Testimony of

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On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on

"The Need for Credit Union Regulatory Relief and Improvements"

March 6, 2008
Washington, D.C.

Mr. Chairman and Ranking Member Bachus, I am R. Michael Stewart Menzies, Sr., President and CEO of Easton Bank and Trust Company in Easton, Maryland. I am also the Chairman-Elect of the Independent Community Bankers of America.[1] Easton Bank is a $140 million asset community bank located in a small town on the Eastern Shore of Maryland. Our main lending focus is on small business, though 15 percent of our loans are to consumers.

ICBA appreciates this opportunity to testify on legislation (H.R. 1537) that would expand the tax-exempt credit union charter. We strongly oppose this bill, the Credit Union Regulatory Improvements Act (CURIA). Congress should not enhance the credit union charter unless it also is prepared to tax credit unions and require them to comply with the Community Reinvestment Act.

I want to make clear that community bankers strongly support locally-based non-profit organizations. I have served on a number of non-profit boards, including the local hospital board. Many of my community bank colleagues perform similar service. And, Easton Bank offers a special savings account to non-profit institutions. Our concern is that tax-exempt credit unions have strayed far from their statutory mission to serve individuals of modest means and are seeking to go even farther.

My statement makes the following key points:

- CURIA is powers enhancement, not regulatory relief and credit union regulation does not appear adequate to deal with the proposed increase in their powers;
- Community banks are seeking true regulatory and tax relief;
- Credit unions should not be given expanded business powers as long as they remain tax exempt.
- Credit unions should be encouraged to convert to the mutual thrift charter if they need additional authorities; and
- Tax-exempt credit unions are not meeting their statutory goal of serving people of modest means and pose unfair competition to community banks;

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

CURIA is Powers Enhancement, Not Regulatory Relief

CURIA goes far beyond eliminating unnecessary paperwork by enhancing credit unions' powers and reducing critical capital requirements.

The bill makes these substantial changes to credit unions' business lending authority:

- Increases overall business loan cap from 12.25 to 20 percent of assets;
- Exempts business loans under $100,000 from the overall cap;
- Excludes faith-based loans entirely;
- Allows undercapitalized credit unions to increase their business lending.

CURIA doubles credit unions' authority to invest in credit union service organizations. Since CUSOs have substantially more authority than credit unions themselves this indirectly increases credit unions' powers.

Credit unions' involvement in last year's Florida real estate investment scheme, dubbed "Millionaire University," illustrates just how far credit unions have strayed from their original tax-exempt mandate to serve low- and moderate-income families and into risky business loans. In this scheme a number of credit unions granted speculative out-of-market land development loans to residents from far away states. Borrowers became credit union "members" by paying a $5 membership fee. Three of those credit unions failed. What original members were served in their home states of Colorado and Michigan when these credit unions made these risky loans on Florida real estate?

While these credit unions strayed far from their home communities, their representatives in Washington have continued to ask Congress to allow them to expand into "underserved" areas, regardless of whether these areas are populated by individuals in a credit union's field of membership.

Under the guise of helping the underserved, the net effect will be to further expand credit unions' reach into the marketplace without a clear demonstration that individuals actually lack access to banking services. And, the proposed expansion does not carry any obligation that the credit unions actually serve low- and moderate-income consumers.

Credit union regulation bears a superficial resemblance to bank regulation, with minimum capital requirements and regular examinations. However, the Millionaire University fiasco and recent losses by the National Credit Union Share Insurance Fund suggests that there are substantial differences between bank and credit union supervision. NCUA has reported that NCUSIF lost $185.4 million in December, the most losses for one month or for an entire year in the fund's existence.[2]

[2]Credit Union Journal, February 22, 2008.

The Congress explicitly placed limits on the types of lending tax-exempt credit unions can do for a good reason – so credit unions can focus their efforts on serving people of modest means that share a common bond. This is not only better for local communities; it is also a much safer form of lending. Congress should conduct substantial oversight of the NCUA before it seriously considers expanding the credit union charter.

While increasing credit unions' powers and risks, CURIA allows credit unions to reduce their capital. It lowers the standard for a credit union to be considered "well-capitalized" from 7 to 5.5 percent of assets. This is particularly unwise at a time when the entire financial system is undergoing substantial stress.

Community Bankers are Seeking True Regulatory Relief

Some in the credit union industry have argued that CURIA is comparable to the community bank regulatory and tax relief bill ICBA is supporting. However, that bill, the Communities First Act (H.R. 1869), introduced by Small Business Chairwoman Nydia Velazquez, does not increase community banks' powers. It simply reduces unnecessary paperwork for community banks and their customers and begins to redress the tax inequality between community banks and their credit union competitors.

ICBA strongly urges this committee to continue the work on regulatory relief for all banking institutions that was begun in the last Congress. This is important if community banks are to remain viable competitors. Community banks have fewer personnel and other resources than larger banks to employ in their efforts to meet steadily increasing regulatory demands. We strongly urge you to continue to rebalance the account by eliminating or reducing outdated and unnecessary regulations.

For example, we urge Congress to enact the CFA provision that would eliminate the requirement that financial institutions send customers annual privacy notices when they do not share customer information and have not changed their policies. And, you could reduce the call report burden by permitting community banks to file short-form call reports for two quarters each year.

CFA also provides additional tax reforms for banks that have elected Subchapter S status. Credit union industry representatives have claimed that Sub-S provides benefits comparable to credit unions' tax exemption. This is not accurate; credit unions are tax exempt, while <u>all</u> Sub-S profits are taxed at the shareholder level at the top income tax rate as high as 35 percent. Community banks and their shareholders pay additional state and local taxes, for a total tax burden often exceeding 40 percent. This is true whether the bank distributes earnings to shareholders or holds them as retained earnings.

Credit Unions Should Not Get More Business Lending Authority if They Remain Tax Exempt

Credit unions are seeking to expand farther into an area that is vital to community banks, small business lending. Community bankers do not object to increased competition; many large banks and other lenders compete for small business loans. But, those lenders pay taxes, credit unions do not.

Credit unions representatives often claim that credit unions represent a small share of the financial services market. They reach this conclusion by including the assets of the entire banking system, including the nation's largest banks. However, those institutions are far less concerned about the unfair competition from tax-exempt credit unions than community banks. While total banking assets are $13 trillion, assets held by ICBA's nearly 5,000 members total $982 billion. Federally-insured credit unions hold a comparable amount, $753 billion.

At the time their tax and regulatory advantages were put in place, credit unions offered little more than basic savings accounts, certificates of deposit, and small personal loans to limited fields of membership. Congress and NCUA have substantially changed this trade-off by expanding credit unions' product line and geographic reach:

- Credit unions have substantial leeway to offer business loans and aggressively skirt the statutory 12.25 percent cap;
- Many credit unions have converted to geographically-based "community" charters, making their geographic footprint equivalent to their community bank competitors; and
- A large number of credit unions now serve so many disparate groups that individual credit unions are allowed to serve virtually anyone with a pulse.
- There is an increasing number of large, full service, credit unions over $1 billion in assets.

The Congressional Research Service has reported that through credit union service organizations, "credit unions may provide their members with a panoply of sophisticated financial services and products that rivals the offerings of banks and thrifts." The CRS report notes that "over the past 30 years, most of the distinctions between credit unions and other depository institutions have been eliminated or reduced because of deregulation; consequently, the justification for the tax exemption for credit unions has been increasingly questioned."[3]

Today's credit unions have virtually no limit to their customer base; the statutory "common bond" requirement has become meaningless because many credit

[3] Congressional Research Service. "Should Credit Unions be Taxed?" August 2005.

unions serve multiple common bonds or have expansive "community" charters. For example, NCUA gave the Los Angeles Financial Credit Union approval to serve: "Anyone who lives, worships, works in, or attends school in Los Angeles County." This encompasses a county of more than 10 million people and a geographic area larger than the states of Delaware and Rhode Island combined. Other examples abound. This hardly meets the statutory requirement that membership in community credit unions be limited to "Persons or organizations within a well-defined local community, neighborhood, or rural district."[4]

ICBA believes that these changes already justify credit union taxation and CRA coverage. Like community banks, credit unions should willingly support our nation's goals by paying their fair share of taxes. Until Congress is at least ready to require credit unions to pay taxes and comply with CRA, it should refrain from granting credit unions new powers.

Credit Unions Could Convert to Mutual Thrifts

The implicit reason for the expansions in CURIA appears to be that the current credit union charter is inadequate for the needs of some credit unions and their customers. However, ICBA believes that there is a far more appropriate alternative for them; if they need bank powers to better serve their customers, they should be encouraged to convert to a Federal savings association charter. Over 30 credit unions have taken advantage of this option, despite the substantial roadblocks that the National Credit Union Administration has put in the way of credit union-to-thrift conversions.

Why should credit unions have to convert to a new charter, rather than simply ask Congress to increase credit union powers? The answer is simple. Congress provided credit unions with a substantial tax advantage over community banks and does not require them to comply with the Community Reinvestment Act. This was part of a basic trade-off put in place decades ago: limited activities, providing credit to individuals of modest means, but valuable tax and regulatory benefits.

If some credit unions believe they need new powers, NCUA would best serve them, their members – and taxpayers – by facilitating their conversion to tax-paying mutual thrifts. Unfortunately, the agency has taken the exact opposite approach; it has erected roadblock after roadblock to conversions, even though those institutions would remain in mutual form.

The agency has imposed unrealistic disclosure requirements on credit unions seeking to convert. At one point, it even attempted to block two conversions because the required disclosures to credit union members were "incorrectly"

[4] Federal Credit Union Act, section 109(b) (12 U.S.C. 1759(b).

folded! It only relented when it became clear that a Federal magistrate was going to rule against the agency.

Unfortunately, the pending legislation would make it more difficult for a credit union to convert. Current law requires a majority of those voting to permit a conversion. CURIA would add that at least 30 percent of members would have to participate in the vote.

This goes in the wrong direction. No other Federal financial regulatory agency imposes anything like the conversion restrictions that NCUA imposes. In fact, in all other charter conversions, the agency that an institution is leaving need only give summary approval. The only analogous situations are instances when a mutual thrift seeks to convert to stockholder form. In those cases the supervising agency seeks to ensure that the process is fair to depositors and does not unduly enrich management. The resulting numbers tell the story; hundreds of mutual institutions have converted to stockholder ownership. In contrast, only around 30 credit unions have converted to mutual thrift charters.

Credit Unions Are Not Serving Their Original Mission

As I have indicated, Congress granted credit unions' their tax exemption with the understanding that they would be serving individuals of modest means. Congress had the same rationale for credit unions' CRA exemption. The record shows that credit unions have not upheld their end of the bargain. In light of this record, there is no justification for granting credit unions additional powers and further extending the reach of their tax exempt activities.

In 2005, the Tax Foundation undertook an analysis of the credit unions' Federal Tax exemption.[5] The study calculated that the tax subsidy is worth $2 billion a year – and growing. It will be over $32 billion over the ten-year budget window. For the average credit union, this meant a return on assets ½ percentage points – 50 basis points – higher than the average bank. Only 6 basis points of the subsidy are used to lower interest rates. Another 11 "are absorbed by higher labor costs."[6] There is little or no effect on deposit rates or other costs.

Of course, these are averages that demonstrate that credit unions do not generally pass on their subsidy to their customers. However, they do have the option to use their subsidy selectively to secure business that they want. One of my customers – a retired pilot with an excellent financial record – applied for a loan to buy a private aircraft. However, his credit union offered far better terms than my bank could offer. The credit union's tax advantage helped make that possible.

[5] "Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions," by Professor John A. Tatom, Ph.D. Tax Foundation, 2005.
[6] Page 22.

A host of other studies round out the picture. A 2005 study by the National Community Reinvestment Coalition determined that banks actually do a better job of fulfilling the credit unions' mission than the credit unions. This study highlighted how banks "consistently exceed credit unions' performance in lending to women, minorities, and low and moderate-income borrowers and communities."[7] A 2003 Government Accountability Office study found that credit unions serve a more affluent clientele than banks. This GAO study concluded that "credit unions overall served a lower percentage of households of modest means than banks."[8]

Another study by the Woodstock Institute concluded that credit unions serve a higher percentage of middle- and upper-income customers than lower-income households.[9] Similarly, a study by the Virginia Commonwealth University concluded that credit unions tend to serve a higher proportion of wealthier households in their customer base.[10]

Today there are more than 120 credit unions with $1 billion or more in assets, providing sophisticated banking products and services to wealthy and middle-income members. There is no justification for their tax-exempt status and CRA exemption.

In one instance, the NCUA acted on these facts. Effective November 27, 2000, NCUA adopted a rule that required all credit unions with a community charter to adopt a Community Action Plan. The rule would have required

> that a community credit union address in either its marketing or business plan or other appropriate separate documentation, such as the strategic plan, project differentiation, etc, how it plans on serving the entire community, including how the credit union will market to the community and what products and services will be offered by the credit union to assist underserved members in the community.[11]

Unfortunately, the membership of the NCUA's board changed soon after the agency adopted the CAP requirements and the rule was repealed. In 2002, JoAnn Johnson – then a board member, now chairman – attempted to justify this

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[7] "Credit Unions: True to Their Mission?" National Community Reinvestment Coalition, May 2005. www.ncrc.org.

[8] General Accounting Office. "Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management." October 2003.

[9] Woodstock Institute. "Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low-Income People. February 2002.

[10] School of Business, Virginia Commonwealth University. A Study on the Comparative Growth of Banks and Credit Unions in Virginia: 1985-1995." August 1997.

[11] NATIONAL CREDIT UNION ADMINISTRATION, 12 CFR Part 701, final rule, effective November 27, 2000, section 5, COMMUNITY CHARTERS, COMMUNITY ACTION PLAN (CAP) (since rescinded).

action by claiming that credit unions were already serving persons of "modest means." This is easier said than proven. During the 2005 Ways and Means Committee hearing on credit unions' tax exemption NCUA Chairman Johnson and credit union representatives had a difficult time demonstrating that they were meeting their statutory mandate of serving persons of modest means.

ICBA believes that the NCUA had the right idea when it adopted the CAP proposal in October of 2000 and took a giant step backward when it repealed the rule the following year. We strongly recommend that Congress build on the agency's work in 2000 and require credit unions to comply with CRA requirements in the same manner, and with the same asset size distinctions, as banks and thrifts.

Conclusion

ICBA strongly urges Congress to reject calls for new powers and reduced capital for the credit union industry. Credit unions should be granted no new powers as long as they remain tax exempt and are not meeting their statutory mission to serve individuals of modest means. Enhanced commercial lending authority is inconsistent with this mission.

Instead, we urge you to continue efforts to provide true regulatory burden relief for all depository institutions. This is vital if community banks are to remain competitive. And, Congress should exercise rigorous oversight of the National Credit Union Administration to determine if it is providing adequate safety and soundness regulation and not unduly restricting credit union conversions.