Testimony of

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on behalf of

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"Legislative Proposals for a More Efficient Federal Financial Regulatory Regime: Part II"

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Introduction

Good afternoon Chairman Luetkemeyer, Ranking Member Clay and Members of the Subcommittee. Thank you for the invitation to appear before you today. My name is Brian Ducharme and I am testifying today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU). I am the President/CEO of MIT Federal Credit Union, headquartered in Cambridge, Massachusetts.

MIT is a federally charted credit union serving the Massachusetts Institute of Technology and the life sciences community in Cambridge. MIT FCU was founded in April of 1940, when 12 employees of MIT each placed $5.00 in a strong box while working out of the basement of a campus building. The purpose then, just as it is today, was to provide the financial services people needed to live a better life.

MIT FCU has three branch locations, however most members conduct business with us through a 24/7 contact service center and an array of electronic delivery channels that provide members immediate access to services and account information.

Today, we serve more than 38,000 members. I have seen the credit union grow from $94 million to over $540 million today. Prior to my time at MIT FCU, I spent time at two other credit unions, and have 25 years of experience in the financial services industry.

As you are aware, NAFCU is the only national organization exclusively representing the interests of the nation's federally-insured credit unions. NAFCU-member credit unions collectively account for approximately 70 percent of the assets of all federal credit unions. It is my privilege to submit the following testimony on behalf of NAFCU, our credit unions and the 110 million credit union members they represent as you seek to create a more efficient Federal regulatory regime.

Regulatory Environment and Economic Growth

NAFCU has always believed that credit unions play an essential and vital role in the economic health of local economies. This was again demonstrated during the recent financial crisis when credit unions were able to continue to lend and help credit worthy consumers and small businesses during difficult times, often when no one else would. Despite the fact that credit unions played no part in causing the financial crisis, they are still heavily regulated and affected by many of the rules meant for those entities that did.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this is why NAFCU was the only credit union trade association to oppose the CFPB having authority over credit unions. Unfortunately, many of our concerns about the increased regulatory burdens that credit unions would face under the CFPB have proven true. As expected, the breadth and pace of the CFPB's rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense. NAFCU continues to believe that credit unions should be exempted from CFPB rulemaking, with authority returned to the National Credit Union Administration (NCUA).

The impact of the growing compliance burden is evident in the declining number of credit unions. Since the second quarter of 2010, we have lost more than 1,700 federally-insured credit unions – over 20% of the industry. The overwhelming majority of these were smaller institutions below $100 million in assets. While it is true that there has been a historical consolidation trend in the industry, the passage of the *Dodd-Frank Act* has accelerated this trend. The fact is that many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge out of business or close their doors. This is why regulatory relief remains a top priority for our nation's credit unions and a key to the continuation of relationship banking in the communities where my credit union operates.

Tenets of a Healthy and Appropriate Regulatory Environment for Credit Unions

NAFCU believes a healthy and appropriate environment is important for credit unions to thrive. History has shown that a robust and thriving credit union industry is good for our nation's economy, as credit unions fill a need for consumers and small businesses in the financial services marketplace that may otherwise not be met by other institutions.

There are some basic tenets of a healthy and appropriate regulatory environment that NAFCU supports:

NAFCU supports a regulatory environment that allows credit unions to grow. NAFCU believes that there must be a regulatory environment that neither stifles innovation nor discourages credit unions from providing consumers and small businesses with access to credit. This includes the ability of credit unions to establish healthy fields of membership that are not limited by outdated laws or regulatory red tape. It also includes modernized capital standards for credit unions that reflect the realities of the 21st century financial marketplace.

NAFCU supports appropriate, tailored regulation for credit unions and relief from growing regulatory burdens. Credit unions are swamped by an ever-increasing regulatory burden from regulators, often on rules that are targeting bad actors and not community institutions. NAFCU supports cost-benefit analysis in regulation, and wants to ensure that we have an effective regulatory environment where positive regulations may be easily implemented and negative ones may be quickly eliminated. NAFCU also believes that enforcement orders from regulators should not be used in lieu of clear guidance or regulation.

NAFCU supports a fair playing field. NAFCU believes that credit unions should have as many opportunities as banks and non-regulated entities to provide provident credit to our nations' consumers. NAFCU wants to ensure that all similarly situated depositories follow the same rules of the road and unregulated entities, such as payday lenders, do not escape oversight. We also believe that there should be a federal regulatory structure for non-bank financial services market players that do not have a prudential regulator, including emerging Fintech companies.

NAFCU supports transparency and independent oversight. NAFCU believes regulators need to be transparent in their actions, with the opportunity for public input, and should respect possible different viewpoints. We believe a bipartisan commission structure is the best form of regulatory governance for independent agencies, and all stakeholders should be able to have input into the regulatory process.

NAFCU supports a strong, independent NCUA as the primary regulator for credit unions. NAFCU believes that the National Credit Union Administration (NCUA) is best situated with the knowledge and expertise to regulate credit unions due to their unique nature. The current structure of NCUA, including a 3-person board, has a track record of success. NCUA should be the sole regulator for credit unions and work with other regulators on joint rulemaking when appropriate. Congress should make sure that NCUA has the tools and powers that it needs to effectively regulate the industry.

Legislative Proposals Before the Subcommittee Today

NAFCU thanks the Subcommittee for holding this important hearing on legislative proposals to create a more efficient regulatory regime. In particular, we are pleased to see the introduction of the *Common Sense Credit Union Capital Relief Act of 2017* (H.R. 4464) by Representative Posey and we would urge the Committee to support and advance this legislation. This legislation would stop the NCUA's risk-based capital rule from taking effect, which is scheduled for January 1, 2019. NAFCU believes this rule is ill-conceived in its current form and will have a negative impact on the credit union industry if it is implemented without changes.

Background on NCUA's Risk-Based Capital (RBC) Rule

In 1998, Congress enacted the *Credit Union Membership Access Act* (CUMAA). Section 301 of CUMAA added section 216 to the *Federal Credit Union Act* (FCU Act), which required the NCUA Board to adopt by regulation a system of Prompt Corrective Action (PCA) to restore the net worth of federally insured "natural person" credit unions that become inadequately capitalized. In 2000, the Board implemented the required system of PCA primarily under Part

702 of NCUA's regulations. Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) a framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions defined as "new"; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as "complex." Congress also mandated that the NCUA Board provide a system of PCA that is "consistent…and comparable" to similar banking regulations. In 2013, the Federal Reserve Board of Governors (the Fed) along with other federal banking regulators promulgated comprehensive reform to banking capital requirements to align with international standards under Basel III. As a result, NCUA is statutorily obligated to update its capital adequacy framework.

In January, 2014, NCUA issued its first RBC proposal. The agency received 2,056 comment letters, many of which urged the agency to make significant changes to the proposed rule particularly with regard to interest rate risk (IRR) and risk-weighting. On May 15, 2014, during the rulemaking process, a bipartisan majority of the U.S. House of Representatives – 324 Members – wrote to NCUA to express concerns about the agency's proposed risk-based capital rule.

After reviewing these comments, NCUA determined that it would incorporate significant changes to the proposal including removing IRR as a factor for setting risk-weights. As such, the *Administrative Procedure Act* required that the agency re-propose the rule with a new comment period. On January 15, 2015, the NCUA board issued a revised RBC proposal. On April 23, 2015, NAFCU submitted an official comment letter, urging the NCUA Board to withdraw the proposal in its entirety, or, at minimum, make additional modifications to ensure that the proposed RBC structure would not unjustly and unnecessarily stifle growth, innovation, and diversification within credit unions. On October 15, 2015, the NCUA board voted to approve this final rule.

The final rule makes the following key changes to the agency's existing capital requirements:

- Establishes a new RBC ratio for federally insured natural person credit unions with over $100 million in assets;
- Changes the definition of "complex credit union," for the purposes of capital requirements, to include credit unions greater than $100 million in assets;
- Establishes a RBC ratio of 10 percent for well-capitalized credit unions;
- Establishes a RBC ratio of 8 percent for adequately-capitalized credit unions;
- Revises existing risk weights to reflect recent changes made by other banking regulators under the Basel System;
- Requires higher minimum levels of capital for credit unions with concentrations of assets in real estate loans, commercial loans or non-current loans; and,
- Sets forth how NCUA, through its supervisory authority, can address a credit union that does not hold capital that is commensurate with its risks.

These changes will take effect on January 1, 2019.

NCUA's RBC Rule is Still Problematic

Credit unions and the National Credit Union Share Insurance Fund (NCUSIF) performed very well during the financial crisis, and since RBC was first proposed, the health of the credit union industry has only continued to improve. In fact, as of September 2017, the number of CAMEL code 4 and 5 credit unions has fallen from 409 in December 2011 to 204. Likewise, the number of CAMEL code 3 credit unions has fallen to 1,086 from a total of 1,741. As a result, over 95 percent of the industry's assets are held in CAMEL 1 or 2 credit unions. Given the continued health of the credit union industry under the current capital regime, as well as continued pressure on earnings, NAFCU still has concerns with going forward with implementing NCUA's risk based capital rule.

Multiple financial experts and economists have conducted in-depth examination of rules similar to RBC, and have found them to be failed experiments. Most recently, at a July 6, 2016, event, Federal Reserve Board Governor Daniel Tarullo acknowledged that risk-based capital requirements are not appropriate for smaller banks and credit unions, noting that the requirements are too complicated. He stated, "when it comes to smaller institutions…any institution under $10 billion, I think we can and should have a substantially simpler capital system."

Similarly, researchers at the Mercatus Center and Heritage Foundation have found that risk-based capital requirements will likely impede economic growth without reductions in systemic-risk, especially considering the fact that risk-based standards based on a set of subjective assessments proved to be inadequate during the financial crisis.

As NCUA explained in the rule's preamble, RBC was developed, in part, to identity risk outliers that posed potential threats to the National Credit Union Share Insurance Fund (NCUSIF). In the months since RBC has been finalized, though, there have been several regulatory developments that more adequately confront the risks that RBC was initially intended to address. One of these risks was interest rate risk (IRR). Thankfully, the agency removed IRR provisions from the final rule, electing instead to address IRR through the use of a tool during examinations.

The IRR examination tool will provide NCUA with increased clarity around the actual levels of market risk in the system, and will allow NCUA to generate more precise methods to measure and address risk at individual credit unions. While the IRR tool will be a minimally invasive procedure allowing NCUA to focus on risk outliers, NAFCU believes that the RBC rule is a blunt instrument that is not as precise, effective, or useful. The IRR tool stands in stark contrast to the RBC rule. Unfortunately, RBC's implementation will unintentionally ensnare healthy credit unions in the attempt to identify outlier risk.

In September of 2017, the NCUA Board raised the normal operating level of the NCUSIF from 1.30% to 1.39%. One effect of this change was to create an additional buffer in the credit union system, mitigating one of the arguments for having the current RBC rule requiring credit unions to hold more capital.

In addition to NCUA developments that address risks, other regulators have also developed new rules since RBC was first proposed. As recently as June 2016, the Financial Accounting Standards Board (FASB) released a final accounting standards update (ASU), which is intended to address the need for a more predictive model for the financial reporting of credit losses on loans and other financial instruments held by lending institutions.

The ASU establishes a "current expected credit loss" (CECL) model for financial institutions that would require credit unions to immediately increase their Allowance for Loan and Lease Loss (ALLL) balance and reduce capital. Again, this is a rule that will address the risks that RBC was initially intended to address, and as such, create a redundant regulatory environment. Now that such significant threats are being addressed independent of the RBC rule, the agency's stated need for this rule is no longer essential, and the rule no longer serves the agency's stated purpose. Quite simply, the rule is now outdated.

Finally, credit unions are locked into a static net-worth ratio system that does not evolve in the face of changing market conditions, unlike other financial institutions. A more flexible RBC framework could counterbalance the immutable requirements of credit union PCA laws, as well as the myriad of other requirements noted above. With all of these factors in mind, credit unions need a fresh approach on capital. NAFCU believes it is even more vital for credit unions than banks, due to the static statutory system credit unions face.

We are pleased that NCUA Chairman Mark McWatters has agreed with NAFCU and indicated that the current rule is problematic and needs reforms. However, the political uncertainty due to one (or potentially two) vacancies on the NCUA Board is impacting the Agency's ability to make timely changes. With the rule set to take effect a year from now, credit unions must soon begin shifting their portfolios to come into compliance. This could lead to some institutions constraining lending in 2018 as they seek to maintain their capital level and capital cushion under the new regime. NAFCU believes that Congress should step in and stop this rule from taking effect on January 1, 2019, and give the NCUA Board time to re-examine and establish a risk-based capital standard that reflects current realities.

RBC's Impact on Credit Unions.

Recent NAFCU analysis has found that over 400 credit unions will see declines in their capital cushions when the rule becomes effective. Over 40 credit unions will face a downgrade in their capital level with their current portfolio under the terms of the new rule. MIT FCU is one of those facing a downgrade.

Our members look to us for many of their financial needs including a wide-range of mortgage services, college advisory, and ways to fund their education. With young adult members, we have been an attractive option for first time home buyers with programs that allow them to balance the needs of a growing family along with owning their first home. Remaining competitive to fund their needs allows us to deliver a diverse set of products that is competitive in a very crowded marketplace.

MIT FCU also provides advisory services on selecting a college, qualifying for grants, scholarships, and other no-cost financial aid as well as federal and private student loans. All of these are important choices and decisions members face. Today MIT FCU helps individuals make informed decisions and provides funding, in many cases, when others will not. Today MIT FCU is the 3rd largest private student loan lender in the credit union industry.

Both of these products, as well as others, have been prudently managed. However, under the new Risk Based Capital (RBC) Rule, MIT FCU's ability to continue servicing our members with these products will be constrained. The new RBC rule has also forced MIT FCU to reconsider offering business services as well as continuing its purchase of SBA loans that are guaranteed by the federal government. Regardless of how prudently we have managed these programs they would all have a negative impact on our risk-based capital ratio, and we may have to stop providing them - which may not be in the best interest of our members.

Enacting H.R. 4464 would stop the outdated NCUA risk-based capital rule from being implemented and, instead, allow the agency to craft a new RBC rule that considers recent developments and better reflects the needs of the credit union system.

Other Bills Before the Committee Today

NAFCU is pleased to see several other bills under consideration by the Subcommittee today and would like to offer comments on a couple of those as well.

H.R. 3746, the *Business of Insurance Regulatory Reform Act of 2017.* Introduced by Representatives Duffy and Moore, this NAFCU-supported legislation would help clarify the limits of the CFPB regulating insurance. The insurance industry is already highly regulated by the states, and Congress rightfully recognized this when drafting the *Dodd-Frank Act* which stated that the CFPB was not to regulate the "business of insurance." Unfortunately, we have seen jurisdiction creep from the CFPC into this realm. Credit unions such as MIT FCU offer regulated insurance products with some loans and we have concern that this jurisdiction creep could create new burdens on institutions like mine.

The *Comprehensive Regulatory Review Act of 2017.* Offered by Representative Loudermilk, this legislation would amend the *Economic Growth and Regulatory Paperwork Reduction Act of 1996* to include both NCUA and CFPB as official participants and increase the frequency from every 10 years to every five years. NAFCU appreciates that NCUA has been voluntarily participating in the EGRPRA review process and we are pleased to see the legislation extending it to the CFPB. We also appreciate increasing the frequency of the process, as it provides the credit union industry with the opportunity to voice concerns over outdated and burdensome regulatory requirements.

Conclusion

The growing regulatory burden on credit unions is the top challenge facing the industry today. One of the biggest impending burdens is the implementation of NCUA's risk-based capital rule. While NAFCU supports a true risk-based capital system for credit unions, the current rule, set to take effect on January 1, 2019, does not provide that and is flawed. We are pleased that NCUA

Chairman Mark McWatters has recognized this as well. However, circumstances necessitate Congress stepping in and stopping this rule in a timely manner in order to give credit unions certainty and NCUA the ability to craft a new rule should they desire. The *Common Sense Credit Union Capital Relief Act of 2017* (H.R. 4464) is needed and we would urge the Committee's support of this timely legislation.

Thank you for the opportunity to appear before you today on behalf of NAFCU. I welcome any questions you may have.