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Introduction

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, thank you for offering me this opportunity to provide a few comments today on the important subject of "Credit Union Regulatory Improvements".

My name is William Jackson, and I am an associate professor of finance and economics at the Kenan-Flagler Business School of the University of North Carolina at Chapel Hill. The University of North Carolina at Chapel Hill is the flagship university of the great state of North Carolina. And, I have had the pleasure of teaching courses on financial institutions and financial markets (as well as other subjects) at this fine institution for about twelve years. Currently, I am on professional leave from the University of North Carolina while I serve as a Visiting Research Scholar at the Federal Reserve Bank of Atlanta where I conduct research on several topics related to the behavior of financial institution and financial markets.

By any reasonable measure, the U.S. financial system is the biggest and the best in the world. With over 80 million members and over $600 billion in assets, credit unions are an integral part of the U.S. financial system. I believe that the proposed Credit Union Regulatory Improvement Act (CURIA) represents significant progress in the economic regulation of federally insured credit unions. It is my opinion that the changes proposed in CURIA will help the U.S. financial system by allowing credit unions to become more efficient members of our dynamic financial services marketplace. It will do this by providing more flexibility, where appropriate, for both credit unions and their regulator, the National Credit Union Administration.

I base this opinion on a recent research study that I was chosen to conduct for the Filene Research Institute (Filene). The research study was published in early 2003. My agreement with Filene was that as part of my study I would prepare an independent evaluation the question: *should* credit unions receive regulatory relief? Thus, the issue of credit union deregulation was central to my study just as it is to the proposed Credit Union Regulatory Improvements Act currently under consideration by this Subcommittee. I am here today to provide a brief summary of my recent research study and to demonstrate that the proposed Credit Union Regulatory Improvements Act is supported in general, and in several specific instances, by my recent Filene research study.

The remainder of my testimony is organized into three sections. In the first section, entitled "The Logic of Credit Union Deregulation", I provide a summary of my Filene research study. In the second section I discuss several specific topics that are both part of the proposed CURIA and discussed in my Filene research study. These topics will include member business lending, capital requirements, general lending restrictions, investing restrictions, incidental powers restrictions, and nonmember services restrictions. In the third section I offer a brief conclusion to my testimony.

The Logic of Credit Union Deregulation

My Filene research study was entitled, "The Future of Credit Unions: Public Policy Issues." The main question addressed in my study was whether state and federal chartered credit unions should be deregulated. Obviously, this is a very broad and complex question. And, I was both honored and challenged when Filene chose me to conduct this study. To address the question of whether credit unions should be deregulated, or receive regulatory relief, I decide I needed to develop a systematic analytical framework. This framework provided a reasonable and rational approach to address this complex question. The approach was based on six steps.

In the first step, I presented some background information on the operations and current trends for the three types of depository institutions (i.e., commercial banks, thrifts, and credit unions). In the second step, I addressed the general question of why Congress and State Legislatures deregulated the depository institutions industry. This step allowed me to develop a general framework for evaluating the dynamics of recent federal and state regulatory policy toward depository institutions. In step three, after establishing a rationale for their deregulation, I briefly summarized the major acts of Congress that codified the deregulation of depository institutions. Next, in step four, I focused in more detail on the recent credit union deregulations initiated by Congress (e.g., CUMAA). Also, in step four, I compared bank and thrift deregulation to credit union deregulation to evaluate whether credit unions had received more or less deregulation than banks or thrifts. The next step, step five, was the most important part of my report. In step five, I investigated those areas where deregulation has been different for credit unions relative to banks or thrifts. This investigation included an evaluation of whether a differential deregulatory treatment of credit unions was reasonable. And, the criteria for judging reasonableness was based on similarities and differences of banks, thrifts, and credit unions in their role as depository institutions, or financial services providers, in the overall U.S. financial system. To be more succinct, I addressed the question: When are good reasons for deregulating banks and thrifts also good reasons for deregulating credit unions? Finally, in step six, I summarized and synthesized the issues presented in the first five steps in order to provide some general guidelines for thinking about the optimal regulation of credit unions. In particular, I addressed two questions in step six. First, what should be the objectives of optimal credit union regulation? And, second, are there unique characteristics of credit unions that would suggest that they need more or less regulation relative to banks or thrifts?

What did I conclude?

The conclusions of my research report were fairly straightforward. First, I concluded that the reason depository institutions were deregulated was that Congress and State Legislatures rightly recognized that the entire financial services industry had fundamentally changed. And, because the industry had changed, the laws and regulations governing the depository institutions had to also change to reflect the new competitive realities facing commercial banks, thrifts, and credit unions. For example, consider how dramatic the changes in the structure and operations of depository institutions have been over the last two decades. To a large degree, these changes can be traced to three factors. These factors, while significant individually, when combined created a "Perfect Storm" of change for the depository institutions industry. The first (and most powerful) of these three factors was advancements in technology. The second was increases in market competition. And, the third factor was financial innovations and new product creation. It was my contention that these three factors were the driving forces behind the need for the deregulation of the depository institutions industry.

My second conclusion was that a significant amount of financial deregulation had occurred over the last twenty years. My third conclusion was that credit unions had been deregulated less than commercial banks or thrifts. My fourth conclusion was that the same factors that reasonably support the deregulation of other depository institutions also reasonably support the deregulation of credit unions. And, my fifth conclusion was that the degree of deregulation recently experienced by the banking industry is very likely to approximate the appropriate degree of deregulation that should be applied to credit unions.

In my opinion, public policy toward depository institutions should not attempt to provide a legislative mandate that universally restricts the set of operational choices available to credit unions, banks, or thrifts. Rather, public policy should seek to provide a broad framework in which operational differences are determined by the strategic choices of these institutions themselves, given their different structures and forms of organization. Of course, these strategic choices will be subject to the discipline of a competitive marketplace; and should be subject to the oversight of a well-informed and prudent regulatory institution. And, the inherent differences in risks associated with different types of financial operations must be carefully considered in developing the optimal principles for regulating our depository institutions. I firmly believe that the legislation codifying these principles must be broad enough to allow the respective regulatory and supervisory agencies to adapt to their industries as their industries adapt to a changing competitive marketplace. Of course, these regulatory and supervisory agencies must be provided adequate resources and incentives to meet these challenges.

Additionally, I believe that good public policy dictates that our regulatory framework be adjusted whenever the costs of regulatory restrictions exceed their benefits. It seems very likely that the current costs of regulatory restrictions on credit unions, greatly exceeds any reasonable measure of their current benefits. In the final analysis, the regulation of credit unions (as well as other depository institutions) should seek to provide as much consumer choice as possible, while insuring a safe and sound financial system. It appears to me that some of our current laws and regulations are unnecessarily limiting credit unions' ability to provide the financial products and services that their members demand. But, I believe that the Credit Union Regulatory Improvements Act currently under consideration by this Subcommittee goes a long way toward improving the level of legislative oversight for credit unions.

In my Filene research report I suggested that credit unions should receive deregulatory relief in several areas. Five of these areas that coincide with issues addressed in the proposed Credit Union Regulatory Improvements Act are: (1) member business lending, (2) capital requirements, (3) investing restrictions, (4) the provision of incidental financial services, and (5) non-member services. I briefly address each of these five areas in the next section of my testimony.

Some Specific Topics addressed in my Filene Research Study

MEMBER BUSINESS LENDING

Current regulations place severe limitations on the member business lending activities of federally insured credit unions. For examples, consider the following four typical limitations. First, a credit union's member business lending is limited to the lesser of either 1.75 times net worth or 12.25 percent of total assets. Second, credit unions' loans can only be made to credit union members. Third, the loans generally require the personal guarantee of the borrower. And, fourth, the member business loans generally must be fully collateralized.

These are very restrictive regulations. In this section I argue that the costs of these restrictions on our financial system are more than their benefits. I make this argument by simply addressing the question: What would happen if we relaxed one of the four restrictions listed above? In particular, I address the likely outcome of relaxing the requirement limiting a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets (note: similar outcomes would likely result from relaxing some of the other restrictions).

Reducing the limitations on member business lending will allow more potential for credit unions to diversify their asset portfolios. This diversification benefit may serve to reduce the overall risk of credit unions' loan portfolios. Furthermore, reducing the limitations on member business lending may well allow credit unions to serve business clients that would otherwise not receive credit. To investigate this latter possibility I provide some evidence below on the current business clientele serviced by credit union member business lending. In particular, I offer evidence to suggest that those who will benefit from an increase in credit union member business lending are small businesses and low- to moderate-income individuals.

Small Business Credit and Member Business Lending

A study published by the U.S. Department of the Treasury in 2001 reported that 59 percent of credit union member business loans had balances less than $50,000 and that only two percent had balances greater than $500,000. These loans amounted to 14 percent and 17 percent, respectively, of the total outstanding principal balance of all U.S. credit union member business loans reported. For all member business loans reported, over half were collateralized with non-agricultural real estate, and another 23 percent were collateralized with taxicab medallions. Agricultural collateral backed 12 percent of the loans.

Additionally, over 50 percent of the member business loans reported were made to businesses with assets under $100,000. And, about 86 percent of all loans were made to businesses with total assets less than $500,000. Loans to service-oriented businesses and for rental property made up nearly 55 percent of the total number of loans.

Looking at the total dollar value of member business loans outstanding, the survey showed that over 70 percent went either to service providers (38.8 percent) or for rental properties (32.9 percent). It appears that the figures for service providers largely reflect the loans made for taxicab medallions. Nearly half of the unpaid principal balance of member business loans outstanding was to businesses with total assets between $100,000 and $500,000. Cumulatively, almost 70 percent of the value of member business loans was made to businesses with total assets less than $500,000.

As might be expected, the vast majority of credit union member business lending goes to small businesses. And, thus, policies that increase credit union member business lending are likely to increase available credit to small business borrowers.

Meeting the Needs of Low- and Moderate-Income Individuals

An interesting question is: To what extent does member business lending help to meet the financial services needs of low- and moderate-income individuals?

The Treasury study also reported that 25 percent of credit unions' member business loans were made to members with household income of less than $30,000. In dollar terms, these loans totaled about 13 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balance) went to households with incomes reported to be between $30,000 and $50,000. Thus, it appears that about 45% (28% in dollar terms) of all credit union member business lending goes to low and moderate-income individuals. And, thus, policies that increase credit union member business lending are likely to increase available business credit to low and moderate-income individuals.

Member Business Loans may be Less Risky

Credit union member business loans are generally loans to individuals for business purposes. Because an individual (or group of individuals) is personally liable for the debt, member business loans tend to be smaller and less risky than typical business loans made by banks and thrifts. Indeed, credit union member business loans share many characteristics of consumer loans. That is, these loans are generally smaller and fully collateralized, and borrower risk profiles are more easily determined. As a result, the credit risk associated with member business loans may be less than that for most banks and thrifts commercial loans.

Because credit union member business loans are likely to be less risky than comparable loans at banks or thrifts, increasing member business lending at credit unions will not likely increase risk in the overall financial system as much as the risk associated with increases in bank or thrift business lending. Reducing the restrictions on member business lending, however, will likely lead to a higher level of average risk in the member business loan portfolios of credit unions. But, given the cooperative philosophy and culture of credit unions this increase in risk is still likely to be less than the risk associated with increases in bank or thrift business lending.

Thus, reducing the restrictions on credit union member business lending is likely to lead to more lending to small businesses, more lending to low- and moderate-income individuals, without adding any significant additional risk into the U.S. financial system.

CAPITAL REQUIREMENTS

With the passage of The Credit Union Membership Access Act of 1998 (CUMAA), federally insured credit unions became subject to similar prompt corrective action regulations as commercial banks. These new regulations formed the basis for the current capital requirements that apply to most credit unions. The capital requirements for credit unions were set at a significantly higher level than those for banks. The rationale for setting a higher capital requirement for credit unions was based (in part) on the inability of credit unions to quickly raise capital by issuing securities, as banks are able to do.

Capital requirements and net worth requirements exist to ensure that potentially troubled institutions do not reach insolvency and impose costs on the deposit insurer and taxpayers. To obtain that goal in the case of undercapitalized credit unions, (1) restrictions may be placed on the choices and activities available to management, (2) management may be replaced, or (3), if necessary, the institutions may be closed. However, under current capital and net worth requirements, faced with profitable opportunities and low capital ratios, commercial banks find it easier than credit unions to simultaneously expand and reach their capital targets.

Banks may, on relatively short notice, issue common stock, subordinated debt, or a variety of debt-equity hybrids that qualify towards their capital requirements. In contrast, credit unions have no flexibility on the choice of instruments that may be used to meet net worth requirements. In effect, current regulations limit the ability of credit unions to serve their members on a timely basis, if their net worth ratios approach their net worth requirements. Several proposals have been made over the last few years, seeking to correct this situation. As might be expected, these proposals seek to expand the range of instruments that credit unions may use to meet their net worth requirements.

Credit union net worth requirements may have been set too high on a risk-adjusted basis

CUMAA codified the net worth requirements for credit unions at a level higher than the corresponding requirements for banks. However, for purposes of providing protection to their respective deposit insurance system, credit unions may actually require a lower net worth mandate than commercial banks of similar size and risk-profile. This is because credit unions are likely to take on less risk than profit-seeking financial institutions because credit unions are nonprofit cooperatives. For example, credit union boards of directors and senior managers do not receive stock or stock options in their credit unions. Thus, the moral hazard and other principal-agent problems associated with deposit insurance are not as problematic in credit unions relative to other types of insured depository institutions.

I suggest that this is an area that needs to be revisited by Congress. I recommend that the minimum net worth requirements from the CUMAA be eliminated. And, that the NCUA, with guidance from Congress, be given the authority to establish and maintain the minimum net worth requirements for federally insured credit unions. I believe a significant amount of guidance in this area has been developed in the proposed Credit Union Regulatory Improvement Act (CURIA). In particular, I believe that the risk-based capital approach contained in CURIA is a step in the right direction toward improving the capital regulation of credit unions.

Optimal regulatory policy must continually weigh the costs and benefits of its restrictions on the operating policies of those regulated. And, when the costs of the restrictions exceed their benefits, it is time to reconsider the regulatory policy. The costs of the current CUMAA based minimum net worth requirements for credit unions are probably higher than their corresponding benefits. Thus, this policy should be reconsidered.

INVESTING RESTRICTIONS

In order to be competitive in the marketplace, credit unions should have a wide range of investment alternatives available to them. The current statutory and regulatory constraints on credit unions' allowable investment products are shocking. In most cases, credit unions can only invest in U.S. government securities and the deposits of other depository institutions, while commercial banks and thrift may choose from a very wide variety of investment products.

Credit unions should be permitted to invest in a wider range of high quality securities, such as, asset-backed securities; corporate debt securities (e.g., commercial paper, notes and bonds); non-agency mortgage-backed securities; and real estate investment trusts. Additionally, credit unions should be allowed to invest in an expanded array of securities that aid credit unions in developing more effective risk management processes.

The proposed Credit Union Regulatory Improvements Act before this Subcommittee would allow for a broader array of alternative investments for credit unions. This is in complete agreement with the conclusions in my Filene research study on investing restrictions. And, I believe it moves public policy in the right direction.

INCIDENTAL POWERS RESTRICTIONS

The Gramm-Leach-Bliley Act of 1999 (GLBA) expanded the principles for determining the permissible activities of a bank from "closely related to banking" to "financial in nature". Activities specifically determined as "financial in nature" are securities brokerage and underwriting, insurance agency and underwriting, and the ability to make merchant capital investments. Additionally, GLBA provided the federal bank regulators with the ability to designate additional activities as "financial in nature." GLBA did not however expand the permissible set of activities for credit unions. Credit unions should be allowed to offer new financial products and services to their members because other depository institutions will be allowed to do so for their customers. Simply put, credit unions should be given parity with other federally insured financial institutions in the areas of incidental powers. Credit union members should have the same access to consumer financial services as customers of other depository institutions.

The proposed Credit Union Regulatory Improvements Act will allow for an expanded set of available financial services to credit union members by increasing the allowable investment limit for credit unions in CUSOs. I believe that this is a move in the right direction.

NON-MEMBER SERVICES

Optimal regulatory policy would imply that credit unions should be encouraged to offer services, even to nonmembers, whenever such services served a recognized social policy objective. Two services that meet such criteria are check-cashing and payday lending services. Both payday lending and check-cashing services seem to fit the culture of credit unions. Many lower-income households – those who can least afford it – pay high fees for these types of financial services in the alternative financial sector. Credit unions can provide most of these services at lower cost, while charging fees consistent with their long-term financial well-being. By reaching out to these households, credit unions can introduce them to products and services that will help them build financial savings, reduce debt burdens, and clean up impaired credit records. Credit unions, working together, can make an enormous contribution to the financial well-being of thousands of lower-income households by offering these non-member services.

The proposed Credit Union Regulatory Improvements Act will allow federal credit unions to provide check-cashing services to non-members as long as those non-members are within the scope of the credit union's field of membership. I believe that this is a good start in the right direction.

Conclusions

When addressing the issue of deregulating credit unions, at the end of the day, we still return to this basic question. Do the costs of the regulatory limitations currently in place for credit unions outweigh their benefits? Here we can consider the benefits of regulatory limitations as enhancing the safety and soundness of the U.S. credit union industry. And, we can consider the costs of regulatory limitations as the detrimental impact on consumer choice caused by the restrictions on financial innovation associated with such limitations. Optimal public policy dictates that the regulatory limitations on credit unions be adjusted whenever their costs exceed their benefits.

Currently, those costs appear to greatly exceed any reasonable measure of their benefits. Recall that the regulation of credit unions should seek to provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace, while insuring a safe and sound financial system. The current deregulatory legislation proposed in the Credit Union Regulatory Improvement Act is a start in the right direction toward removing the restrictions that limit credit unions' ability to provide the products and services that their members' need and demand.

As this Subcommittee continues its good work on the proposed Credit Union Regulatory Improvements Act, it is my belief that it would be appropriate for the Subcommittee to continue to emphasize the option to authorize the National Credit Union Administration to address as many of these important issues as possible from a regulatory basis as opposed to detailed legislative mandates. Such an approach would make it possible for the regulator to adjust, where appropriate, to changing competitive conditions in the marketplace. And, it would allow the regulator to adjust to evolving safety and soundness considerations without the need of statutory revisions.

This concludes my testimony. And, again, I thank you for the honor and privilege of offering comments on this important regulatory issue.

Short Biography for William E. Jackson III, PhD

Dr. William E. Jackson III, an associate professor of finance and economics at the Kenan-Flagler Business School, is a recognized expert in the areas of financial intermediation and industrial economics. During the 2004-2005 academic year Dr. Jackson will be a Visiting Research Scholar at the Federal Reserve Bank of Atlanta where he will continue his current research. Professor Jackson's research centers on the role financial markets and financial institutions play in making the modern economy more efficient and productive. Specific areas of research include corporate governance, small firm finance, monetary policy and macroeconomics, industrial economics, financial markets and institutions, corporate finance, financial literacy, and public policy.

Dr. Jackson earned his BA in economics and applied mathematics at Centre College, his MBA in finance at Stanford University, and his Ph.D. in economics at the University of Chicago. The author of many articles published in major academic and practitioner journals, Dr. Jackson's most recent published work focuses on issues related to small firms access to credit markets, corporate governance and bank mergers, the optimal level of service quality in the financial services industry, and risk management at financial institutions. Dr. Jackson's current research agenda also includes topics related to the comparative consumer deposit pricing behavior of banks and credit unions, small firm finance and public policy interventions in credit markets, executive compensation and commercial bank risk, mergers and acquisitions, private equity markets, and financial markets in emerging economies.

Dr. Jackson's research has been published in the leading academic journals in the areas of empirical economics, management, and banking. His articles have appeared in such journals as, the *Journal of Money Credit and Banking*, the *Review of Industrial Organization*, the *Journal of Banking and Finance, Management Science*, and the *Review of Economics and Statistics*. Dr. Jackson is currently on the Editorial Advisory Board of one of the premier small firm research journals, the *Journal of Small Business Management*.

Dr. Jackson has held positions with the Board of Governors of the Federal Reserve System, The Federal Reserve Bank of Chicago, The Federal Reserve Bank of Cleveland, The Federal Reserve Bank of Atlanta, Boston University, Jackson and Company (his consulting firm), Ernst and Young, and Centre College. Recently, Dr. Jackson provided expert testimony before the Michigan Senate on the deregulation of credit unions.