

Prepared Testimony of Thomas J. Candon
Deputy Commissioner
Vermont Department of Banking, Insurance, Securities and Health Care
Administration
On behalf of the
National Association of State Credit Union Supervisors
Before the Financial Institutions Subcommittee of the Banking, Housing and
Urban Affairs Committee
United States Senate
October 14, 2009

Introduction

Honorable Chairman Johnson, Ranking Member Crapo and the distinguished members of the Financial Institutions Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, thank you for the opportunity to testify before this Subcommittee on the State of the Banking Industry. I am Thomas J. Candon, Deputy Commissioner of Banking and Securities for the Vermont Department of Banking, Insurance, Securities and Health Care Administration. I am pleased to be here on behalf of state credit union regulators as Chairman of the National Association of State Credit Union Supervisors¹ (NASCUS). In this prepared testimony, I will share state credit union regulators' perspectives on the condition of state-chartered credit unions and areas for reform.

¹ NASCUS is the professional association of the 48 state credit union regulatory and territorial agencies that charter and supervise the nation's 3,100 state-chartered credit unions.

NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965. NASCUS is the sole organization dedicated exclusively to the promotion of the dual chartering system and advancing the autonomy and expertise of state credit union regulatory agencies.

The state credit union system is 100 years old. Today, there are 3,065 state-chartered credit unions with a combined \$404 billion in assets.² State-chartered credit unions represent 40 percent of the nation's nearly 7,700 credit unions.

At this hearing, the Subcommittee is assessing the state of financial institutions, areas of concern as well as capital and lending needs. In this testimony, I will detail information from state regulators on the following:

- Condition of state-chartered credit unions
- Corporate credit union impact
- Credit union capital needs
- Regulatory considerations for member business lending
- Trends and regulatory response
- Value and strength of state supervision

Condition of state-chartered credit unions

Like all financial institutions, state credit unions have been adversely affected by the economic downturn. However, at this point, state natural person credit unions remain generally healthy

² As of June 30, 2009.

and continue to serve the needs of their members and their communities. For the most part, natural person credit unions did not engage in many of the practices that have precipitated the current market downturn.

Nationally, the average credit union net worth is down to 10.03%, with 96 percent of all federally insured credit unions having more than 7% in capital as of June 30, 2009. Further, the percentage of delinquent loans is 1.58% for all credit union loans.

State-chartered credit unions in my state of Vermont have the capability to lend due to an increase in deposits that we attribute to a flight to safety. Consumer loans are available to members although underwriting continues to be based on a member's ability to repay. At this time, Vermont credit unions do not make many member business loans and have nominal commercial real estate loans on their balance sheets. Our regulatory focus is on the amount of capital held by some of our credit unions and the impact of the growing unemployment picture on delinquencies.

The capital of Vermont credit unions is affected by the growth of deposits which were up 24.73% in Vermont as of June 30, 2009, and the impact of the corporate credit union losses (which I will discuss later). Income is also being reduced as margins are squeezed and credit union members are struggling to make loan payments.

In Vermont, our small credit unions like many around the country are not only affected by a downturn in the economy but also by increasing regulatory burden. We continue to see mergers

as long-time managers retire and volunteer boards cannot keep up with the increased demands. As state regulators we monitor our credit unions closely. If there is any sign of distress, we have an examiner communicating with the credit union to make sure we understand what needs to be done to correct the problems.

As the Subcommittee knows, the effect of the economy on financial institutions varies from region to region. Some regions are weathering significant impacts from the destabilized real estate market, while others are addressing more localized economic issues. In many cases, state regulators are concerned about unemployment and its impact on members' ability to meet their obligations. State regulators are also concerned about the growing number of delinquencies, charge-offs and pressures on earnings, especially in smaller state-chartered credit unions. While loan delinquency and net charge-offs have generally increased for state-chartered credit unions, state regulators indicate that the levels remain manageable.

State regulators also report increased scrutiny on consumer credit products, including auto loans, credit cards and other consumer credit portfolios given the nation's economic condition. State credit union regulators are cognizant of credit unions' future financial performance as commercial credit problems begin to affect consumer credits. The weak economy creates a tightening of commercial credit, an issue being closely monitored by state regulators.

Some states, including my home state of Vermont, have not experienced the fallout from commercial or subprime lending as our state-chartered credit unions did not engage in those activities. State regulators continue to encourage their credit unions to exercise sound

underwriting, proper risk management and due diligence, the elements that have kept credit unions in a better position throughout this economic downturn. Further, state regulators are monitoring red flags closely, fully utilizing off-site monitoring and using early warning systems to detect risk.

The growing trend toward consolidation is also on the minds of state regulators as credit union mergers continue to occur, both voluntarily and for regulatory purposes. As economic pressures persist, finding suitable merger partners may become more difficult. State regulators recognize this dilemma and see merger issues as an ongoing concern in 2010.

In addition, growth is an issue state regulators are paying close attention to in today's environment. The National Credit Union Administration (NCUA) reported in its Financial Trends in Federally Insured Credit Unions for January-June 2009 an annualized asset growth rate of 14.53%. This growth gives rise to concerns about interest rate risk and the need to ensure quality asset/liability and balance sheet management among credit unions.

Corporate Credit Union Impact

As I noted earlier, one of the issues affecting both state and federal credit unions is the impact of problems in the corporate credit union network. Allow me to elaborate. In addition to direct economic pressures, credit unions are addressing indirect economic pressures by way of the impact of losses from corporate credit unions. The deterioration of asset-backed securities held by two federal corporate credit unions (U.S. Central Corporate Federal Credit Union and Western Corporate Federal Credit Union) and their consequent conservatorship by the NCUA

have resulted in considerable balance sheet impact on natural person credit unions.

For the first time in nearly 20 years, the NCUA Board approved a credit union premium in September 2009 with the assessment of 0.15 percent of insured shares. The premium will both restore the National Credit Union Share Insurance Fund (NCUSIF) equity to 1.30 percent and begin to repay a portion of the Temporary Corporate Credit Union Stabilization Fund borrowings from the U.S. Treasury.

State regulators, in consultation with federal regulators, are working to address the impact of corporate losses and to make regulatory improvements to mitigate recurrence. As the NCUA develops its proposed rule for regulation of corporate credit unions, state regulators continue to stress the following principles:

- Enhance supervision and tighten regulatory standards
- Properly assess risk problems
- Preserve equal opportunity for all corporates to compete as long as they remain safe and sound and retain the support of their members
- Guard against preemption of state authority and homogenization of the corporate system

State regulators have also cautioned the NCUA against regulation that would unnecessarily or adversely impact safe and sound corporate credit unions that have properly managed their investments and remain fully supported by their members.

NCUA has been working cooperatively with state regulators to institute revisions to the agency's Part 704 corporate credit union regulations to strengthen the safety and soundness of the corporate system. Regulators should continue to focus on ensuring any credit union, natural person or corporate, has robust risk management and mitigation policies in place to balance its investment portfolios. Such policies should include adequate reserves, requisite expertise, meaningful shock testing and valuation mechanisms as well as concentration limits.

NASCUS believes there is no question that after recent events corporate credit unions must retain higher capital reserves. NCUA should work with NASCUS and state regulators to develop more comprehensive capital requirements, including risk-based capital.

The regulatory capital program for corporate credit unions should consider an institution's status as a wholesale or retail corporate, its mix of products and services (investment, payment systems, pass through, etc.) and establish parameters of actions for state and federal regulators if capital falls below defined thresholds.

Capital is important to both the corporate credit union system and the natural person credit unions that support the corporate credit unions. During the corporate stabilization process, supplemental capital may have mitigated some of the unintended consequences to net worth categories at natural person credit unions. Further, access to a risk-based capital system would foster safety and soundness for the entire credit union system.

Credit Union Capital Needs

The majority of credit unions are weathering conditions today; however, as stated previously, credit unions' earnings are suffering and credit unions are losing money. We need to act now to ensure credit unions remain as safe and sound as possible. NASCUS has long supported comprehensive capital reform for credit unions and believes that given the current economic climate, reform in this area is critical and timely. Credit unions need more ways to raise capital, notably access to supplemental capital. NASCUS continues to encourage the Senate Banking Committee to consider credit union capital reform as part of its financial reform efforts.

Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings from net income. Since net income is not easily increased in a fast-changing environment, state regulators recommend additional capital-raising capabilities for credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness. Supplemental capital would serve as an extra layer of protection for the credit union deposit insurance fund as well.

Allowing credit unions access to supplemental capital with regulatory approval and robust oversight will improve their ability to react to market conditions, grow safely into the future and serve their members in this challenged economy. It would also provide a tool for credit unions to use if they face declining net worth or liquidity needs. We feel strongly that now is the time to permit this important change.

NASCUS follows several guiding principles in our quest for supplemental capital for credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must provide for full disclosures, investor protection and robust safeguards. Prudential safety and soundness requirements must be maintained for these investments and supplemental capital must preserve credit unions' tax-exempt status. Finally, regulatory approval would be required before a credit union could access supplemental capital.

It is NASCUS' studied belief that a change to the Federal Credit Union Act could provide this valuable tool to the credit union system without altering the not-for-profit, mutual, cooperative structure of credit unions as tax exempt member owned financial institutions. We realize that supplemental capital will not be appropriate for every credit union, nor would every credit union need access to supplemental capital. This is why NASCUS supports regulator approval as a precondition for credit unions issuing supplemental capital.

A task force of NASCUS state regulators is currently studying supplemental capital for credit unions with the NCUA. This regulatory group is researching the appropriate regulatory parameters for supplemental capital for credit unions.

As this Subcommittee addresses regulatory reform and other legislation this fall, NASCUS encourages favorable consideration of access to supplemental capital for credit unions.

Regulatory Considerations for Member Business Lending

Credit union member business lending, when conducted within proper regulatory controls, has proved beneficial for credit unions, their members, and their communities. However, while some credit unions are actively engaged in member business lending, many are not. As Congress considers changes to credit unions' member business lending capabilities, state regulators will work with the NCUA in its capacity as the insurer to build regulatory parameters for proper oversight through the examination and supervision process. Further, credit unions must have a thorough understanding of member business lending and be diligent in their written policies, underwriting and controls for the practice to be conducted in a safe and sound manner. From a prudential regulator view, an arbitrary cap on member business lending is less important than proper underwriting and thorough reporting of all business loans.

Trends and Regulatory Response

I would like to respond to the Subcommittee's request for information regarding developing trends, concerns and state regulatory responses to today's challenges. Rising unemployment continues to be a concern and we expect that it will continue to negatively impact state credit unions well into 2010 as delinquencies and bankruptcies continue to increase.

Some state regulators have seen a marked increase in loan delinquencies and net charge-offs at June 2009; however, the levels remain manageable. Earnings pressures continue so credit unions are seeking ways to reduce overhead expenses. Loan demand has slowed somewhat in the mid- to smaller credit unions; a contrast to the increased indirect lending activities experienced in the larger credit unions. State regulators are closely monitoring both lending and investment

activities within their credit unions and continue to stress the importance of sound underwriting and due diligence at the board level. State regulators also continue to supervise their institutions closely through off-site monitoring and on-site examinations and visitations. Credit unions need to understand their portfolio makeup and the impact that an increasing rate environment will have on their institutions.

Another economic stressor affecting small credit unions is the uncertainty of losing their core field of membership if comprised of select employee groups. Because some small credit unions still rely on one or two employers for their members, if those businesses do not survive, the credit union will not survive either.

Value and Strength of State Supervision

In this challenged economic environment, state regulators have demonstrated the importance of local supervision of state-chartered institutions and the value of a dual regulatory regime. State regulators are properly tuned into both their institutions and the specific needs of local consumers. Further, state regulators have the expertise to identify risk areas and take enforcement actions where necessary. With respect to consumer protection, state regulators are directly accountable to governors and state legislatures, who in turn are directly accountable to their consumer citizens. It is for this reason that many states have always emphasized consumer protection along with safety and soundness in financial services oversight. As regulatory modernization efforts are considered by the Senate Banking Committee, we encourage you to retain state supervision and uphold state authority. Further, we ask you to recognize the essential value of dual chartering to financial institution's ability to innovate.

Finally, as we talk about dual chartering, I wanted to note our regulatory partners, the National Credit Union Administration. In my state of Vermont, all of my credit unions are federally insured, and therefore subject to share insurance oversight from NCUA in addition to state safety and soundness and compliance regulation and supervision. We work extremely well with NCUA, and I believe our strong cooperative relationship has contributed substantially to the stability of the credit union system in my region. Indeed, this cooperative relationship between state regulators and the NCUA exists throughout the nation as well.

NASCUS would be pleased to provide any additional information you deem appropriate as you work through these matters. While the current economic climate has an unquestionable adverse impact on the state credit union system, I remain confident that the generally sound management of credit unions combined with ongoing vigilant state regulatory oversight has enabled the credit union system to prudently meet their members' needs. Thank you for your attention.