STATEMENT

OF

THE HONORABLE JOANN JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

ON THE
"NET WORTH AMENDMENT FOR CREDIT UNIONS ACT"
H.R. 1042

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

APRIL 13, 2005

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee: I appreciate your invitation to appear here today to speak on behalf of the National Credit Union Administration (NCUA) to support the important legislation you have introduced -- the "Net Worth Amendment For Credits Unions Act."

NCUA anticipates that the Financial Accounting Standards Board (FASB) will act in 2005 to lift the current deferral of the acquisition method of accounting for mergers by credit unions thereby eliminating the pooling method and requiring the acquisition method beginning in 2006.[1] When this change to accounting rules is implemented it will require that, in a merger, the net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as "acquired equity," a term not recognized by the "Federal Credit Union Act" (FCUA).

This FASB policy has been in place since mid-2001 for most business combinations and the delay by FASB in implementing it for credit unions has allowed all of us to explore how credit unions could conform to the new financial reporting standards. H.R. 1042 is a good solution.

Without the changes to the "Federal Credit Union Act" proposed by H.R. 1042, only "retained earnings" of the continuing credit union will count as net worth after a merger. This result would seriously reduce the post-merger net worth ratio of a federally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has adverse implications under the statutory "prompt corrective action" (PCA) regulation. This result will discourage voluntary mergers and on occasion make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF). Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost.

This agency, and the credit unions we serve, are grateful for the analysis and time you are devoting to this matter and for bringing us quickly to the point of advancing the narrow and specific changes to the "Federal Credit Union Act" needed to preserve credit union capital in mergers that take place after FASB fully implements its policy for credit unions.

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[1] Statement of Financial Accounting Standard (SFAS) No. 141, Business Combinations, requiring the acquisition method for business combinations and effectively eliminating the pooling method. The pooling method has typically been used by credit unions to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001. Paragraph 60 of the standard deferred the effective date for mutual enterprises (i.e., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

Preserving "Retained Earnings"- The Only Source of "Net Worth" For Federally Insured Credit Unions

The "Credit Union Membership Access Act of 1998" established a statutory system of prompt corrective action standards for federally insured credit unions. Capital, or the term "net worth" for credit unions, is defined as limited to retained earnings as determined in accordance with generally accepted accounting principles (GAAP).

In the context of credit union mergers, where the "pooling method" of accounting has traditionally been used, the retained earnings of the two credit unions are pooled and the sum of these retained earnings become the net worth of the combined credit union. This logical result facilitates the ability of credit unions to merge when it is in the best interests of their members. It preserves the capital accumulated by both institutions and, importantly, is less likely to place the combined institution into a lower PCA category.

FASB's proposed change to accounting rules, along with an amendment to the "Federal Credit Union Act" that allows NCUA to recognize "…any amounts that were previously retained earnings of any other credit union…" will produce results consistent with the goal of FASB and comparable to results achieved for other business combinations.

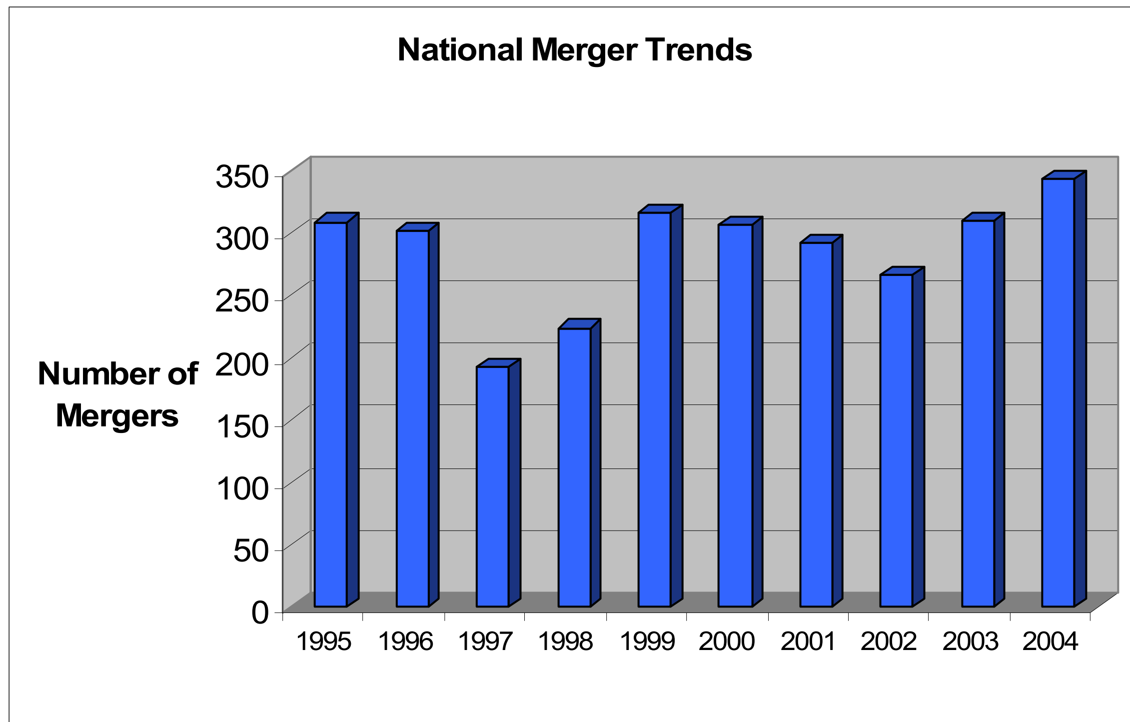
When crafting the PCA provisions of the FCUA in 1998, this policy change by FASB for financial reporting purposes was not anticipated. To explain why a lower net worth ratio has serious adverse implications under PCA, let me summarize the consequences. Under current law an insured credit union is:

- "well capitalized" if it has a net worth ratio of not less than 7%. Falling below 7% triggers an earnings retention requirement and involvement with NCUA that most insured credit unions would like to avoid;
- "adequately capitalized" if it has a net worth ratio of not less than 6%. Falling below 6% requires the credit union to produce a net worth restoration plan and additional regulatory involvement;
- "undercapitalized" if net worth is below 6%. With this status comes restrictions on asset growth and member business loans;
- "significantly undercapitalized" if net worth is less than 4%;
- "critically undercapitalized" if the net worth ratio is less than 2%. Here the NCUA Board has 90-days to take action, such as conserving, liquidating or merging the credit union.

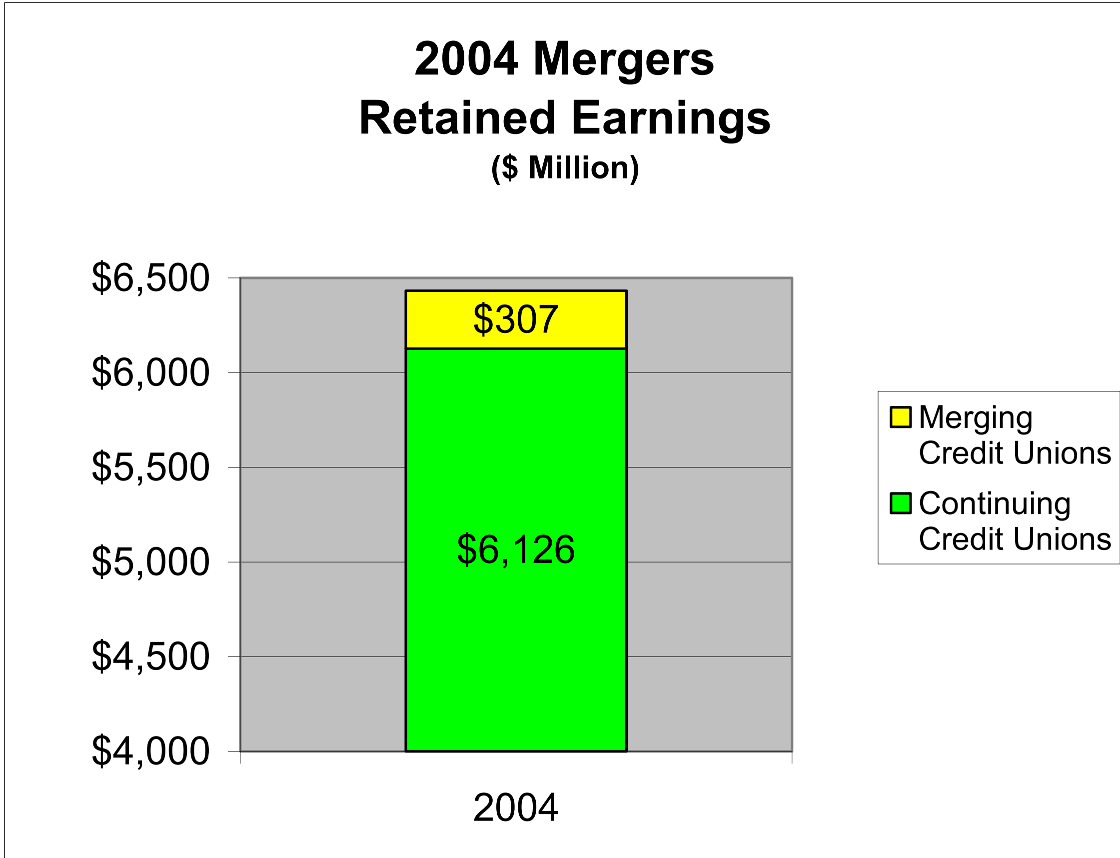
A merger is normally a necessary or beneficial change, but it may cause adverse consequences if the retained earnings of the merged insured credit union are lost -- an unexpected and undesirable consequence for credit unions, their members, FASB and NCUA. The management and board of directors of the continuing

credit union considering a merger will give pause when faced with this result, as will NCUA.

In 2004 there were approximately 338 mergers involving federally insured credit unions. Of those, 237 were voluntary mergers and 7 involved some degree of financial assistance from NCUA. There were 94 mergers in process at year-end.



The number of mergers has been relatively constant for a many of years, so the significance of both the potential problem and the significance of the solution offered by H.R. 1042 is quite real. Without a solution, necessary or beneficial mergers would either be foregone or consummated with a loss of net worth. In the case of assisted mergers, it would be at greater cost to the NCUSIF to make the continuing credit union whole.



The chart above shows if FASB's Statement of Financial Accounting Standard 141 had been applied to federally insured credit unions in 2004 without the statutory adjustment, some $300 million in credit union capital might have been lost for PCA purposes.

The "Net Worth Amendment For Credit Unions Act" clearly and appropriately preserves the only source of hard-earned credit union capital when mergers of institutions are accomplished – retained earnings.

FDIC insured financial institution's equivalent "leverage ratio" includes virtually all GAAP equity components. Therefore, it is my understanding banks and their insurers do not have the same concerns because their existing capital definition under relevant law is broader. The FASB rule, in combination with their statutory definition of capital, would not cause the same problem for acquiring banks and thrifts because they are allowed to include virtually all components of equity in their capital.

Thank you, Mr.Chairman, for introducing H.R. 1042, holding this hearing today and acting to preserve the capital of federally insured credit unions.