STATEMENT

OF

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"MODERNIZING BANK SUPERVISION AND REGULATION"

BEFORE THE

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I. INTRODUCTION

The National Credit Union Administration (NCUA) appreciates this opportunity to provide the agency's position on "Modernizing Bank Supervision and Regulation." Federally-insured credit unions comprise a small but important part of the financial institution community, and NCUA's perspective on this matter will add to the overall understanding of the needs of the credit union industry and the members they serve.[1] The NCUA agrees with the need for establishing a regulatory oversight entity (systemic risk regulator) whose responsibilities would include monitoring the financial institution regulators and issuing principles-based regulations and guidance. The NCUA envisions this entity would be responsible for establishing general safety and soundness guidance for federal financial regulators under its control while the individual federal financial regulators would implement and enforce the established guidelines in the institutions they regulate. This entity would also monitor systemic risk across institution types. For this structure to be effective for federally-insured credit unions, the National Credit Union Share Insurance Fund (NCUSIF) must remain independent of the Deposit Insurance Fund to maintain the dual regulatory and insurance roles for the NCUA that have been tested and proven to work in the credit union industry for almost 40 years.

The 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 examination and supervision of federally-insured state

[1] 12 U.S.C. §1759. Unlike other financial institutions, credit unions may only serve individuals within a restricted field of membership. Other financial institutions serve customers that generally have no membership interest.

chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator of the NCUSIF, the NCUA insures and supervises 7,806 federally-insured credit unions, representing 98 percent of all credit unions and approximately 88 million members.[2]

Overall, federally-insured, natural person credit unions maintained reasonable financial performance in 2008. As of December 31, 2008, federally-insured credit unions maintained a strong level of capital with an aggregate net worth ratio of 10.92 percent.[3] While earnings decreased from prior levels due to the economic downturn, federally-insured credit unions were able to post a 0.30 percent return on average assets in 2008.[4] Delinquency was reported at 1.37 percent, while net charge-offs was 0.84 percent.[5] Shares in federally-insured credit unions grew at 7.71 percent with membership growing at 2.01 percent, and loans growing at 7.08 percent.[6]

II. FEDERALLY-INSURED CREDIT UNIONS REQUIRE SEPARATE OVERSIGHT

Federally-insured credit unions' unique cooperative, not-for-profit structure and statutory mandate of serving people of modest means necessitate a customized approach to their regulation and supervision. The NCUA should remain an independent agency to preserve the credit union model and protect credit union members as mandated by

[2] Approximately 162 state-chartered credit unions are privately insured and are not subject to NCUA oversight. Based on December 31, 2008 Call Report (NCUA Form 5300) data.
[3] Based on December 31, 2008 Call Report (NCUA Form 5300) data.
[4] Ibid.
[5] Ibid.
[6] Ibid.

Congress. An agency responsible for all financial institutions might focus on the larger financial institutions where the systemic risk predominates, potentially to the detriment of smaller federally-insured credit unions. As federally-insured credit unions are generally the smaller, less complex institutions in a consolidated financial regulator arrangement, the unique character of credit unions would quickly be lost, absorbed by the for-profit model and culture of the banking system.

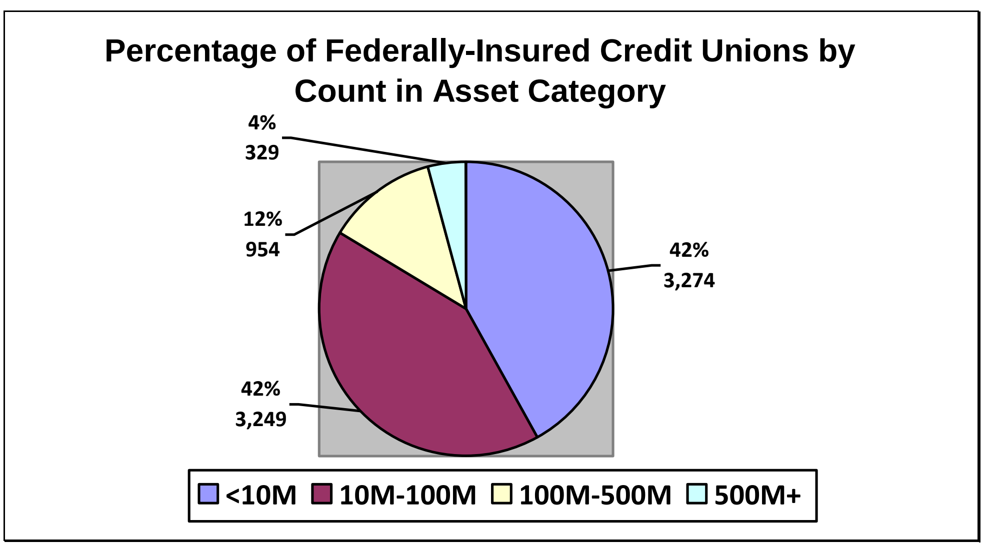
Federally-insured credit unions fulfill a specialized role in the domestic marketplace; one that Congress acknowledged is important in assuring consumers have access to basic financial services such as savings and affordable credit products. Loss of federally-insured credit unions as a type of financial institution would limit access to these affordable financial services for persons of modest means. Federally-insured credit unions serve an important competitive check on for-profit institutions by providing low-cost products and services. Some researchers estimate the competitive presence of credit unions save bank customers $4.3 billion annually.[7] Research also shows that in many markets, credit unions provide a lower cost alternative to abusive and predatory lenders. The research describes the fees, rates, and terms of the largest United States credit card providers in comparison to credit cards issued by credit unions with similar purchase interest rates but with fewer fees, lower fees, lower default rates, and clearer

[7] *An Estimate of the Influence of Credit Unions on Bank CD and Money Market Deposits in the U.S.* - Idaho State University, January 2005. Also, *An Analysis of the Benefits of Credit Unions to Bank Loan Customers* – American University, January 2005.

disclosures. The details of credit union credit card programs show credit card lending is sustainable without exorbitant penalties and misleading terms and conditions.[8]

Federally-insured credit unions provide products geared to the modest consumer at a reasonable price, such as very small loans and low-minimum balance savings products that many banks do not offer. Credit unions enter markets that other financial institutions have not entered or abandoned because these markets were not profitable or there were more lucrative markets to pursue.[9] Loss of credit unions would reduce service to underserved consumers and hinder outreach and financial literacy efforts.

When comparing the size and complexity of federally-insured credit unions to banks, even the largest federally-insured credit unions are small in comparison to the banks. As shown in the graph below, small federally-insured credit unions make up the majority of the institutions the NCUA insures.



[8] *Blindfolded Into Debt: A Comparison of Credit Card Costs and Conditions at Banks and Credit Unions.* The Woodstock Institute, July 2005.
[9] *Increase in Bank Branches Shortchanges Lower-Income and Minority Communities: An Analysis of Recent Growth in Chicago Area Bank Branching*. The Woodstock Institute, February 2005, Number 27.

Eighty-four percent of federally-insured credit unions have less than $100 million in assets as opposed to thirty-eight percent of the institutions that the Federal Deposit Insurance Corporation (FDIC) insures with the same asset size.[10] Total assets in the entire federally-insured credit union industry are less than the individual total assets of some of the nation's largest banks.[11]

<u>Specialized Supervision</u>

In recognition of the importance of small federally-insured credit unions to their memberships, the NCUA established an Office of Small Credit Union Initiatives to foster credit union development, particularly in the expansion of services provided by small federally-insured credit unions to all eligible members. Special purpose programs have helped preserve the viability of several institutions by providing access to training, grant assistance, and mentoring.[12]

The NCUA has developed expertise to effectively supervise federally-insured credit unions. The agency has a highly trained examination force that understands the intricacies and nuances of federally-insured credit unions and their operations.

The NCUA's mission includes serving and maintaining a safe, secure credit union community. In order to accomplish this, the NCUA has put in place specialized programs such as the National Examination Team to supervise federally-insured credit

[10] *FDIC Quarterly Banking Profile – Fourth Quarter 2008.*
[11] December 31, 2008 total assets for federally-insured credit unions equaled $813.44 billion, while total assets for federally-insured banks equaled $13.85 trillion. Based on December 31, 2008 Call Report (NCUA Form 5300) data and *FDIC Quarterly Banking Profile – Fourth Quarter 2008.*
[12] *NCUA 2007 Annual Report.*

unions showing a higher risk to the NCUSIF, Subject Matter Examiners to address specific areas of risk, and Economic Development Specialists to provide hands-on assistance to small federally-insured credit unions.

NCUA's Tailored Guidance Approach

The systemic risk regulator would set the general safety and soundness guidelines, while the NCUA would monitor and enforce the specific rules for the federally-insured credit union industry. For example, the NCUA has long recognized the safety and soundness issues regarding real estate lending. Real estate lending makes up fifty-four percent of federally-insured credit unions' lending portfolio. As a result, the NCUA has provided federally-insured credit unions detailed guidance regarding this matter. The below chart outlines the regulatory approach taken with real estate lending.

Date	Title	Summary
June 1991	Letter to Credit Unions #124	Provides guidelines for developing and maintaining an effective real estate lending portfolio, and addressing both interest rate and credit risk associated with real estate lending.
August 1995	Letter to Credit Unions #174	Discusses potential advantages and disadvantages to federally-insured credit unions of risk-based lending[13] programs or programs where subprime credit could be offered. The letter also included a whitepaper discussing the importance of consumer compliance issues related to risk-based lending and the federally-insured credit unions' obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act.

[13] Risk-based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables federally-insured credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals.

Date	Title	Summary
June 1999	Letter to Credit Unions 99-CU-05	Restates that soundly managed risk-based lending programs are a way to reach out to all members. Explained a federally-insured credit union's capital adequacy would be evaluated considering the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program.
August 1999	Letter to Credit Unions 99-CU-12	Stresses the importance of proper balance sheet risk management for real estate loan products and formally introduced such tools as GAP analysis, income simulation models, Net Economic Value, and other Asset Liability Management concepts.
September 2003	Letter to Credit Unions 03-CU-15	Reemphasizes the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products.
September 2004	Letter to Credit Unions 04-CU-13	Refocuses the industry's attention to proper credit risk management of lending, including real estate lending, in the wake of alternative lending arrangements to increase lending opportunities. Outlines the NCUA's underwriting expectations for federally-insured credit union engaged in subprime lending, noting the need to focus on borrowers' ability to repay loans as structured.
May 2005	Letter to Credit Unions 05-CU-07	Focuses industry attention to an increasing concentration of Home Equity Lines of Credit (HELOCs) and close-end home equity loans. This guidance was issued jointly with the other banking agencies.
October 2005	Letter to Credit Unions 05-CU-15	Addresses the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation, as well as an apparent transition to more liberal mortgage credit standards in general. The NCUA developed guidance for staff focusing on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards was included as an attachment.

Date	Title	Summary
October 2006	Letter to Credit Unions 06-CU-16	Addresses risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. While nontraditional and subprime mortgage lending were not major components of federally-insured lending portfolios, the letter cautions federally-insured credit unions on the potential "ripple effect" to their asset quality if some of their members have these types of loans at other financial institutions. Also, discusses prudent underwriting and risk management practices for nontraditional mortgage loans. Issued jointly with the Federal Financial Institutions Examination Council (FFIEC).[14]
April 2007	Letter to Credit Unions 07-CU-06	Encourages financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations. Explains that prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Issued jointly with the FFIEC.
July 2007	Letter to Credit Unions 07-CU-09	Addresses emerging risks and lending practices associated with certain subprime adjustable rate mortgage products that can cause payment shock to consumers. While these types of loans did not appear prevalent in the credit union industry, the letter again cautions federally-insured credit unions on the potential "ripple effect" to their asset quality. Issued jointly with the FFIEC.

[14] The FFIEC includes the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the NCUA, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the State Liaison Committee (SLC).

Date	Title	Summary
March 2008	Letter to Credit Unions 08-CU-5	Encourages federally-insured credit unions servicing securitized subprime adjustable rate residential mortgages to utilize the HOPE NOW[15] alliance's loan modification standards to report foreclosure prevention efforts.
June 2008	Letter to Credit Unions 08-CU-14	Provides all federally-insured credit unions with the final *Interagency Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products*, particularly those products that offer a low introductory "teaser" rate that could lead to payment shock when associated interest rates reset. Issued jointly with the FFIEC.
August 2008	Letter to Credit Unions 08-CU-19	Re-emphasizes the importance of proper due diligence over third-party relationships, specifically as they relate to the use of mortgage brokers and correspondents.
August 2008	Letter to Credit Unions 08-CU-20	Shares guidance with federally-insured credit unions that was released to the NCUA examiners. Guidance discusses several of the current risks facing the credit union industry, provides guidance for assessing mortgage portfolio risk management, and recommends best practices for conducting risk focused supervision and monitoring.
December 2008	Letter to Credit Unions 08-CU-25	Provides guidance related to holding foreclosed properties as Foreclosed and Repossessed Assets and encourages federally-insured credit unions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

As demonstrated by the guidance issued, the NCUA proactively addresses issues with the industry as they evolve and as they specifically apply to federally-insured credit

[15] HOPE NOW is an alliance between counselors, servicers, investors, and others formed under the direction of the Department of Treasury and the Department of Housing and Urban Affairs in 2007, which serves to maximize outreach efforts to homeowners in distress to help them stay in their homes.

unions. Due to federally-insured credit unions' unique characteristics, the NCUA should be maintained as a separate regulator under an overseeing entity to ensure the vital sector of federally-insured credit unions is not "lost in the shuffle" of the financial institution industry as a whole.

III. MAINTAIN SEPARATE INSURANCE FUND

Funds from federally-insured credit unions have established the NCUSIF. The required deposit is calculated at least annually at one percent of each federally-insured credit union's insured shares. The fund is commensurate with federally-insured credit unions' equity interests and the risk level in the industry. The small institutions that make up the vast majority of federally-insured credit unions should not be required to pay for the risk taken on by the large conglomerates. The NCUA has a successful record of regulating federal credit union charters and also serving as insurer for all federally-insured credit unions. This structure has stood the test of time, encompassing various adverse economic cycles. The NCUA is the only regulator with this 100 percent dual regulator/insurer role. The overall reporting to a single regulatory body creates a level of efficiency for federally-chartered credit unions in managing the regulatory relationship. This unique role has allowed the NCUA to develop economies of scale as a federal agency.

The July 1991 Government Accountability Office (GAO) report to Congress considered whether NCUA's insurance function should be separated from the other functions of chartering, regulating, and supervising credit unions. The GAO concluded "[s]eparation of NCUSIF from NCUA's chartering, regulation, and supervision responsibilities would not, on the basis of their analyses, by itself guarantee either strong supervision or insurance fund health. And such a move could result in additional and duplicative oversight costs. In addition, it could be argued that a regulator/supervisor without insurance responsibility has less incentive to concern itself with the insurance costs, should an institution fail."[16]

The 1997 Treasury study reached conclusions similar to the GAO report. The Treasury study discussed the unique capitalization structure of the NCUSIF and how it fits the cooperative nature of federally-insured credit unions and offered the following:[17]

> *We found no compelling case for removing the Share Insurance Fund from the NCUA's oversight and transferring it to another federal agency such as the FDIC. The NCUA maintains some level of separation between its insurance activities and its other responsibilities by separating the operating costs of the Fund from its non-insurance expenses.*[18]
>
> *Under the current structure, the NCUA can use supervision to control risks taken by credit unions – providing an additional measure of protection for the Fund. We also believe that separating the Fund from*

[16] *GAO, July 1991 Study.*
[17] *Treasury, December 1997 Study of Credit Unions.*
[18] *Treasury, December 1997 Study of Credit Unions, page 52.*

the NCUA could: (1) reduce the regulator's incentives to concern itself with insurance costs, should an institution fail; (2) create possible confusion over the roles and responsibilities of the insurer and of the regulator; and (3) place the insurer in the situation of safeguarding the insurance fund without having control over the risks taken by the insured entities.[19]

The financing structure of the Share Insurance Fund fits the cooperative character of credit unions. Because credit unions must expense any losses to the Share Insurance Fund, they have an incentive to monitor each other and the Fund. This financing structure makes transparent the financial support that healthier credit unions give to the members of failing credit unions. Credit unions understand this aspect of the Fund and embrace it as a reflection of their cooperative character.[20]

The unique dual regulatory role in which the NCUA operates has proven successful in the credit union industry. At no time under this structure has the credit union system cost the American taxpayers any money.

[19] *Ibid, page 52.*
[20] *Ibid, page 58.*

IV. FEDERALLY-INSURED CREDIT UNIONS DEMONSTRATE UNIQUE CHARACTERISTICS

Federally-insured credit unions are unique financial institutions that exist to serve the needs of their members. The statutory and regulatory frameworks in which federally-insured credit unions operate reflect their uniqueness and are significantly different from that of other financial institutions. Comments that follow in this section provide specific examples for federal credit unions. However, most of the examples also apply to federally-insured state chartered credit unions because of their similar organization as institutions designed to promote thrift.[21]

One Member One Vote

The federal credit union charter is the only federal financial charter in the United States that gives every member an equal voice in how their institution is operated regardless of the amount of shares on deposit with its "one member, one vote" cooperative structure.[22] This option allows federal credit unions to be democratically governed. The federal credit union charter provides an important pro-consumer alternative in the financial services industry.

Field of Membership

Federal credit unions are not-for-profit, member-owned cooperatives that exist to provide their members with the best possible rates and service. A federal credit union is chartered to serve a field of membership that shares a common bond such as the employees of a company, members of an association, or a local community. Therefore,

[21] 12 U.S.C. §1781(c)(1)(E).
[22] 12 U.S.C. §1760.

federal credit unions may not serve the general public like other financial institutions and the federal credit unions' activities are largely limited to domestic activities, which has minimized the impact of globalization in the federal credit union industry. Due to this defined and limited field of membership, federal credit unions have less ability to grow into large institutions as demonstrated by 84 percent of federally-insured credit unions having less than $100 million in assets.[23]

Volunteer Board of Directors

Federal credit unions are managed largely on a volunteer basis. The board of directors for each federal credit union consists of a volunteer board of directors elected by, and from the membership.[24] By statute, no member of the board may be compensated as such; however, a federal credit union may compensate one individual who serves as an officer of the board.[25]

Consumer Protection

The Federal Credit Union Act requires federal credit union boards of directors to appoint not less than three members or more than five members to serve as members of the supervisory committee.[26] The purpose of the supervisory committee is to ensure independent oversight of the board of directors and management and to advocate the best interests of the members. The supervisory committee either performs or contracts with a third-party to perform an annual audit of the federal credit union's books and

[23] Based on December 31, 2008 Call Report (NCUA Form 5300) data.
[24] 12 U.S.C. §1761(a).
[25] 12 U.S.C. §1761(c).
[26] 12 U.S.C. §1761b.

records.[27] The supervisory committee also plays an important role as the member advocate.

As the member advocate, the supervisory committee is charged with reviewing member complaints.[28] Complaints cover a broad spectrum of areas, including annual meeting procedures, dividend rates and terms, and credit union services. Regardless of the nature of the complaint, NCUA requires supervisory committees to conduct a full and complete investigation. When addressing member complaints, supervisory committees will determine the appropriate course of action after thoroughly reviewing the unique circumstances surrounding each complaint.[29]

This committee and function of member advocacy are unique to federal credit unions. No member of the supervisory committee can be compensated.[30]

Regulatory Limitations

While there have been significant changes in the financial services environment since 1934 when the Federal Credit Union Act was implemented, federal credit unions have only had modest gains in the breadth of services offered relative to the broad authorities and services of other financial institutions. By virtue of their enabling legislation along with regulations established by the NCUA, federal credit unions are more restricted in

[27] 12 U.S.C. §1761d.
[28] As noted in the preamble of final rule incorporating the standard federal credit union bylaws into NCUA Rules and Regulations Part 701.
[29] Supervisory Committee Guide, Chapter 4, Publication 4017/8023 Revised December 1999.
[30] 12 U.S.C. §1761.

their operation than other financial institutions. A discussion of some of these limitations follows.

Investment Limitations

Federal credit unions have relatively few permissible investment options. Investments are largely limited to United States debt obligations, federal government agency instruments, and insured deposits.[31] Federal credit unions cannot invest in a diverse range of higher yielding products, including commercial paper and corporate debt securities. Also, federal credit unions have limited authority for broker-dealer relationships.[32] These limitations have helped credit unions weather the current economic downturn.

Affiliation Limitations

Federal credit unions are much more limited than other financial institutions in the types of businesses in which they engage and in the kinds of affiliates with which they deal. Federal credit unions cannot invest in the shares of an insurance company or control another financial depository institution. Also, they cannot be part of a financial services holding company and become affiliates of other depository institutions or insurance companies. Federal credit unions are limited to only the powers established in the Federal Credit Union Act.[33]

[31] NCUA Rules and Regulations Part 703.
[32] NCUA Rules and Regulations Part 703.
[33] 12 U.S.C. §1757.

Capital Limitations

Unlike other financial institutions, federal credit unions cannot issue stock to raise additional capital.[34] Also, federal credit unions have borrowing authority limited to 50 percent of paid-in and unimpaired capital and surplus.[35]

A federal credit union can only build net worth through its retained earnings, unless it is a low-income designated credit union that can accept secondary capital contributions.[36] Federally-insured credit unions must also hold 200 basis points more in capital than other federally-insured financial institutions in order to be considered “well-capitalized” under federal “Prompt Corrective Action” laws.[37] In addition, federal credit unions must transfer their earnings to net worth and loss reserve accounts or distribute it to their membership through dividends, relatively lower loan rates, or relatively lower fees.

Lending Limitations

Federal credit unions are not permitted to charge a prepayment penalty in any type of loan whether consumer or business.[38] With the exception of certain consumer mortgage loans, federal credit unions cannot make loans with a maturity greater than 15 years.[39] Also, federal credit unions are subject to a federal statutory usury, currently set

[34] 12 U.S.C. §1790d(b)(1)(B)(i).
[35] 12 U.S.C. §1757(9).
[36] 12 U.S.C. §1790d(o)(2)(B).
[37] 12 U.S.C. §1790d.
[38] 12 U.S.C. §1757(5)(viii).
[39] 12 U.S.C. §1757(5).

at 18 percent, which is unique among federally-chartered financial institutions and far more restrictive than state usury laws.[40]

While federal credit unions have freedom in making consumer and mortgage loans to members, except with regard to limits to one borrower and loan-to-value restrictions, they are severely restricted in the kind and amount of member business loans they can underwrite. Some member business lending limits include restrictions on the total amount of loans, loan to value requirements, construction loan limits, and maturity limits.[41]

<u>Access to Credit</u>

Despite regulatory constraints, federally-insured credit unions continue to follow their mission of providing credit to persons of modest means. Amid the tightening credit situation facing the nation, federally-insured credit unions have continued to fulfill their members' borrowing needs. While other types of lenders severely curtailed credit, federally-insured credit unions experienced a 7.08 percent loan growth in 2008.

Credit unions remain fundamentally different from other forms of financial institutions based on their member-owned, democratically operated, not-for-profit cooperative structure. Loss of credit unions as a type of financial institution would severely limit the access to financial services for many Americans.

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[40] 12 U.S.C. §1757(5)(A)(vi).
[41] 12 U.S.C. §1757a and NCUA Rules and Regulations Part 723.

V. REGULATORY FRAMEWORK RECOMMENDATION

The NCUA agrees with the need for establishing a regulatory oversight entity to help mitigate risk to our nation's financial system. The agency recommends maintaining multiple financial regulators and charter options to enable the continued checks and balances such a structure produces. The oversight entity's main functions should be to establish broad safety and soundness principles and then monitor the individual financial regulators to ensure the established principles are implemented. This structure also allows the oversight entity to set objective-based standards in a more proactive manner, and would help alleviate competitive conflict detracting from the resolution of economic downturns. This type of structure would also promote uniformity in the supervision of financial institutions while affording the preservation of the different segments of the financial industry, including the credit union industry.

VI. CONCLUSIONS

Federally-insured credit union service remains focused on providing basic and affordable financial services to members. Credit unions are an important, but relatively small, segment of the financial institution industry serving a unique niche.[42] As a logical extension to this, the NCUSIF, which is funded by the required insurance contributions

[42] As of December 31, 2008, approximately $14.67 trillion in assets were held in federally-insured depository institutions. Banks and other savings institutions insured by the FDIC held $13.85 trillion, or 94.44 percent of these assets. Credit unions insured by the NCUSIF held $813.44 billion, or 5.56 percent of all federally-insured assets.

of federally-insured credit unions, should be kept separate from any bank insurance fund. This would maintain an appropriate level of diversification in the financial system.

While the NCUA supports a regulatory oversight entity, the agency should maintain its dual regulatory functions of regulator and insurer in order to ensure the federally-insured credit union segment of the financial industry is preserved.