

Testimony of
Albert C. Kelly, Jr.

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

United States House of Representatives



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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is Albert C. Kelly, Jr., Chairman and Chief Executive Officer, SpiritBank, a \$1.3 billion bank headquartered in Bristow, Oklahoma. I am also the chairman-elect of the American Bankers Association. ABA represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

ABA is strongly opposed to recent efforts by the credit union industry to redefine the credit union charter in ways that would effectively turn credit unions into tax-exempt banks. This effort, most recently embodied in H.R. 1418, the "Small Business Lending Enhancement Act of 2011," would allow the NCUA to permit credit unions that are within 80 percent of their member business lending (MBL) cap to increase this cap to 27.5 percent of assets – ***more than double the current cap, and greater business lending authority than that of federal thrifts.***

Under H.R. 1418, credit unions would be allowed to further leverage their tax advantage and compete even more with tax-paying banks. The result of this competition would not be an overall increase in lending. Rather, an increase in the business loan cap would cause some business loans that are currently being made by taxable financial institutions to be shifted to credit unions. Shifting loans in this manner would result in less taxes being paid by banks, leading to an increase in the federal deficit at the very time Congress is looking for ways to reduce it. In fact, the Congressional Budget Office (CBO) in 2010 scored a bill that would raise the credit union business lending cap ***as an increase to the deficit of \$354 million over 10 years relative to the CBO baseline.***

Credit unions already have ample lending authority to make small business loans. ***Business loans under \$50,000 do not count against the current cap of 12.25 percent,*** nor do many other types of business loans. These exemptions mean that credit unions have ***unlimited*** business lending for small loans already, without the need to seek increases in their MBL limits.

In fact, only a few credit unions – **96 out of 7,292 credit unions** – are within 80 percent of their cap, as of year-end 2010.

There is a strong legislative history that supports the unique charter of credit unions **with very specific restrictions on business lending**. The restrictions were put in place to ensure that credit unions remained primarily focused on individuals – people of modest means. By offering an expanded business lending cap only to credit unions that are already close to their limit, H.R. 1418 **would serve as an invitation to credit unions that are not near this cap now to focus on business lending – rather than consumer lending** – in order to be eligible for an increase in their business lending cap. Clearly, this behavior does not encourage a focus on credit unions' central mission.

The restrictions on business lending were also put in place to protect credit unions from lending that could pose serious threats to safety and soundness. The congressional concern that led to these restrictions is well-founded and echoed by many within the credit union industry itself. **Business lending is risky business, and should be limited for all credit unions**. In fact, according to a report from NCUA on the costliest credit union failures, business lending was found to be a major contributor to failure in 7 of the 10 costliest failures.

Instead of trying to broaden tax-advantaged lending, increasing the deficit in the process, credit unions that seek to expand business lending opportunities can reach out with credit in their communities through a method that is already available – **by converting to a mutual savings bank charter**. This charter provides the flexibility credit unions desire and preserves the mutual-member focus that is the trademark of the credit union charter. **It would put these credit unions on equal footing with banks**, with respect to taxes and regulatory oversight. However, rather than encourage the natural evolution to mainstream banking, **NCUA actively impedes the conversion process**. Removal of NCUA's obstructionism would be a far better alternative to enable more business lending.

There are four key points I would like to make today:

- Raising the credit union legal business lending cap is **not necessary** for credit unions to meet small business members' credit needs.
- Business lending is riskier and **raises serious safety and soundness concerns**.

- Expanding the lending cap is *inconsistent with the credit union mission* of serving consumers, especially those of modest means, and *would increase the federal deficit*.
- There is a better option for credit unions that want to expand business lending – *convert to a mutual bank charter*.

I. Raising the credit union legal business lending cap is not necessary for credit unions to meet small business members' credit needs

Credit unions argue that greater business lending authority 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.

Let me state this more clearly. *Credit unions can already make all the business loans they want under \$50,000*. Credit unions begin with a blank slate when they make further business loans over \$50,000.

Moreover, the guaranteed portion of Small Business Administration loans does *not* count against the aggregate business loan limit, *nor* do loans secured by 1 to 4 family primary residences. In addition, NCUA has aggressively provided exclusions from the cap by regulatory fiat. For example, in October 2003, NCUA excluded business loans made to nonmembers from the cap, allowing more loans by credit unions to circumvent the aggregate business loan cap. As of March 2011, credit unions reported extending almost \$6.7 billion in non-member business loans, which account for almost 18 percent of all outstanding credit union business loan balances. This represents a three-fold increase in nonmember business loans on the books of credit unions in 6 years.

Clearly, there is considerable opportunity under current law for credit unions to meet the needs of small business customers. Furthermore, only a few credit unions – *96 out of 7,292 credit unions* – are within 80 percent of their congressionally-mandated cap of 12.25 percent of assets, as of year-end 2010, and could be affected by H.R. 1418. This was acknowledged by

NCUA Chairman Deborah Matz last year in a hearing: “It’s a small number that are at their cap.”¹

The minority who are at or near this cap are a new breed of institution that bears little resemblance to traditional credit unions. These “morphed” credit unions, which seek out large commercial customers, are a far cry from traditional credit unions, which have remained true to their credit union mandate to serve people of small means.

II. Business lending is risky and raises serious safety and soundness concerns

Lifting the business lending cap and allowing more large business loans 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. Even other credit unions are concerned about the impact that increased business lending will have on the credit union industry as a whole. Dale Kerslake, President and CEO of Cascade Federal Credit Union (Kent, WA) wrote:

Doubling [member business lending (MBL)] limits for natural person credit unions is not something a majority of credit unions want or need. Yet, if a minority of powerful credit unions and industry trade associations get their way, which they usually do, MBL could easily become the next industry crisis... The proposed MBL limit increase ... lacks safeguards for the thousands of credit unions that pay into NCUSIF and do not do business lending.²

Ron Burniske echoed these comments, after his credit union, Chartway Federal Credit Union (Virginia Beach, VA) took over a failed Utah credit union:

We shouldn’t be doing strip centers, corporate buildings and land development. That’s not who we are. That’s the banks’ business.³

Credit unions have good reasons to be concerned. As of June 2011, 3.64 percent of all credit union business loans were at least 60 days or more past due. An additional \$2.2 billion in

¹ Senate Committee on Banking, Housing, and Urban Affairs. “State of the Credit Union Industry” December 9, 2010.

² “MBL Limits – Be Watchful of What Others Wish For,” Credit Union Times, February 10, 2010.

³ “1 deal down, at least 1 to go for Chartway,” Inside Business, January 11, 2010.

business loans have been modified. As a concrete example, America First FCU (Riverdale, UT) recently reported that \$148.3 million of its \$430 million of member business loans were 12 months or more past due – 34.5 percent. The average size of a delinquent business loan at America First is \$2.2 million, hardly a small business loan. Moreover, 72 percent of its delinquent loans have been past due for 12 months or more. If America First were regulated by bank regulators, these loans would have been charged off.

In December 9, 2010 testimony, NCUA Chairman Debbie Matz stated: “Presently, 270 of the 633 credit unions which have a 3, 4, or 5 CAMEL rating and make member business loans, MBLs are the primary or secondary contributing factor for the supervisory concern.” *This means that approximately 30 percent of all credit unions that make business loans were a supervisory concern.*

Here are some examples of large business loans that have gone bad:

- Centris FCU (Omaha, NE) held **\$11 million** in bad loans to Great Adventures Water Resort.
- Denali Alaskan FCU filed suit against a prominent real estate developer over **\$17 million** in delinquent loans.
- Telesis Credit Union (Chatsworth, CA) was foreclosing on a **\$3 million loan** on a mixed-use office building in Memphis, Tennessee.⁴

In fact, on November 23, 2010, the NCUA’s Office of the Inspector General released a report summarizing the 10 costliest natural person credit union failures. *In 7 of these 10 failures, business lending was a major contributor to the failure.*⁵

Since the report was issued, NCUA also placed \$1.6 billion Texans Credit Union into conservatorship. The credit union, starting in 2003, grew its commercial real estate loan portfolio very rapidly to almost \$800 million by 2007. It funded projects **hundreds of miles away**: a mall project in Illinois, a luxury condo development in Telluride, Colorado, and subdivisions in Mississippi.⁶ Eventually, some of these commercial real estate projects failed. This action arose from faulty lending on commercial real estate projects – some of which were outside of its market area.

⁴ “Telesis’ Loan Recoup Attempts Go On,” Credit Union Times, December 15, 2010.

⁵ Appendix A provides more details about what the Inspector General discovered.

⁶ “The Rise and Fall of Texans Credit Union,” Dallas Morning News, May 8, 2011, p. D1.

Last month, NCUA placed Chetco FCU of Harbor, Oregon into conservatorship because of problem business loans. As of June, the \$333 million credit union had *over half of its assets in business loans*.

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.⁷ It should come as no surprise that the Inspector General's Material Loss Review⁸ 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.*

In addition, NCUA in 2003 authorized credit union service organizations (CUSOs) to originate business loans as a permissible power, even though these third party vendors are *not* subject to NCUA supervision. Today, many credit unions hold business loans that were originated by these credit union service organizations. For example, CU Business Group reported in 2009 that it has underwritten over \$2 billion in business loans since its inception in 2002. Michigan Business Connection, a CUSO supporting more than two dozen credit unions, reported managing a portfolio of over \$200 million. Cooperative Business Services, LLC, a CUSO owned by nine Ohio credit unions, reported on its website that it recently provided funding for a \$3.56 million investment property.

Unfortunately, loans originated by CUSOs have resulted in credit union failures. Credit Union Times quotes NCUA Board Member Gigi Hyland addressing the National Association of Credit Union Service Organizations earlier this year regarding losses at Texans CU arising from its business lending CUSO as saying: "We could see things were going wrong but we had to go through the side door and through the maze to get there. By the time we got there, it was too late."⁹

⁷ Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management. U.S. General Accounting Office, October 2003 (GAO-04-91), p. 49.

⁸ http://www.ncua.gov/Resources/OIG/Files/Reports/2010/OIG-10-20OIGCappingReportMLRs_11.23.10.pdf

⁹ "NCUA Sells Importance of Increased CUSO Authority to Stay Ahead of Losses," Credit Union Times, May 4, 2011.

III. Expanding the business lending cap is inconsistent with the credit union mission of serving consumers and would increase the federal deficit

The real goal of expanded business lending is for some aggressive credit unions to make even more large dollar loans. The truth is that these new-breed credit unions have made business lending a top priority as they seek to rapidly grow the institution – making loans that any taxpaying financial institution would want to make. In fact, when seeking market share, some credit unions make loans that no insured depository should make. The fact that a few credit unions are hitting the Congressionally-mandated limits on business lending is largely because they are making large commercial loans – including those to businesses out of their market area.

This business lending is coming at the expense of consumer lending, and *H.R. 1418 does nothing to protect members' interests with regard to consumer loans*. In other circumstances where a credit union seeks to switch to a mutual savings bank charter, NCUA requires “a clear and conspicuous disclosure” that this may reduce consumer loans.¹⁰ Ironically, the bill *does not require* the credit union to notify members in a clear and conspicuous manner that they could see a reduction in consumer loans. And the bill *does not require* the members of a credit union to approve in the affirmative an expansion in business lending, an action that would essentially create a tax exempt bank. Credit unions that seek a mutual savings bank charter must both mail such a disclosure to their members *and* have an affirmative vote.

A dramatic example of just how far credit unions have strayed from their mission 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 and is clearly counter to the chartered mission of serving people of modest means. Moreover, the resort is located over 200 miles from the credit union's headquarters. Is this the kind of loan that should be tax-subsidized?

¹⁰ NCUA's own regulations governing the conversion of a credit union to a mutual savings bank have greater protection of members' interests regarding consumer loans than H.R. 1418. NCUA regulations require “... a clear and conspicuous disclosure of how the conversion from a credit union to a mutual savings bank will affect the institution's ability to make non-housing-related consumer loans because of a mutual savings bank's obligations to satisfy certain lending requirements as a mutual savings bank.”

Cases like the Thumper Pond fiasco show that credit unions are leveraging their tax-exemption to provide loans to large businesses that already have plenty of credit options available through taxpaying banks. Make no mistake about it, H.R. 1418 *is nothing less than legislation that would allow a credit union to look and act just like a bank, without the obligation to pay taxes or have bank-like regulatory requirements, such as the Community Reinvestment Act, applied to them.* Provisions included in H.R. 1418 that try to safeguard this high-risk form of lending are not the issue; rather, the issue is that credit unions have a limited charter, focused on people of small means, for which credit unions have a tax exemption.

This credit union tax expenditure 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.

Congress put these current limits in place after considerable debate to ensure credit unions remained focused on individuals, especially people of small means. In fact, the Senate Report implementing the Credit Union Membership Access Act of 1998 stated that the limits “...are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through the emphasis on consumer rather than business loans.”¹¹

IV. There is a better option for credit unions that want to expand business lending – convert to a mutual bank charter.

While credit union rhetoric suggests that without greater business lending 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 and three other credit unions are pursuing. 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.

For example, in 2009, Coastway Credit Union in Cranston, RI converted to a mutual savings bank so that it could make more business loans. Viewpoint Bank, which converted from

¹¹ Senate Report 105-193, May 21, 1998, pp.9-10.

a credit union to a mutual savings bank in 2005, has taken advantage of its greater business lending authority – almost 18 percent of its assets are in business loans.

The savings bank charter gives 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 than a wholesale change in powers that will benefit only a small proportion of large, tax-exempt 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.

Conclusion

Increased business lending powers are not necessary to meet the credit needs of businesses. Credit unions have ample authority under current law to make all the small business loans they want. H.R. 1418 would empower credit unions to make larger commercial loans and cause credit unions to stray even further from their mission to serve consumers, especially those of modest means. Increasing the business lending cap will raise serious safety and soundness concerns, and it will cause an increase to the federal deficit.

Rather than expanding the business lending authority of credit unions, Congress should close the loopholes that are allowing credit unions to make business loans to non-members to circumvent the aggregate business loan cap. Additionally, Congress should rightfully be concerned about the increasing use of third-party vendors by credit unions to originate business loans, as CUSOs are a ticking time bomb waiting to explode given the fact that NCUA does not have authority to regulate these entities.

In the current situation 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