STATEMENT SUBMITTED BY THE CREDIT UNION NATIONAL ASSOCIATION TO THE SENATE BANKING COMMITTEE DECEMBER 9, 2010

THE STATE OF THE CREDIT UNION INDUSTRY

The following statement provides background on the United States credit union system, describes the recent challenges credit unions face, including those as a result of the financial crisis, and identifies statutory, regulatory and supervisory obstacles that inhibit and, in some cases, prevent credit unions from serving their members even better. The statement addresses the significance of credit union's federal income tax exemption, and makes recommendations for changes in legislation to strengthen the credit union system, including increasing the credit union member business lending cap and allowing credit unions to access capital beyond their retained earnings.

General Background

In general, credit unions are doing well and working hard to serve their members' financial needs, including continuing to provide loans at affordable rates in the face of the economic crisis and reduced lending by a number of banks and other creditors.

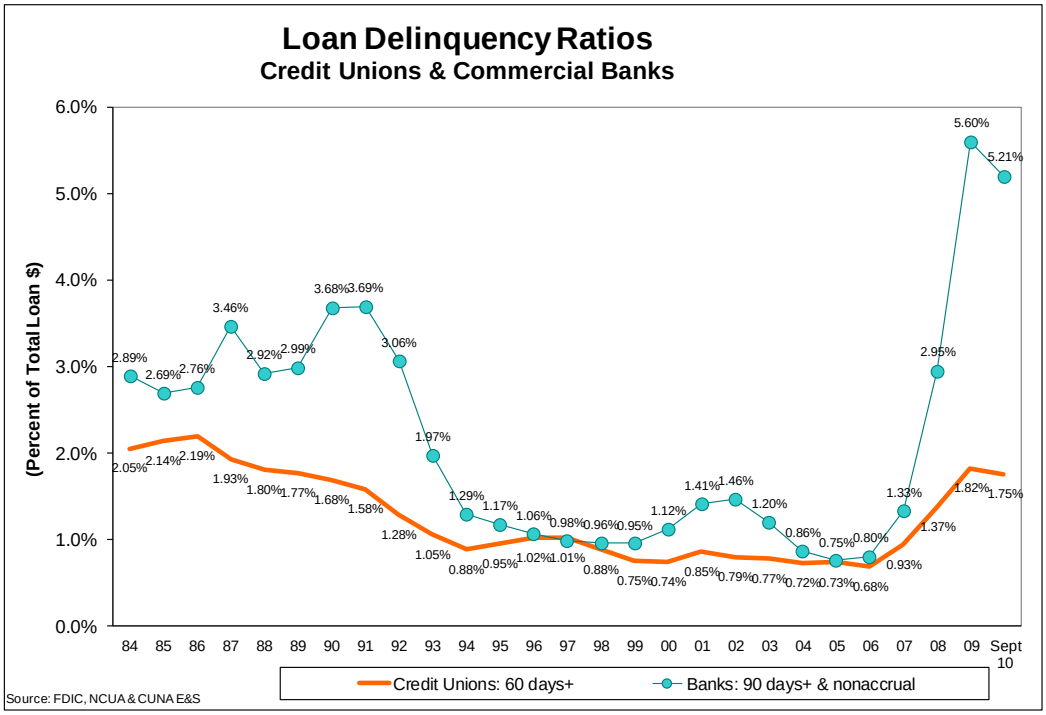
Overall, nearly 92 million U.S. consumers are member-owners of, and receive all or part of their financial services from the nation's 7,600 credit unions. Credit unions are a small, but constant presence in the financial services industry. Credit unions hold about 6.7 percent of household financial assets, a market share that hasn't changed significantly in over 25 years. As not-for-profit cooperatives, credit unions generally offer more attractive savings and loan rates as well as generally lower fees. Surveys consistently rank credit unions first among financial institutions in consumer satisfaction.

Credit unions are democratically owned and controlled institutions that take pride in their "people helping people" philosophy. Credit union boards of directors are elected by members; each member has an equal vote, regardless of how much he or she has on deposit. Only members may serve as directors, and directors generally serve without remuneration. Volunteers are an important credit union resource. Presently, approximately 100,000 Americans volunteer for their credit unions, serving as board members, committee members or providing other assistance. Credit unions have no outside stockholders, so after meeting net worth (capital) requirements, earnings are returned to members in the form of dividends on savings, lower loan rates and fees, or additional services.

Based on this structure, Congress granted credit unions a federal tax exemption in 1934; this status has been reaffirmed by Congress several times over the last 75 years. While this

exemption scores at approximately $1.5 billion per year, we estimate that credit unions provide about $7.5 billion in direct financial benefits to their members per year.[1]

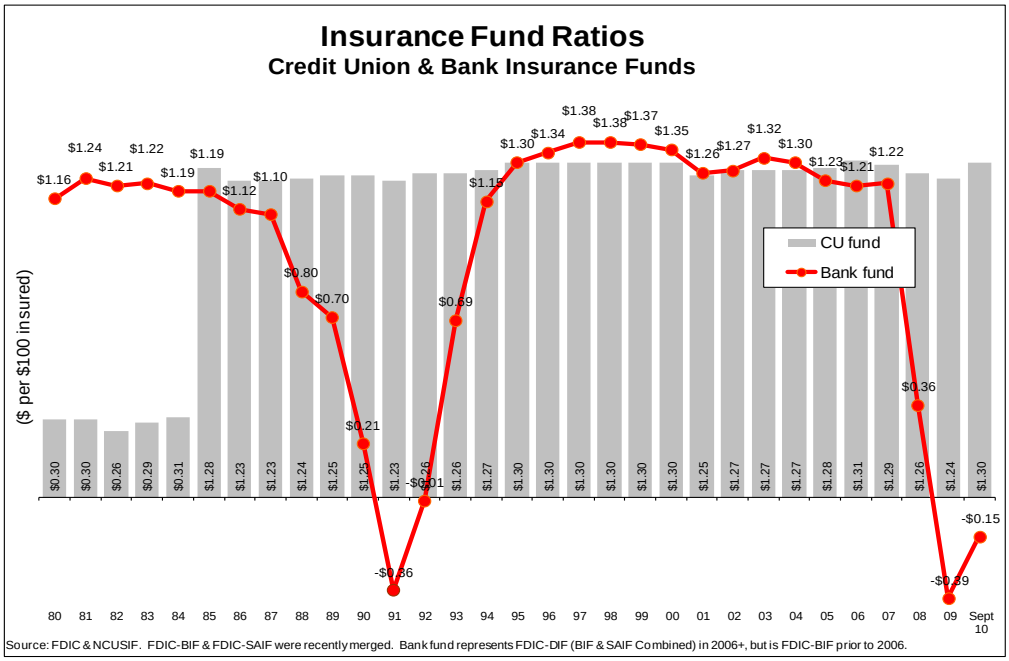
Credit unions engage in consumer, residential real estate and small business lending with their members. Credit union asset quality remains very high in the current shaky market with real estate loan delinquencies at 2.08% and overall loan delinquencies at 1.75% at the end of the third quarter 2010. In contrast commercial bank real estate loan delinquencies stand at 7.67% and bank overall loan delinquencies are 5.21% at the end of the third quarter 2010.



Credit unions' aggregate capital is around 10% of total assets (a level that is well above the statutory "well capitalized" 7% threshold) and the target for the proportion of the amount in the federal insurance fund, National Credit Union Share Insurance Fund (NCUSIF), to credit unions' insured shares is currently 1.3% of equity in the fund to insured shares.

In 1984, credit unions voluntarily recapitalized the NCUSIF by depositing an amount equal to 1 percent of their insured member savings in the Fund, in order to bring its equity ratio up to 1.0 percent. This recapitalization resulted in a one-time reduction in the federal deficit. Each year, credit unions deposit sufficient funds to ensure that the target for the NCUSIF may be reached, which is currently set at 1.2 %. Like the Federal Deposit Insurance Corporation, the NCUSIF protects member deposits to $250,000 and is backed by the full faith and credit of the U.S. Government.

[1] Credit Union National Association. The Benefits of Membership. June 2010. http://www.cuna.org/download/state_mbl/MB_National_10.pdf



Federally chartered credit unions are regulated by the National Credit Union Administration (NCUA), an independent agency. NCUA's three board members are nominated by the President and confirmed by the Senate. State chartered credit unions are regulated by their state supervisory authority. NCUA administers the NCUSIF, and has authority to subject all federally insured credit unions to insurance examinations, in coordination with state regulators for state chartered credit unions.

Current Challenges Facing Credit Unions

Preserving Credit Unions' Tax Exemption

Much attention has been placed of late on the staggering size of the national debt – which at around $14 trillion is the largest in the world and comprises about 90% of our gross national product. Several proposals to address our growing deficit and its impact on our economy now and into the future have already been issued, including the report of the National Commission on Fiscal Responsibility and Reform, which, in part, called for broad changes in the tax code to help reduce government spending.

There is no question that Congress must address and contain our national spending – and a number of tax loopholes that favor the wealthy or big business without providing appreciable benefits to our economy should undoubtedly be closed.

However, as Congress considers deficit reduction proposals, we urge it to keep in mind the value of the credit union tax exemption to consumers as well as to the U.S. economy.

Simply stated, if credit unions lose their tax exemption, consumers will pay the price. As the result of their tax exemption, credit unions provide significant financial benefits to their 92 million members, saving them about $7.5 billion a year. Yet faced with federal income tax liability, a number of credit unions may no longer feel compelled to operate a credit union and

could close or convert to for-profit banks. These institutions have far different incentives than do credit unions and are driven by the desire to return a profit to shareholders rather than ensuring favorable rates are provided to consumers. (One example is that during the current financial crisis, credit unions have continued to make loans while many banks have not.)

With this outcome, consumers would have few, if any other mainstream financial choices than commercial banks, which often do not meet their financial needs well, as evidenced by a number of current problems in the economy. Even if a credit union chooses not to convert, it will inevitably be forced to raise lending rates and fees and lower its returns to its members.

In addition, while these major benefits to consumers and the economy would be forfeited, the returns to the U.S. Treasury would be relatively small. The credit union tax exemption results in no more than $1.5 billion in lost federal revenue per year. However, revenues that might be provided to the Treasury if the credit union tax exemption were repealed will most certainly be lower, as a result of credit union conversions to banks or having to lower dividends to their members. Either way, the U.S. Treasury would not fully recapture the revenue.

We also urge Congress to consider the original reason for the credit union tax exemption, which was to promote credit unions' structure as financial cooperatives, distinct from the paid-director, shareholder-interest-driven model employed by for-profit banks. And while it is a top legislative priority for banking trade groups to remove credit unions' tax exemption because they want to eliminate consumers' choices in the financial marketplace, the tax exemption does foster the financial cooperative system by facilitating the ability of credit union members to pool their collective resources to help themselves and their communities.

As government data clearly shows, credit unions serve working Americans well, as Congress intended, and the tax exemption plays a vital role in supporting this service.[2]

Moreover, in the landmark credit union statute, the Credit Union Membership Access Act, (PL 105-219), Congress specifically included "findings" that described the five distinguishing characteristics of credit unions which are: member ownership; net worth created by retained earnings; dependence on volunteers; not-for-profit basis of operations; and service only to members. CUMAA findings concluded that credit unions are tax exempt because of these characteristics and because credit unions have "the specified mission of meeting the credit and savings needs of consumers, especially (but not only) persons of modest means" (parenthesis added).

Credit unions employ the tax benefit by passing it through to their members, primarily in lower rates on loans, lower fees (or none at all) and higher returns on savings. There are also significant financial benefits to consumers who are not members of credit unions. Based on public data CUNA estimates that even bank customers benefit in the aggregate by $4.3 billion a year as a result of lower loan rates and higher deposit rates banks provide in response to rates

[2] The U.S. Department of the Treasury has conducted several detailed studies of credit unions. These objective studies, which were requested by Congress, are exhaustive and present detailed analyses of the credit union system. The studies portray credit unions generally as robust institutions with a specialized structure serving identifiable groups of members.

credit unions offer their members. In total bank customers and credit union members benefit to the tune of at least $10.6 billion a year – about ten times the amount of the estimated revenue lost from the tax exemption -- because credit unions, supported by the tax exemption, exist.

As the undeniable facts prove, the tax exemption for credit unions helps: (1) facilitate financial choices for consumers, (2) assist credit unions to fulfill their congressional mandate of service to American communities, (3) benefit the economy, including even bank customers; and (4) ensure credit union net worth remains strong. For these best of public policy reasons, we urge Congress to continue credit unions' tax exemption.

The Need for Increased Small Business Lending Authority

The idea behind credit unions is very simple: people pool their savings together and make loans to neighbors and coworkers in order to help each other achieve a better standard of living. While it has not been the predominant book of business for credit unions, credit union business lending dates back to the first days of the movement. The earliest credit unions were founded so that people could borrow money to buy goods at lower cost and sell them for a profit.

The founders of the American credit union movement very specifically noted the important role credit unions should play in providing access to credit for small businesses. As Alphonse Desjardin said in 1908, as he encouraged the founding fathers of St. Mary's Bank Credit Union to organize the United States' first credit union:

> "There are not only the manual laborers, whether of industry or of the land, who need credit and who, very often, are forced to suffer the extortions of the Shylocks of usury: There is also a very interesting class of small merchants, of humble industrialists, of modest entrepreneurs whose financial status does not permit them to have access to the large banks where their well enough known fellow businessmen go to stock up in order to enjoy the benefit of a checking account. To all of them as well, the cooperative offers financial assistance that is most precious."[3]

Business lending is part of the credit union DNA, and until 1998, there was no statutory limit on the amount of business lending in which a credit union could engage. The current credit union business lending cap of 12.25% of total assets was enacted as part of CUMAA and no safety and soundness rationale for the cap was identified during the consideration of this legislation. In fact, the Clinton administration stated in its statement of administration policy that:

> "The Administration sees no safety and soundness basis for an amendment that would limit the ability of credit unions to make business loans to their members. Existing safeguards, coupled with the new capital and other reforms in the bill, are sufficient to protect against any safety and soundness risk from member business lending."[4]

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[3] *L'Avenir National* (Manchester, N.H.), Vol. XXI, No. 67, 28 November 1908, p. 4-5.
[4] http://www.presidency.ucsb.edu/ws/index.php?pid=74369

In contrast to the recently enacted $30 billion Small Business Lending Fund, increasing the credit union member business lending cap could be done without cost to the taxpayers and without an increase to the size of government. Further, not only do credit unions have a long history of engaging in business lending to their members, they also have demonstrated that they can lend to these members safely and soundly. When credit union business loan charge-off and delinquency numbers are side-by-side with the banks', this is made crystal clear. Since 1997, the loss rate on credit union member business loans (MBLs) has averaged only 0.19% compared to 0.89% at banks.

Business Loan Asset Quality Comparisons

	Net Chargeoffs	
	Credit Union MBLs	Commercial Bank Commercial & Industrial Loans
1997	0.18%	0.28%
1998	0.08%	0.43%
1999	0.12%	0.57%
2000	0.05%	0.01%
2001	0.10%	1.43%
2002	0.09%	1.76%
2003	0.08%	1.26%
2004	0.10%	0.50%
2005	0.05%	0.27%
2006	0.08%	0.30%
2007	0.09%	0.52%
2008	0.33%	1.01%
2009	0.59%	2.36%
3Q10	0.65%	1.83%
Avg. since '97	**0.19%**	**0.89%**

Source: FDIC, NCUA, and CUNA E&S. 2010 results are annualized

The only groups that actively oppose additional credit union business lending represent banks to which Congress just gave $30 billion of taxpayer money to do precisely what credit unions are willing to do at zero cost to the taxpayers. These groups put forward many reasons why they believe credit unions should not be able to help small business-owning credit union members; but their reasons are not supported by facts.

Indeed, there is no sound public policy reason not to increase the lending cap for those credit unions that have the demonstrated capacity to manage it well. Failure to expand the credit union member business lending cap would literally leave money on the table when small businesses need as much help as possible.

Some say business lending is not a part of the credit union mission; but the facts show that credit unions have been doing this business from day one. Some also say increased business lending would undermine credit union safety and soundness; but the facts show that credit unions do this safer and sounder than the banks.

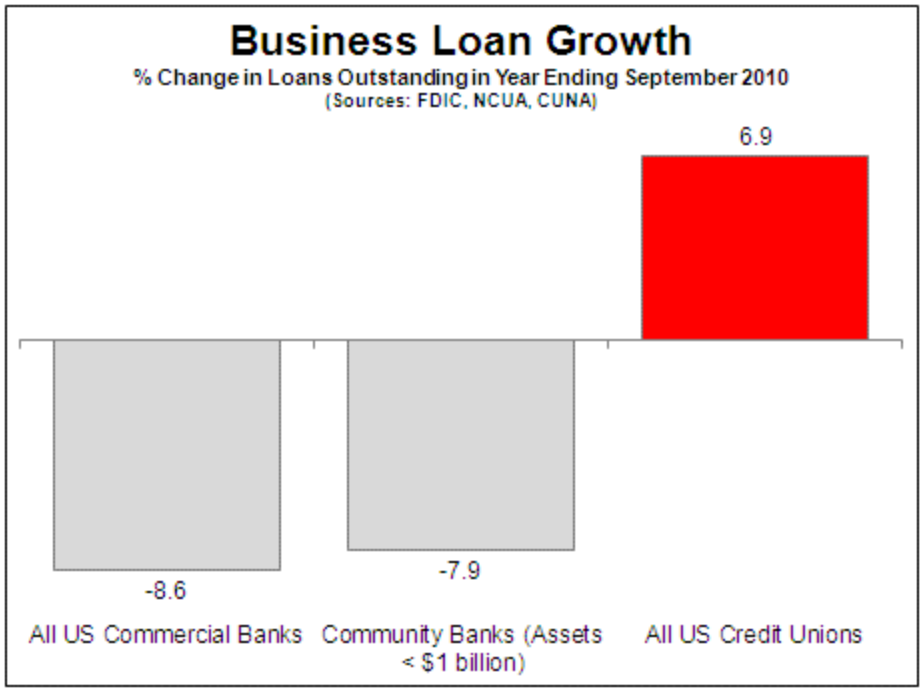
Opponents further argue that increasing the cap will only affect a small number of credit unions while at the same time claiming that increasing the cap will hurt community banks. It is a contradiction – and they are wrong on both accounts. The cap affects every credit union that has a member who looks to them for financing a new or existing small business. Some have active business lending programs; others do not engage in business lending because they view the cap an impediment that does not justify the cost of establishing a sound business lending program in the first place.

Increasing the cap will have a profound effect on the hundreds of credit unions that will reach the cap in the next few years, but it should not adversely affect the banker dominance of the commercial lending market. Credit unions hold just under 5% of the small business loans at all depository institutions, and even less, about 1%, of the total business loan market at depositories. If the cap is increased, that market share might increase slightly – but banks would still have over 90% of the small business loan market. How much market share is enough for the banks that have access to $30 billion of taxpayer money to lend? And more important for small business, given the banks' overwhelming dominance in the marketplace and the taxpayer assistance they have received, why are they failing to meet small business lending needs?

Another faulty argument is that increased credit union business lending will lead to a reduction of other types of credit union lending. However, the fact is that the average credit union has about 26% of its assets in cash and investments, which means if they are permitted to do more lending, they would most likely fund this increase out of excess investment holdings, and not a reduction in consumer lending.

Banker groups talk about the credit union tax status and suggest that credit unions should not be granted an expansion of powers. However, this specious and sidetracking argument ignores the fact that roughly 2,500 banks are Subchapter S institutions, and, like credit unions, have been afforded special federal income tax treatment by Congress. It is more than a little disingenuous for the bankers to use the credit union tax status as an argument against increasing the credit union member business lending cap when one-third of all banks are exempt from federal income tax, these banks are eligible to receive funds under the recently enacted Small Business Lending Fund Act; credit unions have not cost the taxpayer a dime; credit unions fund their own share insurance fund and no credit union member has ever lost a dollar of insured deposits in a federally insured credit union.

Banker groups also say that increased business lending will distract credit unions from serving the underserved. There are many in this country underserved by banks and other financial institutions, and the credit union record on serving these populations is solid. As the nation recovers from this deep recession, it is clear that our small businesses are underserved. Bank business lending portfolios have shrunk while credit unions' have increased.



Credit unions want to meet the needs of their business-owning members, and a Treasury study has found that credit union loans to small businesses go disproportionately to business owners on the lower end of the income scale.[5]

The need for more small business lending is evident; the time for Congress to act is now. Congress recently enacted legislation designed to invest $30 billion of taxpayer money in community banks as part of the solution. Credit unions did not oppose this legislation because we understand that it could help small businesses – if the banks actually use the program. However, there is at least $10 billion of capital in well-capitalized credit unions with business lending experience ready to be loaned if the credit union member business lending cap is increased, and it will cost the taxpayers absolutely nothing.

Senator Mark Udall (D-CO) has introduced legislation (S. 2919) which, if enacted, would increase the credit union member business lending cap from the current level of 12.25% of total assets to 27.5% of total assets. This legislation, which has also been introduced as an amendment to several bills, has been cosponsored by a total of sixteen Senators, and enjoys the support of the Obama administration.[6,7] A similar version of this legislation (H.R. 3380) has been introduced in the House of Representatives by Representatives Kanjorski (D-PA) and Royce (R-CA), and enjoys the support of 127 cosponsors.

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[5] United States Department of the Treasury. *Credit Union Member Business Lending.* January 2001.
[6] Cosponsors of S. 2919 include Senators Michael Bennet, Boxer, Sherrod Brown, Collins, Gillibrand, Lieberman, Bill Nelson, Reid, Sanders, Schumer, Snowe, Specter, and Wyden; additionally, Senators Inouye, Franken and Whitehouse cosponsored S.Amdt. 4906, which is identical to the Administration-endorsed version of this legislation.
[7] A copy of the administration's support letter can be found at: http://www.cuna.org/download/mbl/geithnerltrto_frank0810.pdf.

The legislation establishes a two-tier structure for the credit union member business lending cap. Tier One credit unions would be eligible to engage in business lending to the current cap of 12.25% of total assets. Tier Two credit unions would be required to meet certain criteria and be approved by NCUA, but would then be permitted to engage in business lending to 27.5% of total assets. In order for a credit union to be considered for Tier Two status, the credit union would have to:

- be well-capitalized (currently, at least 7% net worth ratio);
- be at or above 80% of the Tier One cap for one year prior to applying for approval;
- have engaged in member business lending for five years prior to applying; and
- be able to demonstrate sound underwriting and servicing based on historical performance; strong management, adequate capacity to lend, and policies to manage increased business lending.

The proposal calls for Tier Two credit unions to phase in additional business lending by limiting a Tier Two credit union's business lending portfolio growth to no more than 30% per year. NCUA would approve a credit union for Tier Two status using statutory standards, set by Congress, not the regulator. In addition, the proposal states that a credit union that drops below the well-capitalized level would have to stop making new business loans until such time as NCUA determines they are again well-capitalized.

The proposal makes no change to the definition of a business loan, preserving, but not increasing, the current $50,000 *de minimus* threshold. Finally, the proposal directs the NCUA and the GAO to conduct separate studies of credit union business lending and report to Congress three years after enactment.

We believe that this proposal would permit credit unions to help small businesses in need of credit while at the same time ensuring that credit unions engaging in additional business lending are continuing to do so safely and soundly. Many of the new features of this proposal address safety and soundness, and will safeguard the NCUSIF against increased exposure.

We estimate that if this proposal were enacted into law, credit unions could lend an additional $10 billion to small businesses in the first year after implementation, helping small businesses create as many as 108,000 new jobs. This is a job creation proposal that would not cost the taxpayers a dime and would not increase the size of government.

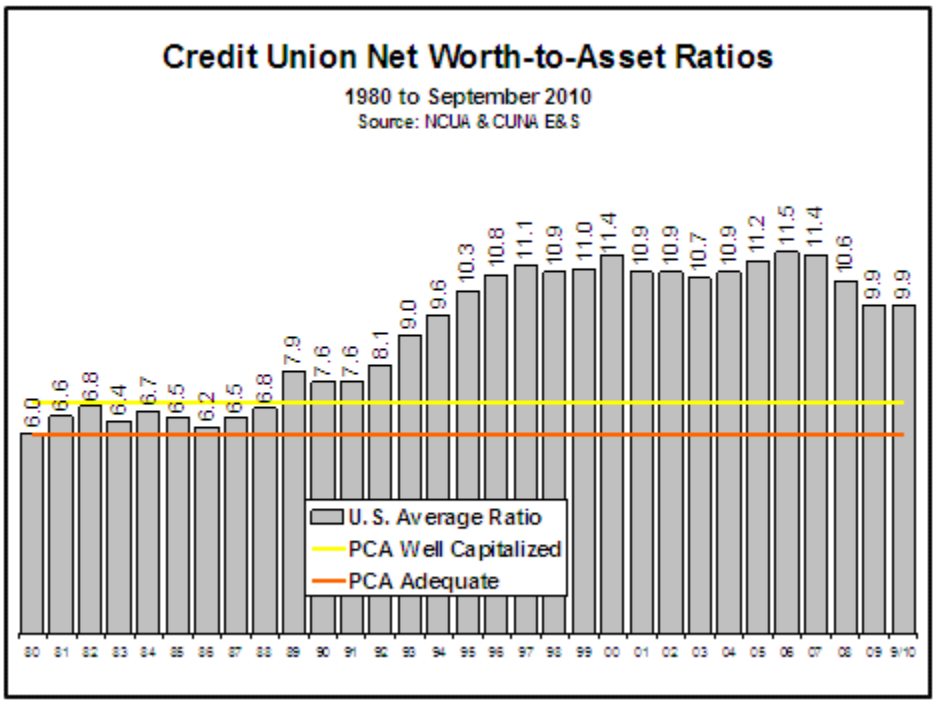
We urge Congress to permit credit unions to do what they were established to do – serve their members, including those who own small businesses. Credit unions have the willingness and capacity to help, but, they need Congress to act now when the need is so great.

The Need for Credit Union Capital and Prompt Corrective Action Reform

Credit unions stand out as the only depository institutions in the United States without the ability to issue some form of capital instrument to augment retained earnings to build capital. All other

U.S. depository institutions and most credit unions in other countries are permitted various forms of alternate or supplemental capital.

Despite the restrictions credit unions face in accessing capital, as the chart below shows, credit unions have for the past decade and a half been very well-capitalized. Since 1994, the average capital ratio has been 9% or higher, well above the 7% threshold to be considered well-capitalized for prompt corrective action (PCA) purposes, or the 6% level for adequately capitalized. In all but three of those years the average capital ratio was above 10%. Credit unions have maintained these high capital ratios in order to maintain a sufficient cushion above the PCA thresholds, and because of the relatively risk-averse nature of their cooperative structure.



However, more recently, the financial crisis led to a substantial drop in the average credit union capital ratio, from 11.4% at the end of 2007 to 9.9% as of September 2010. There were two drivers behind this sharp decline: reduced net income and faster asset growth.

Buffeted by rising loan losses caused by the recession and losses from corporate credit unions, net income averaged only 7 basis points (bp) in 2008 and 2009. In sharp contrast, return on assets had been above 80 bp in all but one of the previous 27 years. Second, as credit union members reduced their spending during the recession, credit union savings grew by almost 8% in 2008 and over 10% in 2009. This in turn contributed to strong asset growth in these two years. The combination of above average asset growth and almost nonexistent earnings caused the 1.5 percentage point decline in the average capital ratio over the period.[8]

[8] The harm the financial crisis has done to credit unions pales in comparison to its effects on many other financial institutions. Of the four largest investment banks that operated before the crisis, two no longer exist, and the other

With a dollar-weighted average capital ratio of 9.9%, the credit union movement as a whole remains very well capitalized, with a cushion of almost 3% above the PCA well capitalized level. However, the financial crisis of the past two years has brought a number of credit unions close to or past the PCA triggers, as is shown in the table below.

Percent of Credit Union in Various Capital Classifications by Capital Ratio

Year-end	**2007**	**Sept. 2010**
Inadequate (Less than 6%)	0.6%	2.2%
Adequate (6% to 7%)	0.8	3.1
Well Capitalized (Over 7%)	98.6	94.7
'Merely' Well (7% to 9%)	7.6	19.1
Very Well (Over 9%)	91.0	75.9
Total	**100**	**100**
Overall Average Capital Ratio	**11.4**	**9.9**

In December 2007, 98.6% of all credit unions were well-capitalized, 0.8% were adequately capitalized, and only 0.6% were inadequately capitalized. By September 2010, the proportion of well capitalized credit unions had fallen to 94.7%, with 3.1% adequately capitalized and 2.2% inadequately capitalized. In addition, the percentage of credit unions "very" well capitalized (capital ratio over 9%) has fallen sharply, from 91% in 2007 to 75.9% in 2010. Therefore, although most credit unions are likely to want to rebuild their net worth ratios somewhat over the next few years, fully one in four is likely to feel a very strong need to do so.

Unfortunately, the need for additional capital comes just at a time when the outlook for the only source of that capital, net income, is not particularly strong. The two factors that sharply reduced earnings during the financial crisis, loan losses and corporate stabilization, will have a diminishing negative effect on earnings going forward. However, other longer term influences on credit union net income are not promising. Net interest income, essentially the difference between what credit unions earn in interest on loans and investments and what they pay in interest and dividends on savings has been on a long-term downtrend caused by intense competition on both sides of the balance sheet. This pressure is unlikely to abate significantly going forward. In addition, interchange income, an important source of non-interest revenue, is under political pressure and is likely to diminish.

The solution for some credit unions has been to discourage deposits from their members or, as in the case of AFTRA-SAG credit union of California, ask high deposit members to withdraw funds from the credit union.[9] These actions are confusing to credit union members, and the

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two have become bank holding companies to gain access to borrowing from the Federal Reserve. A number of huge banks and thrifts, and hundreds of medium and small ones, failed. Many others had to be bolstered by government capital infusions. Fannie Mae and Freddie Mac are under conservatorship. From December 2007 to December 2009, the FDIC's coverage ratio (fund balance divided by insured deposits) plummeted from 1.22% to -0.39%.

[9] "AFTRA-SAG Credit Union Tells Some Members to Move Funds." Los Angeles Times. November 24, 2010. http://latimesblogs.latimes.com/entertainmentnewsbuzz/2010/11/aftra-sag-credit-union-tells-some-members-to-move-funds.html

general public, and they are antithetical to the mission of credit unions; nevertheless, they are absolutely necessary given the way that credit union capital requirements work.

The financial crisis has brought into sharp focus the importance of capital for all financial institutions. Some of the institutions that caused the most damage in the crisis were highly leveraged (were funded largely by debt rather than equity). The recently announced Basel III proposals also point to higher capital requirements for most types of financial institutions. As the economy shows increasing signs of recovering, which will allow the financial institutions still standing to also recover, higher and stricter capital requirements are likely to be imposed on financial institutions. Financial institutions themselves are likely to want to hold more capital than they did before the crisis to be better able to withstand a similar event in the future.

These factors—reduced capital ratios, reduced net income, and policy interest in more capital across the spectrum of financial institutions—all suggest that now is the time to address access to some alternate capital for credit unions. As credit unions battered by the financial crisis recover in the coming few years, rebuilding capital ratios will be paramount. Without access to alternate capital, and with earnings power facing headwinds, these credit unions and their members will face a protracted period of reduced member service, disadvantageous member pricing, and very slow growth.[10]

Were credit unions in this situation permitted to issue some form of alternate capital, they could immediately resume normal credit union service, pricing and growth. In the absence of access to alternate capital, current members of such credit unions would have to "pay" disproportionately for the long-term, future health of the credit union by suffering less attractive pricing and growth as the credit union built capital through the very slow process of retaining earnings.

From a public policy point of view, the economic recovery will be facilitated by financial institutions that are willing to grow and expand service. Without alternate capital, credit unions will not be able to contribute nearly as much to financing the economic recovery as they would if they were not preoccupied with slowing growth and increasing net income in order to build the ratio of retained earnings to assets.

The Chairman of the NCUA recently identified the need for alternative forms of credit union capital as a potential safety and soundness issue for credit unions.

Given the demonstrable need for access to alternate capital for credit unions, the question turns to what form or forms that capital should take. Many of the characteristics of alternate capital used by other depository institutions would need to be replicated in versions for credit unions, although there would need to be modifications to account for credit unions' the unique cooperative ownership and democratic governance structure.

[10] For example, it would take nine years for a credit union with a beginning net worth ratio of 5% to reach the 7% well capitalized threshold earning 80 basis points of net income and growing by 10% each year. Cutting asset growth in half would still require 4 years to reach 7%, and another 5 years to reach 9%. In the alternative, if such a credit union could raise loan rates, lower dividend rates and/or raise fees enough to increase its return on assets (ROA) to 1.2%, it would take just over three years to regain a 7% net worth ratio growing by 10% a year, and another five years after that to reach 9%.

Other depository institutions—such as banks and thrifts—have access to a number of types of capital in addition to retained earnings. The alternate capital sources fall into two categories stemming from regulatory capital requirements: Tier 1 and Tier 2. Tier 1 capital includes retained earnings as well as other forms of equity such as fully paid common stock and non-cumulative perpetual preferred stock. Tier 2 capital for banks and thrifts, also called "supplemental capital," can include subordinated debt, debt-like equity instruments such as cumulative preferred stock, and certain types of reserves.

Banks and thrifts use these two tiers of capital as part of a Basel Accord risk-based capital approach as implemented by the FDIC and other U.S. bank regulators under which the amount of Tier 2 capital cannot exceed the amount of Tier 1 capital. Under these rules a bank or thrift's total Tier 1 capital cannot generally fall below a 4% leverage ratio without being subject to prompt corrective action, although sometimes a 3% leverage ratio is allowed. To be "well capitalized" a bank or thrift must have a minimum 5% leverage ratio of Tier 1 capital to total assets, an at least 6% Tier 1 risk-based capital ratio, and an at least 10% risk-based capital ratio relative to Tier 1 and Tier 2 capital combined.

A credit union alternative capital regime could either incorporate the risk-based capital approach or not. For credit unions to benefit from alternative capital under a risk-based capital approach, however, risk-based capital would have to be accompanied by a reduction in credit unions' net worth leverage ratio. The Federal Credit Union Act currently requires credit unions to have a minimum 7% ratio of retained earnings to total assets to be considered "well capitalized," far higher than the 5% leverage ratio required for a bank or thrift to be "well capitalized." Without a reduction in the required leverage ratio, no amount of Tier 2 capital to meet new risk-based requirements would be of any benefit to credit unions in meeting the basic net worth leverage ratio.

Because of the many features, possible characteristics and requirements of alternate capital, there is no single or simple form that would be appropriate for all credit unions seeking alternate capital. There are many possible variations on the theme of allowing alternate capital to augment retained earnings and to provide extra protection for the share insurance fund. Therefore, credit unions would best be served by having as many options as possible so long as these options are consistent with credit unions' cooperative ownership and governance structure, provide real protection to the National Credit Union Share Insurance Fund, are practical yet optional for credit union to acquire, and are only offered in a suitable fashion and with meaningful disclosures.

Types of possible credit union alternative capital include credit union membership shares, optional debt or equity investments made by members, or subordinated debt from non-members.

Low-income credit unions, for instance, already have access to alternative capital in the form of subordinated debt-- which essentially counts as the equivalent of bank "Tier 2" capital -- and this approach could be expanded to all natural-person credit unions. Also, all credit unions currently require a member to invest in at least one perpetual membership share, usually in an amount between $5 and $50, which is withdrawable only if the member leaves the credit union's

membership; this perpetual membership share would generally meet the definition of "Tier 1" capital under the rules applicable to banks and thrifts. Further, optional investments made by members could either be classified as Tier 1 or Tier 2 capital depending on the terms of those products.

A compelling case can be made that under appropriate rules and guidelines that preserve the cooperative ownership and governance of credit unions, access to alternate capital would be good for credit unions, their members, and the economy. Given the importance of adequate capital to the nation's federal deposit insurance systems, extending authority to credit union regulators to permit access to alternate capital would also provide additional protection to the U.S. taxpayer. We encourage Congress to amend the Federal Credit Union Act to permit alternative capital for credit unions and we look forward to working with the Committee on this issue in the next Congress.

Corporate Credit Union Stabilization

One of the most significant challenges facing the credit union industry today is the resolution of the corporate credit union situation, which was the result of losses on investments in mostly private label mortgage-backed securities held by some corporate credit unions. (Corporate credit unions provide investment, credit, settlement, payment and other correspondent services for natural person credit unions).

At the time of their purchase, these securities were permissible investments and top rated. Examiners who were on site at the largest corporate credit unions did not flag these investments or require changes in corporate credit unions' risk management policies regarding such investments.

In any event, during the most significant financial crisis of the last 80 years, the market for these securities began to collapse, and NCUA was forced to take action to stabilize the corporate credit union system. Such actions, which began in January 2009, included:

- Obtaining additional resources for the Central Liquidity Facility to ensure liquidity remained in the credit union system.
- Providing $1 billion to the largest corporate credit union, U.S. Central, to ensure adequate liquidity.
- Fully guaranteeing deposits in corporate credit unions through December 31, 2012.
- Helping to create the Corporate Credit Union Stabilization Fund to manage the costs associated with corporate credit unions that had problem assets.
- Conserving five corporate credit unions that held the majority of troubled assets (the smallest of those corporates has now been merged.)
- Isolating the troubled assets in asset management estates until the loses are resolved and operating the core functions of the remaining conserved corporate credit unions as bridged corporate credit unions.
- Implementing long-term funding to spread out the costs to credit unions of paying for the corporate stabilization efforts through the creation of a securitization trust

that issues notes collateralized by the cash flows on the troubled assets and are fully guaranteed by the U. S Treasury.

- Issuing a comprehensive regulation setting new standards for capital, investment limitations, corporate governance and other key issues for corporate credit unions.

In general, credit unions have been pleased about the agency's handling of the troubled assets held by some of the corporates. However, NCUA could not have undertaken that initiative or the other actions to address corporate credit union problems without the support of Congress, the U. S. Treasury, and in some measure, the Federal Reserve Board. Credit unions appreciate this support, particularly the ability to spread out the costs of the corporate stabilization fund and the guarantee by the U. S. Treasury for the notes.

NCUA estimates total remaining costs to credit unions of the stabilization of the corporate credit union losses will be about $8.1 billion. NCUA arrived at that estimate based on the following:

- The total estimate of future credit union losses for the five corporate credit unions that were conserved, which is around $15 billion;
- Minus the $5.6 in capital at corporate credit unions that has already been used to absorb losses;
- Minus the $1.3 billion in assessments that have already been paid by credit unions for corporate stabilization, which brings the amount the credit union system must fund to $8.1 billion, which can be paid for over 11 years.

In October, the NCUA Board announced that the ranges for the NCUSIF premium for 2011, to help deal with natural person credit union issues, will be 0-10 basis points, and the Corporate Credit Union Stabilization Fund projected assessment will be 20-25 basis points. CUNA does not challenge the NCUSIF premium projection, although credit unions would like the premium to be as close to zero as possible. However, we do have concerns about the projected assessment for the Stabilization Fund, which may be front-loaded to help NCUA meet short-term liquidity needs -- seemingly counter to the objective to spread out the costs.

We appreciate that NCUA is considering whether credit unions could prefund assessments. Meanwhile, in light of Congress' support for credit unions to have ample time to fund the corporate stabilization costs in order to mitigate the impact on their operations, we urge NCUA to be vigilant in insuring those costs will be minimized and distributed appropriately over the 11-year period that is now permitted. We also urge Congress to maintain its oversight to help ensure those outcomes are achieved.

In addition to concerns about the corporate credit union stabilization program, credit unions need continued access to the crucial payments and settlement functions that the corporates have provided. NCUA's new regulation will require corporates to operate with very small balance sheets, concentrating on offering services on a fee basis, including payments, settlement, investment advisory and broker dealer, and arrangements for liquidity. CUNA and credit unions are nbusy working on ensuring that access to these services for credit unions is preserved.

The future of corporate credit unions depends in part on the success of the implementation of the final corporate rule and the performance of the agency's plan for dealing with the troubled assets of some of the corporates, including spreading out the costs to natural person credit unions.

However, whether or not corporates are willing and able to make the deep and far reaching changes necessary to succeed going forward will have the most profound impact on their future. These fundamental changes in corporate credit unions need to be driven by the members, boards, and management of corporate credit unions.

To further facilitate the resolution of the corporate credit union system and the recovery of natural person credit unions affected by the financial crisis, NCUA has proposed a series of technical amendments to the Federal Credit Union *Act* related to the TCCUSF, the NCUSIF equity ratio and the definition of "net worth" under prompt corrective action. In general, CUNA supports these recommendations. In particular, we appreciate the agency recommending an amendment to the definition of "net worth" that will permit credit unions to count assistance provided under Section 208 of the FCU Act.

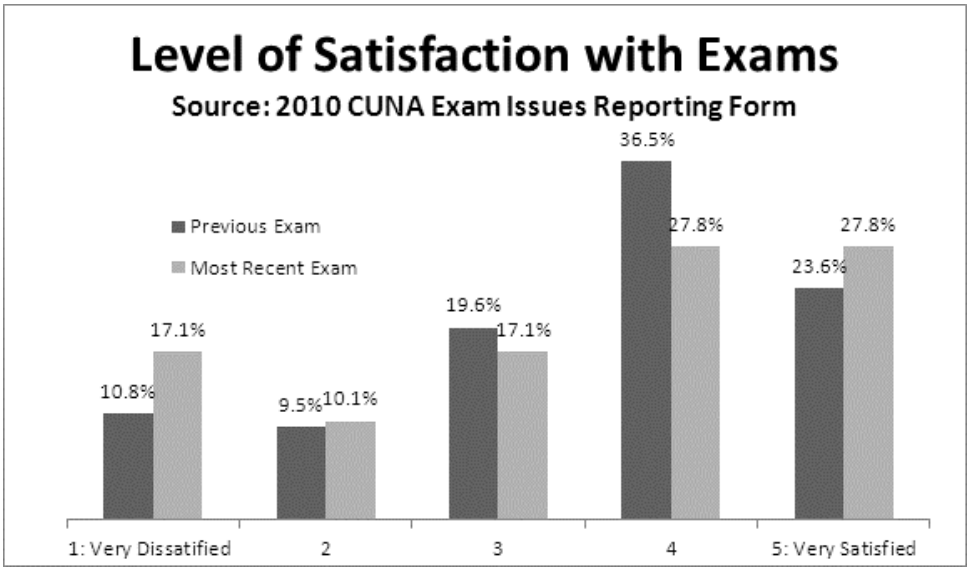
We are also aware that NCUA may ask Congress to propose language that would revive expired legal claims, giving NCUA the ability to bring action on *any* claim on which the statute of limitations has expired, up to 10 years before the Board becomes the conservator of a credit union or liquidates it.

Congress should <u>not</u> approve this proposal for several public policy reasons. Most important, we are concerned that extending the statute of limitations authority would threaten the ability of credit unions to attract volunteers to serve on their boards. Moreover, it would likely not result in significant recovery of losses because, quite frankly, individual credit union officials are not likely to have the means to pay appreciable judicial awards.

Also, it would expand NCUA's authority beyond the similar authority Congress has granted to the Federal Deposit Insurance Corporation, which can resurrect claims up to 5 years before conserving or liquidating a bank. In addition, FDIC's authority is limited only to fraud and intentional misconduct, while NCUA proposes authority to pursue *any* alleged violation of law brought against any official of a credit union or third party involved in the affairs of the credit union. Further, NCUA's statute of limitation proposal raises important constitutional questions of the application of a retroactive statute of limitations that would have otherwise expired. For these reasons, the NCUA proposal represents agency overreaching, and we urge Congress to reject it.

Supervisory Issues

The regulatory environment for financial institutions, including credit unions, has changed dramatically, largely as a result of the economic recession and the subsequent weak recovery. In this climate, credit union and bank regulators are placing many more demands on the performance of the institutions they supervise and regulators have reported increased supervisory issues, many of which relate directly to the economic crisis.



All credit unions and their members deserve and benefit from strong, reasonable safety and soundness supervision. Yet a healthy, robust credit union system depends on a reasonable balance between safety and soundness , i.e., the regulators being able to do their jobs fairly on the one hand, and credit union managers and officials being able to perform their duties independently on the other, and both performing their duties competently and professionally.

Undoubtedly some institutions' problems, particular those that stem from difficult economic times, warrant heightened scrutiny, increased attention to risks, and improved internal controls. Yet, a number of credit unions from around the country, including those that are well-managed and well-capitalized, are raising concerns that their examiner has placed unreasonable demands on their operations, according to a recent study conducted by CUNA. In response, CUNA is developing guidance and resources for the credit union system regarding the examination process and supervisory expectations, including how to appeal examiner decisions and agency actions. Meanwhile, this Committee should work with regulators to insure financial institutions have the ability to manage their risks without being directed by examiners to eliminate it.

NCUA Budget

Credit unions are also concerned about the recent 12% increase in NCUA's 2011 budget—to a total budget of $225.40 million—over its 2010 level. Employee pay and benefits account for

72%, or $163.19 million, of NCUA's 2011 budget, which includes the addition of 78 full time employees—including 53 examiners and 6 supervisory examiners.

NCUA is funded by federally-insured credit unions through two mechanisms: (1) the "overhead transfer rate," which is a transfer of more than half of the National Credit Union Share Insurance Fund's (NCUSIF) annual earnings to NCUA each year to pay much of the agency's administrative expenses; and (2) via assessments on federal credit unions called an "operating fee."

The NCUSIF is capitalized with assets belonging to all federally-insured credit unions, so transfers of the NCUSIF's earnings to NCUA increase the likelihood and magnitude of share insurance assessments on federally-insured credit unions, and reduce the chances of a NCUSIF dividend to those credit unions. NCUA is increasing the 2011 "overhead transfer rate" to 58.9% of the NCUSIF's annual earnings from the current 57.2%, although the agency did also reduce the 2011 "operating fee" assessed on federal credit unions from its 2010 level.

In addition, however, NCUA is estimating significant assessments on federally-insured credit unions in 2011. At its November Board Meeting, NCUA forecasted a 2011 NCUSIF assessment of 0-10 basis points, and a 2011 Stabilization Fund assessment of 20-25 basis points. Combined, the total assessment will likely be between 20 basis points and 35 basis points.

NCUA's budget increases come at a time when most credit unions are cutting back on their own expenses, and we question whether costs such high salary adjustments are justified, especially in light of President Obama's proposed two year pay freeze for federal employees and the significant NCUA assessments forecasted for federally-insured credit unions in 2011.

Concerns about the Regulation of Debit Card Interchange

Credit unions continue to be very anxious about the implementation of the interchange provisions of the Dodd-Frank Act – in particular two broad provisions that amended the EFT Act, the exemption for small issuers under Subsection 920(a)(6), and the routing and exclusivity measures under Subsection 920(b)(1).

Because credit unions are under growing pressure to build net worth as a result of the current economic situation, the issue of fee income is an important one. That is because under prompt corrective action statutory provisions, credit unions may only build capital through retained earnings, which includes fee income, such as debit interchange fees. About 70% of the nation's 7,700 credit unions offer debit card programs.

The language of Section 920(a) and the legislative history associated with the Durbin amendment make it clear that Congress intended to protect small issuers' debit transaction fee income from the letter of the interchange rule as well as from its impact.

Since well before the enactment of the Dodd-Frank Act and consistently since, CUNA has been meeting with our members, payment network representatives, and key congressional officials, in addition to our communications to the Federal Reserve Board. A major focus has been on how to implement the exemption in a manner that will make it as meaningful for small issuers, as Congress intended. Also, nothing in the Act requires the merchant to pass on savings it might receive as a result of interchange regulation and it is reasonable to assume that consumers may not reap any benefits from debit interchange regulation.

We believe the Board has the statutory authority to help ensure the exemption is meaningful, if it will use it. Under Section 920(a)(1), Congress directed the Board to write regulations on interchange transactions fees "to prevent circumvention or evasion of this subsection." This language provides authority for the Board to help ensure the exemption for small issuers is reasonably implemented.

In that connection, monitoring the development and implementation of how the networks are accommodating small issuers would be an important role for the Federal Reserve Board to play in promulgating the interchange provisions.

However, while monitoring by the Board of the networks' efforts to accommodate small issuers would be extremely useful, the statutory purpose of the exemption for small issuers will be frustrated if merchants are allowed to direct the routing of debit card transactions in a manner that disadvantages small issuers.

CUNA realizes that the exclusivity and routing provisions in Section 920(b)(1) do not include an exemption for small issuers. However, if the Board in implementing these provisions is not mindful of their impact on small issuers, merchants' ability to steer transactions to the lowest cost networks could negatively impact interchange fee income for small issuers.

Under Section 920(b)(1), the Board must regulate the prohibition on exclusivity arrangements, which prohibits networks and issuers from limiting the number of networks on which a debit card transaction may be processed to only one (or 2 affiliated networks). How the Board implements the prohibition will significantly impact debit card interchange income for small issuers.

Credit unions are very concerned about the costs they will have to incur if they need to participate in more networks than they do currently. We urge the Board to do all it can in issuing the regulation on this section to minimize issuers' costs.

We also believe more time to implement the interchange provisions would be extremely useful. In light of the significant disruption to interchange programs that could occur for small issuers, we urge this Committee to work with the Board to support a delay and/or changes that will accommodate smaller issuers' interests, as we key members of Congress said they wanted to do.

Regulatory Burden

Regulatory burden is as old but growing issue of concern for credit unions. Every minute a credit union spends filling out a form of questionable utility or complying with a redundant or overly burdensome rule is time that should be spent meeting their primary, statutory mission -- serving their members.

As with other smaller financial institutions, a significant number of credit unions have very limited staff, many of whom have multiple responsibilities and tasks. For all credit unions, it has been extremely difficult to monitor and prepare for the burdens resulting from the onslaught of new rules that have been issued over the past several years, as well as the myriad of new rules that will be implemented under the Dodd-Frank Act. Some have called this expanding regulatory burden on credit unions a "creeping crisis of complexity" which may, in many ways, be partly responsible for increased credit union consolidation. Smaller credit unions increasingly find that high compliance costs make it difficult for them to continue serving their members without merging into a larger credit union to achieve economies of scale. In fact, CUNA's Small Credit Union Committee recently identified regulatory burden as the number-one issue facing small credit unions.[11]

Just since the beginning of 2008, credit unions and other financial institutions have been subjected to new, and very significant, requirements with regard to mortgage lending, credit cards and other types of open-end lending, internet gambling, the Bank Secrecy Act rule changes, the Fair and Accurate Credit Transactions Act, gift cards, overdraft protection plans, student loans, and accounting pronouncements issued by the Financial Accounting Standards Board. There have also been a number of NCUA rules that impact credit unions uniquely, such as field of membership changes. Just in 2010 alone, 32 new rule changes have taken effect for credit unions.

Going forward, new rules under the Dodd-Frank Act include, in addition to the new limitations on interchange fees, additional data collection requirements on consumer loans, a range of new substantive and disclosure requirements under the Truth in Lending Act and the Real Estate Settlement Procedures Act, additional disclosure requirements for remittances, executive compensation rule, and new Home Mortgage Disclosure Act reporting requirements. In addition, the new Consumer Financial Protection Bureau will likely issue new and modify other existing consumer protection rules as the Bureau supplants the Federal Reserve Board as the primary regulator in this area.

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[11] CUNA Small CU Committee Ten Year Review (December 2009) http://www.cuna.org/initiatives/small_cu/download/10yr_review.pdf

CUNA wants to be clear that we support the objectives of many consumer protection rules. However, we urge regulators and Congress to be constantly mindful that the total regulatory burden being imposed on financial institutions today is horrendous and piling on additional regulations without consideration for the requirements already in place is counterproductive.

We urge the Senate Banking Committee to make this nonpartisan issue a priority and to hold hearings in 2011 on steps that can be taken by the regulators and Congress to achieve meaningful safety and soundness regulation and reasonable consumer financial protections without putting financial institutions out of business in the process. We would welcome the opportunity to work with the Committee in this important endeavor.

Government-Sponsored Enterprises

CUNA President and CEO Bill Cheney met recently with representatives of the U. S. Treasury Department on GSE Reform. CUNA has formed a GSE Reform Working Group and will be providing recommendations to Treasury by the end of the year.

While the CUNA group is still formulating its full set of recommendations, it has identified a number of preliminary principles that could form a solid foundation for ensuring a sustainable housing market well into the future. These principles include:

- The secondary market going forward must provide equitable access to credit unions, without discrimination. To the extent this includes new investments and features, such as covered bonds, credit union will need access to alternative capital.
- A goal of the future housing finance system should be to provide a reliable supply of mortgage loans in all types of economic environments, at affordable rates, that will allow borrowers to obtain access to such loans within the bounds of proven underwriting.
- The new housing finance system must be flexible to the extent it provides a variety of finance options to meet the needs of different types of consumers and housing types. The secondary market should support both portfolio lenders and secondary market participants.
- Entities providing secondary market services must be subject to strong regulatory and examination oversight to ensure safety and soundness, including strong capital requirements. These entities should also be permitted to innovate and develop new programs and technologies, consistent with their mission.
- The governance structure of the new entities providing secondary market services should ensure that credit unions are well represented on the boards of directors. This could also include, for example, advisory boards comprised of credit unions and others that would provide information and advice regarding the operations of these new entities.
- The process of mortgage asset securitization must be transparent, verifiable, and subject to sufficient regulatory oversight, for both federally-guaranteed and private label securities.
- To ensure a strong housing finance system in the future, there must be sound underwriting for all mortgage loans. To ensure this result, all loan originators, such as brokers, should be licensed and subject to the same regulatory, supervisory, and enforcement requirements that apply to credit unions.

- Legislation and regulations implementing the new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans.
- Any transition from the current to a new housing finance system must be carefully planned and well-executed, and credit unions will need sufficient time to prepare for these changes so that members are not negatively impacted. This transition plan must carefully consider the impact on the economy and the consequences if this is not well-executed.

CUNA is aware that GSE reform will be a priority in the next Congress, and we urge that these concerns be taken into full consideration as Congress deliberates on the future of the GSEs. We would be glad to share our final report and recommendations with this Committee and would welcome the opportunity to follow up with on this very important issue early next year.

Conclusion

As this statement details, credit unions are generally healthy in the face of the economic downturn and lumbering recovery, despite the fact that the credit union system has not totally escaped the impact of the financial crisis.

Even as credit unions collectively fund NCUA's corporate credit union stabilization efforts and individually seek to maintain robust levels of capital/net worth, they are anxious and eager to do more to serve their members, support their communities, and help the economy recover.

However, credit unions cannot do this without help from Congress and regulators.

Continued support for the credit union tax exemption is essential, because without it credit unions will lose their incentives to continue as credit unions and consumers will lose an important alternative to commercial banks. We appreciate that NCUA Chairman Debbie Matz has communicated her strong support for the exemption to Congress.

In addition, increased small business lending authority as well as alternative capital and capital reform are new tools that Congress should provide to credit unions as soon as possible to help insure small businesses have access to affordable credit and the services consumers need at favorable rates will continue to be provided in the financial marketplace We also urge Congress to ensure interchange statutory provisions are implemented to protect small issuers and to be mindful of the needs of credit unions when it considers GSE reform.

Of course regulators, including NCUA, also have critical roles to play, such as ensuring regulations do not overwhelm institutions with counterproductive requirements that frustrate rather than fulfill congressional directives. Further, more attention needs to be given to holding down agency costs, allowing financial institution boards to exercise their sound business judgments, and ensuring institutions are allowed to innovate and respond to the changing needs of their members/consumers.

Thank you again for holding this important hearing and for the opportunity to share our views and perspectives on the issues facing the credit union system.