit union affairs.

Whether or not a volunteer attends a training session or conference is sometimes determined by whether or not that volunteer will have to miss work and not be paid. I've seen it happen in my own credit union, and my board is comprised of GM employees and retirees. I can imagine this would have an even more substantial impact on boards where the volunteers are not making the income my volunteers do.

Section 111. Providing NCUA with greater flexibility in responding to market conditions

Under this section, in determining whether to lift the usury ceiling for federal credit unions, NCUA will consider rising interest rates or whether prevailing interest rate levels threaten the safety and soundness of individual credit unions.

Section 112. Leasing Space in Buildings with Credit Union Offices in Underserved Areas

This section enhances the ability of credit unions to assist distressed communities with their economic revitalization efforts. It would allow a credit union to lease space in a building or on

property in an underserved area on which it maintains a physical presence to other parties on a more permanent basis. It would permit a federal credit union to acquire, construct, or refurbish a building in an underserved community, then lease out excess space in that building.

Section 113. Credit Union Conversion Voting Requirements

This section would change the Federal Credit Union Act from permitting conversions after only after a majority of those members voting approve a conversion, to requiring a majority vote of at least 20 percent of the membership to approve a conversion.

Time and time again, Congress has made clear its support for credit unions, in order to assure consumers have viable choices in the financial marketplace. Yet, banking trade groups and other credit union detractors have indicated they would like to encourage credit union conversions, particularly those involving larger credit unions, in order that they may control the market, thereby limiting consumers' financial options.

In February, the National Credit Union Administration adopted new regulatory provisions to require credit unions seeking to change their ownership structure to provide additional disclosures to their members to insure they are adequately informed regarding the potential change and are fully aware of the consequences of such action. CUNA strongly supported this action because we feel members should know that their rights and ownership interests will change, particularly if the institution converts to a bank. In such a situation the institution would "morph" from one in which the members own and control its operations to an institution owned by a limited number of stockholders.

CUNA likewise supports the agency's ongoing efforts to ensure members are provided sufficient disclosures and opportunities to present opposing views in relation to a possible conversion.

Congress addressed conversions in the Credit Union Membership Access Act and reinforced that a credit union board which desires to convert must allow its members to vote on its conversion plan. CURIA would require a minimum level of participation in the vote -- at least 20% of the members -- for a conversion election to be valid. Currently, there is a requirement that only a majority of those voting approve the conversion. The legislation would prevent situations in which only a very small number of an institution's membership could successfully authorize such a conversion.

Earlier this year, CUNA's Governmental Affairs Committee developed a resolution that was adopted by our Board relating to credit union ownership, and we want to share its provisions with the Committee.

- The credit union charter presents the best vehicle for serving the financial needs of consumers;
- Credit unions considering changing ownership structure to a bank or thrift charter should decide solely on the basis of what is best for the members of the credit union--not for the management or directors;
- The credit union system should identify and recommend ways to keep the credit union's net worth in the hands of its members;
- Credit unions should provide plain language, full disclosure of all relevant information--including the pros and cons--of a change in the ownership and governance of the credit unions;

- Ensure that credit union senior management and directors are not unjustly enriched, and that appropriate penalties will be imposed for noncompliance with disclosure and other requirements designed to protect the interests of the members; and
- CUNA is rededicated to the improvement of the credit union charter.
- CUNA will continue to look for ways, working with Congress and regulators, to insure a credit union's membership is fully aware of the consequences of a conversion prior to any membership vote.

Section 114. Exemption from pre-merger notification requirement of the Clayton Act

This section gives all federally insured credit unions the same exemption as banks and thrift institutions already have from pre-merger notification requirements and fees of the Federal Trade Commission.

Section 115. Treatment of credit unions as depository institutions under securities laws

This section gives federally insured credit unions exceptions, similar to those provided to banks, from broker-dealer and investment adviser registration requirements.

Title II: Member Business Lending

Section 201. Limits on Member Business Loans

This section eliminates the current asset limit on member business loans at a credit union from the lesser of 1.75 times actual net worth or 1.75% times net worth required for a well-capitalized credit union and replaces it with a flat rate of 20 percent of the total assets of a credit union. This provision therefore facilitates member business lending without jeopardizing safety and soundness at participating credit unions.

Section 202. Definition of Member Business Loans

This section would amend the current definition of a member business loan to facilitate such loans by giving the NCUA the authority to exclude loans of $100,000 or less as de minimus, rather than the current limit of $50,000.

Section 203. Restrictions on Member Business Loans

This section would modify language in the Federal Credit Union Act that currently prohibits a credit union from making any new member business loans if its net worth falls below 6 percent. This change will permit the NCUA to determine if such a policy is appropriate and to oversee all member business loans granted by an undercapitalized institution.

Having described briefly how CURIA would address this issue, I would like to provide the Committee with a detailed rationale for these needed changes.

HELPING SMALL BUSINESS

Title II, Section 203 of the Credit Union Membership Access Act of 1998 (CUMAA) established limits on credit union member business loan (MBL) activity. There were no statutory limits on credit union member business lending prior to1998. 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. Hence the limit is (1.75 x .07) or 12.25% of assets.

NEED FOR REFORM OF CREDIT UNION 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. But this access is seriously constrained by the double-whammy of banking industry consolidation and the CUMAA-imposed limitations on credit union MBLs. 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 held by the largest banks. Federal Deposit Insurance Corporation statistics show that the largest 100 banking institutions now control nearly two-thirds of banking industry assets nationally. In 1992 the largest 100 banking institutions held just 45% of banking industry assets. Thus, CUMAA severely restricts small business access to credit outside the banking industry at a time when small firms are finding increasing difficulty in accessing credit within the banking industry.

Basic problems with the current MBL limits are:

- **THE LIMITS ARE ARBITRARY AND UNNECESSARILY RESTRICTIVE.** Insured commercial banks have no comparable business lending portfolio concentration limitations. Other financial institutions, savings and loans, for example, have portfolio concentration limitations, but those limitations are substantially less restrictive than the limits placed on credit unions in CUMAA.

- **THE 12.25% LIMIT DISCOURAGES ENTRY INTO THE MBL BUSINESS.** Even though very few credit unions are approaching the 12.25% ceiling, the very existence of that ceiling discourages credit unions from entering the field of member business lending. 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 (e.g., data processing systems, furniture and equipment, printing, postage, telephone, occupancy, credit reports and other operating expenses) make member business lending unviable at most credit unions given the current 12.25% limitation. In fact, assuming credit unions could carry salary expense of 2% of portfolio, 76% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum. Alternatively, assuming credit unions could carry salary expense of 4% of portfolio, 63% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum.

- **THE LIMITS ARE NOT BASED ON SAFETY AND SOUNDENSS CONSIDERATIONS.** 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 MBL DEFINITIONS CREATE DISINCENTIVES THAT HURT SMALL BUSINESSES.** The current $50,000 cutoff for defining an MBL is too low and creates a disincentive for credit unions to make loans to smaller businesses. Permitting the cutoff to rise to $100,000 would open up a significant source of credit to small businesses. These "small" business purpose loans are so small as to be unattractive to many larger lenders. Simply inflation adjusting the $50,000 cutoff, which was initially established in 1993 and hasn't been adjusted since that time, would result in an approximate 33% increase in the cutoff to over $65,000.

While some bankers call credit union member business lending “mission creep” this is simply a preposterous fiction. Credit union member business lending is not new -- 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 U.S. Treasury Department study , credit union business lending is more regulated than commercial lending at other financial institutions. In addition, the Treasury found that “member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and the loans generally must be fully collateralized. Ongoing delinquencies – for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due – are lower for credit unions than for banks and thrifts. Credit unions’ mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent).”

Not surprisingly, the Treasury also concluded that MBL “does not pose material risk to the” National Credit Union Share Insurance Fund.

Updated statistics from full-year 2000 through 2003 indicate that the favorable relative performance of MBLs reported in the Treasury study has continued in recent years. Credit union MBL net chargeoffs have averaged just 0.08% over the four-year period since the Treasury study, while the comparable average net chargeoff rate at commercial banks was 1.28% and at savings institutions it was 1.11%. MBLs have even lower loss rates than other types of credit union lending, which themselves have relatively low loss experience.

Credit union member business lending represents a small fraction of total commercial loan activity in the United States. At year-end 2003, the dollar amount of MBLs was less than one-half of one

percent of the total commercial loans held by U.S. depositories. Credit union MBLs represent just 2.5% of the total of credit union loans outstanding and only 17.5% of U.S. credit unions offer MBLs. According to credit union call report data collected by the National Credit Union Administration the median size of credit union MBLs granted in 2003 was $81,125.

An almost two-thirds increase in credit union MBL limits (from 12.25% to 20% of assets, equivalent to the business lending limit for savings institutions) would not cause these numbers to change dramatically.

Raising the current MBL limits would help small business. As noted earlier, small businesses are the backbone of the US economy. The vast majority of employment growth occurs at small businesses. And small businesses account for roughly half of private non-farm gross domestic product in the U.S. each year.

Small businesses are in need of loans of all sizes, including those of less than $100,000, which many have said banks are less willing to make.

Moreover, large banks tend to devote a smaller portion of their assets to loans to small businesses. The continuing consolidation of the banking industry is leaving fewer smaller banks in many markets. In fact, the largest 100 banking institutions accounted for 42% of banking industry assets in 1992. By year-end 2003, the largest 100 banking institutions accounted for 65% of banking industry assets – a 23-percentage point increase in market share in just eleven years.

This trend and its implications for small business credit availability are detailed in a recently released Small Business Administration paper. 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."

In reforming credit union MBL limits Congress will help to ensure a greater number of available sources of credit to small business. 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.

Title III: Capital Levels

Section 301. Amendment to Net Worth Categories

This section modernizes credit union capital requirements by redefining the net worth ratio to include risk assets, thereby instituting a new measurement to determine the relative risk of a credit union's assets and improving the safety and soundness of credit unions and the safety of the National Credit Union Share Insurance Fund.

The following is a detailed discussion of the problem and the need for such reform.

REFORMING PCA

The Prompt Corrective Action (PCA) section of the Credit Union Membership Access Act of 1998 (CUMAA) established for the first time "capital" or "net worth" requirements for credit unions. Prior to that time, credit unions were subject only to a requirement to increase their regular reserves depending on the ratio of these reserves to "risk-assets" (then defined as loans and long-term investments). The purpose of Section 1790d. (Prompt Corrective Action) of the Act is "to resolve the problems of insured credit unions at the least possible long-term loss to the Fund." The

CUMAA instructs the National Credit Union Administration (NCUA) to implement regulations that establish a system of prompt corrective action for credit unions that is consistent with the PCA regime for banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) but that takes into account the unique cooperative nature of credit unions.

NEED FOR REFORM OF CREDIT UNION PCA

The legislative creation of credit union Prompt Corrective Action in 1998 was a significant first step in establishing capital requirements for credit unions. Indeed, during the first two full years of PCA's existence, the number of seriously undercapitalized credit unions has declined substantially, while the costs of resolving failed credit unions have remained modest. However, capital requirements were not the original purpose of the CUMAA. The genesis of the Act was the Supreme Court's field of membership decision of 1998 that prohibited the NCUA from approving credit union fields of membership comprising more than one group. Most of Congress' attention at the time was necessarily devoted to resolving the field of membership issue. 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 some experience with it.

Basic problems with the current PCA system are:

- **HIGH BASIC CREDIT UNION CAPITAL REQUIREMENTS.** Credit unions have higher capital requirements than do banks, even though the credit union share insurance fund 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 to other depository institutions.

- **NET WORTH REQUIREMENT HARD CODED INTO LAW.** Bank and thrift regulatory agencies are empowered to establish the capital ratios that place institutions into the various capitalization categories: well capitalized, adequately capitalized, inadequately capitalized, etc. In the case of credit unions, the actual numerical values for these ratios are specified in the law. This denies the NCUA the opportunity to establish net worth ratios based on its informed understanding of potential threats to the National Credit Union Share Insurance Fund.

- **LACK OF ACCESS TO CAPITAL MARKETS.** Credit unions may only use retained earnings to build net worth. They are currently not permitted any form of secondary capital, which could be used to augment retained earnings in protecting the share insurance fund and meeting capital requirements.

- **RISK BASED SYSTEM COULD BE IMPROVED.** In one way, the risk-based net worth requirements for credit unions under PCA represent an improvement over banks' Basel-type risk based capital requirements. The credit union system explicitly accounts for both interest-rate and credit risk. The current Basel system considers only credit risk. However, the Basel system's method of applying different risk weights to assets permits a more precise accounting for risk than does the credit union system, which focuses on concentrations of assets in the balance sheet.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that those credit unions with net worth ratios 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. However, the pernicious effects of PCA have been on those credit unions that have more than enough capital to operate in a safe and sound manner, but that feel constrained by potential future

reductions in their net worth ratios that can result from growth in member deposits. The 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, 6% is indeed a completely adequate level of net worth. However, because of PCA, a very well run, very healthy, very safe and sound credit union cannot feel comfortable operating with just a 6% net worth ratio. This is because of the effect of potential growth on a credit union's net worth ratio. Without access to capital markets, 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.

This effect goes far beyond those credit unions that are close to the 6% cutoff for being considered adequately capitalized. Again because of the conservative management style that is the product of their cooperative structure, most credit unions wish to be always 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% during 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% capital ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50% higher than that level. The PCA regulation in its present form thus incents credit unions to operate at "overcapitalized" levels. This reduces the ability of credit unions to provide benefits to members and to grow.

There are two ways to resolve these problems. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the share insurance fund and does not upset the unique cooperative ownership structure of credit unions. Secondary capital could come either from members in the form of uninsured shares, or from nonmembers in

the form of subordinated debt or trust preferred securities. There would likely be limits on the extent to which a credit union could rely on secondary capital to meet net worth requirements. For example, secondary capital might be limited to no more than 50% of total capital for purposes of meeting net worth requirements. That said, the rest of this section of the testimony deals with reforming basic PCA requirements rather than with secondary capital.

The other solution would be a reform of PCA requirements themselves. Reform of prompt corrective action should have two primary goals. First, it should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized. This will maintain the very strong incentives for credit unions to avoid becoming seriously undercapitalized. This is essential to achieving the purpose of minimizing losses to the share insurance fund. Second, a reformed PCA should not induce well-capitalized credit unions to feel the need to establish such a large buffer over minimum net worth requirements that they feel required to become overcapitalized.

CUNA believes that the best way to reform PCA consistent with these two requirements would be to transform the system into one which is much more explicitly based on risk measurement. Because of the variety of risk exposures a credit union could come under for a given level of assets, the riskiness of those assets should be given greater consideration in determining capital adequacy.

Such a reform could be achieved by modifying the definition of the "net worth ratio" for PCA as contained in the Act. Specifically, the current definition "the ratio of the net worth of the credit union to the total assets of the credit union" would be changed by inserting "risk" between "total" and "assets." The Act would further authorize NCUA to establish a system for determining risk

assets based on its knowledge of credit union balance sheets and in a fashion designed to minimize losses to the share insurance fund.

A conversion to a risk based system would also need to incorporate a minimum core leverage requirement to ensure that an undercapitalized credit union that held primarily non-risk assets would not be inappropriately shielded from PCA. To that end, in addition to maintaining the stipulated level of net worth to total risk assets, a credit could be required to maintain a ratio of net worth to total assets of at least 4% to be considered adequately capitalized. Further, any credit union with a ratio of net worth to total assets of less than 3% or 2% would be considered significantly or critically undercapitalized respectively, regardless of its net worth ratio.

Under this proposal, a credit union's PCA capitalization classification would be determined as follows:

	Ratio of Net WorthTo Risk Assets*		Ratio of Net WorthTo Total Assets*
Well Capitalized	Over 7%	&	5% and above
Adequately Capitalized	6% and above	&	4% and above
Undercapitalized	4% and above	&	3% and above
Significantly Undercapitalized	2% and above	&	2% and above
Critically Undercapitalized	Under 2%	or	Under 2%

*If a credit union's net worth ratio falls into different categories by risk and total assets, the lower classification would apply.

This reform proposal involves improving the risk-based components of PCA and placing greater emphasis on the risk-based measures, while lowering the pure net worth ratio requirements to be classified as adequately capitalized. It also maintains a basic 4% net worth requirement regardless of risk (compared to the current 6% requirement) to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the net worth levels to be classified as well- or adequately-capitalized is justified for the following reasons:

1. One of the original justifications for higher credit union net worth requirements (higher than for banks) is the 1% NCUSIF deposit. However, the 1% NCUSIF deposit is a systemic, as opposed to an individual credit union issue. The purpose of PCA is to minimize losses to the Share Insurance Fund. It does this in two ways. First, it creates a powerful incentive for individual credit unions to maintain net worth ratios above those required by the regulation. Second, it requires the NCUSIF to take mandatory supervisory corrective action whenever an individual credit union's net worth ratio falls below certain levels. These corrective actions are designed to restore the credit union to an adequately capitalized level, or to force liquidation before that individual credit union's net worth is completely depleted, reducing losses to the Share Insurance Fund. The systemic issue of the 1% deposit really has nothing to do with the level of net worth at which NCUSIF might need to take corrective action with respect to any individual credit union, or to the level of net worth that an individual credit union should aspire to so as to comply with the rule. The only time the 1% issue would come into play in the context of PCA is if huge numbers of credit unions failed concurrently, so that individual credit unions were required to write-down part of their 1% deposits. Given the strong capitalization of credit unions that PCA itself incents, and the existence of PCA to

force corrective action at individual credit unions before failure, such a systemic meltdown is extremely unlikely. Therefore, one might ask why does each credit union have to be overcapitalized compared to a similarly situated bank, to guard against the extremely unlikely event that huge numbers of credit unions fail simultaneously? The answer is they should not be. Establishing credit union PCA with a higher net worth requirement than for banks because of this systemic issue is tantamount to solving the same problem twice.

2. Another reason given for credit unions' higher net worth requirements is their lack of access to capital markets. Credit unions' only source of net worth is the retention of earnings, which is a time consuming process. The idea is that since credit unions cannot access capital markets, they 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 is suggests that a poorly capitalized institution can easily access the capital markets. However, if an institution's net worth ratio falls substantially due to losses, investors are likely to be wary of providing additional capital. Thus lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from other depository institutions as much as it might appear. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. The other reason that a credit union's net worth ratio might fall – rapid asset growth – also should not require a higher net worth requirement for credit unions. Asset growth (which comes from savings deposits) can be substantially influenced by a credit union's dividend policies. Lowering dividend rates creates the dual effects of retarding growth and boosting net income, both of which raise net worth ratios compared to not lowering dividend rates. A credit union should be allowed to protect a reasonable net worth ratio with aggressive dividend rate cutting rather than being required to hold additional capital. Also, a credit union could maintain a 4% net worth ratio earning 1% of assets

(an earnings level consistent with the highest CAMEL rating of 1 and close to the credit union average net income ratio over the past two decades) and still grow by as much as 30% per year. Therefore, lack of access to net worth from sources other than retained earnings does not justify a higher net worth requirement for credit unions.

3. There is substantial evidence that credit unions require **less** net worth than do for-profit financial institutions for purposes of providing 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 incented 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% 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 along the lines of the risk-based approach suggested here would preserve and strengthen the essential share-insurance fund protection of PCA. It would more closely tie a credit union's net worth requirements to 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 unnecessary capital accumulation.

H.R. 1375—Financial Services Regulatory Relief Act (Credit Union Provisions)

Most of the provisions of this bill are also included in H.R. 1375. The single exception is the following section.

Section 301. Privately insured credit unions authorized to become members of a Federal Home Loan Bank

This section permits privately insured credit unions to apply to become members of a Federal Home Loan Bank. Currently, only federally insured credit unions may become members. The state regulator of a privately insured credit union applying for Federal Home Loan Bank membership would have to certify that the credit union meets the eligibility requirements for federal deposit insurance before it would qualify for membership in the Federal Home Loan Bank system.

Additional Legislative Amendments CUNA Supports

- **Allow credit unions to make MBLs unless they are significantly undercapitalized at 4% or less**

Under prompt corrective action, credit unions are not allowed to continue making member business loans if they are undercapitalized, that is have net worth of less than 6%. When this provision was included in the FCU Act, the Treasury had not yet conducted its study of MBLs for credit unions. That study concluded that MBLs within the credit union system are subject to more safeguards and are less risky than such lending at banks. The small business community is in great need of these kinds of business loans, generally for amounts of less than $100,000, which banks are often not willing to make. This change would facilitate the continuation of MBL lending while a credit union works to bring its net worth back to the adequate level of 6%.

- **Allow community credit unions to continue adding members from groups that were part of the field of membership (FOM) before the credit union converted to a community charter but are now outside the community**

Prior to the adoption of amendments to the Federal Credit Union Act in 1998, community credit unions were able to add new members from groups that they had previously served but are outside of the community area the credit union serves. Currently, the credit union may serve members of record but not include additional members from those groups. CUNA supports legislation that would restore that capacity to credit unions.

- **<u>Allow credit unions to serve underserved areas with an ATM</u>**

The legislative history to the Credit Union Membership Access Act indicates that federal credit unions should establish a brick and mortar branch or other facility rather than establishing an ATM to serve an underserved area. This directive makes it far less affordable for a number of credit unions to reach out even more to underserved areas. While credit unions serving underserved areas through an ATM should be as committed to the area as a credit union with another type of facility, this change would facilitate increased service to underserved areas.

- **Eliminate the requirement that only one NCUA Board member can have credit union experience**

Currently, only one member of the NCUA Board may have credit union experience. Such a limit does not apply to any of the other federal regulatory agencies and denies the NCUA Board and

credit unions the experience that can greatly enhance their regulation. At a minimum, the law should be changed to permit **at least one** person with credit union experience on the NCUA Board.

Financial Accounting Standards Board Issues

Two pending issues from the Financial Accounting Standards Board have raised serious concerns for credit unions. One involves the issue of the accounting treatment of credit union mergers. Currently, credit unions may use the pooling method under which the retained earnings of the merging credit union are included in the retained earnings of the continuing credit union. FASB permits this treatment under a delay in the effective date of its Statement of Financial Accounting Standards No. 141, Business Combinations, which requires the acquisition method of accounting for mergers and acquisitions. Under the acquisition method, the retained earnings of the merging credit union must be reflected as "acquired equity" and, although included in GAAP net worth, would not be included in net worth under prompt corrective action of the continuing credit unions. That is because, for purposes of prompt corrective action, net worth is statutorily defined as "retained earnings" as determined under GAAP and does not include "acquired equity," which will be included in GAAP net worth. In other words, regulatory net worth would be more strictly defined than GAAP net worth. It is our understanding that FASB intends to apply the standard to credit unions beginning in early 2006, following a comment period beginning later this year.

Such a change, we believe 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 SFAS No. 141 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 National Credit Union Administration and others, supports a technical correction that would amend the Federal Credit Union Act to make it clear that net worth is equity, including acquired earnings of a merged credit union as determined under GAAP, and as authorized by the National Credit Union Administration Board. Senior legal staff at FASB has indicated support for a legislative approach, and we urge the Committee to likewise support such an effort, well in advance of the effective date of SFAS 141 so credit unions will have certainty regarding the accounting treatment of mergers.

FASB's business combinations proposal is equally problematic for other types of cooperatives, such as farmer-owned and electric cooperatives, which also tend toward mergers of equals rather than acquisitions. CUNA is working with other cooperatives on this issue, all of which oppose the purchase method for member-owned cooperatives.

The other issue relates to the accounting treatment of loan participations. Many of our members currently engage in loan participations, either as the originating institution or as an investor, and FASB's project to review FASB Statement (FAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, is of great concern to us. Other financial institution groups, as well as federal financial regulators, have likewise raised serious questions about the need for and advisability of the proposed guidance.

For a variety of reasons, participations can be important financial and asset liability management tools. They are used increasingly by credit unions, as well as by other institutions, to control interest rate risk, credit risk, balance sheet growth, and maintain net worth ratios. Participations

enable credit unions to utilize assets to make more credit available to their membership than they would be able to do without the use of loan participations.

FASB states that it is concerned that in a loan participation, in which the borrower has shares or deposits at the originating institution, if that institution is liquidated, the participating institution would not be able to recover its pro rata portion of the members' shares/deposits within the originating institution that are "claimed" by the originating institution to setoff the portion of the debt owed to it. This outcome is highly unlikely and we are not aware that it has ever occurred in a credit union.

Nonetheless, FASB is considering amendments to Statement of Financial Accounting Standard 140 that would expressly state that because the right of setoff between the originating institution and the member/depositor/borrower exists (setting up the potential that the participating institution would not have any claim against the member/depositors' funds in the originating institution) the loan transaction does not meet the isolation requirements of FAS 140. Because of this concern, instead of transferring the portion of the loan participated off of its books as a sale, the transaction would be reflected on the originating credit union's financial statements and records as a secured borrowing.

In order for participations to continue being treated as sales for accounting purposes, the amendments would further change the existing accounting standards by requiring an institution to transfer participations through a qualified special purpose entity (QSPE). This is a needless and costly expense that would make it difficult for credit unions to use participation loans as a management tool. Further, it would drastically limit the ability of credit unions to provide low-cost, economical financing for their membership through loan participations.

There are sufficient safeguards already in place that address FASB's concerns about isolating the loan participation asset from the reach of the originating credit union and its creditors in liquidation, without the need for changes to FAS 140 of the nature FASB is contemplating.

CUNA strongly opposes the changes FASB has signaled it is considering because they are unnecessary and would render the use of loan participations impracticable. While we commend FASB for requesting comments on this issue and holding roundtable discussions in which CUNA, the CUA, and the FDIC participated last week, we remain concerned about the scope of the problems its contemplated guidance could create if adopted. We urge the Committee to communicate with FASB and encourage the Board to withdraw this unnecessary, potentially devastating guidance.

CREDIT UNION TAX EXEMPTION

While we recognize that the topic of this hearing is on regulatory relief proposals, we feel compelled to use this opportunity to respond to attacks on the credit union tax-exempt status by the banking industry.

Bankers claim that credit unions are no longer the same types of organizations they were in 1917 and 1937 when the federal income tax exemptions were granted to state and federal credit unions respectively, and because of this credit unions should now be taxed. They point to the evolution and expansion of credit union fields of membership and the addition of a wider range of financial services as evidence that the tax exemption is no longer warranted.

Interestingly, the original justification for credit unions' tax exemption had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Field of membership restrictions were included in the original Federal Credit Union Act as a device to support the operations of small, volunteer-run credit unions. Since lending was to be crucial to credit union operations, the idea was to ensure that credit unions knew to whom they were lending in the days before comprehensive credit reports. Second, when credit unions were first established, the range of financial services to consumers was very limited. It's true that credit unions did not then offer their members credit cards, money market accounts, and a wide range of share certificates in the 1930's. But, of course neither did banks. These services had not yet been invented. Today they are part of the normal portfolio of consumer financial services. Both credit unions and banks have expanded their service offerings over the past seven decades as consumer demand and technological advances have combined to create new products and services.

Rather, the original reason for the tax exemption had everything to do with the cooperative structure of credit unions. As the Treasury Department describes in its January 2001 report, *Comparing Credit Unions and Other Depository Institutions,* the rationale for the 1937 granting of the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937):

> (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members . . ." Thus, the tax

> exemption was based primarily on the organizational form of credit unions..." (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)

Credit unions continue to operate as democratically controlled mutual institutions, serving only their members, on a non-profit basis, meeting the main rationale for the tax exemption. The net income of a credit union is not distributed among stockholders. Instead, that portion not returned to members in lower loan rates and fees, or higher yields on savings, is retained by the credit union to ensure safety and soundness. These retained earnings are not accumulated for the benefit of management or stockholders. They exist only for the benefit of members in the future by providing for the stability of the credit union.

Congress recently reaffirmed the logic behind the tax treatment of credit unions in the findings to the Credit Union Membership Act of 1998:

> The Congress finds the following: . . .
>
> (4) 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.

Despite what bankers say, the reasons for the credit union tax exemption today are the same as they were 70 years ago. Credit unions remain true cooperatives, operating for the benefit of their

members. Credit unions also take seriously their role to serve all their members, including those of modest means.

Credit unions have a proven record of serving those of modest means who fall within their fields of membership. A recently published report on *Who Uses Credit Unions (Third Edition)* by the Filene Research Institute found that: "Households that use a bank only have higher median incomes than those who use a credit union only." And, "Among households that use both a bank and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily." (page 15). The source for this analysis was the Federal Reserve's *Survey of Consumer Finances*.

Credit unions are not as present in the financial lives of those at the very lowest end of the income distribution as they are for those in the middle-income and lower-middle-income groups. Credit union membership is highest in the $30,000 to $80,000 range of household income. At higher and lower income levels, credit union membership is lower. Upper income households are more likely to be bank customers; lower income households are more likely to be unbanked.

The lower membership rates in the very lowest income groups do not mean credit unions have avoided their responsibilities. Credit unions in the U.S. have a 70-year history of serving primarily occupational fields of membership. There have always been a few community credit unions in some parts of the country, but the overwhelming character of credit union fields of membership has been occupational. As such, credit unions have developed into powerful forces of financial betterment in the lives of working people all over the country. The move to serve select employee groups (SEGs)

over the past two decades has extended the availability of credit union service to more Americans, but this membership expansion has been largely restricted to occupational fields.

Those at the very lowest end of the income distribution are less likely to be employed, particularly at the larger employers where credit unions have historically had the greatest presence. Indeed, research shows that “unbanked” households tend to be headed by a person who isn’t working. Therefore, the reason credit unions might not show up in statistics as heavily serving the lowest end of the income distribution is because those households are least likely to have in the past been eligible to join traditional, occupationally based credit unions.

It’s important to note that credit unions didn’t choose the occupational field of membership model as a way of excluding potential members. In fact, just the opposite has been the case. Many credit unions have for much of their history, especially in the past two decades, been doing what they can to expand fields of membership. Yet the bankers attack credit unions when we try to branch out in this way as well.

In summary, restricted by law and regulation that defined fields of memberships on occupational grounds, credit unions have performed very well in serving those of modest means who fell within those fields. With recent field of membership expansions, especially the move to more community based fields of membership, we expect the provision of credit union service to those at the lower end of the income distribution to increase in the coming several years. Evidence of credit union interest in this area is found to the extent to which credit unions have added underserved areas to their fields of membership under the NCUA’s Access Across America program. Since the beginning of 2003, almost 65 million potential members from underserved areas have been added to

credit union fields of membership. Although it will take some time for credit unions to reach out to and serve members in these communities, it is instructive to note that in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth of over three times that of other credit unions (17.4% vs. 5.2% over the three year period).

There are other good public policy reasons to retain the credit union tax exemption. Substantial, tangible benefits accrue to members because of the cooperative operation of the credit union. Precisely because of their cooperative structure, credit unions produce benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over $6 billion a year. That is the additional amount that credit union members would pay if they were to conduct all the business they do with credit unions at banks instead. That is about four times the roughly $1.5 billion that credit unions would pay in federal income tax.

The reason the tax exemption is so leveraged for the benefit of credit union members is directly due to the cooperative structure of credit unions. When comparing banks to credit unions, more important than the tax exemption is the fact that banks must pay dividends to stockholders. In addition, credit unions pay very little in the form of compensation to directors, with the savings passed on to members. Finally, credit unions expense ratios compare very favorably to banks of similar size. Their efficiency of operations, supported by lower compensation for senior staff and lower loan losses, also benefits members.

The tax exemption plays an important role in maintaining the cooperative structure of credit unions. As is pointed out elsewhere in this testimony, credit unions are more heavily regulated than are

other financial institutions. The restrictions on the operations of a credit union are severe: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than throwing off the restrictions by converting to a bank charter. Continuing as credit unions maintains the source of cooperative benefits to 85 million credit union members.

The credit union tax exemption is also a very important element in the structure that supports the safety and soundness of the credit union share insurance fund, thus protecting the general taxpayer from obligation. In it's history, the U.S. has had three federal deposit insurance systems: the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the National Credit Union Share Insurance Fund (NCUSIF). A decade and a half ago, FSLIC failed at a cost of almost $200 billion, borne by the taxpayer. At the same time, FDIC teetered on the brink of insolvency, which could have cost the taxpayer plenty. At the same time, NCUSIF easily maintained its ratio of insurance fund balance to insured shares in the normal operating range of 1.2% to 1.3%.

There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Indeed, the whole purpose of prompt corrective action is to minimize losses to the deposit insurance funds by ensuring there is sufficient capital in insured depositories. Because credit unions have no access to the capital markets, their only source of capital is the retention of earnings. A tax on net income, the only source of credit union capital, would thus disincent credit unions from retaining earnings, weakening protection for NCUSIF. It is

worth noting that the cost to the taxpayer of FSLIC's losses far exceeded the total of of all federal income taxes paid by FSLIC insured institutions prior to FSLIC's failure.

Second, as described in more detail in the section on reforming PCA, as cooperatives credit unions have a systemic inclination to avoid risky activities. This is an especially useful trait for federally insured depository institutions. Again, to the extent the tax exemption is an important part of the reason credit unions remain cooperatives, it serves to protect taxpayers from losses to the share insurance fund.

Finally, the bankers have suggested that large credit unions should be subjected to income taxation. There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Large credit unions are democratically controlled, not-for-profit cooperatives in every way that smaller credit unions are. The boards of directors of large credit unions are volunteers just as they are at small credit unions. Because of its size a large credit union is likely offer a broader array of services, and be a greater presence in a local market, but that makes it no less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say that the American Heart Association should lose its tax exemption simply because of its size while a local health clinic that serves the indigent should not.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs geared to and benefiting low- and

moderate-income households. In the February 2003 CUNA study Serving Members of Modest Means, when asked how many of up to 18 services geared to low/moderate income households were offered, only 6% of credit unions with assets below $20 million offered at least half of the services. Fully 42% of credit unions with assets over $500 million offered 9 or more of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/moderate income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program. Finally, many small credit unions benefit from the assistance they receive from larger credit unions, whether it be from donated equipment or donated training. This is the cooperative spirit in its purest form.

The significance of the credit union tax exemption is well understood by public officials. Both President Bush and Senator Kerry, as well as you, Chairman Shelby, and many other Members of Congress, have written letters or issued statements affirming their appreciation for the important service that credit unions provide to their 85 million members, and indicating their support for the continuation of credit unions' tax exemption.

COMMERCIAL BANK TAX STATUS

Subchapter S Elections and Other Considerations

The commercial banking industry has increasingly attacked the current credit union tax status. Historically, these attacks generally focused on credit union size and/or breadth of service offerings. As explained earlier, the credit union tax status has nothing to do with size or types of services offered.

More recently, as state and federal government budgets have come under pressure, banker attacks have focused on the revenue implications of the credit union tax status.

However, the hypocrisy of the banking industry's new-found concern for government tax receipts is clearly seen in the industry's zealous pursuit of Subchapter S status.

Subchapter S status was originally created to provide federal tax relief to small business owners, and to allow small businesses to incorporate without incurring a tax penalty. Before 1997, banks were prohibited from organizing as S corporations, and therefore were organized and taxed as C corporations. The Small Business Job Protection Act of 1996 allowed certain banks to elect Subchapter S status, beginning January 1, 1997.

An annual average of nearly 300 commercial banking firms (banks and savings & loans) have elected Subchapter S status since that time. According to Federal Deposit Insurance Corporation statistics, a total of 2,020 active Subchapter S banking institutions existed at year-end 2003 and an additional 117 have been added to that total in the first quarter of 2004. This brings the March 2004 total number of Subchapter S banking institutions to 2,137. Overall, 24% of commercial banking firms now hold Subchapter S status.

These Subchapter S banking institutions have $306 billion in total assets – an amount that is equal to 47% of the total assets in the credit union movement. The two largest Subchapter S institutions each has more than $9 billion in total assets, and the third largest has more than $7 billion in total assets.

Subchapter S banking institutions recorded $6.3 billion in annualized net income in the first three months of 2004. This amount is roughly equal to the annualized dollar amount of net income recorded by all U.S. credit unions in the same period.

While Subchapter S status is not the same as the credit union tax status, it results in significant loss of both state and federal government revenue. Collectively, Subchapter S election is estimated to have totaled $626 million in foregone revenue to the U.S. Treasury in 2003 and a total of $3.5 billion in foregone revenue since 1997. These estimates are based upon the fact that Subchapter S shareholders pay tax on their banking institutions income whether it is distributed in the form of dividends or not.

Moreover, the banking industry has lobbied tirelessly for Subchapter S expansion. If successful, such an expansion will add millions to the foregone Treasury revenue totals cited above. While the exact costs are difficult to measure (in part because there is no convenient way of identifying the number of shareholders individual banks have), conservative estimates put Subchapter S expansion costs at roughly $1.2 billion over ten years. Overall, 54% of this total foregone revenue would likely arise from raising the shareholder threshold from 75 to 100, 31% from allowing IRA shareholders, 12% form allowing director-qualifying stock, and 5% from counting family members as one shareholder.

The credit union movement does not oppose Subchapter S status for banking institutions, nor the expansion of Subchapter S status. Yet banking industry attacks on the credit union tax status continue at a torrid pace.

OTHER BANK TAX ISSUES

The use of other tax breaks and tax shelters within the banking industry are well known and widely documented. Like Subchapter S status, these too, result in substantial revenue losses to the Treasury.

One particularly egregious example of this activity was reported on the February 2004 PBS Frontline broadcast "Tax Me if You Can". In this program, Bob McIntyre, Director, Institute on Taxation and Economic Policy, cited the case of one large bank. McIntyre said: "…amazingly, in 2002, even though it reported $4 billion in profits, <the bank> reported that it didn't pay any taxes, and in fact, got a tax rebate from the government of about $160 million."

Of course, the IRS filings of individual corporations are confidential and unavailable to investors, so there is no way to know how widespread this activity is in banking circles. However, the Frontline report suggests it is more prevalent than commonly believed.

Regardless of the exact magnitude of banking industry tax avoidance, it is worth reiterating that the single banking institution cited in the Frontline broadcast earned $4 billion in 2002 profits but paid no taxes. The entire U.S. credit union movement earned $5.9 billion in 2002.

At the state level, in a number of states, banks have set up shell subsidiaries to avoid paying state taxes. For example, a recent study found that 80% of banks in Wisconsin commonly set up subsidiaries in Nevada and transfer their income-earning securities to the Nevada companies to avoid paying Wisconsin taxes. Since Nevada has no corporate income tax, the banks don't pay taxes. Eleven of the 15 largest banks in the state paid no corporate income tax.

While the banking industry professes deep concern about government tax revenue, it is directly responsible for revenue losses that total many times the value of the credit union tax exemption. Increasing government tax revenues would thus be best accomplished by closing banking industry tax loopholes rather than by imposing new taxes on credit unions and their 85 million member-owners.

Facts and Fallacies

Finally, as an additional appendix, I am attaching a report by CUNA entitled *Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends*. This report addresses many of the inaccurate statements made by the banking industry and provides evidence that credit unions deserve their place in the market and consumers and small businesses deserve to have them as a choice for their financial needs.

Conclusion

In summary, Mr. Chairman, we are grateful to the Committee for holding this important hearing. We strongly urge the Committee to act on this very important issue this year. All financial institutions, including credit unions, would benefit greatly from reducing unnecessary and costly regulatory burdens. And so would American consumers benefit from the savings that credit unions would pass along to their 85 million members.