STATEMENT

OF

THE HONORABLE JOANN JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

ON

"CREDIT UNION REGULATORY IMPROVEMENTS"

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 20, 2004

Chairman Bachus, Representative Sanders, and Members of the Subcommittee: thank you for inviting me to appear before you today. On behalf of the National Credit Union Administration (NCUA) I am pleased to provide information on the condition of the credit union industry and the National Credit Union Share Insurance Fund, as well as present our agency's views on regulatory efficiency initiatives originating here on Capitol Hill, and from NCUA.

CONDITION OF THE CREDIT UNION INDUSTRY

I am pleased to report to the Subcommittee that the state of the credit union industry remains strong and healthy. All indicators show that credit unions, which serve nearly 83 million Americans, are safe and sound and well positioned for continued strength and vitality in our nation's financial marketplace.

These indicators include key ratios and trends compiled from call report data submitted to NCUA by all federally insured credit unions as of March 31, 2004.

- The average net worth-to-assets ratio of all federally insured credit unions remains extremely strong at 10.64 percent, notwithstanding share growth of 15.27 percent in 2001, 10.77 percent in 2002, and 9.11 percent in 2003, and 11.31 percent (annualized) as of March 2004. Such strong share deposit growth would bring about a significant decrease in the net worth ratio, but for the fact that, credit unions are managing these increased shares effectively and continuing to build net worth. For example, in the first quarter of 2004, credit union net worth, which is built solely from retained earnings, has increased in total dollars at an annualized rate of 8.35 percent. This growth in actual dollars of net worth results in the highest level in history of total industry net worth, currently at $66.8 billion as of March 31, 2004.
- Return on average assets (ROA) is 0.90 percent. Considering the combined effects of the recent low interest rate environment and historically high growth in credit union share accounts, this compares favorably with recent ROA trends (0.99 percent in 2003 and 1.07 percent in 2002).
- Asset growth was 11.20 percent and share growth was 11.31 percent annualized as of March 2004.
- Loan growth slowed to 4.28 percent (annualized) in the first quarter of 2004. At the same time, share growth increased reducing the loan-to-share ratio to 69.97percent, from 71.2 percent in 2003. Total loans to credit union members totaled $380.2 billion, up $108.6 billion since year-end 1999.
- Credit unions' overall delinquency ratio fell to 0.68 percent and is lower than the ratios recorded in the previous two years (0.77 percent in 2003 and 0.80 percent in 2002), demonstrating effective risk management in the loan portfolios during a period of economic downturn in many industries and communities.

- Savings grew to $543.3 billion in 2004, an annualized increase of 11.31 percent. Due to the slower rate of loan growth, much of the increased savings are placed in the conservative investment options available to credit unions under applicable federal and state laws and regulations. Total assets grew to an all-time high of $627.2 billion, an annualized increase of 11.20 percent.
- First mortgage real estate loans grew at an annualized rate of 4.94 percent to $119 billion as of March 2004, thus continuing the growth of credit unions as a source of access to the American dream of home ownership for millions of their members.
- New auto lending increased 6.72 percent to 64.8 billion in 2004. Used auto loans increased by 4.60 percent to $82.1 billion.

The ratios and trends presented above are not unexpected in the present economic and marketplace environment; however, taken as a whole, they are indeed indicative of a healthy and robust industry.

CONDITION OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

The National Credit Union Share Insurance Fund (NCUSIF) provides federal share insurance coverage on credit union accounts generally up to $100,000 per member in a single federally insured credit union. As with FDIC coverage of deposits in banks and thrifts, there is an opportunity to structure separate account coverage under the NCUSIF based on the number and nature of the accounts established.

As of December 31, 2003, there were $479 billion in insured funds covered by the $6.163 billion NCUSIF, with a 1.27 percent equity ratio. As of May 31, 2004, the equity ratio in the NCUSIF was 1.29 percent.

Under the Federal Credit Union Act (FCUA), the NCUA Board has the authority to determine the annual operating level of the fund between the statutorily prescribed parameters of 1.2 and 1.5 percent. This year, as in the last several years, the Board has set the operating level at 1.3 percent. If, at the end of the calendar year, the NCUSIF equity level is above 1.3 percent, the Board may declare a dividend. If it is below 1.3 percent, the Board may assess a premium. If the equity ratio falls below 1.2 percent, the FCUA requires a premium be assessed. However, based upon the limited number of losses in federally insured credit unions, history has proven that in most years the fund level can be maintained without the assessment of a premium through the combination of the one percent of insured funds required deposit plus earnings on those deposits.

Since the NCUSIF was capitalized in 1985, only one insurance premium has been assessed. That single premium assessment took place in 1992 when the problems in New England area credit unions and in the real estate markets resulted in significant losses to the NCUSIF. Other than in that extraordinary

situation, no premium assessments have been required. In fact, effective management of the NCUSIF and minimal credit union losses have resulted in the end-of-year equity ratio being above the required operating level in an amount sufficient to allow the NCUA Board to declare dividends to insured credit unions for six consecutive years beginning in 1995. As a result of the combined effects of the high rate of share growth in 2001, 2002 and 2003 and declining rates of return on the NCUSIF investment portfolio of U.S. Treasury securities, the Fund ended each of those years just below the 1.3 percent operating level and dividends were not paid.

There are two primary factors influencing the NCUSIF and its equity ratio at this time. First, as noted above, the low interest rate environment of recent years has reduced the investment income to the NCUSIF. In December 2003 gross income was $10.6 million, while in December 2002 gross income was $16.2 million. Gross income for May 31, 2004 was $10.9 million. Investment earnings have been significantly reduced since many of the fund's older investments which yielded over six percent have matured over the past several years. The funds are now being reinvested in Treasury Notes of similar maturities with yields of two to three percent. During this same period, the yield of the NCUSIF has fallen over 300 basis points to 2.02 percent for December 31, 2003. The NCUSIF yield for May 31, 2004 is 2.05 percent.

Second, in July 2002 the NCUA Board adopted a policy of building its reserves for losses to the NCUSIF by transferring $1.5 million a month to the reserve account for incurred losses not specifically identified, in addition to reserves for specific cases and a pool for CAMEL Code 4/5 credit unions. The final $1.5 million transfer was made as of December 31, 2003 to the reserve account for incurred losses not specifically identified.

Earnings on the fund principal have been sufficient to keep the NCUSIF appropriately funded into the future absent extraordinary losses, but dividends to insured credit unions that are allowable by statute when the fund equity level exceeds the established operating level are not likely to return until interest rates rise sufficiently to allow earnings to return to historical levels.

Based on the above discussed financial trends and indicators, and as a result of our ongoing programs of examination and supervision of federally insured credit unions, we expect that losses will remain low and we do not anticipate any extraordinary lass cases.

As of May 31, 2004 there are 245 problem credit unions, up from 217 at year-end 2003. This number has remained relatively constant over the last four years. For purposes of comparison, there were 338 problem credit unions in 1999 and, for a 10-year indication, there were 319 in 1994.

For 2003, NCUA was called upon to provide assistance to liquidate, merge or arrange a purchase and assumption for 13 federally insured credit unions. This number is significantly lower than the average of 27.8 such cases over the last ten years.

REGULATORY RELIEF AND EFFICIENCY

Mr. Chairman, this Subcommittee has been taking the lead in the 107th and 108th Congress in many areas of interest to consumers, financial institutions, credit unions and their members. The "Financial Institutions Regulatory Relief Act of 2004," H.R. 1375, is a significant bipartisan achievement that NCUA greatly appreciates and enthusiastically supported as it moved through the House of Representatives. I also strongly supported it in testimony I presented before the Senate last month.

The introduction of the "Credit Union Regulatory Improvements Act of 2003," H.R. 3579 (CURIA), includes many of the same credit union provisions you included in H.R. 1375. Additionally, it addresses some of the most compelling issues being discussed within the credit union industry today. These issues need your attention and I welcome the opportunity to explain their importance. Thank you for demonstrating determination to bring these matters to the attention of your colleagues and the public.

Effective regulation, not excessive regulation is my guiding principle as a federal regulator. Before I discuss the new regulatory reform issues, I would like to comment on the progress NCUA is making under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and report to you on what we are doing through our own annual review of regulations.

EGRPRA AND NCUA ANNUAL REVIEW OF REGULATIONS

NCUA is participating with the other four federal financial institution regulatory agencies in the review project mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). We will soon be publishing our third request for public comment on ways in which we might improve or eliminate regulations that are burdensome or unnecessary. NCUA is carefully coordinating with the other agencies. However, because of the unique nature of credit unions and their differences from other financial institutions, NCUA is publishing separate notices.

We are also coordinating the EGRPRA effort with our own internal regulatory review process. Annually, we scrutinize one-third of our entire body of existing regulations to find ways to simplify or improve any regulation that is outdated or in need of revision. This internal process, which NCUA has had in place for a number of years, has brought about important regulatory reform for credit unions,

including complete overhaul and modernization of NCUA's rules on lending, share accounts and incidental powers.

We expect that both EGRPRA and our internal review will continue to further a critical and strategic initiative of reducing or eliminating unduly burdensome regulation on the credit union system, and that the EGRPRA effort will result in additional recommendations for legislative reform as we work to complete the EGRPRA review by the 2006 statutory deadline.

NEW LEGISLATIVE RECOMMENDATIONS

Since the passage by the House of Representatives of the "Financial Institutions Regulatory Relief Act of 2004" and the introduction of CURIA, two issues have come to my attention for which NCUA is suggesting legislative solutions.

Accounting Treatment of Net Worth in Credit Union Mergers

A time-sensitive recommendation involves an expected Financial Accounting Standards Board (FASB) decision coming later this year with a January 2006 effective date. The issue arises from the interface between the statutory definition of "net worth" in the Federal Credit Union Act and the accounting treatment of net worth in credit union mergers. This issue is important separate and apart from the question of converting to a system of risk-weighted net worth requirements addressed elsewhere in NCUA's testimony.

The Credit Union Membership Access Act of 1998 established a statutory system of capital standards and prompt corrective action (PCA) for federally insured institutions. Capital, or the term "net worth" for credit unions, is defined as being limited to their 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 is a logical result that facilitates the ability of credit unions to merge when it is in the best interests of their members.

A proposed change to the accounting standards for credit union mergers that FASB expects to implement as early as January 1, 2006, will dramatically alter this treatment of retained earnings and net worth in a manner that will make it difficult or impossible for many credit unions to consider combining their strengths through merger. Specifically, FASB's proposed change to accounting rules will require, in a merger, that the retained earnings of one credit union be carried over as "acquired equity" rather than retained earnings. Thus, only the retained earnings of the remaining credit union will count as net worth after the merger. This seriously reduces the post-merger net worth ratio, because that ratio is the retained earnings stated as a percentage of the combined assets of

the two institutions. A lower net worth ratio has serious adverse implications under the statutory PCA scheme, and it is this result that will strongly discourage voluntary mergers and, on occasion, make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF).

To follow the new FASB rule, while still allowing the capital of both credit unions to flow forward as regulatory capital for purposes of PCA, an amendment to the Federal Credit Union Act is sought.

The FASB has indicated it supports a legislative solution and that such a solution will not impact their standard-setting activities. The amendment redefines net worth for PCA purposes as equity, rather than just retained earnings. NCUA has suggested statutory language, as well as report language, clarifying the very limited purpose of this amendment, and they are attached for the Subcommittee's consideration.

Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other related services to insured credit unions. Statutory authority did previously exist for NCUA, but under a temporary provision that expired in 2001. We are currently required to work through credit unions to obtain vendor information or seek voluntary cooperation from vendors. We do not have direct examination authority nor related powers to enforce full disclosure and cooperation in a case where that might become necessary.

We believe that in these times, when privacy, money laundering and financing of terrorism are issues of such paramount national interest, as well as safety and soundness concerns, NCUA should have direct examination authority over those vendors providing services to federally insured credit unions. Direct examination authority would provide NCUA parity with other financial regulators with respect to examinations and would eliminate the need for us to approach the matter indirectly through credit unions, thus providing some measure of regulatory relief. NCUA requests only direct examination authority, and not rulemaking authority, with respect to vendors.

I should also note that the Government Accounting Office (GAO), in its October 2003 report on credit unions stated:

> To improve oversight of third-party vendors, Congress may wish to consider granting NCUA legislative authority to examine third-party vendors that provide services to credit unions and are not examined through FFIEC. (GAO-04-91)

Attached for the Committee's consideration are suggested legislative and report language to accomplish this recommendation.

“CREDIT UNION REGULATORY IMPROVEMENTS ACT OF 2003”

CURIA addresses three prominent issues being discussed in the credit union industry today; adjusting Prompt Corrective Action (PCA) standards for federally insured credit unions based on the risk profile of the institution; member business loan limitations for federally insured credit unions; and conversions of federally insured credit unions to mutual savings banks.

Prompt Corrective Action: Risk-Based Net Worth

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This principle is consistent with our fiduciary responsibility to the insurance fund. However, the current statutory net worth structure establishes a system based largely on net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA’s ability to incorporate behavioral incentives related to higher risk activities.

Section 301 of CURIA would address these inequities by establishing a risk-based system for PCA. NCUA strongly supports such a risk-weighted system. 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 risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

Since first advocating the idea of a risk-based PCA system, NCUA has envisioned a system similar to that currently employed in the banking system where assets are weighted by risk. However the Basel accords do not appropriately apply to credit unions as not-for-profit financial cooperatives that can only build net worth through retained earnings. In addition, unlike the current bank PCA system, which is intended only to address credit risk, we believe a risk-based credit union PCA system should be designed to address all relevant and material risks.

While NCUA supports a statutorily mandated PCA system, the system should contain a statutory definition of net worth with NCUA provided the ability through regulation to exclude certain accounts as necessary from what qualifies as net worth. The system should also establish statutory thresholds based on risk-assets defined by the NCUA Board for all of the net worth classifications, and a minimum leverage component (net worth in relation to total, non-weighted assets) either for all classifications or for the critically undercapitalized and well capitalized classifications.

While NCUA is continuing to develop its specific recommendations we suggest that the leverage ratio below which a credit union is critically undercapitalized remain at its current 2 percent, and that the minimum leverage ratio for a well-capitalized credit union be set at 5 percent.

Although the minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, there are important reasons why that ratio should be lowered. First, our experience tells us that the vast majority of credit unions will operate at a range well above whatever is established as the minimum. This is due to the conservative nature of credit unions (as member-owned cooperatives) and their recognition of the time it takes to rebuild from any unexpected decline in their net worth ratio. The practical result is a "one-size-fits-all" system with capital ratios at levels that are well above those needed and that limit the ability of credit unions to use their capital to improve member services and to manage changes in their assets associated with normal swings in the economy.

We are well aware of the primary argument for a 7 percent leverage ratio, namely that it is comprised of a 5 percent ratio (the ratio banks that wish to take advantage of full powers under the Gramm-Leach-Bliley Act) plus an additional 2 percent to reflect credit union investments in the National Credit Union Share Insurance Fund and in corporate credit unions. These investments are assets, however, under Generally Accepted Accounting Principles and like any asset, have value to individual credit unions. The NCUSIF capitalization deposit is returned to a credit union that leaves the Fund, it is available to cover losses in a failed credit union, and it is protected from the risk of a write-down by virtue of the fact that NCUA is required to assess insurance premiums as necessary to maintain the NCUSIF ratio at a minimum level of 1.2 percent. Capitalization investments in corporate credit unions are not uniform, indeed not all credit unions even belong to a corporate, and those investments would be better addressed on the risk-based side of the PCA system.

All financial assets carry some risk. Indeed, many carry far greater risk than the insurance deposit and corporate capitalization deposits. It is inappropriate to single out these assets and impose a dollar-for-dollar capitalization requirement.

For the remaining elements of the risk-based PCA system, NCUA should be provided with the authority to set risk-based net worth levels and corrective actions by regulation. This will enable us to ensure the system remains relevant and up-to-date with emerging trends in credit unions and the marketplace.

Member Business Lending

Federal credit unions have been authorized since 1934 to make member business loans and have had a successful record of meeting the small business loan needs of their members. NCUA issued regulations establishing safety and

soundness standards for member business lending as a result of some losses on business lending beginning in the early 1980's. Those regulations, which apply to all federally insured credit unions, have been successful in ensuring that credit union business lending is carried out in a safe and sound manner that does not present undue risk to the NCUSIF. In fact, since the time that NCUA issued its regulation, defaults for member business lending have consistently been lower than the ratios for member loans generally.

Nonetheless, Congress in 1998, as part of the Credit Union Membership Access Act, established an aggregate cap on member business lending. The cap, 12.25 percent of total assets for well-capitalized credit unions and lower for those with less capital, has had two detrimental effects. First, for those credit unions with successful business programs, they must shut down their programs once they reach the cap, and they are prevented from providing needed and valuable services to their members. Second, the cap discourages other credit unions from entering the program because of the difficulties in operating a successful and economically viable program within the limits of the cap.

To address these concerns, Section 201 of CURIA would: (1) raise the cap to 20 percent of total assets, and (2) increase the threshold, below which an individual loan is not treated as a business loan for purposes of the cap, from the current $50,000 level to the new level of $100,000.

In view of the historical success of NCUA's regulatory and supervisory efforts in ensuring that business loans are made in a safe and sound manner and at no increased risk to the Insurance Fund, NCUA continues to believe, as it did in 1998, that a cap on business lending is unwarranted and hampers the ability of individual credit unions to meet the varying needs of their memberships. The increases proposed by CURIA are, however, a vast improvement over the current limitations, and NCUA therefore strongly supports these initial changes.

Credit Union Conversions to Mutual Savings Bank Charter

Prior to the enactment of CUMAA, NCUA rules required that a majority of all members of a federal credit union approve a conversion to a mutual savings bank charter. That rule was intended to ensure full democratic control of a federal credit union's capital and its future by its member owners. CUMAA, however, restricted NCUA's authority over these conversions and provided that a majority of those members who choose to vote will determine the outcome of a conversion proposal. The post CUMAA record of conversions is clear in demonstrating that these conversions are often motivated in part by the ability of officials to enrich themselves, that the voting process is often structured to minimize member turnout, and that disclosures are designed to obfuscate the facts related to loss of democratic ownership and control of the institution.

Section of 113 of CURIA addresses these concerns to a limited extent by conditioning conversion to a savings bank charter on a vote in which least 20% of the members cast their ballot. While a better solution would be to encourage even greater member participation in a vote of this importance, Section 113 is an improvement over the current law, and for that reason we support it.

Authorizing Credit Unions to Lease Space in Credit Union Office Buildings in Underserved Areas

Current NCUA rules permit federal credit unions to lease space to third parties, but only in commercial space the credit union intends to fully occupy at a later time.

Section 112 of CURIA proposes to expand leasing authority by allowing federal credit unions to lease space indefinitely to third parties, so long as the building is in an "underserved area" and the building is "purchased or constructed by the credit union for a credit union office or credit union operations…" The credit union would not plan to use all of the space for its own use, but would be free to lease the remainder to a third party. NCUA is provided necessary rulemaking responsibility to ensure the safety and soundness of the credit union.

The section uses and defines the term "underserved area" differently than the same term is currently defined in the FCUA. NCUA prefers the use of the term "underserved area" as it is currently defined at Section 109(c)(2) of the FCU Act (12 U.S.C. 1759(c)(2)), that is based on an area qualifying as an investment area under the Community Development Financial Institutions Act (CDFI Act).

NCUA current policy and practice with regard to federal credit unions adopting underserved areas is to require them to establish a "bricks and mortar" presence in the underserved area in order to encourage active relationship development (ATM's and electronic kiosks won't do). While a building purchased or constructed in an underserved area meets the "bricks and mortar" policy, language might be added to specify that "any building purchased be staffed to provide service to credit union members in that underserved area." This could also be accomplished through regulations implementing Section 112.

OTHER PROVISIONS OF CURIA RECOMMENDED BY NCUA AND INCLUDED IN HR 1375

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.

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, as proposed in CURIA, 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. Section 303 of H.R. 1375, as passed by the House of Representatives, 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.

Section 313 of HR 1375, and Section 115 of CURIA, 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.

ADDITIONAL CREDIT UNION PROVISIONS IN CURIA

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

NCUA has reviewed all of the additional credit union provisions included in H.R. 3579 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 (Section 102); member business loans for non-profit religious organizations (Section 106); criteria for continued membership of certain member groups in community charter conversions (Section 109); credit union governance changes (Section 110); and 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 (Section 111). Again, though we recognize these issues as statutory in nature and therefore a public policy decision only the Congress can make, we have carefully examined each and have determined that these provisions present no safety and soundness concerns for the credit unions we regulate and/or insure. Also, Section 114 of H.R. 3579 provides for an exemption from pre-merger notification requirements of the Clayton Act. We have likewise reviewed this provision, and have no objections and actually see benefit from a safety and soundness perspective.

Conclusion

As we implement regulatory reforms through our own annual review of regulations, through the EGRPRA process or through any legislative improvements the Congress ultimately chooses to enact, effective regulation, not excessive regulation, should be the basis of fulfilling our mission and ensuring the safety and soundness of our nation's credit unions.

The additional legislative proposals I have presented here are consistent with the mission of credit unions and the principles of safety and soundness. The credit union provisions of H.R. 1375 and H.R. 3579 will benefit credit union members and have a positive impact on credit unions by lowering the cost of doing business and complying with regulations and the Federal Credit Union Act.

I would be pleased to assist your further deliberations on these in any way I can.

Thank you.

ADDENDUM TO CHAIRMAN JOHNSON'S TESTIMONY

Proposed Language to the Federal Credit Union Act Regarding Mergers and Net Worth

Proposed technical correction to Section 216 of the Federal Credit Union Act (12 USC 1790d(o)(2)(A)):

(2) **Net Worth**.---The term 'net worth'--

(A) with respect to any insured credit union, means equity as determined under generally accepted accounting principles and as authorized by the Board; and

(B) 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 claims of creditors, shareholders, and the Fund.

Draft Report Language

This amendment to Section 216 of the Federal Credit Union Act (FCU Act) (12 USC 1790d(o)(2)(A)) redefines the term "net worth" for PCA purposes by replacing the phrase "retained earnings balance" with the phrase "equity" and by inserting the phrase "and as authorized by the Board" (i.e., NCUA Board) where indicated. The amendment is necessary to cure the unintended consequence of business combination accounting rules the Financial Accounting Standards Board (FASB) is intending to apply to the combinations of mutual enterprises (e.g., credit unions).[1]

[1] In June 2001, the FASB adopted 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).

When FASB lifts the paragraph 60 deferral of the acquisition method that credit unions have enjoyed, this will eliminate the practice of accounting for mergers as a pooling of interests. The acquisition method would require the valuation of the target credit union at fair value; the recognition of identifiable intangibles (e.g., core deposit intangibles and/or goodwill), when relevant; and the application of a market-based acquisition model to a non-bargained transaction. The FASB intends to expose a statement for public comment in the 2nd quarter of 2004 and to finalize the standard in the 2005 with an effective date in early 2006.

Currently, under the FCU Act, a credit union's capital is measured based on the retained earnings balance as determined under GAAP. The FASB is preparing to revise GAAP in relation to the combination of mutual enterprises (i.e., credit unions) with the effective result that the interplay between the capital definition in the FCU Act and FASB's new rules will create a disincentive to otherwise desirable credit union mergers. Additionally, the change will make it more difficult for the NCUA to carry out its responsibilities to protect the public interest in managing and minimizing losses to the National Credit Union Share Insurance Fund (NCUSIF) through the merger option. The FASB has expressed support for a legislative solution and has indicated that a legislative redefinition of capital (net worth) will not affect their standards-setting activities. The remedy needed is an expanded definition of capital in the FCU Act in advance of the FASB rule effective date (expected January 2006) to mitigate this unintended result. Banks and their insurers do not have the same concerns because their existing capital definition under relevant law is broader.

This amendment is intended to address a narrow and technical accounting issue and in the process remove the unintended disincentive to credit union mergers that FASB's imminent action will create.

The "as authorized by the Board language" has the limited effect of allowing the Board comparable authority as federal banking regulators to exclude items within the capital structure that do not have value to the insurance fund in a liquidation scenario, e.g., core deposit intangibles, goodwill, etc., thus not "overvaluing" resulting post-merger capital. The "as authorized" language does not provide the Board any other authority to either limit the definition of net worth or alter the PCA net worth categories. The authority would be exercised only after due deliberation and public comment through a federal register notice and rulemaking process.

Unlike FDIC-insured financial institutions, credit unions are permitted by law to count as capital only their "retained earnings" as determined under GAAP. The law excludes all other equity components. Federally-insured credit unions are required to comply with a Congressionally-mandated system of minimum regulatory capital standards known as "prompt corrective action." 12 U.S.C.§1790d. A credit union's "net worth ratio" determines its classification among five statutory net worth categories. The lower the category, the more supervisory actions the credit union must comply with and implement. The denominator of the net ratio is the balance of a credit union's total assets. The numerator of the ratio is narrowly limited by law to the "retained earnings" component of equity. 12 U.S.C.§1790d(o)(2)(A). In contrast, the numerator of an FDIC-insured financial institution's equivalent "leverage ratio" may include virtually all GAAP equity components.

Under FASB's expected approach, however, a combination between credit unions would cause the acquiring credit union's capital ratio to *decline* in most cases. Potential acquiring credit unions would naturally find the prospect of being demoted to a lower net worth category, and potentially subject to more supervisory actions, too high a price to pay to merge with another credit union. In contrast, the expected approach would not inflict this problem on acquiring banks and thrifts because they are allowed to include virtually all components of equity in their capital.

The adverse impact on an acquirer's post-merger capital level will be a disincentive to otherwise desirable credit union mergers. In turn, it will be much more difficult for NCUA to carry out its responsibility to protect the public interest. Fewer potential merger partners will come forward to rescue a troubled credit union when they realize that the reward for doing so is a reduction in post-merger capital. This also will undermine the purpose of "prompt corrective action" which is to resolve the problems of credit unions while minimizing losses to the NCUSIF. Fewer willing merger partners mean fewer opportunities to avert losses to the NCUSIF by merging a troubled credit union. Credit union mergers have traditionally been effective in accomplishing both objectives while preserving the continuity of credit union service to the target credit union's members. We have no doubt that Congress neither intended nor expected to discourage mergers when it adopted GAAP retained earnings as the definition of credit union capital.

Proposed Amendment to the Federal Credit Union Act Regarding Vendor Examinations.

The Federal Credit Union Act, (12 U.S.C. §1752 et seq.) is amended by deleting existing Section 206A, 12 U.S.C. §1786a, and adding the following new section:

§1786a

Examination of credit union service providers -

(a) If an insured credit union causes to be performed for itself, by contract or otherwise, any service that provides information systems support, technology services, data processing services, loan services or other services related to the credit union's operations (as those terms are defined by the Board, by regulation) such service shall be subject to examination by the Board to the same extent as if such services were being performed by the insured credit union itself on its own premises.

(b) Administration by the Board – The Board may issue such regulations and orders as may be necessary to enable it to carry out examinations under this Section.

Draft Report Language on Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other services to federally insured credit unions. This statutory authority did previously exist for NCUA, but under a sunset provision that expired in 2001. Indeed, the authority that expired in 2001 allowed NCUA to examine and regulate all third-party service providers, and was thus broader than the authority now being requested by NCUA.

As of December 2003 approximately 25% of all federally insured credit unions contract with outside vendors to perform many of their automated back room accounting processes. Another 70% use vendor supplied software and data processing programs that rely upon vendor servicing and maintenance to function effectively. These services may include such things as electronic money transfers, check clearance, transactional internet services, and varying levels of internal controls to assist credit unions in identifying and reporting suspicious activity. Other third-party vendors provide processing and support services in areas such as loan processing and overdraft protection.

This heavy and increasing reliance on vendors by credit unions for many critical functions makes it essential for NCUA to have the authority to examine and

evaluate vendor operations. The General Accounting Office in October 2003 recommended that Congress consider giving NCUA the authority to examine third-party vendors. NCUA's ability to timely identify weaknesses and require their correction is critical to our ability to assure credit unions operate in a safe and sound manner.