

Statement for the Record

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Committee on Banking

United States Senate



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December 9, 2010

Chairman Dodd, Ranking Member Shelby, and members of the Committee, the American Bankers Association appreciates the opportunity to submit this statement for the record for the December 9, 2010 Senate Banking Committee hearing entitled “The State of the Credit Union Industry.” The American Bankers Association (ABA) represents banks of all sizes and charters and is the voice for the nation’s \$13 trillion banking industry and its two million employees.

There are several key points we would like to make in this statement:

- Even though credit unions pay no federal taxes, the industry received taxpayer assistance to resolve insolvent corporate credit unions.
- Raising the credit unions legal business lending cap is not necessary for credit unions to meet members’ credit needs. Moreover, expanding the lending cap is inconsistent with the credit union mission and raises serious safety and soundness concerns.
- Alternative or secondary capital is not appropriate for credit unions. It would dramatically change the focus of credit unions away from member-owned to a market-driven capital structure, and would force credit unions to generate a level of return necessary to attract such capital – all of which will negatively impact credit union members.

Credit unions, like many in the banking industry, have suffered losses as the recession took hold and unemployment dramatically increased. For the credit union industry, several multi-billion-dollar corporate credit unions (which were designed to provide investments and

financial services to smaller, “natural person” credit unions) dramatically increased their level of risk and ended up failing. This caused severe losses to the National Credit Union Share Insurance Fund and created an environment where many smaller credit unions could fail. Even though credit unions pay no federal taxes – a privilege bestowed on credit unions in order to focus their lending on “people of small means” – the credit union industry sought taxpayer help to facilitate the repayment of these losses.¹

This assistance, like many other special programs related to banking and financial institutions, was appropriate for that time. It appears that now, however, some credit unions are using the financial crisis and the recession to argue for more business lending authority and access to alternative sources of capital. Credit unions argue that these greater authorities would enable them to meet the needs of small businesses seeking credit. *Such arguments are simply not true.* Under current law, business loans under \$50,000 do not count against the aggregate business loan cap of 12.25 percent of assets. Moreover, the guaranteed portion of Small Business Administration loans does not count against the aggregate business loan limit. Thus, *there is considerable opportunity under current law for credit unions to meet the needs of small business.*

In addition, only a small percentage of credit unions – *one-half of one-percent* – are at or near the congressionally mandated cap. Thus, even for larger business loans in excess of \$50,000, there is little constraint on credit union lending except for these small numbers of large, fast-growing, profit-seeking credit unions.

The real goal of expanded business lending is for some aggressive credit unions to make even more *large* dollar loans – such as loans for luxury golf and condominium developments. For some aggressive credit unions, it is not unusual for them to make multi-million dollar loans. A dramatic example of just how far these credit unions have gone is the financing of Thumper Pond, a resort development in Minnesota that went bankrupt. This luxury resort featured a golf course, spa, water park, hotels, and a planned condominium community. The resort was financed by a large commercial loan made by Spire Federal Credit Union. Not only is this far

¹ See Appendix B for details on the taxpayer assistance which benefited the credit union industry. The mission of credit unions to serve people of small means was articulated in the preamble to the 1934 Federal Credit Union Act.

beyond any sensible definition of modest means, but the resort is located over 200 miles from the credit union's headquarters. Is this the kind of loan that should be tax-subsidized?

Such loans are clearly counter to the chartered mission of serving people of small means. It is leveraging the tax-exemption to provide loans to large businesses that have plenty of credit options available through taxpaying banks. ***This credit union tax expenditure is neither focused nor contained; it takes revenue from banks that compete for these same loans – revenue that would be taxed and would help to offset some of the current federal budget deficit.***

Lifting the business lending cap also raises serious safety and soundness concerns. As credit unions have aggressively pursued business lending options, business loan delinquencies have risen and some credit unions have failed. In fact, just a few weeks ago (November 23), the NCUA's Office of the Inspector General (OIG) released a report summarizing the 10 costliest natural person credit union failures. ***In 7 of these 10 failures, business lending contributed to the failure.***²

Moreover, the General Accountability Office in 2003 warned about the danger of business lending by credit unions and it was skeptical that NCUA was up to the challenge to monitor the expansion of credit union business lending.³ It should be no surprise that the Inspector General's *Material Loss Review* found adequate oversight often missing: business loans were made to non-members; credit unions exceeded the legal Member Business Loan cap of 12.25 percent; credit unions violated the loan-to-one borrower limit; and credit unions made business loans without a Member Business Loan policy. Expanding credit union business lending only encourages larger, riskier loans, without any assurance of adequate oversight.

Just as business lending is not the answer to the misfortunes of credit unions, neither is access to alternative or secondary capital. In fact, it will blur the line between credit unions and other depository institutions. By granting credit unions the ability to issue secondary capital, the capital structure of the credit union industry would fundamentally change. This would potentially permit any credit union to issue secondary capital to members and non-members alike. By moving away from the concept of "*member-owned*" equity towards a reliance on capital contributions from non-members and the broader marketplace, the very essence of a

² Appendix A provides more details about what the Inspector General discovered.

³ Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management. General Accounting Office, October 2003 (GAO-04-91), p. 49.

credit union's ownership structure is called into question. It would force credit unions to generate a level of returns necessary to attract such capital and therefore would be a costlier source of funds. Not only does this dramatically change the focus of credit unions away from serving their membership towards a market-driven capital structure, it also raises a host of corporate governance concerns, such as voting rights of holders of such ownership stakes, board composition, etc.

Moreover, granting all credit unions the ability to raise alternative capital may negatively impact the ability of low-income credit unions to attract capital. Low-income credit unions would have to compete with other credit unions for this additional capital, thus, raising their cost of capital and making it more difficult to fulfill their social mission.

NCUA will point to where credit unions in Australia and Canada have the ability to issue alternative capital. It should also be noted that *credit unions in Australia and Canada are taxed*. The lack of taxation of credit unions in the United States is the key difference.

Finally, Congress, Treasury, and the GAO have questioned the need for alternative capital. In 1998, Congress specifically reinforced its view that credit unions, in maintaining their distinct character, should rely upon retained earnings to build net worth, while not issuing capital stock. For example, the report of the Senate Banking Committee [Rept. No. 105-193, page 12] states that the "NCUA [National Credit Union Administration] must design the system of prompt corrective action to take into account that credit unions are not-for-profit cooperatives that (1) do not issue capital stock, and (2) must rely on retained earnings to build net worth." This was reinforced by Emil Henry, former Assistant Secretary of the Treasury for Financial Institutions, who noted in 2006 that the ability to "raise equity capital by increasing retained earnings...is an important feature that is grounded in the cooperative nature of credit unions." And in 2004, GAO found that there was no compelling evidence for alternative or secondary capital for credit unions.

In conclusion, while the common perception about credit unions is that they are small mom-and-pop operations, the reality is that there are *167 credit unions that have over \$1 billion in assets*. To put that in perspective, *these credit unions are larger than 91 percent of the taxpaying banks in this country*. Moreover, the traditional credit unions are being squeezed out by the invasive tactics of these growth-oriented credit unions. It is no surprise that over 2,600 credit unions have been absorbed into larger credit unions since the beginning of 2001.

While the rhetoric suggests that without greater business lending or capital authority there are no options for these institutions to grow and better serve their customers, the reality is that a very viable option is available *today* through switching to a mutual savings bank charter – a route that some credit unions have already taken. This charter provides greater flexibility, still preserves the mutual-member focus that credit unions find desirable, and is accompanied by the effective and experienced supervision of traditional banking regulators. This savings bank charter would give these credit unions the ability to expand their business lending and retain their mutual structure. ***However, NCUA actively impedes the ability of credit unions to engage in charter choice.*** Removal of NCUA’s obstructionism is a far better alternative to enabling more business lending and access to alternative capital than a wholesale change in powers that will benefit only a small proportion of large credit unions. Facilitating conversion to a mutual savings bank charter will benefit those credit unions that have outgrown their charter, and will also improve the fiscal position of the United States as these entities pay their fair share of taxes.

Congress is rightfully concerned about the state of the corporate credit unions in receivership and the significant costs their rescue imposes on the rest of the credit union industry. While the taxpayer assistance was appropriate for the circumstances, it is ironic that taxpayer dollars would be used to support an industry that has not paid a single dollar in federal taxes. The answer to the stresses currently suffered by credit unions is not to increase business lending powers or allow alternative forms of capital. Nor are these necessary to meet the credit needs of businesses. The fact is that there is ample authority under existing law to meet credit unions small business member needs. Equally important is that expanding the lending cap is inconsistent with the credit union mission and raises serious safety and soundness concerns. Similarly, alternative capital may sound appealing, but it would dramatically change the member-owned focus of credit unions to a market-driven one, which ultimately will negatively impact credit union members.

Against a backdrop where non-traditional credit unions forsake the common bond in favor of fast growth, and where energies are diverted to favoring the well-off and businesses rather than meeting their chartered obligation to serve people of modest means, it is no surprise that ABA opposes expansion of credit union powers. To allow such expansion will only move the new breed of credit unions further and further away from their mandated mission.

Appendix A

Business Lending Helped Lead to Credit Union Failures

The NCUA Office of Inspector General's Capping Report on Material Loss Reviews (MLR) found that the concentration of Member Business Lending (MBL) was a frequent area of concern. Of the ten MLRs that were reviewed for the report, the MBL issue was a factor in seven of the credit union failures. The table below explains each credit union's MBL problem.

Credit Union	MLR Issue: Member Business Lending
Huron River Area CU	Management violated NCUA's MBL limits by failing to limit its aggregate net MBL balance to the lesser of 1.75 times its net worth or 12.25 percent of its total assets. Based on Huron's December 2006 net worth and total assets of approximately \$41 million and \$363 million, respectively, Huron's MBL balance should not have exceeded approximately \$44 million. As of February 2007, NCUA determined Huron had approximately \$187 million worth of MBLs in its Florida construction loan portfolio, an amount over four times the statutory limit.
Norlarco CU	Management allowed some borrowers to own multiple properties - some on the same street, which were not reported as member business loans. By December 2006, the credit union's MBL balance was approximately \$39 million, or 1.15 times its net worth and 10.9 percent of its total assets, which was within NCUA's statutory limits. After reclassifying the loans, the MBL balance increased to \$86.7 million, nearly three times its net worth and double its statutory limits. The credit union's ratio of MBLs to assets was more than 24 percent. Although examiners did not have accurate information regarding the credit union's MBL balance because of misclassified MBLs, examiners failed to recognize the borrower's intent was often misrepresented on the loan applications underwritten by the credit union's third-party provider, First American. In fact, not until the credit union was placed in NCUA's Special Actions did NCUA officials learn that management's internal controls over the RCL program were so lax that the Board and management failed to recognize the vast majority of the loans in the RCL portfolio were for investment purposes. Additionally, officials in Special Actions determined some borrowers owned multiple properties - some on the same street, which were not being reported as member business loans (MBLs). As a result, NCUA Special Actions required management to reclassify every construction loan as a MBL until each borrower could be contacted to verify the intent of their loan.
High Desert FCU	Management did not have an adequate MBL policy, particularly related to equity requirements and lack of proper recordkeeping to monitor compliance with an MBL waiver issued in August 2003, and ensuring income verification for MBL borrowers. Although examiners identified the credit union's MBL issues such as underwriting and permissible MBLs through DORs in every examination from 2003 through 2008, examiners did not draw management's attention to the fact that the credit union's DOR issues were repeat issues that should have been addressed more timely.
Eastern Florida Financial CU	Management violated numerous MBL regulatory limits. Also, MBL underwriting was not robust. Approximately \$51 million of the MBL balances remained on the credit union's delinquency report for the first three Call Report cycles in 2008. One of the larger MBLs in delinquent status was not properly classified in the credit union's Call Report resulting in an understated delinquent loan ratio. Examiners needed earlier and stronger supervisory action, which may have influenced the credit union's Board and management to limit the significant level of risk assumed during the institution's rapid growth period, especially in their CDO leverage strategy and MBL activities, where they suffered the largest losses that caused the failure.
Clearstar FCU	Management continued to make MBLs despite being undercapitalized, a violation of NCUA Rules and Regulations.
Ensign FCU	Management violated NCUA Rules and Regulations over member MBL limitations for construction and development loans, MBLs to one individual or associated group, and aggregate MBLs, respectively. All repeat violations from a prior examination.
St. Paul Croatian FCU	Management had no MBL policies in place despite having MBLs in the portfolio.

Source: NCUA OIG Capping Report on MLRs, 10/20/10

Appendix B

Credit Unions Have Received Taxpayer Assistance to Facilitate Repayment of the Cost of Corporate Credit Union Failures

Financial problems at corporate credit unions have imposed a significant cost on federally-insured credit unions (FICUs) and caused NCUA to seek taxpayer assistance to ameliorate the cost.

In 2009, NCUA estimated that the initial cost of resolving troubled corporate credit unions would impose a one-time 99 basis point NCUSIF assessment on FICUs – 30 basis point (bp) premium assessment and 69 bp write down of their one percent NCUSIF capitalization deposit. Testifying before a House Financial Services Subcommittee on May 29, 2009, NCUA Chairman Michael Fryzel stated that the 99 basis point cost to FICUs would reduce each credit union's return on assets by 72 bps and net worth by 65 bps.

As a result, NCUA went to Congress in the Spring of 2009 seeking the creation of a Temporary Corporate Credit Union Stabilization Fund (TCCUSF). Section 204(f) of Helping Families Save Their Homes Act of 2009 (Public Law 111-22) authorized the establishment of the TCCUSF by amending Title II the Federal Credit Unions Act. The TCCUSF authorized NCUA to borrow up to \$6 billion from the Treasury on a revolving basis. The TCCUSF must repay the Treasury all amounts borrowed with interest; but the TCCUSF would have discretion as to the timing of each repayment and the amount of principal included with each repayment. The TCCUSF would make assessments on FICUs as it determined necessary to make each repayment. The TCCUSF must be shut down seven years after its initial borrowing; however U.S. Department of Treasury extended the operation of the TCCUSF through 2021.

In a June 2009 letter to FICUs, NCUA wrote that both the NCUSIF and FICUs benefitted from the creation of the TCCUSF. The TCCUSF “allows the Board to improve the NCUSIF's equity ratio to better position the NCUSIF to cover future insurance losses. Essentially, it means insured credit unions will not bear a significant, current, concentrated, onetime burden for stabilizing the corporate system.”

With the creation of the TCCUSF, NCUA has tapped its line of credit at the Treasury to resolve the five failed corporate credit unions. Aggregate borrowings could be as high as \$9 billion to \$10 billion.