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# THE STATE OF THE CREDIT UNION INDUSTRY

# HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE HEALTH OF THE CREDIT UNION INDUSTRY AS WE EMERGE FROM THE FINANCIAL CRISIS AND RECOVER AND GROW OUR ECONOMY

DECEMBER 9, 2010

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# THE STATE OF THE CREDIT UNION INDUSTRY

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**THURSDAY, DECEMBER 9, 2010**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Senator Tim Johnson, presiding.

## OPENING STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. I would like to call this hearing to order.

Today's first hearing will examine the current state of the credit union industry, including the National Credit Union Administration's ongoing efforts to stabilize the corporate credit union system. As the supervisor of Federal credit unions that insure the deposits of over 90 million account holders in all Federal credit unions and many State-chartered credit unions, this hearing is an important and needed opportunity to explore the health of the credit union industry as we emerge from the financial crisis and recover and grow our economy.

I want to welcome and thank NCUA Chairman Debbie Matz for being here today. The NCUA has taken unprecedented steps over the past several years to stabilize the credit union system as the troubled corporates pulled liquidity and capital out of the natural person credit unions. The system has also shared many of the same challenges as the FDIC concerning the insurance of Americans' savings and retirement.

These steps have had a significant impact on thousands of credit unions across the country, and I am pleased that we can have a serious conversation about the current state of the credit union industry and the impact of increased assessments on credit unions that serve millions of Americans across this country. I have certainly heard concerns from my constituents in South Dakota about this matter.

This is not the first, and certainly not the last, hearing on the financial condition of specific sectors of our financial services industry. The financial crisis took a toll, and the historic Dodd-Frank legislation will bring many additional changes to all sectors of this industry. It is very important to me that these types of hearings become a common occurrence with all of the financial institutions' regulators. I look forward to your testimony, Chairman Matz, and to the question-and-answer period.

Senator Shelby, your opening statement.

## STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I will try to be brief here today. This is a very important hearing, I believe.

Like other financial institutions, credit unions have faced unprecedented challenges from the financial crisis and our weak economy. Five of the largest corporate credit unions suffered substantial losses on mortgage-backed securities and had to be placed into conservatorship by the National Credit Union Administration. The NCUA had to take extraordinary actions to prevent the failure of these corporate credit unions from triggering problems with traditional credit unions. Given that these events occurred more than 1 year ago, an examination by the National Credit Union Administration of our Nation's credit unions I believe is long overdue.

Accordingly, I hope that today's hearing will shed light on the reasons for the failure of the corporate credit unions, the adequacy of the National Credit Union Administration's rescue plan, and whether these failures pose any risks to our taxpayers. I also hope to hear the NCUA's assessment of what steps need to be taken to prevent large-scale failures from happening again.

Mr. Chairman, there are a number of legislative measures before the Committee that have been proposed by the National Credit Union Administration. This hearing I hope will provide us with an opportunity to discuss their merits and whether they should be enacted into law.

But because credit unions play a vital role in providing loans to American consumers, a strong and vibrant credit union industry will be an important participant in any economic recovery in the future. Weak and failing credit unions will only further erode our Nation's already struggling economy and prolong unprecedented levels of unemployment.

Thank you for calling this hearing.

Senator JOHNSON. Senator Reed.

Senator REED. Mr. Chairman, I just want to thank you for calling the hearing, and I look forward to the witnesses. Thank you.

Senator JOHNSON. Senator Hutchison.

## STATEMENT OF SENATOR KAY BAILEY HUTCHISON

Senator HUTCHISON. Well, thank you, Mr. Chairman. I, too, appreciate that she is here to talk about the state of credit unions, and I would just say that I think the NCUA has done a great job in not burdening taxpayers with help for the credit unions. But I also want to hear what she says about the assessments and the cost to the credit unions of those assessments, because we do not want to hurt their capability to be solvent and successful, too.

Thank you, Mr. Chairman.

Senator JOHNSON. Senator Johanns.

Senator JOHANNS. Mr. Chairman, my time here today is somewhat limited, so I think I will just offer that if I have anything in terms of an opening, I will submit it in writing, and we will get right to the witness.

Senator JOHNSON. Mrs. Matz has had a distinguished public and private career. She served at the Department of Agriculture where she was Deputy Assistant Secretary for Administration and also chaired the Loan Resolution Task Force, which was charged with the responsibility of resolving over $1 billion in delinquent farm loans. Prior to her service at USDA, Mrs. Matz was an economist with the Joint Economic Committee of Congress. She served as a board member of NCUA from January 2002 to October 2005. In the private sector, Mrs. Matz was the executive vice president and chief operating officer of a large Federal credit union. She was confirmed as Chairman of the NCUA in August 2009.

Mrs. Matz, before you begin, please be assured that your written statement will be part of the record. If you could confine your remarks to 5 to 8 minutes, that would be greatly appreciated. Any other materials we have received will also be added to the record.

Mrs. Matz, you can begin your statement.

## STATEMENT OF DEBORAH MATZ, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. MATZ. Thank you, Mr. Chairman, for inviting me to appear before this Committee to discuss the state of the credit union industry. Today I will update you on major developments since I last appeared before the full Committee in August 2009 at my confirmation hearing.

As with other sectors of the financial service industry, the credit union industry faced unprecedented threats to its stability in 2008 and 2009. When the housing bubble burst and the value of mortgage-backed securities plummeted, several of the largest corporate credit unions were in danger of insolvency. This posed a grave threat to the industry because corporate credit unions provide needed liquidity for 7,400 consumer credit unions and process electronic payments for 90 million credit union members.

Five corporate credit unions held extremely high concentrations of what were once highly rated mortgage-backed securities. When the market for those securities dried up, it froze their liquidity and threatened their operations. If these corporates had been forced to sell their assets at that time, at least $30 billion in losses would have flowed through the system, causing thousands of consumer credit unions to fail.

From the onset of this crisis, NCUA took decisive actions. We worked in consultation with Congress, the Treasury Department, and the Fed to design a comprehensive plan to stabilize, resolve, and reform the corporate system. On behalf of the NCUA Board, I sincerely thank this Committee for the instrumental role you played in creating the Temporary Corporate Credit Union Stabilization Fund in 2009. The Stabilization Fund permitted NCUA to assess credit unions to cover the costs of corporate losses over 7 years rather than in one lump sum.

On September 24, 2010, with concurrence from Treasury Secretary Geithner, NCUA extended the Stabilization Fund through June 2021. This means credit unions will reimburse the fund for an additional $7 to $9 billion over the next 10 years. Let me emphasize this point. These losses are being paid for entirely by credit unions.

Throughout the fall of 2010, NCUA has taken aggressive actions to remove the long-term threats in the corporate system. We conserved three additional corporates that were no longer viable. We seized control of over 98 percent of all impaired securities and began an orderly disposition. We securitized cash-flows from those impaired securities to raise billions of dollars in liquidity. We created four bridge corporates to effect the winding down of the five conserved corporates with no interruption in service to consumers. And we finalized a new rule to ensure that remaining corporates operate with much stronger standards for safety and soundness.

NCUA's actions meet the four strategic objectives we set from the beginning of the crisis. We prevented any disruption in service to 7,400 consumer credit unions and 90 million consumers. We preserved public confidence in the credit union system. We resolved the problem at the lowest long-term cost consistent with sound public policy, and we facilitated an orderly transition to a new regulatory regime.

Even as NCUA managed the corporate resolution, we have been working diligently to protect the safety and soundness of consumer credit unions. Despite the challenging economy, America's credit unions remain strong overall. Total assets are over $900 billion. Net worth is holding steady. Delinquencies are showing signs of moderating, and charge-offs have inched lower. However, credit unions have not escaped the effects of the economic downturn. Millions of credit union members are suffering from falling home values, business failures, unemployment, and bankruptcy. Some credit union balance sheets reflect their members' struggles.

This situation has caused us to reevaluate our resource needs as well as our examination procedures. As a result, since 2009 NCUA has hired more than 100 examiners. To be effective, however, the field staff needed to be reinforced by more frequent exams. We are, therefore, examining credit unions at least annually. By conducting more frequent exams and increasing offsite supervision, we are identifying issues earlier.

To this end, NCUA enhanced our red flag early warning system. To resolve issues before they become material concerns, examiners are reviewing credit union data off-site. When they find credit unions holding high concentrations of fixed-rate mortgages, rising delinquencies or other red flags, they follow up with immediate corrective actions. We are taking these actions in an effort to save as many credit unions as possible.

NCUA's increased supervision has contributed significantly to the credit unions' ability to withstand the extraordinary economic shocks over the past 2 years. Our experience demonstrates the value of rigorous regulation, diligent oversight, and a healthy insurance fund. Equity in the National Credit Union Share Insurance Fund is now up to 1.29 percent, near the high end of its normal operating range.

To improve the tools for supervising and insuring credit unions, NCUA has a package of three technical amendments that clarify important provisions of the Insurance Fund and the Stabilization Fund.

The first amendment would strengthen the ability of NCUA to complete emergency mergers. A recent change in merger accounting would dilute the net worth of the recipient credit union, thus discouraging the merger. Often, as a result, the troubled credit union has to be liquidated. We are requesting that NCUA assistance to the failing credit union be counted as capital by the surviving credit union, as in the past. This would reduce the costs to the Insurance Fund and provide members of troubled credit unions with continued services from healthy credit unions.

The second amendment would prevent credit unions from being assessed artificially inflated insurance premiums. The language clarifies that the equity ratio of the Insurance Fund is based solely on its own unconsolidated financial statements. This would eliminate any confusion about whether the Insurance Fund is required to consolidate statements with the Stabilization Fund or with credit unions under conservatorship. It would ensure that independent accounting would be consistent with the original congressional intent.

The third amendment would allow NCUA the option of repaying expenditures from the Stabilization Fund without having to first borrow from Treasury. Current statute requires NCUA to borrow from Treasury before making assessments. We are requesting a modification to permit NCUA to assess credit unions when necessary and appropriate to satisfy the Stabilization Fund's obligations, thus avoiding the cost of interest payments.

With this legislation, America's credit unions would be even better positioned to help consumers take advantage of opportunities that a recovering economy will offer.

Again, I appreciate this opportunity to come before you and look forward to answering your questions.

Senator JOHNSON. Thank you, Chairman Matz.

I am going to put 7 minutes on the clock for Members' questions. Also, if Members have additional questions, you can submit them for the record, and I ask you, Chairman Matz, to respond in a timely manner.

Chairman Matz, as you have noted in your testimony, extensive losses by some corporate credit unions have led to conservatorships and also to significant losses to the National Credit Union Share Insurance Fund. What is the extent of the losses to the Share Insurance Fund in 2010? And how did this compare to previous years? Also, to what extent do the losses result from corporate failures?

Ms. MATZ. Thank you, Mr. Chairman. The losses that have occurred in the corporate sector have been separated from the Share Insurance Fund, and those are reflected in the Corporate Stabilization Fund. The loss to the Share Insurance Fund this year I believe is about $250 million, and the number of failures is not far off from what we had last year.

The Corporate Stabilization Fund is where we realize the losses from the corporate credit unions, and overall we expect the losses to total about $15 billion. But credit unions have already paid in about $7 billion of that through the capital that was in the corporates and through two assessments this past year that totaled $1.3 billion. So we anticipate that over the next 10 years credit unions will be assessed a total of between $7 and $9 billion.

Senator JOHNSON. What new steps has the NCUA taken to ensure that credit unions do not accumulate a concentration of high-risk assets?

Ms. MATZ. In terms of the corporates where that was a problem—I should indicate that when we passed the previous corporate rule in 2002, I voted against the rule. I was the only Member who voted against it because it did not contain limits on concentration risk. On September 24, 2010, the NCUA Board approved a new rule which has very stringent limits on concentration risk by sector and by obligor, and I believe that will satisfy that issue going forward.

As far as consumer credit unions, we are currently working on a proposal that we will likely put out for comment in the first or second quarter of next year to address concentration risks in natural person credit unions, and we have already put out guidance to credit unions and to examiners dealing with that issue.

Senator JOHNSON. What will be the ultimate cost to federally insured credit unions from the resolution of problem corporate credit unions?

Ms. MATZ. The ultimate cost we estimate will be between $7 and $9 billion paid over the next 10 years.

Senator JOHNSON. You indicate in your written testimony that NCUA has shortened its exam cycle to 12 months from the previous 18-month cycle in order to stay ahead of developing problems at Federal credit unions. Has the agency taken any other steps to detect problems in the natural person or corporate credit unions in a more rapid or effective manner?

Ms. MATZ. Yes. We have hired 100 additional examiners in the past 2 years and are intending to hire 61 more examiners this year. In addition to doing the annual exams at federally chartered credit unions, we are going to be examining all State-chartered credit unions over $250 million every year. We have also enhanced our red flag alert system, so we have examiners reviewing quarterly the call reports of credit unions. Those are the reports that display all the financial data for credit unions. And if they see any aberration, a sharp increase in delinquencies or some other red flag that catches their eye, they will not wait for the next exam. Examiners will immediately go into the credit union and address the problem.

In addition, when I came on as chairman, I learned that there were some credit unions that were repeatedly being cited for the same infractions, through the most benign administrative sanction that we utilize, which is called a Document of Resolution. They were getting the same Document of Resolution over and over again, but that stopped last year at this time. Our examiners were given guidance and told that a credit union gets one shot at addressing a Document of Resolution. Examiners are to go back very quickly, within 90 or 120 days, and if that DOR has not been addressed, they will escalate the administrative action.

So we are working very diligently to address problems as early as possible and to keep costs to the system as low as possible.

Senator JOHNSON. The October NCUA Inspector General report said that credit unions' management's actions greatly contributed to the ten largest credit union failures. Specifically, there were significant actions that management was either unwilling or unable to effectively manage or mitigate that exposed these credit unions to significant amounts of risk. The Office of the IG also identified several shortcomings related to NCUA supervision efforts, specifically examiner deficiencies and quality control efforts in examination procedures. The OIG reported that had the problems been identified sooner, the eventual losses to the NCUSIF could have been stopped or mitigated.

First, do you think this assessment is accurate?

Ms. MATZ. Yes, I do.

Senator JOHNSON. Second, what is the NCUA doing to address management and risk management within the credit unions and deficiencies in supervision and examination at the NCUA?

Ms. MATZ. First, I would just like to point out that the IG provided material loss reviews on any financial institution that incurs losses of more than $10 million to the Share Insurance Fund. So just to put it in perspective, over the period studied, which was about 24 months, there were 10 such institutions out of over 7,400 credit unions. I just wanted to put into perspective, that it is really a small number of credit unions that actually caused material losses. Nonetheless, we are working closely to address those issues.

I also wanted to point out that the 10 credit unions are all federally insured, but only four of them are federally chartered. The others are State-chartered, and their primary supervisor is the State supervisor. So I just wanted to make that distinction.

The IG had pointed out that the management in the 10 credit unions overall lacked strategic decision making and oversight of lending and investments, and in several instances there was fraud. As far as the examiner supervision, the IG recommended that we should be improving our examination and regs as related to concentration risks, third-party vendors, our quality control reviews, our examination of new business strategies, and that we should step up our administrative actions when Documents of Resolution have been issued.

We have begun to address all of these issues. As I indicated before, we have put out guidance on concentration risks and are working on a new reg to address that issue. We do not have authority to examine third-party vendors as all the other FIRREA agencies have. So we work with the credit unions to get the data that we need, but if we find a problem or suspect there is a problem, we can only request that credit union stop doing business with that third-party vendor. We do not have control over the third-party vendor.

We are working to improve our quality control reviews. Those are reviews of examinations to make sure that they are being done properly and that there is sufficient supporting documentation. And the staff for the past year, has been working on reviewing and revising our national examination standards, and those should be in effect relatively soon. In addition, the IG commented on our examination of new business strategies, when credit unions take on a new line of business. We believe that our annual exams will help catch any problems that develop with new lines of business.

So we are pleased that we have such a good relationship with the IG. We work very closely with them. And we have already taken steps to implement all of their findings.

Senator JOHNSON. Thank you, Chairman Matz.

Senator Shelby.

Senator SHELBY. Thank you.

I want to continue in the line of questioning that the Chairman was into, the Inspector General report. I will try not to replicate it all. But I want to just read into the record part of the report, and it said, and I am quoting: "Had examiners acted more aggressively in their supervision actions over these critical issues, the looming safety and soundness concerns that were present early on in nearly every failed institution could have been identified sooner and the eventual losses to the National Credit Union Share Insurance Fund could have been stopped or mitigated."

I am going to ask you again. Do you agree with that assessment? I think you indicated you did.

Ms. MATZ. Yes, I do.

Senator SHELBY. I think that is very important. Now, what steps specifically have you taken—it has been over a year—to ensure that the problems identified by the Inspector General will be corrected? In other words, that we will not go down this road again; perhaps we will never visit the taxpayer.

Ms. MATZ. Probably the biggest change that we have made is going from an 18-month exam cycle to an annual exam cycle so that we get into the credit unions every 12 months and can catch problems earlier. That is probably the single biggest change that we have made. Also, not allowing credit unions to receive repeat administrative sanctions. Complying with administrative sanctions is not optional. They get one shot to comply, and if they do not comply within 90 or 120 days, we take more aggressive action. I think those two actions in and of themselves will go a long way toward preventing any of these problems in the future, but in addition, we are in the process of overhauling our quality control review process. That should be done very soon, and that will make sure that all the regions have the same standards for conducting exams and for verifying the accuracy of the exams. And we will be putting out a new reg on concentration limits for natural person credit unions.

Senator SHELBY. Aren't the credit unions generally getting more and more into—or want to get into commercial loans and small business loans and so forth? Is that the trend?

Ms. MATZ. There are more credit unions making business loans today than there were several years ago.

Senator SHELBY. Is that dangerous to you, I mean from your perspective, because so many of the banks have gotten in trouble with lack of supervision, lack of control, quality control and so forth?

Ms. MATZ. As a regulator, I think all lending is risky.

Senator SHELBY. Well, we know that, but from your perspective to protect that fund.

Ms. MATZ. I think it is more important how they manage the risk. I think business lending is an extremely important service for credit unions to offer their members. The average credit union business loan is about $250,000, which is a very, very small loan, and those are often loans to people who really do not have access to capital from other institutions. For example, a credit union business loan might be to open up a car repair shop or a small boutique. So I think it is a very, very important service that they provide, and it just needs to be done carefully.

Senator SHELBY. Are a lot of these loans that you make to small businesses and so forth what we would call in the financial world "covered loans"? Do you do that with part of your capital? Do you sell these loans or what do you do?

Ms. MATZ. Some of them are sold, and some are not.

Senator SHELBY. I know, but "some" is what percentage?

Ms. MATZ. I do not know the percentage.

Senator SHELBY. Can you furnish that for the record?

Ms. MATZ. I certainly can.

Senator SHELBY. OK.

You talked about the assessment as part of the plan to resolve the corporate credit union debacle, that you intend to impose assessments on credit unions to pay for the losses you expect to suffer on $50 billion in troubled mortgage-backed assets. In your testimony you stated that the National Credit Union Administration expects to levy approximately $8 billion in assessments, which is a good bit of money. What impact will these assessments have on credit unions? Can they sustain this and still be viable?

Ms. MATZ. Generally, yes. In the aggregate, the credit union industry is well capitalized. They have capital of about $90 billion, and that is just under 10 percent. No doubt the assessments are a burden to credit unions, and I hear that all the time, and that is why we try to keep the assessments as low as possible. The Corporate Stabilization Fund was one way of doing that. We appreciate your support for that. It allowed us to spread out the costs to the credit unions. The assessments will affect the ROA of some credit unions, but overall we do feel that because of the significant capital credit unions have, they will be able to meet those assessments.

Senator SHELBY. Your Insurance Fund, what is the value of it today?

Ms. MATZ. It is about $800 billion.

Senator SHELBY. In other words, you have $800 billion in hand? Now, that would be a lot more money than the FDIC ever had—surplus, so to speak.

Ms. MATZ. $8 billion. I am sorry.

Senator SHELBY. How much?

Ms. MATZ. $8 billion on hand.

Senator SHELBY. $8 billion. Now you are coming back——

Ms. MATZ. Yes.

Senator SHELBY. Now, that $8 billion insures how many—the value of your accounts right now today roughly, 1st of December?

Ms. MATZ. The insured shares of the credit unions are about $800 billion.

Senator SHELBY. $8 billion insures the credit, in other words, the integrity of $800 billion. Do you think that is adequate?

Ms. MATZ. Yes, I do.

Senator SHELBY. Especially in today's world?

Ms. MATZ. I do.

Senator SHELBY. OK. Is that $8 billion shrinking or growing? In other words, are your assets shrinking or growing or remaining constant?

Ms. MATZ. It has been pretty constant this year.

Senator SHELBY. My last area, and I appreciate the Chairman's indulgence here, the National Credit Union Administration's regulations governing the investments of corporate credit unions, which I think is an important area, relied heavily on the use of credit ratings. Specifically, the regulations allowed corporate credit unions to invest in securities rated AAA or AA by credit rating agencies. We now know that the credit ratings on mortgage-backed securities were deeply flawed. In fact, the Dodd-Frank Act requires, as you probably know, all Federal agencies, which you are one of them, to review and to modify regulations to remove any reference to a requirement of reliance on credit ratings and to substitute a standard of creditworthiness.

What steps are you and your administration taking to ensure that credit unions do their own due diligence, so to speak, when evaluating investments to make them creditworthy rather than an investment based on the opinion or the rating of an agency which we know is very flawed?

Ms. MATZ. When we voted on the rule on September 24, the rule had been put out for comment and pretty much finalized before the Dodd-Frank Act was passed. The language in the corporate rule says that the credit unions need to get ratings from multiple agencies and then to use the least of those——

Senator SHELBY. Wait a minute. Say that again. In other words, you have ratings—you are going to still get ratings from the agencies that are so flawed?

Ms. MATZ. No, we will be modifying that rule.

Senator SHELBY. Are you going to do your own due diligence?

Ms. MATZ. We do not have the proposed rule out yet, but we are going to modify the current rule.

Senator SHELBY. Well, are you thinking about doing that? I guess my question to you, if you look at some of the financial institutions, insurance companies, and so forth, all financial, that have weathered the recent debacle—I can name a few, but I will not here on the podium—and that are really well done did their own due diligence and are very viable today, did not ask for money from the taxpayers, no bailout and so forth. So you, as the administrator of the credit unions, I think it is very important for you to do your own due diligence. That is my message, and I think that was the message of this legislation.

Do you disagree with that?

Ms. MATZ. I do not disagree with that, and as I said, we are in the process of drafting a revision, so we will certainly——

Senator SHELBY. Do you have now or will you have the personnel in your administration to evaluate the creditworthiness of your investments? In other words, you have been relying—a lot of people have been relying on the credit rating agencies—Moody's, S&P, Fitch, and so forth. Well, we know the history of that.

Ms. MATZ. Yes.

Senator SHELBY. Are you going to have the proper people to do that? I think this is important, that you have personnel that can do this in lieu of outsourcing it to something that we know is a dead end.

Ms. MATZ. We might have to enhance our Office of Capital Markets——

Senator SHELBY. What does "might" mean?

Ms. MATZ. It means that I do not have an answer to your question right now.

Senator SHELBY. Will you let us know in the Committee?

Ms. MATZ. Yes.

Senator SHELBY. We think this is very important because we want the credit unions to remain viable and strong and not ever visit, to come up here for problems.

Ms. MATZ. I appreciate that, and we will get back to you on that.

Senator SHELBY. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, Madam Chairman.

Does the NCUA have a list of problem credit unions similar to what the FDIC does in terms of their watch list, and if so, how many of these institutions are on your list?

Ms. MATZ. We do have a list of credit unions that we watch. There are about 2 dozen institutions on the list.

Senator REED. Which would be roughly what percentage?

Ms. MATZ. Well, we have over 7,400 institutions that we insure.

Senator REED. Is there any geographic concentration or business model concentration that is more prone on this list than——

Ms. MATZ. Yes, credit unions that are located in the States that were most distressed. Florida, California, Arizona, Utah, and Nevada have been hit the worst.

Senator REED. Let me ask a question that parallels some of the comments made by both the Chairman and the Ranking Member. In your testimony, you indicate that there are a growing level of delinquent member business loans——

Ms. MATZ. Yes.

Senator REED. ——and that they are a primary or secondary contributing factor for supervisory concern in many cases. And so the first question, are you concerned with this increasing number of member business loan delinquencies?

Ms. MATZ. I am concerned, but it is still a relatively small number of affected credit unions.

Senator REED. You are aware there are proposals to increase the level of lending in member business loans. What would be your view on that proposed, or these proposed legislative——

Ms. MATZ. I support that.

Senator REED. And support that given the indication that there are increasing, as you would, I think put in context, not as yet decisive but increasing delinquencies in this category?

Ms. MATZ. Yes, because as I said, I believe that it is still a very small number of credit unions. There are 2,200 credit unions that make member business loans and there are 270 that fall into the category where they are either what we call CAMEL 3 or CAMEL 4. CAMEL 4 are the troubled ones where the business lending is the primary or secondary reason for their being there. So it is a manageable number. We do not like to have credit unions in that category, period, but we feel that business lending done properly is really an important tool for credit unions to have at their disposal to serve their members.

Also, in terms of the legislation, if the cap gets lifted, we would anticipate coming through with very rigorous regulations. We would not just be opening the flood gates, so all credit unions ccould not just go in and make high levels of loans. They would have to demonstrate their ability to make a low level of loans, and once they demonstrate that, we would increase it by a small amount and then keep working with them, supervising them, and let them gradually increase to a higher level.

Senator REED. Do you have a notion of the number of credit unions that have already reached their limit? I mean, is this a situation where a huge majority of credit unions have no extra capacity, or is this a few members or concentrated in a few areas?

Ms. MATZ. It is a small number.

Senator REED. That have reached——

Ms. MATZ. That are at their cap.

Senator REED. That have reached their cap.

Ms. MATZ. Yes.

Senator REED. And is there any particular area of the country where the cap is reached, or is it just dispersed somewhat random?

Ms. MATZ. I am guessing that it is dispersed, but I do not know that for sure. We can get back to you on that.

Senator REED. All right. There is another aspect that I want to explore and that is that the NCUA is the only regulator subject to FIRREA that does not have the authority to examine vendors that provide services to insured institutions. And now with the increasing role of particularly information management systems, computer systems, *et cetera* that are provided to vendors, and concerns about money laundering, privacy, a host—I do not have to tell you the concerns—are you concerned this lack of authority affects your ability to fully implement your statutory responsibilities?

Ms. MATZ. Absolutely.

Senator REED. Absolutely. So that you would like to have that authority in place?

Ms. MATZ. Yes. I think we could do a better job of protecting the safety and soundness of credit unions if we had that authority.

Senator REED. Let me ask the question—I think we will get the same answer, but are there instances where you have seen significant problems at credit unions causing you to have to step in because of vendor contracts and other arrangements that you might have been upset about but could take no effective steps until, in fact, the institution became insolvent?

Ms. MATZ. Yes.

Senator REED. Yes. Would that apply to the corporate credit unions, also?

Ms. MATZ. Correct.

Senator REED. Correct. Well, thank you very much, Madam Chairman. Thank you.

Senator JOHNSON. Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman.

Let me, if I might, just get a little perspective here. The institutions that went into conservatorship, basically, their problem was real estate lending, would that be the case, or is it——

Ms. MATZ. The corporate credit unions?

Senator JOHANNS. Yes.

Ms. MATZ. It was an over-concentration of mortgage-backed securities.

Senator JOHANNS. So it was real estate related?

Ms. MATZ. Yes.

Senator JOHANNS. Yes. When you look at the other issues that you were talking about, the commercial lending, you said that was a relatively small number of credit unions out there that were dealing with that. Let me just ask your opinion on something. Would you describe that as something that just normally you would go through in a recession, that that is what you are seeing, or are you seeing something bigger and greater and more problematic there than that description?

Ms. MATZ. With the business lending?

Senator JOHANNS. Yes.

Ms. MATZ. It is probably somewhat higher than it would ordinarily have been because some of the loans were collateralized by real estate.

Senator JOHANNS. Yes. So again, we kind of get back to that——

Ms. MATZ. Yes.

Senator JOHANNS. ——problem that everybody has dealt with.

Now, the Ranking Member read into the record an IG report that basically said, I think, if I could summarize it, that if there had been better oversight, a lot of these problems would not have occurred, and you agree with that assessment.

Ms. MATZ. Yes.

Senator JOHANNS. I am just going to offer an observation, that if the whole system, whether it is banks or credit unions or whatever, if there had been better oversight, we would have avoided a lot of these problems. Is that a fair—do you kind of agree with that?

Ms. MATZ. Well, you know, the IG was addressing these 10 credit unions——

Senator JOHANNS. Yes.

Ms. MATZ. ——and I certainly agree with it in terms of those 10 credit unions. You know, I think in terms of the consumer credit unions, I think we have done an adequate job. Of course, nobody could have foreseen the significant drop in the value of real estate and all the havoc that that has created. But, certainly in terms of those 10 credit unions, we could have done a better job.

Senator JOHANNS. As I talk to small businesses that I interface with, and we have had small business roundtables and a whole host of efforts to try to be attuned to challenges that they are facing, one of the things I hear, and I am sure every Member on the Committee is hearing it, whatever State they are in, and that is that credit is still very tough for a small business. I was just in a small business over Thanksgiving, and boy, that was the message. "I cannot get credit."

And I see your efforts, and I do not disagree with them. I think you are trying to make sure that your fund is stable, that—and I think you are trying to do those things to kind of rebuild from what was a fairly disastrous situation. But it does occur to me that as we pull that capital into whatever fund or try to minimize risk by requiring margin, *et cetera,* that capital is not available to be lent.

What is your observation on that? Does that appear problematic to you?

Ms. MATZ. We encourage credit unions that are interested in making business loans to make sure that they have commercial lending staff that can do very solid underwriting. We also are concerned that credit unions reserve for losses adequately, and that does take capital out of the system. But it protects the Share Insurance Fund, and if it prevents losses, it also prevents additional assessments, ultimately. So we do make sure that credit unions are adequately allowing for potential losses.

Senator JOHANNS. As you should. But that kind of describes what small businesses are struggling with. They are struggling to find somebody who will be their lender, because the system very, very quickly became risk adverse. Would you agree with that?

Ms. MATZ. I think that credit unions have always been conservative and perhaps they are being more conservative now, but I do believe that credit unions are still making business loans. In fact, business lending has gone up in the last quarter. Of course, there are only 2,200 credit unions making business loans, so it is not a lot of capital. But in the communities that they serve, I think they make an important difference to the small businesses.

Senator JOHANNS. Just to wrap up in this vein, just for my education, and, of course, maybe other Members of the Committee would also be interested, I would like to see whatever charts or analysis you have available of what happened over the last 2, 3 years relative to lending. Again, I think that would be good information just in terms of trying to work with small businesses who are continuing to describe this very difficult problem of getting access to capital.

Ms. MATZ. Are you interested in lending in general or specifically small business lending?

Senator JOHANNS. Whatever you provide will be helpful.

Ms. MATZ. Credit union lending has actually grown over the past few years, despite the downturn, except for the most recent quarter, where it has leveled off. But that is not specific to business lending.

Senator JOHANNS. Yes. I would be interested in business lending if those numbers can be extracted from the whole, if you will.

Ms. MATZ. We will get that for you.

Senator JOHANNS. OK. Thank you. Thank you, Mr. Chairman.

Senator JOHNSON. I would like to thank Chairman Matz for testifying today, and with that, conclude our first hearing today.

[Whereupon, at 10:54 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR TIM JOHNSON

Today's first hearing will examine the current state of the credit union industry, including the National Credit Union Administration's ongoing efforts to stabilize the corporate credit union system. As the supervisor of Federal credit unions that insure the deposits of over 90 million account holders in all Federal credit unions and many State-chartered credit unions, this hearing is an important and needed opportunity to explore the health of the credit union industry as we emerge from the financial crisis and recover and grow our economy.

I want to welcome and thank NCUA chairman Debbie Matz for being here today. The NCUA has taken unprecedented steps over the past several years to stabilize the credit union system as the troubled corporates pulled liquidity and capital out of the natural person credit unions. The system has also shared many of the same challenges as the FDIC concerning the insurance of Americans' savings and retirement.

These steps have had a significant impact on thousands of credit unions across the country, and I am pleased that we can have a serious conversation about the current state of the credit union industry and the impact of increased assessments on credit unions that serve millions of Americans across this country. I have certainly heard concerns from my constituents in South Dakota about this matter.

This is not the first, and certainly not the last, hearing on the financial condition of specific sectors of our financial services industry. The financial crisis certainly took a toll, and the historic Dodd-Frank legislation will bring many additional changes to all sectors of this industry. It is very important to me that these types of hearings become a common occurrence with all of the financial institutions regulators. I look forward to your testimony, Chairman Matz, and to the question and answer period.

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## PREPARED STATEMENT OF DEBORAH MATZ

CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

DECEMBER 9, 2010

### I. Introduction

The National Credit Union Administration (NCUA) appreciates the opportunity to provide views on "The State of the Credit Union Industry." NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all Federal credit unions, participating in the supervision of federally insured State-chartered credit unions in coordination with State regulators, and insuring federally insured credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund (NCUSIF), [1] NCUA provides oversight and supervision to 7,402 federally insured credit unions, representing 98 percent of all credit unions and 90.8 million members. [2]

The severe economic crisis that began in earnest in 2007 has impacted all facets of the financial sector. Though credit unions by and large maintained traditional standards and risk profiles, they have not been immune to the broad effects of historically high unemployment and severely declining home values. More specifically, these national trends systemically affected credit unions in two particular ways. First, several of the largest corporate credit unions' [3] investment portfolios were subjected to material losses.

Second, many consumer credit unions, [4] have experienced increased delinquency and loan losses. This is most pronounced in States hardest hit by the economic

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[1] The NCUSIF was created by Public Law 91-468 (Title II of the Federal Credit Union Act), which was amended in 1984 by Public Law 98-369. The Fund was established as a revolving fund in the United States Treasury under the NCUA Board for the purpose of insuring member share deposits in all Federal credit unions and in qualifying State credit unions that request insurance.

[2] Approximately 152 State-chartered credit unions are privately insured and are not subject to NCUA oversight. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

[3] Corporate credit unions provide necessary liquidity, investment, and payment services to consumer credit unions.

[4] The term "consumer" credit union is used throughout this document to refer to retail "natural person" credit unions which interact with consumers on a daily basis. "Corporate" credit

Continued

downturn, such as Arizona, California, Florida, and Nevada. The combined impact of these two occurrences has presented significant financial and operational challenges for both NCUA and credit unions and is discussed in detail in sections II and III below.

Throughout the crisis, NCUA, with the assistance of Congress and the Administration, has taken extraordinary steps to successfully maintain the stability of the credit union system for the 90 million Americans who depend on it.

**II. Corporate Credit Union System**

The primary purpose of a corporate credit union is to provide consumer credit unions with correspondent banking, liquidity and investment services. Correspondent banking services help financial institutions, including credit unions, to process and clear checks, process and settle electronic transactions, and move funds through the financial system.

In the mid-2000s, several of the largest corporate credit unions invested heavily in mortgage-backed securities (MBS), which resulted in concentrated exposure to the real estate market. Virtually all of the investments were AAA or AA rated when purchased. However, their value plummeted when the housing bubble burst.

In April 2007, several months before the distress in the mortgage market surfaced, NCUA issued Corporate Credit Union Guidance Letter No. 2007-02. This letter addressed credit, liquidity, market, and concentration risks associated with MBS. By and large, corporates ceased the purchase of nonagency mortgage-related securities by mid-2007. At that time, all investments held by corporate credit unions, including MBS, were rated investment grade, and 98 percent were rated AA or higher.

What began as a market disruption thought to stem from concerns with subprime products, spread throughout the overall financial and real estate markets sector with unprecedented severity. By the time it became apparent that this was not an isolated market dislocation, there was no longer an active market for these types of securities. Like other financial institutions, the corporates could not have found buyers for the volume of these types of investments they held. The declining values of these mortgage-backed securities created severe liquidity and capital problems for these institutions.

Five corporate credit unions, which served more than half of the entire credit union system, were financially imperiled by the losses in their investment portfolios, with a far-reaching effect on the entire credit union industry. The industry has been adversely impacted by consumer credit union losses from impaired capital investments held in corporate credit unions.

Consumer credit unions will continue to face necessary NCUA assessments to resolve the nonfinancially viable corporates. Had the agency not acted to inject liquidity and guarantee deposits in the corporate credit unions in the face of this crisis, the costs to the industry would have been far greater—threatening the entire credit union system.

Without NCUA intervention, the losses, in their entirety, from immediate failure of large corporates would have cascaded to consumer credit unions via their uninsured shares in the corporates.[5] This would have resulted in the failure of approximately 1,000 consumer credit unions. Consistent with the manner in which deposit insurance functions, the costs of resolving these failures would have been borne by all remaining federally insured credit unions, generating additional losses and failures. Ultimately, inaction would have resulted in massive disruption to consumer services and total costs to any remaining insured credit unions would have been far greater than the resolution strategy NCUA employed.

To address the systemic financial and operational impact of these five troubled corporate credit unions, NCUA designed a three-phase strategy to stabilize, resolve, and reform the corporate system based on the following guiding principles:

- Prevent interruption of payments services to consumer credit unions and their 90 million members;
- Preserve confidence in the credit union system;
- Manage to the least long-term cost consistent with sound public policy; and
- Facilitate an orderly transition to a new regulatory framework for the corporate credit union system based on consumer credit union choice.

unions provide services to consumer credit unions and process consumer payments, but do not interact with consumers directly.

[5] Credit unions refer to deposit and savings accounts as share accounts, or “shares” for short.

Specific details of the actions implemented during these three phases are discussed below.

*Stabilization Phase*

Given the deterioration of the corporates' financial conditions and quality of their investment portfolios, their access to external sources of funds was compromised. This resulted in consumer credit unions losing confidence in the corporate credit unions and starting to withdraw their deposits. These withdrawals, and the prospect of a wave of additional withdrawals, placed severe liquidity pressures on the corporates, peaking in 2008. The losses and operational impact on the credit union system from a nonorderly resolution of this crisis would have been untenable, severely impacting consumer credit unions and their 90 million members.

Accordingly, in the fall of 2008, it became critical for NCUA to initiate dramatic action to bolster confidence in the corporates and ensure the flow of liquidity in the credit union system. In the last half of 2008, NCUA began implementing actions to stabilize and strengthen the credit union system. The first step in the stabilization program was to increase liquidity throughout the entire credit union system, especially within the corporates.

NCUA's primary tool to address liquidity concerns in the credit union industry is the Central Liquidity Facility (CLF). [6] At the time, the CLF was operating under a Congressionally imposed borrowing cap of $1.5 billion. At the NCUA Board's request, in September 2008, Congress raised the CLF's borrowing cap to its full statutory limit of approximately $41 billion. Ultimately, lifting the cap proved to be one of the primary reasons NCUA could successfully develop and implement a series of critical liquidity interventions that served as the foundation for its corporate stabilization efforts.

With the full borrowing authority of the CLF now available, NCUA began working with staff at both the Board of Governors of the Federal Reserve System (FRB) and the U.S. Department of the Treasury (U.S. Treasury) to develop tools, such as the Credit Union System Investment Program and the Credit Union Homeowners Affordability and Relief Program, to address the liquidity pressures in corporates. These two programs enabled consumer credit unions to essentially invest funds borrowed from the CLF into corporate credit union offerings, which raised approximately $8.5 billion in liquidity.

The NCUA Board approved the "Temporary Corporate Credit Union Liquidity Guarantee Program" (TCCULGP) on October 16, 2008. Under the TCCULGP, the NCUSIF provided a 100 percent guarantee on new unsecured debt obligations issued by eligible corporates on or before June 30, 2009, and maturing on or before June 30, 2012. [7] The TCCULGP and the other CLF-based programs were successful in restoring credit lines and funding in the corporate system.

To address the lack of confidence in the corporates and the resulting deposit outflow, the NCUA Board approved the "Temporary Corporate Credit Union Share Guarantee Program" (TCCUSGP), which presently guarantees uninsured shares, excluding capital accounts, at participating corporates through December 31, 2012. This program was vital in maintaining the confidence of consumer credit unions and stabilizing the precarious liquidity situation at the corporates. The TCCUSGP has proven very successful in stabilizing liquidity and continues to serve an important role in the transition process under the resolution phase discussed later.

The NCUA Board also issued a $1 billion NCUSIF capital note to U.S. Central Federal Credit Union (U.S. Central) to address realized losses on MBS and other asset-backed securities. This action was necessary to maintain external sources of funding and to preserve confidence in U.S. Central, given its pivotal liquidity and payment systems roles as a wholesale service provider to the corporate credit union system.

*Creation of the Temporary Corporate Credit Union Stabilization Fund*

The stabilization programs discussed so far came at a significant, but unavoidable, cost to the industry. Given the structure of the NCUSIF and existing law in early 2009, NCUA would have been required to assess this cost to consumer credit unions in one lump sum. To give the NCUA Board flexibility to manage the impact of the costs to consumer credit unions, NCUA requested that Congress establish the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund). On May

[6] The Central Liquidity Facility was created by Congress in 1978 to improve the general financial stability of the credit union industry by meeting the liquidity needs of individual credit unions.

[7] On May 21, 2009, the TCCULGP was revised to cover unsecured debt obligations issued on or before June 30, 2010, and maturing on or before June 2017.

20, 2009, the Helping Families Save Their Homes Act of 2009 [8] was signed into law and created the Stabilization Fund, allowing costs to be assessed over a 7-year period instead of in a lump sum. [9] This is, perhaps, the most critical tool available to NCUA to help ease the credit unions' burden of resolving the corporate crisis. The NCUA Board is appreciative that Congress acted so quickly to pass this legislation.

In addition to the Stabilization Fund provision, the Helping Families Save Their Homes Act of 2009 also contains another important provision that assisted NCUA's ability to mitigate the corporate problems. This law increases the NCUSIF's authority to borrow from the U.S. Treasury from $100 million to $6 billion, an aggregate total available to both the Stabilization Fund and the NCUSIF. The Stabilization Fund relies on the $6 billion borrowing authority in providing the NCUA Board flexibility to manage the impact of the assessments on credit unions. The enhanced authorities provided by Congress will permit NCUA to fairly and effectively distribute the insurance costs associated with the current economic downturn, including not just the costs of the corporate losses but also other costs that may arise. The Stabilization Fund must repay the U.S. Treasury, with interest, all amounts borrowed. As such, the total costs of the corporate stabilization, resolution, and reform will be fully borne by credit unions with the flexibility to absorb those costs over a longer time period.

NCUA's stabilization efforts were successful in preserving the vital electronic payments and liquidity services that credit unions provide to over 90 million Americans.

*Resolution Phase*

The stabilization phase provided NCUA with the time and resources to design and implement a strategy to resolve the troubled corporate credit unions and the distressed securities they held. Collaborating with the FRB and the U.S. Treasury, NCUA carefully evaluated a wide range of options to arrive at the least cost, long-term solution consistent with sound public policy. On September 24, 2010, the NCUA Board approved a comprehensive strategy to fully resolve the ongoing solvency, liquidity, and reputation risks associated with the nonfinancially viable corporate credit unions.

NCUA conducted a comprehensive evaluation of the entire corporate system. Of the 27 corporates, this evaluation identified five corporates that were not financially viable. These five corporates represented approximately 70 percent of the entire corporate system's assets and 98.6 percent of the investment losses within the system. NCUA took direct control of these five institutions through Federal conservatorship. [10] In doing so, NCUA was able to achieve the goals of (1) protecting the vital services to the thousands of consumer credit unions that rely on the corporate network and (2) implementing the process to resolve the distressed assets.

NCUA employed a traditional resolution model used in the financial sector often referred to as the "good bank/bad bank" model. The "good bank/bad bank" model was necessary given that the conserved corporates were correspondent service providers to thousands of credit unions and no viable acquisition partners were available. This strategy involved the creation of new charters, called "bridge" corporates, and transfer of the good assets, deposits, and operations from the conserved corporates to these new entities.

The four bridge corporates are led by chief executive officers selected by NCUA, and who report directly to NCUA. Additionally, NCUA maintains control over their operations. NCUA has established policies to ensure that the bridge corporates operate soundly, and minimize the long-term costs to the insurance fund. The bridge corporates are temporary entities, created to maintain necessary services during the transition period. NCUA intends to maintain the bridge corporate operations long enough to allow consumer credit unions adequate time to determine their long-term service options, perform appropriate due diligence, and implement the necessary operational changes.

Remaining assets in the failed corporate charters were then placed into an inactive status and managed via asset management estates established to house the

[8] Public Law 111-22, which was amended in July 2010 by Public Law 111-203.

[9] The closing date of the Stabilization Fund can be extended with the concurrence of the U.S. Treasury. Subsequently, as part of its plan to reduce the annual burden of assessments on credit unions, in September 2010, NCUA requested the concurrence of the U.S. Treasury to extend the life of the Stabilization Fund to June 2021; the U.S. Treasury concurred with this request.

[10] On September 24, 2010, NCUA conserved Constitution Corporate Federal Credit Union, Members United Corporate Federal Credit Union, and Southwest Corporate Federal Credit Union. Western Corporate Federal Credit Union and U.S. Central were conserved on March 20, 2009.

"legacy assets"[11] With the legacy assets isolated in the asset management estates, NCUA is pursuing a least-cost solution for an orderly disposition of these assets. After extensive analysis, NCUA determined that the least-cost disposition strategy involved holding the distressed assets by obtaining long-term funding. This strategy prevents much larger market losses and, in conjunction with the extension of the Stabilization Fund, provides credit unions more time to absorb the lower credit losses.

The long-term funding is being obtained through securitizing the legacy assets. In summary, the legacy assets are being combined into new structured securities that are being issued in the financial markets as NCUA Guaranteed Notes (ticker symbol NGN). The new securities have a guarantee on the timely payment of principal and interest from NCUA, which is backed by the full faith and credit of the United States. To date, NCUA has finalized four issuances of the structured notes; all met with strong investor demand.

The underlying defaults on distressed legacy assets and other resolution costs are expected to be between $13.9 billion to $16.1 billion.[12] This cost will be borne solely by the credit union system. Credit unions that contributed capital to the corporates holding these legacy assets bear the first loss, totaling $5.6 billion. The losses above $5.6 billion will be borne by all federally insured credit unions through Stabilization Fund assessments over time. Currently the expected range of total assessments is between $8.3 billion and $10.5 billion. Credit unions have already paid $1.3 billion in assessments. Thus, the projected range of remaining assessments is $7.0 billion to $9.2 billion to be paid in annual installments through 2021.

*Reform Phase*

On September 24, 2010, NCUA issued a final rule reshaping the regulatory framework of corporate credit unions, addressed in Part 704 of NCUA's rules. NCUA's primary purpose in reforming Part 704 was to prevent catastrophic losses from ever recurring. The new corporate regulation is designed to both address the cause of the current crisis and to provide stronger protections against future potential risks.

The major elements of this new corporate rule can be divided into (1) investment and asset liability management (ALM) restrictions, (2) capital standards, and (3) corporate governance.

*Investment and ALM Restrictions*

Through a series of provisions related to investment suitability and asset liability management, NCUA's new corporate rule will force corporate credit unions to properly diversify their investments and take other steps to minimize potential credit, market, and liquidity risk. In short, key provisions:

- Institute a variety of more stringent standards that each security must pass before a corporate can purchase the investment.
- Prohibit certain highly complex and leveraged securities. Going forward, a corporate cannot buy a particular security if it is a collateralized debt obligation, a net interest margin security, a private-label residential mortgage-backed security, or a security subordinated to any other securities in the issuance.
- Reduce the single obligor limit. The new rule tightens the existing limit on securities from a single obligor from 50 percent of capital down to 25 percent of capital.
- Establish sector concentration limits. The new rule establishes sector concentration limits to diversify the composition of the investment portfolio.
- Limit portfolio Weighted Average Life (WAL) to 2 years or less. The WAL limit reduces not only market and liquidity risk, but also credit risk, since credit fears negatively affect the price of longer-lived assets more severely than shorter-lived assets.

The new rule contains other ALM measures to reduce risk. For example, to discourage investment arbitrage, the rule tightens a corporate's borrowing limits. To

[11] The term "legacy assets" is used to describe the impaired private-label residential mortgage backed securities and other asset-backed securities held by the failed corporates.

[12] Given the complexity of projecting credit losses, the NCUA has relied on multiple expert sources to validate NCUA's internal results. These external sources include the analysis done by the corporates' external vendors; a detailed, bond-by-bond analysis conducted by the Pacific Investment Management Company (PIMCO) expressly for NCUA; and a detailed bond-by-bond analysis performed by Barclays Capital, New York, New York, as part of the securitization. These analyses incorporate assumptions about future economic events. Hence NCUA relies on a range of estimates to project future costs to credit unions.

reduce the potential for overdependence by a corporate on one member credit union, the rule also limits funding from a single member, whether it comes from deposits or loans.

*Capital Standards and Prompt Corrective Action*

The new corporate rule strengthens capital requirements including new minimum capital ratios, new risk-based capital calculations, and new definitions of capital modeled after the Basel I capital requirements.[13] Corporate credit unions will now need to satisfy three different minimum capital requirements: a 4 percent leverage ratio, a 4 percent tier one risk-based capital ratio, and an 8 percent total risk-based capital ratio.[14] The rule also mandates that a certain portion of a corporate's capital consist of retained earnings.

The rule also contains new Prompt Corrective Action (PCA) standards for enforcement of the capital requirements. The consequences of failing to retain adequate capitalization can include restrictions on activities, restrictions on investments and asset growth, restrictions on the payment of dividends, restrictions on executive compensation, requirements to elect new directors or dismiss management, and the possibility of conservatorship, liquidation, or a supervisory merger. These new capital and PCA requirements will ensure that corporates hold adequate capital commensurate with the risks of both their balance sheet assets and off-balance sheet activities.

*Corporate Governance Provisions*

As a result of the recent corporate crisis, NCUA identified certain weaknesses in corporate governance. The new corporate rule improves upon the existing governance provisions in several ways. All board members will be required to hold either a CEO, CFO, or COO position at their member credit union or other member entity. A majority of a corporate's board of directors will have to be representatives of consumer credit unions. No person will be permitted to sit on the boards of two or more corporates at the same time, nor will a single organizational member be permitted to have more than one individual representative on the board of any given corporate.

Other governance changes relate to transparency. The new rule requires that each corporate disclose to its members the compensation of its most highly compensated employees.[15] In the case of merger involving a federally chartered corporate, the corporate must disclose to both its members and NCUA any material merger-related increase in compensation for any senior executive or director as a result of the merger.

The new rule also prohibits "golden parachutes," defined as payments made to an institution-affiliated party that are contingent on the termination of that person's employment and received when the corporate making the payment is either troubled, undercapitalized, or insolvent.

*Additional Proposed Amendments to NCUA's Corporate Rule*

During the rulemaking process leading to NCUA's recent final amendments to its corporate rule, NCUA received many suggestions for further amending the rule that deserved consideration. Some of these suggestions were beyond the scope of the proposed rule, and so legally could not be included in the final rule. Other suggestions were within the scope of the first proposal, but deserving of additional public comment before adoption.

Accordingly, on November 18, 2010, NCUA issued seven additional proposed amendments to the corporate rule for public comment. Briefly, these proposed amendments, if adopted by NCUA, would:

- Increase the transparency of corporate credit union decision making by requiring corporates conduct all board of director votes as recorded votes and include the votes of individual directors in the meeting minutes;
- Require that corporate credit unions follow certain audit, reporting, and audit committee practices required of commercial banks by the Federal Deposit Insur-

[13] Basel 1 is a risk-based capital framework developed by the Basel Committee, a group of 11 industrialized nations, including the U.S., formed to harmonize banking standards and regulations among member nations.

[14] Both the old and new corporate rules also require that a corporate maintain a minimum net economic value ratio of 2 percent.

[15] The disclosure includes the three, four, or five most highly compensated employees at each corporate, with the exact number of employees depending on the size of the corporate. The compensation of the corporate credit union's CEO must also be disclosed, even if the CEO is not among the most highly compensated at the corporate.

ance Act, Part 363 of the Federal Deposit Insurance Corporation Regulations, and the Sarbanes-Oxley Act of 2002;

- Provide for the equitable sharing of Stabilization Fund expenses among all members of corporate credit unions, including both credit union and non– credit union members, by establishing procedures for requesting members not insured by the NCUSIF to make premium payments to the Stabilization Fund;
- Protect against unnecessary competition between corporates by limiting consumer credit unions to membership in one corporate of the consumer credit union's choice at any one time;
- Improve risk management at corporates by requiring corporates to establish enterprise-wide risk management committees staffed with at least one independent risk management expert;
- Provide corporates with more options to grow retained earnings by allowing corporates to charge their members reasonable one-time or periodic membership fees; and
- Require the disclosure of compensation received from a corporate credit union service organization (CUSO) by highly compensated corporate credit union executives who are also employees of the CUSO.

The public comment period on these proposals ends January 28, 2011.

*Current State of Corporate Credit Unions*

The corporate credit union system is in a state of transition, which is going according to plan. To date, that transition process has been extremely successful. The four bridge corporates continue to deliver the critical payment and settlement services on which their members depend. The 22 corporates operating independent of NCUA control are in the process of implementing critical operational changes to conform with the new regulatory framework.

NCUA's number one priority in launching the corporate resolution efforts was to ensure that the critical payment, settlement, and liquidity services corporates provide their member credit unions would continue uninterrupted. That goal has been met. At no time over the past 2 years was there a lapse in services to the 90 million consumers served by credit unions.

The future of the corporate credit union system will ultimately be decided by the consumer credit unions they serve. If consumer credit unions are committed to a corporate system for their financial service needs, the system must conform to the new more rigorous regulatory framework NCUA has established. If credit unions choose not to obtain services from corporates going forward, NCUA will ensure an orderly transition for credit unions to new service providers. Under either circumstance, NCUA's primary goal is to ensure uninterrupted financial services to the 90 million credit union consumers.

NCUA is working closely with consumer credit unions to provide as much guidance as possible in making the critical decisions related to their future service needs. NCUA has assured credit unions that they do not need to make an immediate decision. However, NCUA has also been clear in communicating that the decision process is complex and that credit unions need to begin evaluating their options now.

**III. Status of Consumer Credit Unions**

Despite the stresses on credit union earnings, the industry remains very well capitalized. As of September 30, 2010, aggregate net worth totaled $90.6 billion, representing the highest dollar level in credit union history. This equates to a net worth ratio of 9.97 percent of total assets. Ninety-eight percent of all credit unions were at least "adequately capitalized" or better, with 94.8 percent of all credit unions "well capitalized." [16]

During the past several years, credit unions have experienced strong membership and deposit growth, indicating they continue to provide valuable services to members. They currently serve 90.8 million members, an increase of 5 million since 2006. Over the same period, shares have grown by $178 billion, or 30 percent, to $780 billion.

*Credit Unions Continue To Meet Member Lending Needs*

Even during the height of the recent recession, credit unions continued to lend to their members as demonstrated by 15 percent growth in loans originated since

[16] *See,* 12 C.F.R. Part 702.

2008. Loans account for 62 percent of all credit union assets, with more than half secured by real estate.

Focusing more closely on credit union mortgage lending, 68 percent of credit unions offer mortgage loans to their members, originating $55 billion in first mortgage loans through the third quarter of 2010. In the first nine months of 2010, total mortgage loans held on credit union balance sheets increased $667 million, to a new high of 54.6 percent of total loans.

All other consumer loans, such as auto loans and credit cards, make up 40 percent of credit unions' loan portfolios. Used vehicle loans are the fastest-growing segment of consumer lending.

Regarding member business loans (MBLs), currently, 2,210 or approximately 30 percent of all credit unions offer these types of loans. MBLs comprise 6.5 percent of all outstanding loans, or $36.7 billion. The majority of these MBLs are secured by real estate. The average size of an MBL is $249,000, indicating credit unions are largely serving the needs of small businesses.

*Loan Portfolio Quality*

Despite overall adherence to sound underwriting practices, the credit union industry was not immune to the macroeconomic impact of high unemployment and home value declines. Since the end of 2006, the aggregate delinquent loan ratio and net charge-off ratios more than doubled to highs of 1.84 percent and 1.21 percent respectively as of year-end 2009. However, aggregate delinquency and net charge-offs have stabilized in 2010. While historically high for credit unions, these figures still compare favorably to other types of lenders.

*Real Estate Loan Delinquency*

At more than half of total loans, real estate is the predominant factor in overall portfolio performance. Rising delinquency rates and losses present a challenge for credit unions. Real estate loan delinquency has been steadily increasing as the economic crisis has unfolded, from 0.34 percent in 2006 to 2.06 percent as of September 2010. For this same time period, net charge-offs for real estate loans demonstrate a similar trend, increasing to 0.63 percent as of the third quarter 2010.

*Loan Modifications and Foreclosures*

NCUA continues to support loan modifications to resolve credit union member issues. For borrowers experiencing financial difficulties, in lieu of foreclosures, it may be in the best interest of credit unions and their members to develop prudent workout arrangements or loan modifications. Credit unions have shown a willingness to work with their members experiencing financial difficulty as noted by the rapid growth in loan modifications. They have increased from $1.5 billion in 2008 to $8.4 billion, which is approximately 2 percent of total real estate loans.

Foreclosed assets represent only a small fraction (0.49 percent) of total real estate loans outstanding in credit unions, but have been rising since 2007. In light of the recent concerns over marketwide real estate foreclosure practices and documentation, NCUA is examining a sample of the largest credit unions selling mortgages to ensure adequate controls are in place.

*Member Business Loan Delinquency*

While MBLs represent only 4 percent of total credit union industry assets and approximately 1 percent of total commercial loans in the financial markets,[17] the levels of delinquent member business loans have increased from 0.53 percent to 4.29 percent from 2006 to September 2010 (compared to total loan delinquency of 1.74 percent). A similar trend during this period was noted in net MBL charge-offs, which increased to 0.71 percent. Presently, at 270 of the 633 credit unions which have a 3, 4, or 5 CAMEL rating[18] and make member business loans, MBLs are the primary or secondary contributing factor for the supervisory concern.

*Investment Portfolio Quality*

Credit union investments account for a third of total assets. These are generally short-term in nature, with nearly half maturing in less than 1 year, and the majority are conservatively invested in Federal Government obligations.

[17] Mortgage Bankers Association Commercial and Multifamily Mortgage Debt Outstanding Report as of 6/30/2010. (*http://www.mortgagebankers.org/NewsandMedia/PressCenter/74019.htm*)

[18] Credit unions with a CAMEL rating of 3 have supervisory concerns; credit unions with a CAMEL rating of 4 or 5 are considered "troubled."

*Earnings Have Been Stressed*

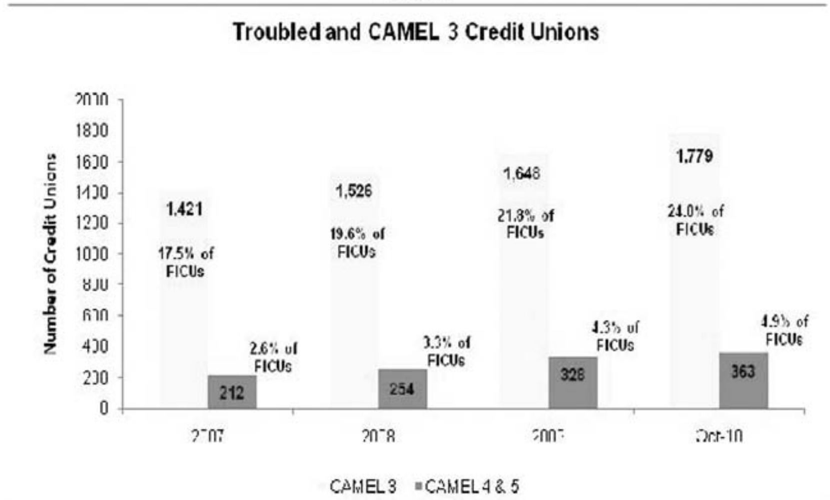
Earnings have been depressed over the last several years and will likely continue to be stressed in the near future. As of September 2010, credit unions reported a return on average assets of 0.45 percent compared to 0.82 percent in 2006. This has reduced credit unions' ability to build net worth. Credit union earnings are under stress due to compressed net interest margins in the current interest rate environment, NCUSIF premiums and Stabilization Fund assessments, and higher provision for loan loss expenses. Also, any future rise in interest rates will likely further reduce margins. NCUA's ability to better manage the timing of Stabilization Fund assessments improves the credit union system's capacity to absorb these costs, continue to provide needed member services, and remain well capitalized.

*The Number of Troubled Credit Unions Is Increasing*

The level of troubled credit unions [19] is highly correlated to the state of the economy. As of October 31, 2010, there were 363 troubled credit unions holding $44.4 billion in assets and $39.1 billion in shares. These credit unions represent 5.0 percent of all credit unions and total shares. The number of troubled credit unions has increased in the current year, from 328 at year-end 2009.

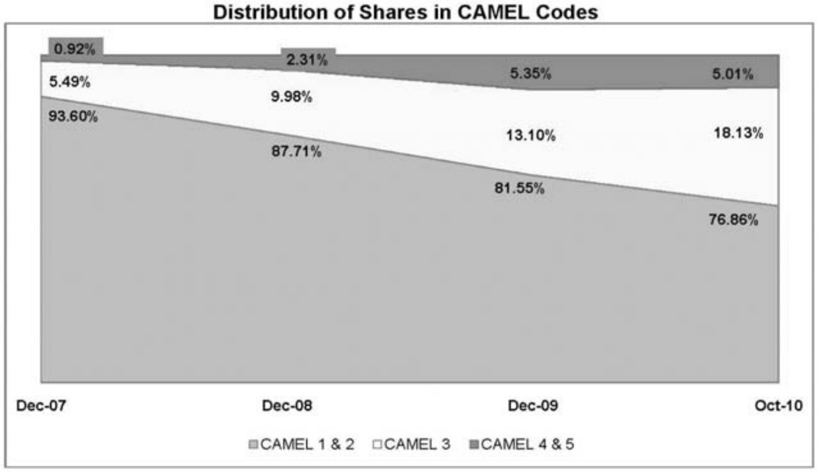
Similarly, CAMEL code 3 credit unions, which exhibit some degree of supervisory concern due to less than satisfactory risk management practices, increased from 1,648 to 1,779 over the same period. The following charts illustrate the changes in the number of troubled and CAMEL code 3 credit unions and the dollars in total shares held by these credit unions since year-end 2007.

Chart 1




[19] NCUA defines a troubled credit union as rated either a CAMEL Code 4 or 5.

**Chart 2**
**Distribution of Shares in CAMEL Codes**




As Chart 2 illustrates, the majority of shares are held in CAMEL 1 and 2 credit unions. While NCUA is working diligently with affected credit unions to resolve problems in weaker institutions, the level of troubled credit unions will also depend heavily on the pace of the economic recovery.

*Impact on the NCUSIF*

One of the primary factors impacting the NCUSIF equity level is losses due to credit union failures. As a result of the above stresses on the credit union system and the corresponding increase in troubled credit unions, the NCUSIF has experienced increased losses during the past 2 years.

For proper financial statement reporting, the shifting of credit union assets to more adverse CAMEL codes results in an increase in the amount of NCUSIF reserves for credit union failures. The increase in reserves lowered the equity ratio [20] of the NCUSIF below 1.2 percent during the summer of 2010. Thus, in September the NCUA Board approved a restoration plan consisting of a premium of 0.124 percent of insured shares to return the equity ratio to near 1.3 percent. The September 2010 premium was slightly more than the 2009 premium of 0.10 percent of insured shares. As of October 31, 2010, the NCUSIF's equity ratio was restored to 1.29 percent and is projected to remain above 1.2 percent through at least June 2011.

NCUA regularly conducts stress tests to measure the resilience of the NCUSIF. The most recent tests included analyzing the impact of further declines in real estate values and other economic conditions. The results of this year's stress tests indicate the risk profile of the NCUSIF has not changed. The amount of losses at modeled stress levels remain within the ability of the NCUSIF to absorb. NCUA will continue to assess the risk profile of the NCUSIF and take appropriate actions based on the results.

*Potential Future Risks*

While credit unions are financially strong and well positioned to weather the continuing impact of the economic recession, NCUA has identified the following potential future risks.

*Interest Rate Risk*

As of September 2010, fixed-rate mortgages represent 63 percent of total mortgage loans, indicating a clear preference by credit union members for this product in the current economic environment. While NCUA recognizes the benefit to consumers of refinancing higher-rate real estate loans into lower fixed-rate loans, NCUA is concerned with the interest rate and liquidity risk associated with a high level of fixed-rate, long-term assets should rates rise rapidly.

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[20] Equity ratio means the ratio of the amount of NCUSIF's capitalization, meaning insured credit unions' 1 percent capitalization deposits plus the retained earnings balance of the NCUSIF (less contingent liabilities for which no provision for losses has been made) to the aggregate amount of the insured shares in all insured credit unions.

Credit unions are taking some positive steps to mitigate interest rate risk. Credit unions sold $27.6 billion in first mortgage real estate loans to date in 2010. These sales represent nearly 50 percent of first mortgages granted. However, significant exposure to rapidly rising rates remains.

*Credit Union Service Organizations*

A Credit Union Service Organization (CUSO) is a corporation, limited partnership, or limited liability company that provides services primarily to credit unions or members of affiliated credit unions. These entities can be wholly owned by a single credit union or owned by a group of credit unions with or without other investors. A credit union's invested interest in a CUSO is subject to NCUA regulations.[21]

Credit unions are increasingly using CUSOs to perform various functions and achieve economies of scale by partnering with other financial institutions. This partnering is especially critical to the 2,833 credit unions with less than $10 million in assets. Credit unions currently have $1.3 billion invested in CUSOs and approximately 33 percent of all credit unions reported using CUSO services. While this arrangement can be beneficial from an efficiency standpoint, especially for smaller credit unions, it places the systemic risk inherent in the delivery of these services outside of NCUA's direct regulatory and supervisory domain. NCUA is the only Federal financial institution regulator that does not have oversight authority of third-party vendors.

*Privately Insured Credit Unions*

While NCUA has no regulatory authority over privately insured institutions, they do pose a unique reputation risk to federally insured credit unions. All financial institutions have been negatively affected by high unemployment, declines in real estate values, and loan losses all arising from the recent, protracted recession. Consumers do not always differentiate between private share insurance and Federal share insurance. As a result, any pervasive problems that may develop with privately insured credit unions could have an impact on federally insured credit unions.

American Mutual Share Insurance Corporation (ASI) is a private share insurer incorporated in Ohio. ASI, along with its wholly owned subsidiary Excess Share Insurance Corporation (ESI), provides primary share insurance to 152 credit unions in nine States and excess share insurance to several hundred credit unions, including federally insured credit unions, in 32 States.[22] ASI has geographic concentration in two States particularly hard hit by the recent recession: California and Nevada.

**IV. NCUA Supervisory Improvements**

The last several years have provided clear evidence of the importance of a strong regulatory and supervisory approach. The depth and severity of the recent economic crisis has provided new insight to all regulatory agencies. NCUA is committed to proactively identifying areas of concern and implementing corrective action in a timely manner.

To better accomplish this, NCUA modified its risk-based examination program to require annual examinations of every Federal credit union and increased on-site reviews of State-chartered credit unions. Annual examinations provide more frequent onsite contacts at credit unions, enabling NCUA to more effectively stay ahead of developing problems than the previous 18-month examination schedule allowed. Full implementation of the annual exam cycle is anticipated in 2011 as NCUA hires and trains additional staff.

In addition to more frequent contacts at credit unions, NCUA is also taking stronger resolution action earlier in the process when problems are identified. In 2010 NCUA issued a supervisory letter and increased training for field staff directing more rapid escalation of administrative remedies to resolve problems that had been left uncorrected by credit union management.

NCUA has increased the resources provided for credit union supervision to ensure problem areas are brought to a timely and appropriate resolution. A particular focus going forward will be strong regulation and supervision relative to interest rate risk management. NCUA has also been acquiring additional specialized expertise and incorporating an enhanced training program for examination staff.

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[21] *See,* 12 C.F.R. Part 712.

[22] ASI provides primary insurance directly in nine States (Alabama, California, Idaho, Illinois, Indiana, Maryland, Nevada, Ohio, and Texas), excess insurance directly in Arizona and California, and excess insurance indirectly through ESI in 30 other States. ASI and ESI both operate Web sites that list their respective States of operation.

NCUA has made necessary adjustments over the past 2 years to address the increased challenges associated with the financial crisis and implement additional proactive risk mitigation programs.

While NCUA remains a highly effective regulator and insurer, NCUA is also operating more efficiently. For every $1,000 in federally insured credit union assets, NCUA is currently spending just 22 cents—compared with 31 cents in the year 2000.

**V. Legislative Remedies**

*Current Legislative Requests*

Due to the financial environment and the evolving nature of financial reporting rules, NCUA is requesting statutory changes to its enabling statute, the Federal Credit Union Act (Act), to enhance its ability to serve as an effective safety and soundness regulator of over 7,400 credit unions and deposit insurer for 90 million members. While these amendments are technical and noncontroversial, they are nonetheless critical to NCUA's role as regulator and insurer. [23]

NCUA requests the following statutory changes to the Act.

- Change the "Net Worth" definition to allow certain loans and accounts established by the NCUA Board to count as net worth. NCUA's ability to resolve problem credit unions at the least cost to the NCUSIF has been limited by the Financial Accounting Standard Board's changes in accounting standards, in combination with the existing statutory definition of net worth. Since NCUA does not have the ability to adjust the definition of net worth similar to the Federal Deposit Insurance Corporation's authority, this results in the dilution of a credit union's net worth when it acquires another credit union, regardless of whether or not NCUSIF assistance is provided to facilitate the acquisition. This increases costs to resolve failed institutions and necessitates more outright liquidations instead of mergers. Liquidations immediately cut members off from credit union services.
- Amend the Act to clarify that the equity ratio of the NCUSIF is based on NCUSIF-only, unconsolidated financial statements. Evolving accounting standards could result in the consolidation of the financial statements of the NCUSIF with regulated entities when NCUA exercises its role as the Government regulator and insurer by conserving failed institutions. The requested amendment would be consistent with Congress' original intent in defining the NCUSIF equity ratio, and prevent insured credit unions from being assessed artificially inflated insurance premiums resulting from the consolidation of financial statements with failed institutions.
- Streamline the operation of the Stabilization Fund. As currently written, the Stabilization Fund must borrow from the U.S. Treasury to obtain funds to make expenditures related to losses in the corporate credit union system. The Stabilization Fund then assesses federally insured credit unions to repay the U.S. Treasury borrowing over time. Relevant amendments to Section 217(d) of the Act would give NCUA the option of making premium assessments on federally insured credit unions in advance of anticipated expenditures, thereby avoiding borrowing directly from the U.S. Treasury. In addition, while the existing statutory language includes the implicit authority for ongoing advances, a clarification of this in the statute is recommended.

*Anticipated Requests for Next Congress*

The following are important legislative initiatives for further improving the regulation of the credit union industry.

- *Statute of Limitations.* NCUA proposes that Congress amend the Act to extend the statute of limitations [24] provision applicable to actions filed by NCUA as conservator/liquidating agent of a credit union. This would provide parity with similar authority already provided to FDIC, clarify other ambiguities in the statute, and allow the NCUSIF to better mitigate losses.
- *Third-Party Vendor Authority.* NCUA is the only regulator subject to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 that does not have authority to perform examinations of vendors which provide services to insured institutions. Credit unions are increasingly relying on third-party vendors to support technology-related functions such as Internet banking, transaction processing, and funds transfers. Vendors are also providing important loan un-

[23] *See,* Appendix 1 for applicable proposed legislative text.
[24] 12 U.S.C. §1787(b)(14)

derwriting and management services for credit unions. The third-party arrangements present risks such as threats to credit risk, security of systems, availability and integrity of systems, and confidentiality of information. Without vendor examination authority, NCUA has limited authority to minimize risks presented by vendors.

- *Supplemental Capital.* Some financially healthy, well-capitalized credit unions that offer desirable products and services are discouraged from marketing them too vigorously out of concern that attracting share deposits from new and existing members will inflate the credit union's asset base, thus diluting its net worth for purposes of PCA. In effect, the reward for their success in attracting new shares is the risk of a demotion to a lower net worth category if accepting those shares drives down the credit union's net worth ratio. NCUA believes two legislative remedies would help reverse the disincentive to accept new share deposits—one that addresses the "total assets" denominator of the net worth ratio, and another that addresses the "retained earnings" numerator. For more information on the specific remedy proposed, refer to NCUA's letter to the Honorable Barney Frank (appended to this testimony document as Appendix 2).
- *Member Business Lending Statutory Limit.* The Act limits the amount of member business loans the vast majority of credit unions can grant to the lesser of 1.75 percent of net worth or 12.25 percent of assets. NCUA recognizes the importance of small businesses in our Nation's economy. As such, NCUA supports efforts to allow credit unions to provide businesses additional avenues of credit when appropriate under a comprehensive regulatory framework, by increasing or eliminating the current statutory MBL limitation. Given such a change, NCUA would promptly revise MBL regulations to appropriately mitigate any additional risk. For more information on the specific remedy proposed, refer to NCUA's letter to the Honorable Timothy Geithner (appended to this testimony document as Appendix 3).

**VI. Conclusion**

Over the last 24 months, the credit union industry has faced profound and unprecedented threats to its stability. A steep plunge in global financial markets triggered the most severe economic downturn in recent memory. The resulting cascade of job losses, home foreclosures, and bankruptcies exerted significant pressure on the entire American financial services sector, including credit unions.

NCUA's experience during these years of crisis demonstrated the value of rigorous regulation, diligent oversight, and a robust insurance fund. NCUA's increased supervision contributed significantly to the credit union system's ability to withstand the extraordinary economic shocks over the past 2 years.

Going forward, NCUA has also implemented proactive measures to address the ongoing strains and emerging risks to consumer credit unions. Coming out of this extraordinary economic downturn, the credit union industry remains financially stable and well positioned to emerge from the current economic downturn as a leader in the delivery of financial products and services to more than 90 million consumers.

# Appendix 1

## National Credit Union Administration's Request for Congressional Actions in this Session – Legislative Language

The National Credit Union Administration (NCUA) needs statutory changes to its enabling statute, the Federal Credit Union Act (Act), to enhance NCUA's ability to serve as an effective safety and soundness regulator. The proposed amendments to the Act include 1) revising the Prompt Corrective Action definition of "net worth" to include loans to, or the establishment of accounts in, an insured credit union by the NCUA Board; 2) clarifying that the equity ratio of the NCUSIF is based solely on the unconsolidated financial statements of the NCUSIF; and 3) clarifying that NCUA may make assessments directly against credit unions to pay Temporary Corporate Credit Union Stabilization Fund expenses. The following statutory amendments would accomplish these goals.

**SECTION 1. DEFINITION OF NET WORTH.**

Section 216(o)(2) of the Federal Credit Union Act, 12 U.S.C. 1790d(o)(2), is amended by striking existing subsection (2) and inserting the following:

(2) **Net worth**.—The term 'net worth'—

(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined;

(B) with respect to any insured credit union may, at the Board's option and subject to rules and regulations established by the Board, include loans to, or the establishment of accounts in, and insured credit union provided pursuant to section 208; and

(C) with respect to a low-income credit union, includes secondary capital accounts that are—

(i) uninsured; and

(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.

**SECTION 2. EQUITY RATIO OF SHARE INSURANCE FUND.**

Section 202(h)(2) of the Federal Credit Union Act (12 U.S.C. 1782(h)(2)) is amended by striking "when applied to the Fund," and inserting "which shall be calculated using the financial statements of the Fund alone, without any consolidation or combination with the financial statements of any other fund or entity,".

**SECTION 3. STABILIZATION FUND.**

(a) ADDITIONAL ADVANCES.—Section 217(c)(3) of the Federal Credit Union Act (12 U.S.C. 1790e(c)(3)) is amended by inserting before the period at the end the following: "and any additional advances".

(b) ASSESSMENTS.—Section 217 of the Federal Credit Union Act (12 U.S.C. 1790e) is amended by striking subsection (d) and inserting the following:

"(d) ASSESSMENT AUTHORITY.—
"(1) ASSESSMENTS RELATING TO EXPENDITURES UNDER SUBSECTION (B).
—In order to make expenditures, as described in subsection (b), the Board may assess a special premium with respect to each insured credit union in an aggregate amount that is reasonably calculated to make any pending or future expenditure described in subsection (b), which premium shall be due and payable not later than 60 days after the date of the assessment.

"(2) SPECIAL PREMIUMS RELATING TO REPAYMENTS UNDER SUBSECTION (C)(3).—
Not later than 90 days before the scheduled date of each repayment described in subsection (c)(3), the Board shall set the amount of the upcoming repayment and shall determine whether the Stabilization Fund will have sufficient funds to make the repayment. If the Stabilization Fund is not likely to have sufficient funds to make the repayment, the Board shall assess with respect to each insured credit union a special premium, which shall be due and payable not later than 60 days after the date of the assessment, in an aggregate amount calculated to ensure that the Stabilization Fund is able to make the required repayment.

"(3) COMPUTATION.—Any assessment or premium charge for an insured credit union under this subsection shall be stated as a percentage of its insured shares, as represented on the previous call report of that insured credit union. The percentage shall be identical for each insured credit union. Any insured credit union that fails to make timely payment of the assessment or special premium is subject to the procedures and penalties described under subsections (d), (e), and (f) of section 202.".

# Appendix 2

National Credit Union Administration

Office of the Chairman

December 7, 2009

The Honorable Barney Frank, Chairman
Committee on Financial Services
U. S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

As Chairman of the NCUA Board, I am writing to call your attention to a trend reported by some credit unions that adversely affects consumers—including those of modest means, who benefit from access to the reasonably-priced financial services that credit unions offer. Some financially healthy, well-capitalized credit unions that offer desirable products and services are discouraged from marketing them too vigorously out of concern that attracting share deposits from new and existing members will inflate the credit union's asset base, thus diluting its net worth for purposes of prompt corrective action ("PCA").

Under PCA, a credit union's classification among five statutory net worth categories is determined by its "net worth ratio"—the ratio of retained earnings (numerator) as a percentage of total assets (denominator). 12 U.S.C. 1790d(o)(3). As a credit union accepts new share deposits, its total assets (denominator) rises. Unless a credit union's retained earnings (numerator) grows commensurately, the rising denominator will dilute the credit union's net worth ratio. As a credit union's net worth ratio declines, so does its classification among the five statutory net worth categories, exposing it to an expanding range of mandatory restrictions imposed by law, as well as discretionary restrictions imposed by regulation—all designed to restore net worth. *Id.* §1790d(c); 12 C.F.R. Part 702, Subpart B.

For example, a credit union's decline from "well capitalized" (net worth ratio of 7 percent or greater) to "adequately capitalized" (net worth ratio between 6 and 6.99 percent) triggers a mandatory "earnings retention requirement" that compels the credit union to annually transfer 40 basis points of net income to build net worth. 12 U.S.C. 1790d(e). A credit union's decline from "adequately capitalized" to "undercapitalized" (net worth ratio between 4 and 5.99 percent) triggers not only the "earnings retention requirement," but also three further mandatory restrictions: a freeze on its asset balance, a freeze on its Member Business Loan balance, and the requirement to obtain NCUA approval of a Net Worth Restoration Plan ("NWRP"). *Id.* §1790d(f) and (g). A further decline below

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"undercapitalized" subjects a credit union to all four mandatory restrictions plus a series of further discretionary restrictions. *Id.* §1790d(b)(A); 12 C.F.R. 702.203, 702.204.

The risk of reputational damage from being branded less than "well capitalized" and in need of "restoring" net worth, and from being subjected to the mandatory and discretionary restrictions that accompany a falling net worth ratio, is reportedly having a significant chilling effect on the willingness of some "well capitalized" credit unions to accept new share deposits. In effect, the reward for their success in attracting new shares is the risk of a demotion to a lower net worth category if accepting those shares drives down the credit union's net worth ratio. In turn, the net effect on existing and new credit union members is that they cannot fully rely on the financial institutions that are supposed to be the most accessible to persons of modest means who have the least consumer choice.

It is clear that controlling accelerated, unmanageable growth of credit union assets was a principal purpose of PCA, and NCUA's implementing regulations respect that goal. It is for that reason that in the course of implementing PCA over the last 9 years, NCUA did not propose statutory remedies in response to occasional periods of reluctance by credit unions to grow assets. That reluctance in the present period of national economic distress has become acute, however, warranting a statutory remedy. Surely it was never the objective of PCA to discourage manageable asset growth by financially healthy credit unions in times of economic distress. To the extent PCA does so now, it does not contribute to the objective of "resolv[ing] the problems of insured credit unions," 12 U.S.C.1790d(a)(1); it unintentionally creates a problem for them, which redounds to the detriment of consumers.

I believe two legislative remedies would help reverse the disincentive to accept new share deposits—one that addresses the "total assets" denominator of the net worth ratio, and another that addresses the "retained earnings" numerator. With respect to the denominator, I encourage Congress to consider allowing qualifying credit unions to exclude from the "total assets" denominator those assets that have a zero risk-weighting, exposing the credit union to virtually no risk of loss. An example of such "no-risk" assets is short-term Treasury securities.

To qualify for exclusion of no-risk assets from its denominator, I propose that a credit union should be required to meet at least two criteria: (1) Maintain a minimum net worth classification, as determined by the NCUA Board, calculated *before excluding no-risk assets;* and (2) show that share growth is the cause of its declining net worth ratio, *i.e.,* that the decline is not due to poor management or material unsafe or unsound practices. Permitting the "total assets" denominator to exclude "no risk" assets would moderate the growth of assets due to the inflow of new shares, while still imposing PCA that is appropriate to the circumstances.

With respect to the numerator of the net worth ratio, I encourage Congress to consider authorizing qualifying credit unions, as determined by the NCUA Board, to issue alternative forms of capital to supplement their retained earnings. To ensure the proper authority, alternative forms of capital would be subject to necessary regulations addressing safety and soundness criteria, investor protections, and any impact on the cooperative credit union governance model.

Congress already permits low-income designated credit unions to offer uninsured secondary capital accounts to non-members. 12 U.S.C. 1757(6); *see also* 12 C.F.R. 701.34. Modifying the Federal Credit Union Act ("Act") to permit qualifying credit unions to offer uninsured alternative capital instruments subject to regulatory restrictions, and expanding the Act's definition of "net worth" to include those instruments, would allow well-managed credit unions to better manage net worth levels under varying economic conditions.

The legislative remedies suggested above would, I believe, go a long way toward removing an obstacle to accepting new shares, thereby enhancing consumers' access to the benefits of credit union service. Please do not hesitate to contact me should you have questions or wish further information about this proposal.

Sincerely,

Debbie Matz

Debbie Matz
Chairman

# Appendix 3

National Credit Union Administration

**Office of the Chairman**

February 24, 2010

The Honorable Timothy F. Geithner, Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Geithner:

I am writing as a follow-up to the recent discussions our agencies have had about credit union member business loan limitations.

The Federal Credit Union Act limits the amount of member business loans (MBLs) the great majority of credit unions can grant to the lesser of 1.75 percent of net worth or 12.25 percent of assets. Congress presently contemplates legislation that would raise or eliminate that statutory limitation by enabling credit unions to grant more MBLs. Should the legislative process result in an increase to or elimination of the current MBL limitations, I assure you NCUA would remain vigilant in carrying out our supervisory responsibilities.

NCUA has long exercised caution in monitoring MBLs from the standpoint of safety and soundness. We routinely issue guidance to ensure the credit union community and agency staff understand the risks associated with MBLs. For example, last month, the agency released NCUA Letter to Credit Unions 10-CU-02 ("Current Risks in Business Lending and Sound Risk Management Practices"). This guidance reminds credit union officials of the importance of ensuring that risk management practices must continue to evolve as the size and complexity of MBL portfolios increase. NCUA also plans to provide extensive MBL training to our field staff in the coming months.

NCUA recognizes that successful MBL programs depend upon credit unions limiting products to only those consistent with the capabilities of their respective lending staffs and the principles of sound risk management. In consideration of these precepts, NCUA already has efforts underway to strengthen the regulatory qualifications that credit union officials must have to serve as business lenders.

Let me assure you: **If legislative changes increase or eliminate the current aggregate MBL cap, NCUA would promptly revise our regulation to ensure that additional capacity in the credit union system would not result in unintended safety and soundness concerns.**

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Treasury Secretary Geithner
February 24, 2010
Page Two

As one of the most important changes, NCUA would only permit credit unions to increase their MBL capacities on a gradual basis by adopting a tiered approval process. In addition to other regulatory changes, the agency would develop procedures to fully monitor MBL growth.

Earlier this month, NCUA joined the other Federal Financial Institution Examination Council members in advocating prudent lending to creditworthy small businesses. We recognize the importance of small businesses in leading our nation's recovery efforts. As such, we support efforts to allow credit unions to provide businesses additional avenues of credit when appropriate under a comprehensive regulatory framework.

Sincerely,

Debbie Matz
Chairman

CC: Michael Barr
Assistant Secretary for Financial Institutions

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

**LETTER SUBMITTED BY FRED R. BECKER, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS**

NAFCU
**National Association of Federal Credit Unions**
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**Fred R. Becker, Jr.**
*President and CEO*

December 8, 2010

| | |
|---|---|
| The Honorable Christopher Dodd | The Honorable Richard Shelby |
| Committee on Banking, Housing | Committee on Banking, Housing |
| and Urban Affairs | and Urban Affairs |
| United States Senate | United States Senate |
| Washington, D.C. 20510 | Washington, D.C. 20510 |

Dear Chairman Dodd and Ranking Member Shelby:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, I am writing in conjunction with the Committee's scheduled hearing on "The State of the Credit Union Industry."

While credit unions have faced many challenges in these turbulent economic times, the industry remains stalwart as credit unions have continued to serve their 92 million members since the inception of the nation's economic malaise. Nevertheless, credit unions, like other small financial depository institutions, are experiencing ever-increasing pressure from rising regulatory burdens; burdens for which mounting compliance costs are not only hindering credit unions' ability to serve their members, but forcing unwanted consolidation due to substantially escalating economies of scale. As the Committee continues to examine the state of credit unions and the financial services industry, we would urge careful oversight to examine the unintended, but nevertheless substantially adverse, impact of the ever-increasing regulatory burden on smaller financial institutions.

In addition, we would like to thank you for your leadership in the adoption of the corporate credit union stabilization fund as part of the *Helping Families Save Their Homes Act of 2009* (P.L. 111-22). By providing the mechanism to spread out the cost of the corporate credit union stabilization over a number of years, the corporate stabilization fund has enabled natural-person credit unions to continue to provide vital financial services to their 92 million American members in these turbulent economic times

The National Credit Union Administration (NCUA) has been faced with the daunting task of resolving the corporate credit union situation and implementing the stabilization fund. While

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NAFCU has not agreed with all of the agency's decisions, we recognize that the NCUA has attempted to make the best of a very difficult situation by striving to minimize the impact on natural person credit unions. We hope that the Committee will continue its careful oversight to ensure the NCUA implements the corporate stabilization legislation in a transparent manner.

Finally, to assist the nation as it continues its economic recovery, we would urge the Committee to make every effort to ensure that credit unions have the tools that they need to meet the needs of their 92 million members and that the NCUA continues in its role of ensuring safety and soundness.

NAFCU thanks you for your time and consideration regarding these matters. Should you have any questions or require any additional information please do not hesitate to contact me or Brad Thaler, NAFCU's Director of Legislative Affairs, at 703-842-2204.

Sincerely,

Fred R. Becker, Jr.
President/CEO

cc: Members of the Senate Banking Committee

**LETTER SUBMITTED BY BILL CHENEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CREDIT UNION NATIONAL ASSOCIATION**

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BILL CHENEY
President & CEO

December 9, 2010

The Honorable Christopher Dodd
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20515

Dear Chairman Dodd and Ranking Member Shelby:

On behalf of the Credit Union National Association (CUNA), I am pleased to submit a statement in connection with today's Committee hearing on the "State of the Credit Union Industry." CUNA is the largest credit union advocacy organization in the United States, representing nearly 90 percent of America's 7,600 state and federally chartered credit unions and their 92 million members.

We appreciate your calling today's hearing. It has been several years since the Committee has focused on the state of the credit union industry. Given the recent financial crisis, we believe there is much that can be learned from how credit unions weathered the storm that nearly caused the collapse of the global economy. While credit unions were certainly not unaffected by the crisis, using the authority conveyed through the *Helping Families Save Their Homes Act* (PL 111-22), the National Credit Union Administration Board has taken steps to help credit unions spread the costs associated with problems relating to the financial crisis over a more manageable period of time. This, in turn, will permit credit unions to continue to serve their members without requiring the level of assistance from taxpayers that has been provided to commercial and investment banks.

The attached statement describes our view of the condition of credit unions in greater detail. Like other sectors of the financial services industry, the credit union system faces significant challenges as a result of the worldwide financial crisis. Nevertheless, throughout the crisis credit unions have continued to lend when other creditors abandoned consumers and small businesses. Credit unions worked with their members to modify mortgages, and they have not been beset by "robo-signing" and other foreclosure problems. Considering the considerable stresses that the financial sector has experienced over the last several years and the activities which caused and perpetuated the crisis, credit unions serving consumers should be viewed as a shining example of what generally went right when so much else went wrong.

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As it was before the crisis, this statement remains true today: credit unions are the best option for consumers to conduct their financial services. As addressed in our statement, credit unions stand willing and able to do more for consumers and small businesses, if empowered to do so by Congress.

Again, thank you very much for convening today's hearing and providing CUNA the opportunity to submit a statement for the hearing record.

Best regards,

Bill Cheney
President & CEO

**STATEMENT SUBMITTED BY THE CREDIT UNION NATIONAL ASSOCIATION**

**STATEMENT SUBMITTED BY THE CREDIT UNION NATIONAL ASSOCIATION TO THE SENATE BANKING COMMITTEE DECEMBER 9, 2010**

**THE STATE OF THE CREDIT UNION INDUSTRY**

The following statement provides background on the United States credit union system, describes the recent challenges credit unions face, including those as a result of the financial crisis, and identifies statutory, regulatory and supervisory obstacles that inhibit and, in some cases, prevent credit unions from serving their members even better. The statement addresses the significance of credit union's federal income tax exemption, and makes recommendations for changes in legislation to strengthen the credit union system, including increasing the credit union member business lending cap and allowing credit unions to access capital beyond their retained earnings.

**General Background**

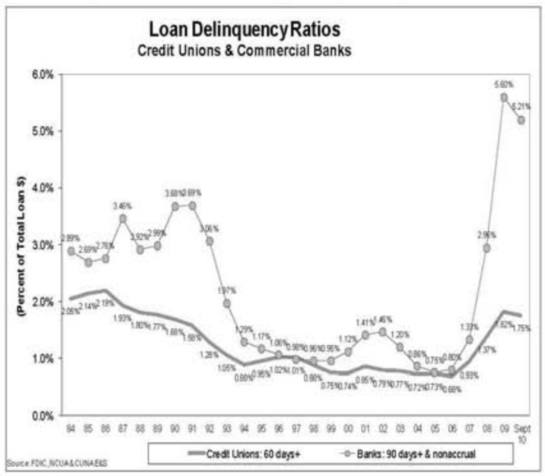
In general, credit unions are doing well and working hard to serve their members' financial needs, including continuing to provide loans at affordable rates in the face of the economic crisis and reduced lending by a number of banks and other creditors.

Overall, nearly 92 million U.S. consumers are member-owners of, and receive all or part of their financial services from the nation's 7,600 credit unions. Credit unions are a small, but constant presence in the financial services industry. Credit unions hold about 6.7 percent of household financial assets, a market share that hasn't changed significantly in over 25 years. As not-for-profit cooperatives, credit unions generally offer more attractive savings and loan rates as well as generally lower fees. Surveys consistently rank credit unions first among financial institutions in consumer satisfaction.

Credit unions are democratically owned and controlled institutions that take pride in their "people helping people" philosophy. Credit union boards of directors are elected by members; each member has an equal vote, regardless of how much he or she has on deposit. Only members may serve as directors, and directors generally serve without remuneration. Volunteers are an important credit union resource. Presently, approximately 100,000 Americans volunteer for their credit unions, serving as board members, committee members or providing other assistance. Credit unions have no outside stockholders, so after meeting net worth (capital) requirements, earnings are returned to members in the form of dividends on savings, lower loan rates and fees, or additional services.

Based on this structure, Congress granted credit unions a federal tax exemption in 1934; this status has been reaffirmed by Congress several times over the last 75 years. While this exemption scores at approximately $1.5 billion per year, we estimate that credit unions provide about $7.5 billion in direct financial benefits to their members per year.[1]

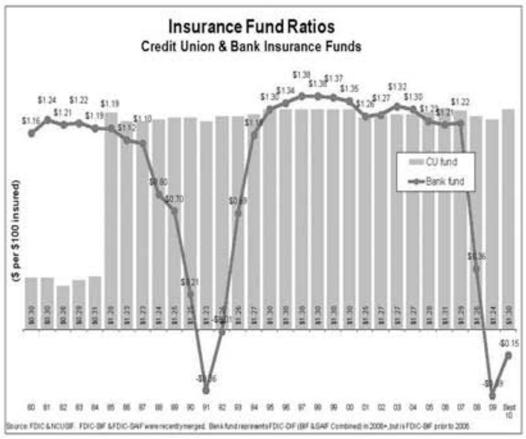
Credit unions engage in consumer, residential real estate and small business lending with their members. Credit union asset quality remains very high in the current shaky market with real estate loan delinquencies at 2.08% and overall loan delinquencies at 1.75% at the end of the third quarter 2010. In contrast commercial bank real estate loan delinquencies stand at 7.67% and bank overall loan delinquencies are 5.21% at the end of the third quarter 2010.




Credit unions' aggregate capital is around 10% of total assets (a level that is well above the statutory "well capitalized" 7% threshold) and the target for the proportion of the amount in the federal insurance fund, National Credit Union Share Insurance Fund (NCUSIF), to credit unions' insured shares is currently 1.3% of equity in the fund to insured shares.

In 1984, credit unions voluntarily recapitalized the NCUSIF by depositing an amount equal to 1 percent of their insured member savings in the Fund, in order to bring its equity ratio up to 1.0 percent. This recapitalization resulted in a one-time reduction in the federal deficit. Each year, credit unions deposit sufficient funds to ensure that the target for the NCUSIF may be reached, which is currently set at 1.2 %. Like the Federal Deposit Insurance Corporation, the NCUSIF protects member deposits to $250,000 and is backed by the full faith and credit of the U.S. Government.

[1] Credit Union National Association. The Benefits of Membership. June 2010. http://www.cuna.org/download/state_mbl/MB_National_10.pdf




Federally chartered credit unions are regulated by the National Credit Union Administration (NCUA), an independent agency. NCUA's three board members are nominated by the President and confirmed by the Senate. State chartered credit unions are regulated by their state supervisory authority. NCUA administers the NCUSIF, and has authority to subject all federally insured credit unions to insurance examinations, in coordination with state regulators for state chartered credit unions.

## Current Challenges Facing Credit Unions

### *Preserving Credit Unions' Tax Exemption*

Much attention has been placed of late on the staggering size of the national debt – which at around $14 trillion is the largest in the world and comprises about 90% of our gross national product. Several proposals to address our growing deficit and its impact on our economy now and into the future have already been issued, including the report of the National Commission on Fiscal Responsibility and Reform, which, in part, called for broad changes in the tax code to help reduce government spending.

There is no question that Congress must address and contain our national spending – and a number of tax loopholes that favor the wealthy or big business without providing appreciable benefits to our economy should undoubtedly be closed.

However, as Congress considers deficit reduction proposals, we urge it to keep in mind the value of the credit union tax exemption to consumers as well as to the U.S. economy.

Simply stated, if credit unions lose their tax exemption, consumers will pay the price. As the result of their tax exemption, credit unions provide significant financial benefits to their 92 million members, saving them about $7.5 billion a year. Yet faced with federal income tax liability, a number of credit unions may no longer feel compelled to operate a credit union and could close or convert to for-profit banks. These institutions have far different incentives than do credit unions and are driven by the desire to return a profit to shareholders rather than ensuring favorable rates are provided to consumers. (One example is that during the current financial crisis, credit unions have continued to make loans while many banks have not.)

With this outcome, consumers would have few, if any other mainstream financial choices than commercial banks, which often do not meet their financial needs well, as evidenced by a number of current problems in the economy. Even if a credit union chooses not to convert, it will inevitably be forced to raise lending rates and fees and lower its returns to its members.

In addition, while these major benefits to consumers and the economy would be forfeited, the returns to the U.S. Treasury would be relatively small. The credit union tax exemption results in no more than $1.5 billion in lost federal revenue per year. However, revenues that might be provided to the Treasury if the credit union tax exemption were repealed will most certainly be lower, as a result of credit union conversions to banks or having to lower dividends to their members. Either way, the U.S. Treasury would not fully recapture the revenue.

We also urge Congress to consider the original reason for the credit union tax exemption, which was to promote credit unions' structure as financial cooperatives, distinct from the paid-director, shareholder-interest-driven model employed by for-profit banks. And while it is a top legislative priority for banking trade groups to remove credit unions' tax exemption because they want to eliminate consumers' choices in the financial marketplace, the tax exemption does foster the financial cooperative system by facilitating the ability of credit union members to pool their collective resources to help themselves and their communities.

As government data clearly shows, credit unions serve working Americans well, as Congress intended, and the tax exemption plays a vital role in supporting this service.[2]

Moreover, in the landmark credit union statute, the Credit Union Membership Access Act, (PL 105-219), Congress specifically included "findings" that described the five distinguishing characteristics of credit unions which are: member ownership; net worth created by retained earnings; dependence on volunteers; not-for-profit basis of operations; and service only to members. CUMAA findings concluded that credit unions are tax exempt because of these characteristics and because credit unions have "the specified mission of meeting the credit and savings needs of consumers, especially (but not only) persons of modest means" (parenthesis added).

Credit unions employ the tax benefit by passing it through to their members, primarily in lower rates on loans, lower fees (or none at all) and higher returns on savings. There are also significant financial benefits to consumers who are not members of credit unions. Based on public data CUNA estimates that even bank customers benefit in the aggregate by $4.3 billion a year as a result of lower loan rates and higher deposit rates banks provide in response to rates

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[2] The U.S. Department of the Treasury has conducted several detailed studies of credit unions. These objective studies, which were requested by Congress, are exhaustive and present detailed analyses of the credit union system. The studies portray credit unions generally as robust institutions with a specialized structure serving identifiable groups of members.

credit unions offer their members. In total bank customers and credit union members benefit to the tune of at least $10.6 billion a year – about ten times the amount of the estimated revenue lost from the tax exemption -- because credit unions, supported by the tax exemption, exist.

As the undeniable facts prove, the tax exemption for credit unions helps: (1) facilitate financial choices for consumers, (2) assist credit unions to fulfill their congressional mandate of service to American communities, (3) benefit the economy, including even bank customers; and (4) ensure credit union net worth remains strong. For these best of public policy reasons, we urge Congress to continue credit unions' tax exemption.

***The Need for Increased Small Business Lending Authority***

The idea behind credit unions is very simple: people pool their savings together and make loans to neighbors and coworkers in order to help each other achieve a better standard of living. While it has not been the predominant book of business for credit unions, credit union business lending dates back to the first days of the movement. The earliest credit unions were founded so that people could borrow money to buy goods at lower cost and sell them for a profit.

The founders of the American credit union movement very specifically noted the important role credit unions should play in providing access to credit for small businesses. As Alphonse Desjardin said in 1908, as he encouraged the founding fathers of St. Mary's Bank Credit Union to organize the United States' first credit union:

> "There are not only the manual laborers, whether of industry or of the land, who need credit and who, very often, are forced to suffer the extortions of the Shylocks of usury: There is also a very interesting class of small merchants, of humble industrialists, of modest entrepreneurs whose financial status does not permit them to have access to the large banks where their well enough known fellow businessmen go to stock up in order to enjoy the benefit of a checking account. To all of them as well, the cooperative offers financial assistance that is most precious."[3]

Business lending is part of the credit union DNA, and until 1998, there was no statutory limit on the amount of business lending in which a credit union could engage. The current credit union business lending cap of 12.25% of total assets was enacted as part of CUMAA and no safety and soundness rationale for the cap was identified during the consideration of this legislation. In fact, the Clinton administration stated in its statement of administration policy that:

> "The Administration sees no safety and soundness basis for an amendment that would limit the ability of credit unions to make business loans to their members. Existing safeguards, coupled with the new capital and other reforms in the bill, are sufficient to protect against any safety and soundness risk from member business lending."[4]

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[3] *L'Avenir National* (Manchester, N.H.), Vol. XXI, No. 67, 28 November 1908, p. 4-5.
[4] http://www.presidency.ucsb.edu/ws/index.php?pid=74369

In contrast to the recently enacted $30 billion Small Business Lending Fund, increasing the credit union member business lending cap could be done without cost to the taxpayers and without an increase to the size of government. Further, not only do credit unions have a long history of engaging in business lending to their members, they also have demonstrated that they can lend to these members safely and soundly. When credit union business loan charge-off and delinquency numbers are side-by-side with the banks', this is made crystal clear. Since 1997, the loss rate on credit union member business loans (MBLs) has averaged only 0.19% compared to 0.89% at banks.

**Business Loan Asset Quality Comparisons**

| | Net Chargeoffs | |
|---|---|---|
| | Credit Union MBLs | Commercial Bank Commercial & Industrial Loans |
| 1997 | 0.18% | 0.28% |
| 1998 | 0.08% | 0.43% |
| 1999 | 0.12% | 0.57% |
| 2000 | 0.05% | 0.01% |
| 2001 | 0.10% | 1.43% |
| 2002 | 0.09% | 1.76% |
| 2003 | 0.08% | 1.26% |
| 2004 | 0.10% | 0.50% |
| 2005 | 0.05% | 0.27% |
| 2006 | 0.08% | 0.30% |
| 2007 | 0.09% | 0.52% |
| 2008 | 0.33% | 1.01% |
| 2009 | 0.59% | 2.36% |
| 3Q10 | 0.65% | 1.83% |
| Avg. since '97 | 0.19% | 0.89% |

Source: FDIC, NCUA, and CUNA E&S. 2010 results are annualized

The only groups that actively oppose additional credit union business lending represent banks to which Congress just gave $30 billion of taxpayer money to do precisely what credit unions are willing to do at zero cost to the taxpayers. These groups put forward many reasons why they believe credit unions should not be able to help small business-owning credit union members; but their reasons are not supported by facts.

Indeed, there is no sound public policy reason not to increase the lending cap for those credit unions that have the demonstrated capacity to manage it well. Failure to expand the credit union member business lending cap would literally leave money on the table when small businesses need as much help as possible.

Some say business lending is not a part of the credit union mission; but the facts show that credit unions have been doing this business from day one. Some also say increased business lending would undermine credit union safety and soundness; but the facts show that credit unions do this safer and sounder than the banks.

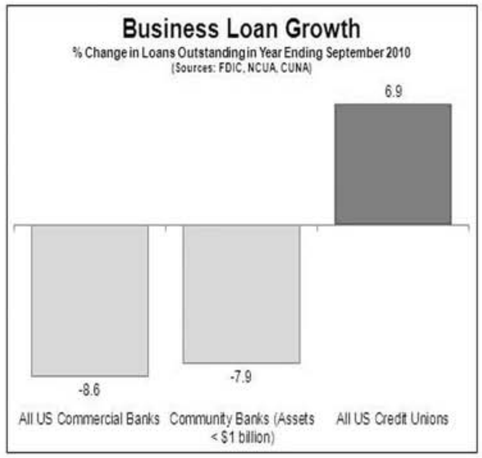
Opponents further argue that increasing the cap will only affect a small number of credit unions while at the same time claiming that increasing the cap will hurt community banks. It is a contradiction – and they are wrong on both accounts. The cap affects every credit union that has a member who looks to them for financing a new or existing small business. Some have active business lending programs; others do not engage in business lending because they view the cap an impediment that does not justify the cost of establishing a sound business lending program in the first place.

Increasing the cap will have a profound effect on the hundreds of credit unions that will reach the cap in the next few years, but it should not adversely affect the banker dominance of the commercial lending market. Credit unions hold just under 5% of the small business loans at all depository institutions, and even less, about 1%, of the total business loan market at depositories. If the cap is increased, that market share might increase slightly – but banks would still have over 90% of the small business loan market. How much market share is enough for the banks that have access to $30 billion of taxpayer money to lend? And more important for small business, given the banks' overwhelming dominance in the marketplace and the taxpayer assistance they have received, why are they failing to meet small business lending needs?

Another faulty argument is that increased credit union business lending will lead to a reduction of other types of credit union lending. However, the fact is that the average credit union has about 26% of its assets in cash and investments, which means if they are permitted to do more lending, they would most likely fund this increase out of excess investment holdings, and not a reduction in consumer lending.

Banker groups talk about the credit union tax status and suggest that credit unions should not be granted an expansion of powers. However, this specious and sidetracking argument ignores the fact that roughly 2,500 banks are Subchapter S institutions, and, like credit unions, have been afforded special federal income tax treatment by Congress. It is more than a little disingenuous for the bankers to use the credit union tax status as an argument against increasing the credit union member business lending cap when one-third of all banks are exempt from federal income tax, these banks are eligible to receive funds under the recently enacted Small Business Lending Fund Act; credit unions have not cost the taxpayer a dime; credit unions fund their own share insurance fund and no credit union member has ever lost a dollar of insured deposits in a federally insured credit union.

Banker groups also say that increased business lending will distract credit unions from serving the underserved. There are many in this country underserved by banks and other financial institutions, and the credit union record on serving these populations is solid. As the nation recovers from this deep recession, it is clear that our small businesses are underserved. Bank business lending portfolios have shrunk while credit unions' have increased.




Credit unions want to meet the needs of their business-owning members, and a Treasury study has found that credit union loans to small businesses go disproportionately to business owners on the lower end of the income scale.[5]

The need for more small business lending is evident; the time for Congress to act is now. Congress recently enacted legislation designed to invest $30 billion of taxpayer money in community banks as part of the solution. Credit unions did not oppose this legislation because we understand that it could help small businesses – if the banks actually use the program. However, there is at least $10 billion of capital in well-capitalized credit unions with business lending experience ready to be loaned if the credit union member business lending cap is increased, and it will cost the taxpayers absolutely nothing.

Senator Mark Udall (D-CO) has introduced legislation (S. 2919) which, if enacted, would increase the credit union member business lending cap from the current level of 12.25% of total assets to 27.5% of total assets. This legislation, which has also been introduced as an amendment to several bills, has been cosponsored by a total of sixteen Senators, and enjoys the support of the Obama administration.[6,7] A similar version of this legislation (H.R. 3380) has been introduced in the House of Representatives by Representatives Kanjorski (D-PA) and Royce (R-CA), and enjoys the support of 127 cosponsors.

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[5] United States Department of the Treasury. *Credit Union Member Business Lending.* January 2001.
[6] Cosponsors of S. 2919 include Senators Michael Bennet, Boxer, Sherrod Brown, Collins, Gillibrand, Lieberman, Bill Nelson, Reid, Sanders, Schumer, Snowe, Specter, and Wyden; additionally, Senators Inouye, Franken and Whitehouse cosponsored S.Amdt. 4906, which is identical to the Administration-endorsed version of this legislation.
[7] A copy of the administration's support letter can be found at: http://www.cuna.org/download/mbl/geithnerltrto_frank0810.pdf.

The legislation establishes a two-tier structure for the credit union member business lending cap. Tier One credit unions would be eligible to engage in business lending to the current cap of 12.25% of total assets. Tier Two credit unions would be required to meet certain criteria and be approved by NCUA, but would then be permitted to engage in business lending to 27.5% of total assets. In order for a credit union to be considered for Tier Two status, the credit union would have to:

- be well-capitalized (currently, at least 7% net worth ratio);
- be at or above 80% of the Tier One cap for one year prior to applying for approval;
- have engaged in member business lending for five years prior to applying; and
- be able to demonstrate sound underwriting and servicing based on historical performance; strong management, adequate capacity to lend, and policies to manage increased business lending.

The proposal calls for Tier Two credit unions to phase in additional business lending by limiting a Tier Two credit union's business lending portfolio growth to no more than 30% per year. NCUA would approve a credit union for Tier Two status using statutory standards, set by Congress, not the regulator. In addition, the proposal states that a credit union that drops below the well-capitalized level would have to stop making new business loans until such time as NCUA determines they are again well-capitalized.

The proposal makes no change to the definition of a business loan, preserving, but not increasing, the current $50,000 *de minimus* threshold. Finally, the proposal directs the NCUA and the GAO to conduct separate studies of credit union business lending and report to Congress three years after enactment.

We believe that this proposal would permit credit unions to help small businesses in need of credit while at the same time ensuring that credit unions engaging in additional business lending are continuing to do so safely and soundly. Many of the new features of this proposal address safety and soundness, and will safeguard the NCUSIF against increased exposure.

We estimate that if this proposal were enacted into law, credit unions could lend an additional $10 billion to small businesses in the first year after implementation, helping small businesses create as many as 108,000 new jobs. This is a job creation proposal that would not cost the taxpayers a dime and would not increase the size of government.

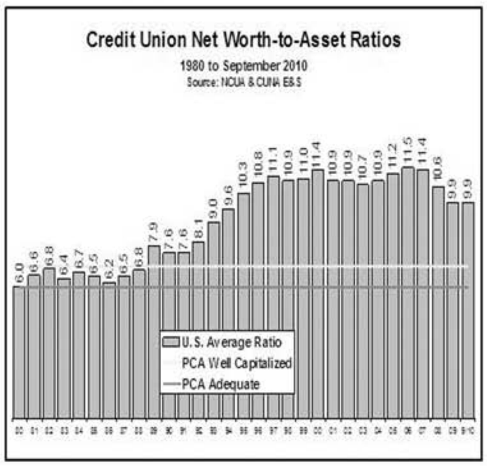
We urge Congress to permit credit unions to do what they were established to do – serve their members, including those who own small businesses. Credit unions have the willingness and capacity to help, but, they need Congress to act now when the need is so great.

***The Need for Credit Union Capital and Prompt Corrective Action Reform***

Credit unions stand out as the only depository institutions in the United States without the ability to issue some form of capital instrument to augment retained earnings to build capital. All other

U.S. depository institutions and most credit unions in other countries are permitted various forms of alternate or supplemental capital.

Despite the restrictions credit unions face in accessing capital, as the chart below shows, credit unions have for the past decade and a half been very well-capitalized. Since 1994, the average capital ratio has been 9% or higher, well above the 7% threshold to be considered well-capitalized for prompt corrective action (PCA) purposes, or the 6% level for adequately capitalized. In all but three of those years the average capital ratio was above 10%. Credit unions have maintained these high capital ratios in order to maintain a sufficient cushion above the PCA thresholds, and because of the relatively risk-averse nature of their cooperative structure.




However, more recently, the financial crisis led to a substantial drop in the average credit union capital ratio, from 11.4% at the end of 2007 to 9.9% as of September 2010. There were two drivers behind this sharp decline: reduced net income and faster asset growth.

Buffeted by rising loan losses caused by the recession and losses from corporate credit unions, net income averaged only 7 basis points (bp) in 2008 and 2009. In sharp contrast, return on assets had been above 80 bp in all but one of the previous 27 years. Second, as credit union members reduced their spending during the recession, credit union savings grew by almost 8% in 2008 and over 10% in 2009. This in turn contributed to strong asset growth in these two years. The combination of above average asset growth and almost nonexistent earnings caused the 1.5 percentage point decline in the average capital ratio over the period.[8]

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[8] The harm the financial crisis has done to credit unions pales in comparison to its effects on many other financial institutions. Of the four largest investment banks that operated before the crisis, two no longer exist, and the other

With a dollar-weighted average capital ratio of 9.9%, the credit union movement as a whole remains very well capitalized, with a cushion of almost 3% above the PCA well capitalized level. However, the financial crisis of the past two years has brought a number of credit unions close to or past the PCA triggers, as is shown in the table below.

**Percent of Credit Union in Various Capital Classifications by Capital Ratio**

| **Year-end** | **2007** | **Sept. 2010** |
|---|---|---|
| Inadequate (Less than 6%) | 0.6% | 2.2% |
| Adequate (6% to 7%) | 0.8 | 3.1 |
| Well Capitalized (Over 7%) | 98.6 | 94.7 |
| 'Merely' Well (7% to 9%) | 7.6 | 19.1 |
| Very Well (Over 9%) | 91.0 | 75.9 |
| **Total** | **100** | **100** |
| **Overall Average Capital Ratio** | **11.4** | **9.9** |

In December 2007, 98.6% of all credit unions were well-capitalized, 0.8% were adequately capitalized, and only 0.6% were inadequately capitalized. By September 2010, the proportion of well capitalized credit unions had fallen to 94.7%, with 3.1% adequately capitalized and 2.2% inadequately capitalized. In addition, the percentage of credit unions "very" well capitalized (capital ratio over 9%) has fallen sharply, from 91% in 2007 to 75.9% in 2010. Therefore, although most credit unions are likely to want to rebuild their net worth ratios somewhat over the next few years, fully one in four is likely to feel a very strong need to do so.

Unfortunately, the need for additional capital comes just at a time when the outlook for the only source of that capital, net income, is not particularly strong. The two factors that sharply reduced earnings during the financial crisis, loan losses and corporate stabilization, will have a diminishing negative effect on earnings going forward. However, other longer term influences on credit union net income are not promising. Net interest income, essentially the difference between what credit unions earn in interest on loans and investments and what they pay in interest and dividends on savings has been on a long-term downtrend caused by intense competition on both sides of the balance sheet. This pressure is unlikely to abate significantly going forward. In addition, interchange income, an important source of non-interest revenue, is under political pressure and is likely to diminish.

The solution for some credit unions has been to discourage deposits from their members or, as in the case of AFTRA-SAG credit union of California, ask high deposit members to withdraw funds from the credit union.[9] These actions are confusing to credit union members, and the

two have become bank holding companies to gain access to borrowing from the Federal Reserve. A number of huge banks and thrifts, and hundreds of medium and small ones, failed. Many others had to be bolstered by government capital infusions. Fannie Mae and Freddie Mac are under conservatorship. From December 2007 to December 2009, the FDIC's coverage ratio (fund balance divided by insured deposits) plummeted from 1.22% to -0.39%.

[9] "AFTRA-SAG Credit Union Tells Some Members to Move Funds." Los Angeles Times. November 24, 2010. http://latimesblogs.latimes.com/entertainmentnewsbuzz/2010/11/aftra-sag-credit-union-tells-some-members-to-move-funds.html

general public, and they are antithetical to the mission of credit unions; nevertheless, they are absolutely necessary given the way that credit union capital requirements work.

The financial crisis has brought into sharp focus the importance of capital for all financial institutions. Some of the institutions that caused the most damage in the crisis were highly leveraged (were funded largely by debt rather than equity). The recently announced Basel III proposals also point to higher capital requirements for most types of financial institutions. As the economy shows increasing signs of recovering, which will allow the financial institutions still standing to also recover, higher and stricter capital requirements are likely to be imposed on financial institutions. Financial institutions themselves are likely to want to hold more capital than they did before the crisis to be better able to withstand a similar event in the future.

These factors—reduced capital ratios, reduced net income, and policy interest in more capital across the spectrum of financial institutions—all suggest that now is the time to address access to some alternate capital for credit unions. As credit unions battered by the financial crisis recover in the coming few years, rebuilding capital ratios will be paramount. Without access to alternate capital, and with earnings power facing headwinds, these credit unions and their members will face a protracted period of reduced member service, disadvantageous member pricing, and very slow growth.[10]

Were credit unions in this situation permitted to issue some form of alternate capital, they could immediately resume normal credit union service, pricing and growth. In the absence of access to alternate capital, current members of such credit unions would have to "pay" disproportionately for the long-term, future health of the credit union by suffering less attractive pricing and growth as the credit union built capital through the very slow process of retaining earnings.

From a public policy point of view, the economic recovery will be facilitated by financial institutions that are willing to grow and expand service. Without alternate capital, credit unions will not be able to contribute nearly as much to financing the economic recovery as they would if they were not preoccupied with slowing growth and increasing net income in order to build the ratio of retained earnings to assets.

The Chairman of the NCUA recently identified the need for alternative forms of credit union capital as a potential safety and soundness issue for credit unions.

Given the demonstrable need for access to alternate capital for credit unions, the question turns to what form or forms that capital should take. Many of the characteristics of alternate capital used by other depository institutions would need to be replicated in versions for credit unions, although there would need to be modifications to account for credit unions' the unique cooperative ownership and democratic governance structure.

[10] For example, it would take nine years for a credit union with a beginning net worth ratio of 5% to reach the 7% well capitalized threshold earning 80 basis points of net income and growing by 10% each year. Cutting asset growth in half would still require 4 years to reach 7%, and another 5 years to reach 9%. In the alternative, if such a credit union could raise loan rates, lower dividend rates and/or raise fees enough to increase its return on assets (ROA) to 1.2%, it would take just over three years to regain a 7% net worth ratio growing by 10% a year, and another five years after that to reach 9%.

Other depository institutions—such as banks and thrifts—have access to a number of types of capital in addition to retained earnings. The alternate capital sources fall into two categories stemming from regulatory capital requirements: Tier 1 and Tier 2. Tier 1 capital includes retained earnings as well as other forms of equity such as fully paid common stock and non-cumulative perpetual preferred stock. Tier 2 capital for banks and thrifts, also called "supplemental capital," can include subordinated debt, debt-like equity instruments such as cumulative preferred stock, and certain types of reserves.

Banks and thrifts use these two tiers of capital as part of a Basel Accord risk-based capital approach as implemented by the FDIC and other U.S. bank regulators under which the amount of Tier 2 capital cannot exceed the amount of Tier 1 capital. Under these rules a bank or thrift's total Tier 1 capital cannot generally fall below a 4% leverage ratio without being subject to prompt corrective action, although sometimes a 3% leverage ratio is allowed. To be "well capitalized" a bank or thrift must have a minimum 5% leverage ratio of Tier 1 capital to total assets, an at least 6% Tier 1 risk-based capital ratio, and an at least 10% risk-based capital ratio relative to Tier 1 and Tier 2 capital combined.

A credit union alternative capital regime could either incorporate the risk-based capital approach or not. For credit unions to benefit from alternative capital under a risk-based capital approach, however, risk-based capital would have to be accompanied by a reduction in credit unions' net worth leverage ratio. The Federal Credit Union Act currently requires credit unions to have a minimum 7% ratio of retained earnings to total assets to be considered "well capitalized," far higher than the 5% leverage ratio required for a bank or thrift to be "well capitalized." Without a reduction in the required leverage ratio, no amount of Tier 2 capital to meet new risk-based requirements would be of any benefit to credit unions in meeting the basic net worth leverage ratio.

Because of the many features, possible characteristics and requirements of alternate capital, there is no single or simple form that would be appropriate for all credit unions seeking alternate capital. There are many possible variations on the theme of allowing alternate capital to augment retained earnings and to provide extra protection for the share insurance fund. Therefore, credit unions would best be served by having as many options as possible so long as these options are consistent with credit unions' cooperative ownership and governance structure, provide real protection to the National Credit Union Share Insurance Fund, are practical yet optional for credit union to acquire, and are only offered in a suitable fashion and with meaningful disclosures.

Types of possible credit union alternative capital include credit union membership shares, optional debt or equity investments made by members, or subordinated debt from non-members.

Low-income credit unions, for instance, already have access to alternative capital in the form of subordinated debt-- which essentially counts as the equivalent of bank "Tier 2" capital -- and this approach could be expanded to all natural-person credit unions. Also, all credit unions currently require a member to invest in at least one perpetual membership share, usually in an amount between $5 and $50, which is withdrawable only if the member leaves the credit union's membership; this perpetual membership share would generally meet the definition of "Tier 1" capital under the rules applicable to banks and thrifts. Further, optional investments made by members could either be classified as Tier 1 or Tier 2 capital depending on the terms of those products.

A compelling case can be made that under appropriate rules and guidelines that preserve the cooperative ownership and governance of credit unions, access to alternate capital would be good for credit unions, their members, and the economy. Given the importance of adequate capital to the nation's federal deposit insurance systems, extending authority to credit union regulators to permit access to alternate capital would also provide additional protection to the U.S. taxpayer. We encourage Congress to amend the Federal Credit Union Act to permit alternative capital for credit unions and we look forward to working with the Committee on this issue in the next Congress.

***Corporate Credit Union Stabilization***

One of the most significant challenges facing the credit union industry today is the resolution of the corporate credit union situation, which was the result of losses on investments in mostly private label mortgage-backed securities held by some corporate credit unions. (Corporate credit unions provide investment, credit, settlement, payment and other correspondent services for natural person credit unions).

At the time of their purchase, these securities were permissible investments and top rated. Examiners who were on site at the largest corporate credit unions did not flag these investments or require changes in corporate credit unions' risk management policies regarding such investments.

In any event, during the most significant financial crisis of the last 80 years, the market for these securities began to collapse, and NCUA was forced to take action to stabilize the corporate credit union system. Such actions, which began in January 2009, included:

- Obtaining additional resources for the Central Liquidity Facility to ensure liquidity remained in the credit union system.
- Providing $1 billion to the largest corporate credit union, U.S. Central, to ensure adequate liquidity.
- Fully guaranteeing deposits in corporate credit unions through December 31, 2012.
- Helping to create the Corporate Credit Union Stabilization Fund to manage the costs associated with corporate credit unions that had problem assets.
- Conserving five corporate credit unions that held the majority of troubled assets (the smallest of those corporates has now been merged.)
- Isolating the troubled assets in asset management estates until the loses are resolved and operating the core functions of the remaining conserved corporate credit unions as bridged corporate credit unions.
- Implementing long-term funding to spread out the costs to credit unions of paying for the corporate stabilization efforts through the creation of a securitization trust

that issues notes collateralized by the cash flows on the troubled assets and are fully guaranteed by the U. S Treasury.

- Issuing a comprehensive regulation setting new standards for capital, investment limitations, corporate governance and other key issues for corporate credit unions.

In general, credit unions have been pleased about the agency's handling of the troubled assets held by some of the corporates. However, NCUA could not have undertaken that initiative or the other actions to address corporate credit union problems without the support of Congress, the U. S. Treasury, and in some measure, the Federal Reserve Board. Credit unions appreciate this support, particularly the ability to spread out the costs of the corporate stabilization fund and the guarantee by the U. S. Treasury for the notes.

NCUA estimates total remaining costs to credit unions of the stabilization of the corporate credit union losses will be about $8.1 billion. NCUA arrived at that estimate based on the following:

- The total estimate of future credit union losses for the five corporate credit unions that were conserved, which is around $15 billion;
- Minus the $5.6 in capital at corporate credit unions that has already been used to absorb losses;
- Minus the $1.3 billion in assessments that have already been paid by credit unions for corporate stabilization, which brings the amount the credit union system must fund to $8.1 billion, which can be paid for over 11 years.

In October, the NCUA Board announced that the ranges for the NCUSIF premium for 2011, to help deal with natural person credit union issues, will be 0-10 basis points, and the Corporate Credit Union Stabilization Fund projected assessment will be 20-25 basis points. CUNA does not challenge the NCUSIF premium projection, although credit unions would like the premium to be as close to zero as possible. However, we do have concerns about the projected assessment for the Stabilization Fund, which may be front-loaded to help NCUA meet short-term liquidity needs -- seemingly counter to the objective to spread out the costs.

We appreciate that NCUA is considering whether credit unions could prefund assessments. Meanwhile, in light of Congress' support for credit unions to have ample time to fund the corporate stabilization costs in order to mitigate the impact on their operations, we urge NCUA to be vigilant in insuring those costs will be minimized and distributed appropriately over the 11-year period that is now permitted. We also urge Congress to maintain its oversight to help ensure those outcomes are achieved.

In addition to concerns about the corporate credit union stabilization program, credit unions need continued access to the crucial payments and settlement functions that the corporates have provided. NCUA's new regulation will require corporates to operate with very small balance sheets, concentrating on offering services on a fee basis, including payments, settlement, investment advisory and broker dealer, and arrangements for liquidity. CUNA and credit unions are nbusy working on ensuring that access to these services for credit unions is preserved.

The future of corporate credit unions depends in part on the success of the implementation of the final corporate rule and the performance of the agency's plan for dealing with the troubled assets of some of the corporates, including spreading out the costs to natural person credit unions.

However, whether or not corporates are willing and able to make the deep and far reaching changes necessary to succeed going forward will have the most profound impact on their future. These fundamental changes in corporate credit unions need to be driven by the members, boards, and management of corporate credit unions.

To further facilitate the resolution of the corporate credit union system and the recovery of natural person credit unions affected by the financial crisis, NCUA has proposed a series of technical amendments to the Federal Credit Union *Act* related to the TCCUSF, the NCUSIF equity ratio and the definition of "net worth" under prompt corrective action. In general, CUNA supports these recommendations. In particular, we appreciate the agency recommending an amendment to the definition of "net worth" that will permit credit unions to count assistance provided under Section 208 of the FCU Act.

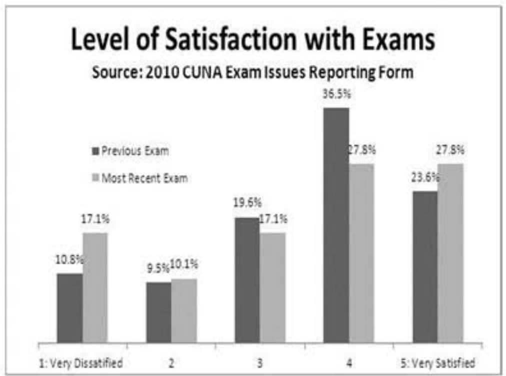
We are also aware that NCUA may ask Congress to propose language that would revive expired legal claims, giving NCUA the ability to bring action on *any* claim on which the statute of limitations has expired, up to 10 years before the Board becomes the conservator of a credit union or liquidates it.

Congress should <u>not</u> approve this proposal for several public policy reasons. Most important, we are concerned that extending the statute of limitations authority would threaten the ability of credit unions to attract volunteers to serve on their boards. Moreover, it would likely not result in significant recovery of losses because, quite frankly, individual credit union officials are not likely to have the means to pay appreciable judicial awards.

Also, it would expand NCUA's authority beyond the similar authority Congress has granted to the Federal Deposit Insurance Corporation, which can resurrect claims up to 5 years before conserving or liquidating a bank. In addition, FDIC's authority is limited only to fraud and intentional misconduct, while NCUA proposes authority to pursue *any* alleged violation of law brought against any official of a credit union or third party involved in the affairs of the credit union. Further, NCUA's statute of limitation proposal raises important constitutional questions of the application of a retroactive statute of limitations that would have otherwise expired. For these reasons, the NCUA proposal represents agency overreaching, and we urge Congress to reject it.

***Supervisory Issues***

The regulatory environment for financial institutions, including credit unions, has changed dramatically, largely as a result of the economic recession and the subsequent weak recovery. In this climate, credit union and bank regulators are placing many more demands on the performance of the institutions they supervise and regulators have reported increased supervisory issues, many of which relate directly to the economic crisis.




All credit unions and their members deserve and benefit from strong, reasonable safety and soundness supervision. Yet a healthy, robust credit union system depends on a reasonable balance between safety and soundness , i.e., the regulators being able to do their jobs fairly on the one hand, and credit union managers and officials being able to perform their duties independently on the other, and both performing their duties competently and professionally.

Undoubtedly some institutions' problems, particular those that stem from difficult economic times, warrant heightened scrutiny, increased attention to risks, and improved internal controls. Yet, a number of credit unions from around the country, including those that are well-managed and well-capitalized, are raising concerns that their examiner has placed unreasonable demands on their operations, according to a recent study conducted by CUNA. In response, CUNA is developing guidance and resources for the credit union system regarding the examination process and supervisory expectations, including how to appeal examiner decisions and agency actions. Meanwhile, this Committee should work with regulators to insure financial institutions have the ability to manage their risks without being directed by examiners to eliminate it.

***NCUA Budget***

Credit unions are also concerned about the recent 12% increase in NCUA's 2011 budget—to a total budget of $225.40 million—over its 2010 level. Employee pay and benefits account for

72%, or $163.19 million, of NCUA's 2011 budget, which includes the addition of 78 full time employees—including 53 examiners and 6 supervisory examiners.

NCUA is funded by federally-insured credit unions through two mechanisms: (1) the "overhead transfer rate," which is a transfer of more than half of the National Credit Union Share Insurance Fund's (NCUSIF) annual earnings to NCUA each year to pay much of the agency's administrative expenses; and (2) via assessments on federal credit unions called an "operating fee."

The NCUSIF is capitalized with assets belonging to all federally-insured credit unions, so transfers of the NCUSIF's earnings to NCUA increase the likelihood and magnitude of share insurance assessments on federally-insured credit unions, and reduce the chances of a NCUSIF dividend to those credit unions. NCUA is increasing the 2011 "overhead transfer rate" to 58.9% of the NCUSIF's annual earnings from the current 57.2%, although the agency did also reduce the 2011 "operating fee" assessed on federal credit unions from its 2010 level.

In addition, however, NCUA is estimating significant assessments on federally-insured credit unions in 2011. At its November Board Meeting, NCUA forecasted a 2011 NCUSIF assessment of 0-10 basis points, and a 2011 Stabilization Fund assessment of 20-25 basis points. Combined, the total assessment will likely be between 20 basis points and 35 basis points.

NCUA's budget increases come at a time when most credit unions are cutting back on their own expenses, and we question whether costs such high salary adjustments are justified, especially in light of President Obama's proposed two year pay freeze for federal employees and the significant NCUA assessments forecasted for federally-insured credit unions in 2011.

***Concerns about the Regulation of Debit Card Interchange***

Credit unions continue to be very anxious about the implementation of the interchange provisions of the Dodd-Frank Act – in particular two broad provisions that amended the EFT Act, the exemption for small issuers under Subsection 920(a)(6), and the routing and exclusivity measures under Subsection 920(b)(1).

Because credit unions are under growing pressure to build net worth as a result of the current economic situation, the issue of fee income is an important one. That is because under prompt corrective action statutory provisions, credit unions may only build capital through retained earnings, which includes fee income, such as debit interchange fees. About 70% of the nation's 7,700 credit unions offer debit card programs.

The language of Section 920(a) and the legislative history associated with the Durbin amendment make it clear that Congress intended to protect small issuers' debit transaction fee income from the letter of the interchange rule as well as from its impact.

Since well before the enactment of the Dodd-Frank Act and consistently since, CUNA has been meeting with our members, payment network representatives, and key congressional officials, in addition to our communications to the Federal Reserve Board. A major focus has been on how to implement the exemption in a manner that will make it as meaningful for small issuers, as Congress intended. Also, nothing in the Act requires the merchant to pass on savings it might receive as a result of interchange regulation and it is reasonable to assume that consumers may not reap any benefits from debit interchange regulation.

We believe the Board has the statutory authority to help ensure the exemption is meaningful, if it will use it. Under Section 920(a)(1), Congress directed the Board to write regulations on interchange transactions fees "to prevent circumvention or evasion of this subsection." This language provides authority for the Board to help ensure the exemption for small issuers is reasonably implemented.

In that connection, monitoring the development and implementation of how the networks are accommodating small issuers would be an important role for the Federal Reserve Board to play in promulgating the interchange provisions.

However, while monitoring by the Board of the networks' efforts to accommodate small issuers would be extremely useful, the statutory purpose of the exemption for small issuers will be frustrated if merchants are allowed to direct the routing of debit card transactions in a manner that disadvantages small issuers.

CUNA realizes that the exclusivity and routing provisions in Section 920(b)(1) do not include an exemption for small issuers. However, if the Board in implementing these provisions is not mindful of their impact on small issuers, merchants' ability to steer transactions to the lowest cost networks could negatively impact interchange fee income for small issuers.

Under Section 920(b)(1), the Board must regulate the prohibition on exclusivity arrangements, which prohibits networks and issuers from limiting the number of networks on which a debit card transaction may be processed to only one (or 2 affiliated networks). How the Board implements the prohibition will significantly impact debit card interchange income for small issuers.

Credit unions are very concerned about the costs they will have to incur if they need to participate in more networks than they do currently. We urge the Board to do all it can in issuing the regulation on this section to minimize issuers' costs.

We also believe more time to implement the interchange provisions would be extremely useful. In light of the significant disruption to interchange programs that could occur for small issuers, we urge this Committee to work with the Board to support a delay and/or changes that will accommodate smaller issuers' interests, as we key members of Congress said they wanted to do.

***Regulatory Burden***

Regulatory burden is as old but growing issue of concern for credit unions. Every minute a credit union spends filling out a form of questionable utility or complying with a redundant or overly burdensome rule is time that should be spent meeting their primary, statutory mission -- serving their members.

As with other smaller financial institutions, a significant number of credit unions have very limited staff, many of whom have multiple responsibilities and tasks. For all credit unions, it has been extremely difficult to monitor and prepare for the burdens resulting from the onslaught of new rules that have been issued over the past several years, as well as the myriad of new rules that will be implemented under the Dodd-Frank Act. Some have called this expanding regulatory burden on credit unions a "creeping crisis of complexity" which may, in many ways, be partly responsible for increased credit union consolidation. Smaller credit unions increasingly find that high compliance costs make it difficult for them to continue serving their members without merging into a larger credit union to achieve economies of scale. In fact, CUNA's Small Credit Union Committee recently identified regulatory burden as the number-one issue facing small credit unions.[11]

Just since the beginning of 2008, credit unions and other financial institutions have been subjected to new, and very significant, requirements with regard to mortgage lending, credit cards and other types of open-end lending, internet gambling, the Bank Secrecy Act rule changes, the Fair and Accurate Credit Transactions Act, gift cards, overdraft protection plans, student loans, and accounting pronouncements issued by the Financial Accounting Standards Board. There have also been a number of NCUA rules that impact credit unions uniquely, such as field of membership changes. Just in 2010 alone, 32 new rule changes have taken effect for credit unions.

Going forward, new rules under the Dodd-Frank Act include, in addition to the new limitations on interchange fees, additional data collection requirements on consumer loans, a range of new substantive and disclosure requirements under the Truth in Lending Act and the Real Estate Settlement Procedures Act, additional disclosure requirements for remittances, executive compensation rule, and new Home Mortgage Disclosure Act reporting requirements. In addition, the new Consumer Financial Protection Bureau will likely issue new and modify other existing consumer protection rules as the Bureau supplants the Federal Reserve Board as the primary regulator in this area.

[11] CUNA Small CU Committee Ten Year Review (December 2009) http://www.cuna.org/initiatives/small_cu/download/10yr_review.pdf

CUNA wants to be clear that we support the objectives of many consumer protection rules. However, we urge regulators and Congress to be constantly mindful that the total regulatory burden being imposed on financial institutions today is horrendous and piling on additional regulations without consideration for the requirements already in place is counterproductive.

We urge the Senate Banking Committee to make this nonpartisan issue a priority and to hold hearings in 2011 on steps that can be taken by the regulators and Congress to achieve meaningful safety and soundness regulation and reasonable consumer financial protections without putting financial institutions out of business in the process. We would welcome the opportunity to work with the Committee in this important endeavor.

***Government-Sponsored Enterprises***

CUNA President and CEO Bill Cheney met recently with representatives of the U. S. Treasury Department on GSE Reform. CUNA has formed a GSE Reform Working Group and will be providing recommendations to Treasury by the end of the year.

While the CUNA group is still formulating its full set of recommendations, it has identified a number of preliminary principles that could form a solid foundation for ensuring a sustainable housing market well into the future. These principles include:

- The secondary market going forward must provide equitable access to credit unions, without discrimination. To the extent this includes new investments and features, such as covered bonds, credit union will need access to alternative capital.
- A goal of the future housing finance system should be to provide a reliable supply of mortgage loans in all types of economic environments, at affordable rates, that will allow borrowers to obtain access to such loans within the bounds of proven underwriting.
- The new housing finance system must be flexible to the extent it provides a variety of finance options to meet the needs of different types of consumers and housing types. The secondary market should support both portfolio lenders and secondary market participants.
- Entities providing secondary market services must be subject to strong regulatory and examination oversight to ensure safety and soundness, including strong capital requirements. These entities should also be permitted to innovate and develop new programs and technologies, consistent with their mission.
- The governance structure of the new entities providing secondary market services should ensure that credit unions are well represented on the boards of directors. This could also include, for example, advisory boards comprised of credit unions and others that would provide information and advice regarding the operations of these new entities.
- The process of mortgage asset securitization must be transparent, verifiable, and subject to sufficient regulatory oversight, for both federally-guaranteed and private label securities.
- To ensure a strong housing finance system in the future, there must be sound underwriting for all mortgage loans. To ensure this result, all loan originators, such as brokers, should be licensed and subject to the same regulatory, supervisory, and enforcement requirements that apply to credit unions.

- Legislation and regulations implementing the new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans.
- Any transition from the current to a new housing finance system must be carefully planned and well-executed, and credit unions will need sufficient time to prepare for these changes so that members are not negatively impacted. This transition plan must carefully consider the impact on the economy and the consequences if this is not well-executed.

CUNA is aware that GSE reform will be a priority in the next Congress, and we urge that these concerns be taken into full consideration as Congress deliberates on the future of the GSEs. We would be glad to share our final report and recommendations with this Committee and would welcome the opportunity to follow up with on this very important issue early next year.

**Conclusion**

As this statement details, credit unions are generally healthy in the face of the economic downturn and lumbering recovery, despite the fact that the credit union system has not totally escaped the impact of the financial crisis.

Even as credit unions collectively fund NCUA's corporate credit union stabilization efforts and individually seek to maintain robust levels of capital/net worth, they are anxious and eager to do more to serve their members, support their communities, and help the economy recover.

However, credit unions cannot do this without help from Congress and regulators.

Continued support for the credit union tax exemption is essential, because without it credit unions will lose their incentives to continue as credit unions and consumers will lose an important alternative to commercial banks. We appreciate that NCUA Chairman Debbie Matz has communicated her strong support for the exemption to Congress.

In addition, increased small business lending authority as well as alternative capital and capital reform are new tools that Congress should provide to credit unions as soon as possible to help insure small businesses have access to affordable credit and the services consumers need at favorable rates will continue to be provided in the financial marketplace We also urge Congress to ensure interchange statutory provisions are implemented to protect small issuers and to be mindful of the needs of credit unions when it considers GSE reform.

Of course regulators, including NCUA, also have critical roles to play, such as ensuring regulations do not overwhelm institutions with counterproductive requirements that frustrate rather than fulfill congressional directives. Further, more attention needs to be given to holding down agency costs, allowing financial institution boards to exercise their sound business judgments, and ensuring institutions are allowed to innovate and respond to the changing needs of their members/consumers.

Thank you again for holding this important hearing and for the opportunity to share our views and perspectives on the issues facing the credit union system.

**STATEMENT SUBMITTED BY THE AMERICAN BANKERS ASSOCIATION**

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, the American Bankers Association appreciates the opportunity to submit this statement for the record—for the December 9, 2010, Senate Banking Committee hearing entitled “The State of the Credit Union Industry.” The American Bankers Association (ABA) represents banks of all sizes and charters and is the voice for the Nation’s $13 trillion banking industry and its two million employees.

There are several key points we would like to make in this statement:

- Even though credit unions pay no Federal taxes, the industry received taxpayer assistance to resolve insolvent corporate credit unions.
- Raising the credit unions legal business lending cap is not necessary for credit unions to meet members’ credit needs. Moreover, expanding the lending cap is inconsistent with the credit union mission and raises serious safety and soundness concerns.
- Alternative or secondary capital is not appropriate for credit unions. It would dramatically change the focus of credit unions away from member-owned to a market-driven capital structure, and would force credit unions to generate a level of return necessary to attract such capital—all of which will negatively impact credit union members.

Credit unions, like many in the banking industry, have suffered losses as the recession took hold and unemployment dramatically increased. For the credit union industry, several multi- billion-dollar corporate credit unions (which were designed to provide investments and financial services to smaller, “natural person” credit unions) dramatically increased their level of risk and ended up failing. This caused severe losses to the National Credit Union Share Insurance Fund and created an environment where many smaller credit unions could fail. Even though credit unions pay no Federal taxes—a privilege bestowed on credit unions in order to focus their lending on “people of small means”—the credit union industry sought taxpayer help to facilitate the repayment of these losses. [1]

This assistance, like many other special programs related to banking and financial institutions, was appropriate for that time. It appears that now, however, some credit unions are using the financial crisis and the recession to argue for more business lending authority and access to alternative sources of capital. Credit unions argue that these greater authorities would enable them to meet the needs of small businesses seeking credit. *Such arguments are simply not true.* Under current law, business loans under $50,000 do not count against the aggregate business loan cap of 12.25 percent of assets. Moreover, the guaranteed portion of Small Business Administration loans does not count against the aggregate business loan limit. Thus, *there is considerable opportunity under current law for credit unions to meet the needs of small business.*

In addition, only a small percentage of credit unions—*one-half of one-percent*—are at or near the congressionally mandated cap. Thus, even for larger business loans in excess of $50,000, there is little constraint on credit union lending except for these small numbers of large, fast-growing, profit-seeking credit unions.

The real goal of expanded business lending is for some aggressive credit unions to make even more *large* dollar loans—such as loans for luxury golf and condominium developments. For some aggressive credit unions, it is not unusual for them to make multimillion dollar loans. A dramatic example of just how far these credit unions have gone is the financing of Thumper Pond, a resort development in Minnesota that went bankrupt. This luxury resort featured a golf course, spa, water park, hotels, and a planned condominium community. The resort was financed by a large commercial loan made by Spire Federal Credit Union. Not only is this far beyond any sensible definition of modest means, but the resort is located over 200 miles from the credit union’s headquarters. Is this the kind of loan that should be tax-subsidized?

Such loans are clearly counter to the chartered mission of serving people of small means. It is leveraging the tax-exemption to provide loans to large businesses that have plenty of credit options available through taxpaying banks. *This credit union tax expenditure is neither focused nor contained; it takes revenue from banks that compete for these same loans—revenue that would be taxed and would help to offset some of the current Federal budget deficit.*

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[1] *See,* Appendix B for details on the taxpayer assistance which benefited the credit union industry. The mission of credit unions to serve people of small means was articulated in the preamble to the 1934 Federal Credit Union Act.

Lifting the business lending cap also raises serious safety and soundness concerns. As credit unions have aggressively pursued business lending options, business loan delinquencies have risen and some credit unions have failed. In fact, just a few weeks ago (November 23), the NCUA's Office of the Inspector General (OIG) released a report summarizing the 10 costliest natural person credit union failures. *In 7 of these 10 failures, business lending contributed to the failure.* [2]

Moreover, the General Accountability Office in 2003 warned about the danger of business lending by credit unions and it was skeptical that NCUA was up to the challenge to monitor the expansion of credit union business lending. [3] It should be no surprise that the Inspector General's Material Loss Review found adequate oversight often missing: business loans were made to nonmembers; credit unions exceeded the legal Member Business Loan cap of 12.25 percent; credit unions violated the loan-to-one borrower limit; and credit unions made business loans without a Member Business Loan policy. Expanding credit union business lending only encourages larger, riskier loans, without any assurance of adequate oversight.

Just as business lending is not the answer to the misfortunes of credit unions, neither is access to alternative or secondary capital. In fact, it will blur the line between credit unions and other depository institutions. By granting credit unions the ability to issue secondary capital, the capital structure of the credit union industry would fundamentally change. This would potentially permit any credit union to issue secondary capital to members and nonmembers alike. By moving away from the concept of "*member-owned*" equity towards a reliance on capital contributions from nonmembers and the broader marketplace, the very essence of a credit union's ownership structure is called into question. It would force credit unions to generate a level of returns necessary to attract such capital and therefore would be a costlier source of funds. Not only does this dramatically change the focus of credit unions away from serving their membership towards a market-driven capital structure, it also raises a host of corporate governance concerns, such as voting rights of holders of such ownership stakes, board composition, *etc.*

Moreover, granting all credit unions the ability to raise alternative capital may negatively impact the ability of low-income credit unions to attract capital. Low-income credit unions would have to compete with other credit unions for this additional capital, thus, raising their cost of capital and making it more difficult to fulfill their social mission.

NCUA will point to where credit unions in Australia and Canada have the ability to issue alternative capital. It should also be noted that *credit unions in Australia and Canada are taxed.* The lack of taxation of credit unions in the United States is the key difference.

Finally, Congress, Treasury, and the GAO have questioned the need for alternative capital. In 1998, Congress specifically reinforced its view that credit unions, in maintaining their distinct character, should rely upon retained earnings to build net worth, while not issuing capital stock. For example, the report of the Senate Banking Committee [Rept. No. 105-193, p. 12] states that the "NCUA [National Credit Union Administration] must design the system of prompt corrective action to take into account that credit unions are not-for-profit cooperatives that (1) do not issue capital stock, and (2) must rely on retained earnings to build net worth." This was reinforced by Emil Henry, former Assistant Secretary of the Treasury for Financial Institutions, who noted in 2006 that the ability to "raise equity capital by increasing retained earnings . . . is an important feature that is grounded in the cooperative nature of credit unions." And in 2004, GAO found that there was no compelling evidence for alternative or secondary capital for credit unions.

In conclusion, while the common perception about credit unions is that they are small mom-and-pop operations, the reality is that there are *167 credit unions that have over $1 billion in assets.* To put that in perspective, *these credit unions are larger than 91 percent of the taxpaying banks in this country.* Moreover, the traditional credit unions are being squeezed out by the invasive tactics of these growth-oriented credit unions. It is no surprise that over 2,600 credit unions have been absorbed into larger credit unions since the beginning of 2001.

While the rhetoric suggests that without greater business lending or capital authority there are no options for these institutions to grow and better serve their customers, the reality is that a very viable option is available *today* through switching to a mutual savings bank charter—a route that some credit unions have already taken. This charter provides greater flexibility, still preserves the mutual-member

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[2] Appendix A provides more details about what the Inspector General discovered.

[3] Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management. General Accounting Office, October 2003 (GAO-04-91), p. 49.

focus that credit unions find desirable, and is accompanied by the effective and experienced supervision of traditional banking regulators. This savings bank charter would give these credit unions the ability to expand their business lending and retain their mutual structure. *However, NCUA actively impedes the ability of credit unions to engage in charter choice.* Removal of NCUA's obstructionism is a far better alternative to enabling more business lending and access to alternative capital than a wholesale change in powers that will benefit only a small proportion of large credit unions. Facilitating conversion to a mutual savings bank charter will benefit those credit unions that have outgrown their charter, and will also improve the fiscal position of the United States as these entities pay their fair share of taxes.

Congress is rightfully concerned about the state of the corporate credit unions in receivership and the significant costs their rescue imposes on the rest of the credit union industry. While the taxpayer assistance was appropriate for the circumstances, it is ironic that taxpayer dollars would be used to support an industry that has not paid a single dollar in Federal taxes. The answer to the stresses currently suffered by credit unions is not to increase business lending powers or allow alternative forms of capital. Nor are these necessary to meet the credit needs of businesses. The fact is that there is ample authority under existing law to meet credit unions small business member needs. Equally important is that expanding the lending cap is inconsistent with the credit union mission and raises serious safety and soundness concerns. Similarly, alternative capital may sound appealing, but it would dramatically change the member-owned focus of credit unions to a market-driven one, which ultimately will negatively impact credit union members.

Against a backdrop where nontraditional credit unions forsake the common bond in favor of fast growth, and where energies are diverted to favoring the well-off and businesses rather than meeting their chartered obligation to serve people of modest means, it is no surprise that ABA opposes expansion of credit union powers. To allow such expansion will only move the new breed of credit unions further and further away from their mandated mission.

## Appendix A

### Business Lending Helped Lead to Credit Union Failures

The NCUA Office of Inspector General's Capping Report on Material Loss Reviews (MLR) found that the concentration of Member Business Lending (MBL) was a frequent area of concern. Of the ten MLRs that were reviewed for the report, the MBL issue was a factor in seven of the credit union failures. The table below explains each credit union's MBL problem.

| Credit Union | MLR Issue: Member Business Lending |
|---|---|
| Huron River Area CU | Management violated NCUA's MBL limits by failing to limit its aggregate net MBL balance to the lesser of 1.75 times its net worth or 12.25 percent of its total assets. Based on Huron's December 2006 net worth and total assets of approximately $41 million and $363 million, respectively, Huron's MBL balance should not have exceeded approximately $44 million. As of February 2007, NCUA determined Huron had approximately $187 million worth of MBLs in its Florida construction loan portfolio, an amount over four times the statutory limit. |
| Norlarco CU | Management allowed some borrowers to own multiple properties - some on the same street, which were not reported as member business loans. By December 2006, the credit union's MBL balance was approximately $39 million, or 1.15 times its net worth and 10.9 percent of its total assets, which was within NCUA's statutory limits. After reclassifying the loans, the MBL balance increased to $86.7 million, nearly three times it's net worth and double its statutory limits. The credit union's ratio of MBLs to assets was more than 24 percent. Although examiners did not have accurate information regarding the credit union's MBL balance because of misclassified MBLs, examiners failed to recognize the borrower's intent was often misrepresented on the loan applications underwritten by the credit union's third-party provider, First American. In fact, not until the credit union was placed in NCUA's Special Actions did NCUA officials learn that management's internal controls over the RCL program were so lax that the Board and management failed to recognize the vast majority of the loans in the RCL portfolio were for investment purposes. Additionally, officials in Special Actions determined some borrowers owned multiple properties - some on the same street, which were not being reported as member business loans (MBLs). As a result, NCUA Special Actions required management to reclassify every construction loan as a MBL until each borrower could be contacted to verify the intent of their loan. |
| High Desert FCU | Management did not have an adequate MBL policy, particularly related to equity requirements and lack of proper recordkeeping to monitor compliance with an MBL waiver issued in August 2003, and ensuring income verification for MBL borrowers. Although examiners identified the credit union's MBL issues such as underwriting and permissible MBLs through DORs in every examination from 2003 through 2008, examiners did not draw management's attention to the fact that the credit union's DOR issues were repeat issues that should have been addressed more timely. |
| Eastern Florida Financial CU | Management violated numerous MBL regulatory limits. Also, MBL underwriting was not robust. Approximately $51 million of the MBL balances remained on the credit union's delinquency report for the first three Call Report cycles in 2008. One of the larger MBLs in delinquent status was not properly classified in the credit union's Call Report resulting in an understated delinquent loan ratio. Examiners needed earlier and stronger supervisory action, which may have influenced the credit union's Board and management to limit the significant level of risk assumed during the institution's rapid growth period, especially in their CDO leverage strategy and MBL activities, where they suffered the largest losses that caused the failure. |
| Clearstar FCU | Management continued to make MBLs despite being undercapitalized, a violation of NCUA Rules and Regulations. |
| Ensign FCU | Management violated NCUA Rules and Regulations over member MBL limitations for construction and development loans, MBLs to one individual or associated group, and aggregate MBLs, respectively. All repeat violations from a prior examination. |
| St. Paul Croatian FCU | Management had no MBL policies in place despite having MBLs in the portfolio. |

Source: NCUA OIG Capping Report on MLRs, 10/20/10

## Appendix B

### Credit Unions Have Received Taxpayer Assistance to Facilitate Repayment of the Cost of Corporate Credit Union Failures

Financial problems at corporate credit unions have imposed a significant cost on federally-insured credit unions (FICUs) and caused NCUA to seek taxpayer assistance to ameliorate the cost.

In 2009, NCUA estimated that the initial cost of resolving troubled corporate credit unions would impose a one-time 99 basis point NCUSIF assessment on FICUs – 30 basis point (bp) premium assessment and 69 bp write down of their one percent NCUSIF capitalization deposit. Testifying before a House Financial Services Subcommittee on May 29, 2009, NCUA Chairman Michael Fryzel stated that the 99 basis point cost to FICUs would reduce each credit union's return on assets by 72 bps and net worth by 65 bps.

As a result, NCUA went to Congress in the Spring of 2009 seeking the creation of a Temporary Corporate Credit Union Stabilization Fund (TCCUSF). Section 204(f) of Helping Families Save Their Homes Act of 2009 (Public Law 111-22) authorized the establishment of the TCCUSF by amending Title II the Federal Credit Unions Act. The TCCUSF authorized NCUA to borrow up to $6 billion from the Treasury on a revolving basis. The TCCUSF must repay the Treasury all amounts borrowed with interest; but the TCCUSF would have discretion as to the timing of each repayment and the amount of principal included with each repayment. The TCCUSF would make assessments on FICUs as it determined necessary to make each repayment. The TCCUSF must be shut down seven years after its initial borrowing; however U.S. Department of Treasury extended the operation of the TCCUSF through 2021.

In a June 2009 letter to FICUs, NCUA wrote that both the NCUSIF and FICUs benefitted from the creation of the TCCUSF. The TCCUSF "allows the Board to improve the NCUSIF's equity ratio to better position the NCUSIF to cover future insurance losses. Essentially, it means insured credit unions will not bear a significant, current, concentrated, onetime burden for stabilizing the corporate system."

With the creation of the TCCUSF, NCUA has tapped its line of credit at the Treasury to resolve the five failed corporate credit unions. Aggregate borrowings could be as high as $9 billion to $10 billion.

**STATEMENT SUBMITTED BY MARY MARTHA FORTNEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS**

The National Association of State Credit Union Supervisors (NASCUS) appreciates the opportunity to provide a submission for the record of the December 9, 2010, Senate Banking Committee hearing "The State of the Credit Union Industry."

NASCUS, the professional association of State credit union regulators, has been committed to enhancing State credit union supervision and advocating for a safe and sound State credit union system since its inception in 1965. NASCUS and State regulators would like to take this opportunity to brief the Committee on a needed critical reform: natural person credit union access to supplemental capital.

As this Committee knows, the credit union capital structure is unique among financial institutions. Credit unions can only rely on retained earnings for capital growth, an archaic structure that does not allow credit unions to raise capital in times of need. The current economic environment facing credit unions only reinforces NASCUS and State regulators' steadfast support of supplemental capital access for natural person credit unions. NASCUS and State regulators have believed for years that supplemental capital is appropriate for credit unions, a necessary tool for safety and soundness and critical to the credit union system's long term health and sustainability.

In addition to the general economic impact, credit unions are paying for the deterioration of the corporate credit union network through assessments to the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) at an estimated total cost of $13.9–16.1 billion spread across 10 years. This is putting additional stress on credit union balance sheets already challenged by a restrictive capital regime.

As evidenced by the development of the third iteration of Basel standards, international regulators are capital planning far into the future and addressing prospective capital considerations for banks and other financial institutions. What are U.S. credit unions doing as far as capital planning for the future? Unfortunately, relying on just retained earnings for net worth does not provide needed flexibility for capital planning. Credit unions cannot thrive and compete under these archaic capital standards.

Non– low income, natural person credit unions remain virtually the only class of depository institutions denied access to supplemental capital. This distinction carries enormous implications for natural person credit unions' ability to manage both the current economic climate, but also the eventual economic recovery. Further, from a regulatory standpoint, a well managed supplemental capital program can provide increased systemic stability, additional balance sheet management tools and an extra buffer to mutualized losses.

NASCUS encourages this Committee to make the necessary changes to the definition of net worth in the Federal Credit Union Act to allow access to supplemental capital. Following the legislative change, State and Federal regulators would establish prudent regulatory standards for supplemental capital. However, State and Federal regulators would not be starting from scratch—there are supplemental capital models in use around the world, and NCUA and State regulators have studied the regulatory considerations for its use in the United States.

For NASCUS and State regulators (many of whom are familiar with supplemental capital through bank regulatory responsibilities) achieving capital reform has long been a matter of safety and soundness. Increased capital and investor discipline can provide critical buffers during economic downturns. We believe credit unions can manage the complexities of supplemental capital. We know that State regulators can manage its regulation.

NASCUS urges this Committee to make credit union access to supplemental capital a priority in the upcoming Congress. NASCUS and State regulators welcome questions from the Committee on this issue.