For release on delivery

STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"FINANCIAL SERVICES REGULATORY RELIEF: THE REGULATORS VIEWS"

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 9, 2005

Chairman Bachus, Representative Sanders, and Members of the Subcommittee: on behalf of the National Credit Union Administration (NCUA) I am pleased to be here today to present our agency's views on regulatory efficiency and reform initiatives being considered by Congress. Enacting legislation that will directly and indirectly benefit the consumer and the economy by assisting all financial intermediaries and their regulators perform the role and functions required of them is prudent.

REGULATORY RELIEF AND EFFICIENCY

The Subcommittee on Financial Institutions and Consumer Credit has been taking the lead over the last several years in many areas of interest to consumers, financial institutions such as credit unions and their members. Legislation of the type being considered today epitomizes the real connection between, and benefits of, effective financial institutions efficiently delivering consumer credit to the public.

In July of 2004 I testified in favor of the credit union provisions included in the "Financial Institutions Regulatory Relief Act of 2004," (H.R. 1375), approved by the Financial Services Committee and passed by the House of Representatives by a vote of 392-25. That legislation was a significant bipartisan achievement that NCUA greatly appreciated and enthusiastically supported as it moved through the House of Representatives. They have merited your support in the past and NCUA supports inclusion of those credit union provisions in any new legislation that is introduced this year.

The recent introduction of the "Credit Union Regulatory Improvements Act of 2005," H.R. 2317 (CURIA), by Representatives Royce, Kanjorski, Sanders, LaTourette, Maloney, Gutierrez and Paul from the House Financial Services Committee to name a few, addresses some of the most compelling statutory and consequently, regulatory reform issues being discussed within the credit union industry today. HR 2317 also includes many of the same credit union provisions approved in H.R. 1375 last Congress. On May 25, 2005 NCUA provided a response and letter of support for CURIA which is included with this testimony.

CURIA of 2003 made the suggestion that NCUA should be authorized to design and implement a risk based prompt corrective system for federally insured credit unions. Without more details, policy makers and credit unions could not make an accurate assessment of the proposal, so NCUA went to work to demonstrate how such a system could be implemented. Title I of CURIA of 2005 now includes the necessary statutory changes required. I have provided the complete plan as an attachment to this testimony and would like to briefly discuss it here.

Prompt Corrective Action Reforms

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This mandate is good public policy and consistent with NCUA's fiduciary responsibility to the insurance fund. While NCUA supports a statutorily mandated PCA system, the current statutory requirements for credit unions are too inflexible and establish a structure based primarily on a "one-size-fits all" approach, relying largely on a high leverage requirement of net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to design a meaningful risk-based system.

Reform of capital standards is vital for credit unions as the other federal banking regulators explore implementation of BASEL II and other capital reforms for banks in the United States. While maintaining a leverage ratio, NCUA's PCA reform proposal incorporates a more risk-based approach to credit union capital standards consistent with BASEL I and II. In recognition of the inherent limitations in any risk-based capital system, our proposal incorporates leverage and risk-based standards working in tandem. The risk-based portion of the proposed tandem system uses risk portfolios and weights based on the BASEL II standard approach.

For the leverage requirement, NCUA supports a reduction in the standard net worth (i.e., leverage) ratio requirement for credit unions to a level comparable to what is required of FDIC insured institutions. The minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, compared to the threshold of 5% for FDIC-insured institutions. There are important reasons why the leverage ratio for credit unions ratio should be lowered to work in tandem with a risk-based requirement.

First, credit unions should not be placed at a competitive disadvantage by being held to higher capital standards when they are not warranted to protect the insurance fund. For FDIC insured institutions, a 5% leverage requirement coupled with a risk-based system has provided adequate protection for their insurance fund. In comparison, the credit union industry has a relatively low risk profile, as evidenced by our low loss history. This is largely due both to the greater restrictions on powers of credit unions relative to other financial institutions and credit unions' conservative nature given their member-owned structure. In fact, our experience has shown that given economic needs and their conservative nature, the vast majority of credit unions will operate with net worth levels well above whatever is established as the regulatory minimum.

In addition, the current 7% leverage requirement is excessive for low risk institutions and overshadows any risk-based system we design, especially if you consider that under BASEL the risk-based capital requirement is 8% of risk assets. A meaningful risk-based system working in tandem with a lower leverage requirement provides incentives for financial institutions to manage the risk they take in relation to their capital levels, and gives them the ability to do so by reflecting the composition of their balance sheets in their risk-based PCA requirements. The current high leverage requirement provides no such ability or incentive and, in fact, it can be argued could actually contribute to riskier behavior to meet these levels given the extra risk isn't factored into the dominant leverage requirement.

We recognize, however, that achieving comparability between the federal insurance funds does require us to factor in the NCUSIF's deposit-based funding mechanism. Thus, our reform proposal incorporates a revised method for calculating the net worth ratio for PCA purposes by adjusting for the deposit credit unions maintain in the share insurance fund. However, our proposed treatment of the NCUSIF deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles, or NCUA's steadfast support of the mutual, deposit-based nature of the NCUSIF.

As for capitalization investments in corporate credit unions, these are not uniformly held by all credit unions. Indeed, not all credit unions even belong to a corporate credit union. Thus, these investments are appropriately addressed under the risk-based portion of PCA. Our reform proposal addresses capitalization investments in corporate credit unions consistent with BASEL and the FDIC's rules applicable to capital investments in other financial institutions.

For the risk-based requirement, our proposal tailors the risk-asset categories and weights of BASEL II's standard approach, as well as related aspects of the FDIC's PCA system, to the operation of credit unions. The internal ratings-based approach of BASEL II for the largest internationally active banks is not applicable to credit unions. However, it is our intention is to maintain comparability with FDIC's PCA requirements for all other insured institutions and keep our risk-based requirement relevant and up-to-date with emerging trends in credit unions and the marketplace.

As there are limitations in any regulatory capital scheme, NCUA's reform proposal also includes recommendations to address these other forms of risk under the second pillar of the supervisory framework, a robust supervisory review process. Through our examination and supervision process, NCUA will continue to analyze each credit union's capital position in relation to the overall risk of the institution, which may at times reflect a need for capital levels higher than regulatory minimums.

I would also point out that our reform proposal addresses an important technical amendment needed to the statutory definition of net worth. NCUA anticipates that the Financial Accounting Standards Board (FASB) will act soon 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. 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). Without this important change, 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. Thus, our reform proposal provides for a revised definition of net worth to include any amounts that were previously retained earnings of any other credit union.

Enabling NCUA to adopt a PCA system that remains relevant and up-to-date with emerging trends in credit unions and the marketplace provides safety, efficiency, and benefits to the credit union consumer. I believe our reform proposal achieves a much needed balance between enabling credit unions to utilize capital more efficiently to better serve their members while maintaining safety and soundness and protecting the share insurance fund. A well-designed risk-based system would alleviate regulatory concerns by not penalizing low risk activities and by providing credit union management with the ability to manage their compliance through adjustments to their assets and activities. A PCA system that is more fully risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

PROVISIONS FOR REGULATORY REFORM SUGGESTED BY NCUA AND PREVIOUSLY APPROVED BY THE HOUSE OF REPRESENTATIVES

Check Cashing, Wire Transfer and Other Money Transfer Services

The Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members (12 USC 1757(12)). To reach the "unbanked," federal credit unions should be authorized to provide these services to anyone eligible to become a member. This is particularly important to federal credit unions in furthering their efforts to serve those of limited income or means in their field of membership. These individuals, in many instances, do not have mainstream financial services available to them and are often forced to pay excessive fees for check cashing, wire transfer and other services. Allowing federal credit unions to provide these limited services to anyone in their field of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations. Representative Gerlach introduced this provision as H.R. 749 in the 109th Congress and it has been passed by the House of Representatives on April 26, 2005.

The Twelve-Year Maturity Limit on Loans
Federal credit unions are authorized to make loans to members, to other credit unions and to credit union organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a twelve-year maturity limit that is subject to only limited exceptions (12 USC 175(5)). This maturity limit should be eliminated. It is outdated and unnecessarily restricts federal credit union lending authority. Federal credit unions should be able to make loans for second homes, recreational vehicles and other purposes in accordance with conventional maturities that are commonly accepted in the market today. It is our view that NCUA should retain the rulemaking authority to establish any maturity limits necessary for safety and soundness.

Increase One Percent Investment Limit in CUSOs to Three Percent
The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations (12 USC 1757(7)(I)). These organizations, commonly known as credit union service organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risks are isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the NCUSIF, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation. Increasing the CUSO investment limit from 1 percent to 3 percent, is an improvement over the current limit, and NCUA supports the change.

Expanded Investment Options
The Federal Credit Union Act limits the investment authority of federal credit unions to loans, government securities, deposits in other financial institutions and certain other very limited investments (12 USC 1757(7)). This limited investment authority restricts the ability of federal credit unions to remain competitive in the rapidly changing financial marketplace. The Act should be amended to provide such additional investment authority as approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state

chartered credit unions or other financial institutions. As drafted last Congress, the provision appropriately addresses the issues NCUA has presented in our recommendation, limits additional investment to corporate debt securities (as opposed to equity) and further establishes specific percentage limitations and investment grade standards.

Voluntary Merger Authority
The Federal Credit Union Act, as amended by the Credit Union Membership Access Act, allows voluntary mergers of healthy federal credit unions, but requires that NCUA consider a spin-off of any group of over 3,000 members in the merging credit union (12 USC 1759(d)(2)(B)(i)). When two healthy federal credit unions wish to merge, and thus combine their financial strength and service to their members, they should be allowed to do so. There is no reason to require in connection with such mergers that groups over 3,000, or any group for that matter, be required to spin off and form a separate credit union. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns. These groups are already included in a credit union in accordance with the statutory standards, and that status should be unaffected by a voluntary merger.

Regulatory Relief from SEC Registration Requirements
NCUA is seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker-dealers when engaging in certain de minimus securities activities.
The Gramm Leach Bliley Act, enacted in 1999, created exemptions from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisers Act of 1940. The principle established by these exemptions is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate. The provision would provide similar exemptions for federally insured credit unions. NCUA supports these exemptions. Because of significant differences between broker-dealer capital requirements and depository institution capital requirements, it is virtually impossible for depository institutions, including credit unions, to register as a broker-dealer and submit to broker-dealer requirements. Without an exemption credit unions may find that although they are authorized under their chartering statutes to engage in particular securities-related activities, their inability to register as a broker-dealer would keep them from engaging in these activities. Recently, the Securities and Exchange Commission proposed a rule that would exempt credit unions from the definition of broker and dealer for a few of the activities exempted for banks under Gramm Leach Bliley, including third party brokerage arrangements and sweep account arrangements. NCUA supports the SEC proposal. We believe, however, that the SEC's proposal does not go far enough, and we continue to support legislative relief. The relief sought for credit unions would be more limited in scope and application than that which is available to banks and requested by thrifts. Credit union powers are limited by

their chartering statutes, and credit unions do not have certain powers, such as general trust powers, that are available to banks and thrifts. The requested parity relief for credit unions would apply only to those activities otherwise authorized for credit unions under applicable credit union chartering statutes, currently including third-party brokerage arrangements, sweep accounts, and certain safekeeping and custody activities.

Technical Corrections to the Federal Credit Union Act

Included and approved in H.R. 1375 last Congress, these provisions are purely drafting, numerical and incorrect references without any policy impact that need to be made to the Federal Credit Union Act.

ADDITIONAL CREDIT UNION PROVISIONS

I would also like to take this opportunity to comment on credit union provisions not originating from NCUA, but included in CURIA or H.R. 1375 as passed by the House of Representatives last Congress.

NCUA has reviewed all of these additional credit union provisions and the agency has no safety and soundness concerns with these provisions. Among these are provisions which address leases of land on Federal facilities for credit unions; member business loans for non-profit religious organizations; criteria for continued membership of certain member groups in community charter conversions; credit union governance changes; revising the economic factors the NCUA Board must use when considering adjustments to the statutory 15% interest rate that can be charged by federal credit unions on loans; and an exemption from pre-merger notification requirements of the Clayton Act.

Conclusion

Thank you, Mr. Chairman, for the opportunity to appear before you today on behalf of NCUA to discuss the public benefits of regulatory efficiency for NCUA, credit unions and 84 million credit union members. I am pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.