

**THE EFFECTS OF THE ECONOMIC CRISIS ON  
COMMUNITY BANKS AND CREDIT UNIONS IN  
RURAL COMMUNITIES**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
FINANCIAL INSTITUTIONS  
OF THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE EFFECTS OF THE ECONOMIC CRISIS ON COMMUNITY  
BANKS AND CREDIT UNIONS IN RURAL COMMUNITIES

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JULY 8, 2009  
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# C O N T E N T S

WEDNESDAY, JULY 8, 2009

	Page
Opening statement of Chairman Johnson .....	1
Prepared statement .....	25
Opening statements, comments, or prepared statements of:	
Senator Crapo	
Prepared statement .....	25
<b>WITNESSES</b>	
Jack Hopkins, President and Chief Executive Officer, CorTrust Bank National Association, Sioux Falls, South Dakota, on behalf of the Independent Community Bankers of America .....	2
Prepared statement .....	25
Responses to written questions of:	
Chairman Johnson .....	55
Senator Kohl .....	55
Senator Crapo .....	55
Frank Michael, President and Chief Executive Officer, Allied Credit Union, Stockton, California, on behalf of the Credit Union National Association .....	3
Prepared statement .....	33
Responses to written questions of:	
Senator Kohl .....	55
Senator Crapo .....	57
Arthur C. Johnson, Chairman and Chief Executive Officer, United Bank of Michigan, Grand Rapids, Michigan, on behalf of the American Bankers Association .....	5
Prepared statement .....	39
Responses to written questions of:	
Chairman Johnson .....	57
Senator Kohl .....	58
Senator Crapo .....	59
Ed Templeton, President and Chief Executive Officer, SRP Federal Credit Union, North Augusta, South Carolina, on behalf of the National Association of Federal Credit Unions .....	7
Prepared statement .....	47
Responses to written questions of:	
Senator Kohl .....	60
Senator Crapo .....	60
Peter Skillern, Executive Director, Community Reinvestment Association of North Carolina .....	9
Prepared statement .....	51
Responses to written questions of:	
Senator Crapo .....	61



# THE EFFECTS OF THE ECONOMIC CRISIS ON COMMUNITY BANKS AND CREDIT UNIONS IN RURAL COMMUNITIES

WEDNESDAY, JULY 8, 2009

U.S. SENATE,  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Subcommittee met at 2:38 p.m., in room SD-538, Dirksen Senate Office Building, Senator Tim Johnson (Chairman of the Subcommittee) presiding.

## OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. We had a slight delay in timing of this, and I will forego my opening statement in the interest of time. I encourage the others to be brief.

Senator CRAPO.

Senator CRAPO. Thank you very much, Chairman. I have an opening statement that I can submit for the record as well, so following your lead, I will forego my opening statement and just thank you for holding this important hearing.

Chairman JOHNSON. Senator TESTER.

Senator TESTER. Well, since you guys did not have opening statements, I will take three times as much time.

[Laughter.]

Senator TESTER. No. I will also forego my time and look forward to see what the panelists say, and I look forward to the questions and answers afterwards. Thank you all for being here.

Chairman JOHNSON. I would like to welcome our witnesses to today's hearing. Our first witness is Jack Hopkins on behalf of the Independent Community Bankers of America.

Our second witness is Mr. Frank Michael, President and CEO of Allied Credit Union located in Stockton, California, on behalf of the Credit Union National Association.

Our third witness is Mr. Arthur Johnson, Chairman and CEO of United Bank of Michigan, from Grand Rapids, Michigan, on behalf of the American Bankers Association.

The next witness is Mr. Ed Templeton, President and Chief Executive Officer of SRP Federal Credit Union, in North Augusta, South Carolina, testifying on behalf of the National Association of Federal Credit Unions.

Our last witness is Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina.

I will ask the witnesses please limit your testimony to 5 minutes. Your full statements and any additional materials you may have will be entered into the record.

Mr. Hopkins, please begin.

**STATEMENT OF JACK HOPKINS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CORTRUST BANK NATIONAL ASSOCIATION, SIOUX FALLS, SOUTH DAKOTA, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA**

Mr. HOPKINS. Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee, thank you very much for the opportunity to provide you with the community bank perspective on the impact of the credit crisis in rural areas. My name is Jack Hopkins, and I am President and CEO of CorTrust Bank in Sioux Falls, South Dakota. I am testifying on behalf of the Independent Community Bankers of America, and I serve on the ICBA's Executive Committee. I am a past President of the Independent Community Bankers of South Dakota and have been a banker in South Dakota for 25 years.

CorTrust Bank is a national bank with 24 locations in 16 South Dakota communities and assets of \$550 million. Eleven of the communities we serve have fewer than 2,000 people. In seven of those communities, we are the only financial institution. The smallest community has a population of 122 people. Approximately 20 percent of our loan portfolio is agricultural lending to businesses that rely heavily on the agricultural economy. CorTrust Bank is also one of the leading South Dakota lenders for the USDA's Rural Housing Service home loan program.

Mr. Chairman, as we have often stated before this Committee, community banks played no part in causing the financial crisis fueled by exotic lending products, subprime loans, and complex and highly leveraged investments. However, rural areas have not been immune from rising unemployment, tightening credit markets, and the decline in home prices. We believe that, although the current financial crisis is impacting all financial institutions, most community banks are well positioned to overcome new challenges, take advantage of new opportunities, and reclaim some of the deposits lost to larger institutions over the last decade.

A recent Aite study shows that even though some community banks are faced with new lending challenges, they are still lending, especially when compared to larger banks. In fact, while the largest banks saw a 3.23-percent decrease in 2008 net loans and leases, institutions with less than \$1 billion in assets experienced a 5.53-percent growth.

Mr. Chairman, small businesses are the lifeblood of rural communities. We believe small businesses will help lead us out of the recession and boost needed job growth. Therefore, it is vitally important to focus on the policy needs of the small business sector during this economic downturn.

As I mentioned earlier, most of my commercial lending is to small businesses dependent on agriculture. The Small Business Administration programs are an important component of community bank lending. SBA must remain a viable and robust tool in supplying small business credit.

The frozen secondary market for small business loans continues to impede the flow of credit to small business. Although several programs have been launched to help unfreeze the frozen secondary market for pools of SBA-guaranteed loans, including the new Term Asset-Backed Securities Loan Facility—TALF and a new SBA secondary market facility, they have yet to be successful due to the program design flaws and unworkable fees. ICBA recommends expanding these programs to allow their full and considerable potential.

Several of my colleagues have told us about the mixed messages they received from bank examiners and from policy makers regarding lending. Field examiners have created a very harsh environment that is killing lending as examiners criticize and require banks to write down existing loans, resulting in capital losses. Yet policy makers are encouraging lending from every corner.

Some bankers are concerned that regulators will second-guess their desire to make additional loans, and others are under pressure from their regulators to decrease their loan-to-deposit ratios and increase capital levels. Generally, the bankers' conclusions are that ample credit is available for creditworthy borrowers. They would like to make more loans, and they are concerned about the heavy-handedness from the regulators.

Finally, Mr. Chairman, community bankers are looking closely at the regulatory reform proposals. ICBA supports the administration's proposal to prevent too-big-to-fail banks or nonbanks from ever threatening the collapse of the financial system again. Community banks support the dual system of State and Federal bank charters to provide checks and balances which promote consumer choice and a diverse and competitive financial system sensitive to the financial institutions of various complexity and size. Washington should allow community banks to work with borrowers in troubled times without adding to the costs and complexity of working with customers.

Mr. Chairman, ICBA stands ready to work with you and the Senate Banking Committee on all of the challenges facing the financial system and how we may correct those issues gone awry and but-tress those activities that continue to fuel the economies in rural areas. I am pleased to answer any questions you may have.

Chairman JOHNSON. Thanks, Jack.

Mr. Michael.

**STATEMENT OF FRANK MICHAEL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ALLIED CREDIT UNION, STOCKTON, CALIFORNIA, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION**

Mr. MICHAEL. Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing on behalf of the Credit Union National Association.

My name is Frank Michael, and I am President and CEO of Allied Credit Union in Stockton, California. Allied is a small institution with \$20 million in assets and approximately 2,600 member owners.

Credit unions—rural, urban, large, and small—did not contribute to the subprime meltdown or the subsequent credit market crisis.

Credit unions are careful lenders. As not-for-profit cooperatives, our objective is to maximize member service. Incentives at credit unions are aligned in a way that ensures little or no harm is done to our member owners.

Rural credit unions are unique in many respects. There are nearly 1,500 U.S. credit unions with a total of \$60 billion in assets headquartered in rural areas.

Rural credit unions tend to be small—even by credit union standards. Over half of the rural credit unions are staffed by five or fewer full-time equivalent employees.

Even in good times, rural credit unions tend to face challenges in a way that larger institutions do not. Competitive pressures from large multistate banks and nontraditional financial services providers, greater regulatory burdens, growing member sophistication, and loss of sponsors loom large for most of the Nation's small credit unions.

A bad economy can make things even worse. Small credit unions come under tremendous pressure as they attempt to advise, consult with, and lend to their members.

In addition, all credit unions have suffered as a result of the effects of the financial crisis of corporate credit unions. Despite these substantial hurdles, rural credit unions are posting comparatively strong results, and they continue to lend. Loans grew by 7 percent in the 12 months ending in March compared to a 3-percent decline at all banks.

There are several concerns raised by small credit unions, and rural credit unions in particular, that deserve mention. The credit union movement has seen small institutions merge into larger credit unions at an alarming pace. And by far, the largest contributor to this consolidation is the smothering effect of the current regulatory environment.

Small credit union leaders believe that the regulatory scrutiny they face is inconsistent with both their exemplary behavior and their nearly imperceptible financial exposure they represent. A large community of credit unions, free of unnecessary regulatory burden, would benefit the public at large and especially our rural communities.

As the Subcommittee considers regulatory restructuring proposals, we strongly urge you to continue to keep these concerns in the forefront of your decision making. Moreover, we implore you to look for opportunities to provide exemptions from the most costly and time-consuming initiatives to cooperatives and other small institutions.

As noted above, credit unions have generally continued to lend while many other lenders have pulled back. This is certainly true in the business lending arena. Currently, 26 percent of all rural credit unions offer member business loans to their members. These loans represent over 9 percent of the total loans in rural credit union portfolios. In contrast, member business loans account for less than 6 percent of all total loans in the movement as a whole. Total member business loans at rural credit unions grew by over 20 percent in the year ending March 2009, with agricultural loans



increasing by over 12 percent. Agricultural loans at rural credit unions now account for over one-third of the total member business loans. This is strong evidence that rural credit unions remain “in the game” during these trying times. But more could be done.

And more should be done. A chorus of small business owners complains that they cannot get access to credit. Federal Reserve surveys show that the Nation’s large banks tightened underwriting standards for the better part of the past year, and SBA research shows that large bank consolidation is making it more difficult for small businesses to obtain loans.

The chief obstacle for credit union business lending is the statutory limits imposed by Congress in 1998 under which credit unions are restricted from member business lending in excess of 12.25 percent of their total assets. This arbitrary cap has no basis in either actual credit union business lending or safety and soundness considerations. Indeed, a report by the U.S. Treasury Department found that delinquencies and charge-offs for credit union business loans were much lower than those of banks.

While we support strong regulatory oversight of how credit unions make member business loans, there is no safety and soundness rationale for the current law which restricts the amount of credit union business lending. There is, however, a significant economic reason to permit credit unions to lend without statutory restriction, as they were able to do prior to 1998.

A growing list of small business and public policy groups agree that now is the time to eliminate the statutory credit union business lending cap. We urge Congress to eliminate the cap and provide NCUA with the authority to permit a credit union to engage in business lending above 20 percent of assets if safety and soundness considerations are met. If the cap were removed, credit unions could safely and soundly provide as much as \$10 billion in new loans for small businesses within the first year. This is an economic stimulus that would truly help small business and not cost the taxpayers a dime.

In conclusion, Chairman Johnson and Ranking Member Crapo, and all the Members of the Subcommittee, we appreciate your review of these issues today.

Chairman JOHNSON. Thank you, Mr. Michael.  
Mr. Johnson.

**STATEMENT OF ARTHUR C. JOHNSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UNITED BANK OF MICHIGAN, GRAND RAPIDS, MICHIGAN, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION**

Mr. JOHNSON. Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee, my name is Art, and I am the Chairman and CEO of United Bank of Michigan, and I am the Chairman-Elect of the American Bankers Association. I am pleased to share the banking industry’s perspective on banking and the economy in rural America.

Community banks continue to be one of the most important resources supporting the economic health of rural communities. Not surprisingly, the banks that serve our Nation’s small towns also tend to be small community banks. Less well known is that over

3,500 banks—41 percent of the banking industry—have fewer than 30 employees. These banks understand fully the needs of their customers and their community.

This is not the first recession faced by banks. Most banks have been in their communities for decades and intend to be there for many decades to come. My bank was chartered in 1903. We have survived the Great Depression and many other ups and downs for over a century. And we are not alone. Over 2,500 banks—nearly one-third of the industry—have been in business for more than a century. These numbers tell a dramatic story about the staying power of community banks and their commitment to their communities. We cannot be successful unless we develop and maintain long-term relationships and treat our customers fairly.

In spite of the downturn, community banks in rural communities expanded lending by 7 percent since the recession began. Loans made by banks that focus on farmers and ranchers also increased by 9 percent.

Considerable challenges remain, of course. In my home State of Michigan, for example, we are facing our eighth consecutive year of job losses. Other rural areas with manufacturing employment bases are also suffering similar problems. In this environment, businesses are reevaluating their credit needs and, as a result, loan demand is declining. Banks, too, are being prudent in underwriting, and our regulators demand it. Accordingly, it is unlikely that loan volumes will increase this year.

With the recession, credit quality has suffered and losses have increased. Fortunately, community banks entered this recession with strong capital levels. However, it is very difficult to raise new capital today. Without access to capital, maintaining the flow of credit in rural communities will be increasingly difficult.

We believe the Government can take action to help viable community banks weather the current downturn. The success of local economies depends on the success of these banks. Comparatively small steps now can make a huge difference to these banks, their customers, and their communities—keeping capital and resources focused where they are needed most.

Importantly, the amount of capital required to provide an additional cushion for all community banks—which had nothing to do with the current crisis—is tiny compared to the \$182 billion provided to AIG. In fact, the additional capital needed is less than \$3 billion for all smaller banks to be well capitalized, even under a baseline stress test. Simply put, capital availability means credit availability.

In addition to providing avenues for new capital for community banks, we believe there are three key policy issues that deserve congressional action: one, creating a systemic regulator; two, providing a strong mechanism for resolving troubled systemically important firms; and, three, filling gaps in the regulation of the shadow banking industry.

The critical issue in this regard is “too-big-to-fail.” This concept has profound moral hazard implications and competitive effects that need to be addressed. In an ideal world, no institution would be “too-big-to-fail,” and that is ABA’s goal.

While recent events have shown how difficult that is to accomplish, whatever is done on the systemic regulator and on a resolution system should narrow dramatically the range of circumstances that might be expected to prompt Government action. These actions would address the causes of the financial crisis and constitute major reform. We believe there is a broad consensus in addressing these issues.

I would be happy to answer any questions that you may have. Chairman JOHNSON. Thank you, Mr. Johnson.  
Mr. Templeton.

**STATEMENT OF ED TEMPLETON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SRP FEDERAL CREDIT UNION, NORTH AUGUSTA, SOUTH CAROLINA, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS**

Mr. TEMPLETON. Good afternoon, Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee. My name is Ed Templeton, and I am here testifying today on behalf of the National Association of Federal Credit Unions. I am President of SRP Federal Credit Union in North Augusta, South Carolina.

NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding how the economic crisis has impacted America's credit unions serving in rural communities.

While credit unions have fared better than most financial institutions in these turbulent times, many have been impacted, through no fault of their own, by the current economic environment. Credit unions were not the cause of the current economic downturn, but we believe we can be an important part of the solution. Surveys of NAFCU member credit unions have shown that many are seeing increased demand for mortgage and auto loans as other lenders leave the markets. Credit unions have seen small businesses that have lost credit from other lenders turning to credit unions for the capital that they need.

Credit unions are meeting those needs specifically in rural areas. NCUA data shows that credit unions have seen a growth in the percentage of the total amount of credit union farm loans for the last nine consecutive quarters. Additionally, the most recent HMDA data shows that credit union mortgage loans to Native Americans increased over the previous year and that credit unions had a higher percentage of approved loans—75.3 percent—than any other type of financial institution.

Throughout the country, small credit union roundtables have emerged and engaged in discussions about operations with like institutions. Larger credit unions also serve as partners for the smaller ones and perform functions from shared branching to back-office operations.

Credit unions are the most regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital, among a host of other limitations. There are small statutory steps Congress can take to enhance the ability of credit unions to serve their members, such as:

First, removal of the arbitrary credit union member lending cap. The Credit Union Membership Access Act established an arbitrary

cap on credit union member business lending of 12.25 percent in 1998. Many credit unions have available capital that other lenders do not have in this environment, but are hampered by this arbitrary limitation. We are pleased that Senator Schumer has indicated that he plans to introduce legislation to remove this arbitrary cap, and we urge the Subcommittee to support these efforts.

Second, underserved areas. As the Subcommittee may be aware, many rural areas are also underserved. Credit unions can play an important role in these communities. The 1998 Credit Union Membership Access Act gave the NCUA the authority to allow Federal credit unions to add underserved areas to their fields of membership; however, the language was unclear as to what types of charters can add underserved areas. NCUA believes that addressing this issue through legislation would clear up this ambiguity, allowing all Federal credit unions to add underserved areas to their fields of membership.

Before wrapping up, I would like to make a few comments on the issue of regulatory reform. As not-for-profit member-owned cooperatives, credit unions are unique institutions in the financial services arena. We believe that the NCUA should remain an independent regulator of credit unions and are pleased to see that the administration's proposal would maintain the Federal credit union charter and an independent NCUA.

NAFCU supports the creation of a Consumer Financial Protection Agency that would have authority over nonregulated institutions that operate in the financial services marketplace. However, we do not support extending that authority to federally insured credit unions, given that the CFPB has authority to regulate, examine—or would have authority to regulate, examine, and supervise credit unions that are already regulated by the NCUA, which would add an additional burden and cost to credit unions.

Recognizing that more should be done to help consumers, we propose that each functional regulator establish or strengthen a new office on consumer protection. We believe that such an approach would strengthen consumer protection while not adding unnecessary regulatory burdens on our Nation's credit unions. We are pleased to see that NCUA Board Chairman Mr. Michael Fryzel recently announced the creation of such an office at NCUA.

In conclusion, the current economic crisis is having an impact on credit unions in rural areas, but we are continuing to serve our members well. As an illustration, we at SRP Federal Credit Union are actually expanding at this time into one of the most rural areas within our field of membership. We are about to break ground on a new branch in Allendale County, South Carolina. The county has a population of 10,477 and an unemployment rate of 22.1 percent.

We urge the Subcommittee to support efforts to remove the credit union member business lending cap and to clarify the ability of credit unions of all charter types to add underserved areas. Finally, while there are positive aspects to consumer protection in regulatory reform, we believe that Federal credit unions continue to warrant an independent regulator that handles both safety and soundness and consumer protection matters.

I thank you for the opportunity to appear before you today on behalf of NAFCU and our country's credit unions, and I would welcome any questions you may have.

Chairman JOHNSON. Thank you, Mr. Templeton.  
Mr. Skillern.

**STATEMENT OF PETER SKILLERN, EXECUTIVE DIRECTOR,  
COMMUNITY REINVESTMENT ASSOCIATION OF NORTH  
CAROLINA**

Mr. SKILLERN. Thank you, Senator Johnson, for the opportunity to testify today on lenders, consumers, and the economy in rural areas. I am Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina. We are a nonprofit community advocacy and development agency.

North Carolina has strong rural and banking sectors. Eighty-five of our 100 counties are rural and 50 percent of our population live in them. We have 106 credit unions and 106 banks, ranging from the largest in the country, Bank of America, down to Mount Gilead Savings and Loan at \$9.8 million.

The current economic stresses for our rural communities and small financial institutions are significant, and they are best understood in the context of two long-term trends: one is a decline in the rural economy, and two is the consolidation of the financial sector. And our policy recommendations focus on two issues: one is the financial regulatory reform to provide greater consumer protections and stability; and two is the investment needed in our rural communities for recovery and growth—in particular, through the Neighborhood Stabilization Program.

Rural Economies are in long-term decline. In North Carolina, the unemployment rate is the fifth highest in the country, but our rural communities are taking it even harder. The rates in 19 counties range between 14 and 17 percent. But these rates are years in the making. Rural North Carolina did not recover from the 2001 recession. From 2002 to 2008, rural counties lost more than 100,000 jobs in the manufacturing sector of textiles, apparel, furniture, and automobiles. Changes in tobacco and the agricultural sector have reduced the number of small farms. Tobacco farms have dropped by 70 percent since 2002. Forty of our rural counties lost population. These long-term trends, in combination with the credit crisis and recession, have contributed to an estimate 31,000 foreclosures in rural North Carolina. That is more than in the urban areas.

Small banks also face challenges in the consolidation of the financial sector. During this crisis, a number of small banks across the Nation have failed, but far more have been lost through consolidation. Nationally, the number of banks with under \$100 million in assets dropped by more than 5,000 from 1992 to 2008. In North Carolina, rural counties hold 50 percent of the population and 50 percent of bank branches, and only 16 percent of the deposit base. Nationally, approximately 4,000 small banks accounted for less than 2 percent of the national mortgage activity.

By contrast, the consolidation of assets and market share of megabanks has increased. In 1995, the top five banks had 11 percent of the deposit share; today, they have nearly 40 percent. In

the first quarter of 2009, 56 percent of mortgage activity was conducted by just four lenders.

Small banks are at a competitive disadvantage in terms of efficiencies, pricing products, and geographical service areas, and consolidation will continue in the foreseeable future. This is a problem.

As a rule, small banks and credit unions avoided subprime credit and provided stability and diversification in the financial sector. Without smaller institutions, many areas would go completely unserved. Banking policy and regulatory oversight should proactively support small banks and credit unions as essential to the local economic ecology of credit and commerce.

Financial reform will help consumers, lenders, and the rural communities. Consumers in rural and urban areas face similar lending abuses. Rural areas had a higher percentage of subprime high-cost loans than urban areas. Rural areas have a high rate of refund anticipation loans, and payday lenders are prevalent in the rural areas of the 35 States that allow this usurious type of lending. Consumers need better protections from unsound and unscrupulous lending practices, and if so provided, our economy would be safer as well. Our financial sector would be better.

Our agency is supportive of President Obama's recommendation for the Consumer Financial Protection Agency Act. We support the CRA Modernization Act, H.B. 1492. And faced with a rising tide of foreclosures and insufficient loan modification programs, we ask the Senate to reconsider and favorably pass a loan judicial modification bill. We support reforms for greater oversight and capital requirements to mitigate the risk of megabanks.

Finally, please invest in our rural communities. Although the problems created by the financial crisis and recession are felt by every community and the solutions needed are national in scope, it would be a mistake to assume that urban and rural communities will shake off the recession with the same speed. The long-term challenges for small banks and rural communities are systemic as well as cyclical. Unless we invest in rebuilding these communities, no banks of any size will thrive.

Please expand the Neighborhood Stabilization Program both in scale of funding and in scope to include rural areas. NSP funds are to revitalize foreclosed properties and to rebuild distressed communities. But no rural areas receive NSP funds because the needs test emphasizes concentration. Yet in 23 States, such as North Carolina, in the aggregate there are more foreclosures in rural area than urban areas. More funding is needed given the need in both urban and rural areas.

The future for rural communities and banks is brighter if we recognize and act on the need for financial regulatory reform and investment in our communities. Thank you very much for your attention.

Chairman JOHNSON. Thank you, Mr. Skillern.

A question for Mr. Hopkins and Mr. Johnson. In May, the FDIC decided to place a special assessment to rebuild the Deposit Insurance Fund on assets instead of deposits, largely because of concerns raised by small banks that they were being unfairly affected by the irresponsible behavior of larger banks.

Is the FDIC's change a good thing for your institutions? Do you have any concerns about this change? Mr. Hopkins.

Mr. HOPKINS. Obviously, we were very supportive of the change. We have long held that it is the assets of a bank that create the risk, and not the deposits. And, therefore, the risks should be associated with the assets of the bank. It is giving credit for the higher capital levels, so from the standpoint of a community bank where its assets are on the books and its liabilities are primarily core deposits and not other sources of liquidity, be it commercial paper or other borrowings, we think it was appropriate, and it has been very positive for community banks.

Chairman JOHNSON. Do you have any concerns?

Mr. HOPKINS. Do I have any concerns?

Chairman JOHNSON. Yes.

Mr. HOPKINS. I would ask that they consider using that base for the deposit insurance premium going forward.

Chairman JOHNSON. Mr. Johnson.

Mr. JOHNSON. I do have some concerns. It seems to me that this is a change that has the potential to have a rather profound public policy impact going forward and should be something that is considered very carefully. And I think it should be considered in the context of the solutions that the Congress is seeking for the "too-big-to-fail" issue and the systemically important institutions, these systemically important institutions are—some of whom are depository institutions, and some of which are not. And as you consider what you are going to do with them, what is going to be the resolution for future problems with systemically important firms, both depositories and nondepositories, presumably there will be a consideration of how the cost of that resolution is going to be considered and solved. And I think to tackle the assessment base and the FDIC fund prior to dealing with the solution to the funding of resolution of systemically important firms, both depositories and nondepositories, would be premature.

Chairman JOHNSON. Thank you.

A question for Mr. Hopkins, Mr. Michael, Mr. Johnson, and Mr. Templeton. Mr. Skillern's testimony said that in North Carolina there is a higher percentage of subprime mortgages in rural areas than urban areas although the actual volume is lower. Do you find that this is true in the areas your institutions serve? Are you finding that those homeowners with subprime mortgages in your areas are underwater? Are existing loan modification programs useful to you in helping these homeowners? Mr. Hopkins.

Mr. HOPKINS. I would say that we do not have the issues with the subprime mortgages in South Dakota and, in general, most of the rural areas of the Midwest. I think it was more of a conservative lending philosophy, and we did not have a lot of the mortgage brokers in our areas. Those that we have had have come in to us, and we did not have the rapid increases in the home valuations as seen in some of the more urban areas of California, Nevada, Florida, Michigan, and some of those areas—Michigan, I take that back, has not had the rapid rise. But some of these other areas that have had the rapid rise, therefore, they have been easier to refinance into conventional mortgages when they have come in.

And we have used the loan modification program for those that have come in and have found it to be successful to this point.

Chairman JOHNSON. Mr. Michael.

Mr. MICHAEL. Well, I am from Stockton, California. Home values in Stockton are down 63 percent from the peak. They are down 37 percent in the last 12 months, and they are still declining. Yes, subprime mortgages, 0 percent down mortgages, clearly contributed significantly to our problems.

We are finding, as I work with my members, that many—the credit unions did not originate these loans. We did not—we always, as lenders, have been originating generally for our own portfolios, which means the ones that were really originating these loans were those that were originating to sell and looking for the fee income that came with that. Credit unions generally portfolio their own loans as part of the process, so I am dealing with members who are coming to me today trying to deal with other lenders in this process and other servicing companies.

We are finding in my conversations with my particular members that the lenders are slow on the modification process. I am hearing from those that are working in the real estate industry working with individuals and doing modifications, and even short sales, that those institutions trying to process modifications are not geared up at this time to processes effectively, and the delays are substantial and the results are generally not positive.

Chairman JOHNSON. Mr. Johnson.

Mr. JOHNSON. In our bank, we are having some elevated levels of delinquency and foreclosures within our bank, but they are all driven by employment issues rather than by product issues. We did not make any subprime or high-risk mortgages.

We have 11 offices, and eight of them are in rural communities, and it would be my observation that—well, the administration has stated that 94 percent of high-risk mortgages were made by non-depository institutions, and my rough observation of what is going on in our marketplace, including our rural offices, is that that percentage is even higher than that because the community banks in our area simply were not making those types of mortgages.

I can tell you that in our office with our own customers, we are working very diligently with them to keep those families in their homes wherever it is remotely possible to do so and are having a fair amount of success with that.

We are having our customers who opted within the last few years to obtain a mortgage from one of the many mortgage brokers, mortgage originators that are in our entire marketplace, simply to have a lower monthly payment, they are now coming in to us and seeing whether or not they can get a solution to keep themselves in their home. And we are successful in about 20 percent of those cases to be able to get them refinanced into a conventional mortgage product. Unfortunately, I do not always know what happens to the other 80 percent.

Chairman JOHNSON. Mr. Templeton.

Mr. TEMPLETON. We have seen some of the things more similar to what the gentleman from South Dakota was saying. We just did not see a big inflow into our marketplace of lenders who were offering loans that just didn't make good sense, and I think primarily



because we didn't see extreme home value rises over the past 2 or 3 years in our marketplace. It was a more reasonable rise, which I think led to people searching for more reasonable loans.

Now, that said, we have certainly had foreclosures. We have had modifications that we have done. But I am not sure that I am—I am not aware of any loan that specifically was a result of some type of egregious act, where somebody put somebody in an interest-only loan or something like that. All we have been seeing is the normal re-fis that people are going through because of the market that we are in.

Like the gentleman from South Dakota, we did not originate the sales, so every loan we made through last year is currently in a portfolio. This year, we are originating some for sale, but they are what everybody would call a conforming, main-stream type of loan.

I would go one step further to say one thing as concerns the rural areas. In our market, anyway, those brokers weren't interested in the rural areas because those homes were not homes that they could sell as a package to anybody. There was no appreciation in values. They were—before we invented the phrase subprime mortgage, you go back 4 or 5 years ago, if you think about what you would call a subprime home or subprime mortgage, it was an inexpensive home on a dirt street that needed painting and that is what a lot of the homes in our rural communities are and we lend to a lot of those people. So that is what we call internally our subprime, because nobody else will touch a home like that, but that is what we do and that is what we are about.

And consequently, we are not suffering in our community from a serious issue with egregious lending. Maybe some are there, I am just not aware of it, but I stay pretty close with the community. Thank you very much.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and I want to commend all of our witnesses for very capably explaining the important role that community banks play in our rural communities as well as throughout our economy.

I am going to use my time today to focus on the administration's Consumer Financial Protection Agency, and Mr. Johnson, I will focus on you, but I welcome comments or responses to my question from anybody else on the panel. The issue I have is that I think in our effort to find the right balance between protecting consumers from abusive products and practices while promoting responsible lending to spur economic growth to help get our economy moving again, we need to get it right with regard to consumer protection. And to me, at least, the case has not been adequately made that we should bifurcate consumer protection from safety and soundness regulation.

I know there are some recent articles that have come out with regard to Fannie Mae and Freddie Mac with some of those who are very prominent in the current management of them who indicated that the bifurcation of consumer protection and safety and soundness regulation with our GSEs was, in fact, one of the problems that helped us get into trouble with regard to Fannie Mae and Freddie Mac. The administration's proposal would have sole rule-making authority for consumer financial protection statutes, as

well as the ability to fill gaps through rulemaking, placed in this one single new agency to be created.

I guess the question I would like to toss out, really to the whole panel but start with you, Mr. Johnson, is has the case been made that bifurcating the protections from prudential supervision is the best option to protect consumers from abusive practices and products?

Mr. JOHNSON. Well, I think that it has not been made, and at least in my mind, it will be very difficult to make that. I think in addition to the commentators about Freddie Mac and Fannie Mae, I believe that Sheila Bair has made similar comments that for the FDIC, that it would be a mistake to divide prudential regulation from consumer protection and compliance into more than one agency.

It strikes me that knowing something—that there are two elements here, and for each element to do their job correctly, they need to know something about what is going on in the other piece and that would be, it strikes me, it would be very difficult to accomplish when it is two completely different agencies that have two completely different missions.

It seems to me, as I mentioned before, that the fact of the matter is that 94 percent of the high-risk lending that has gotten us into much of what our current problem is occurred in nondepository institutions. Clearly, we need to focus on the 6 percent, but probably we don't need to overhaul the entire system to deal with 6 percent. But we shouldn't forget about dealing with the 94 percent, and that is what I am afraid we are doing here.

My bank is a State-chartered nonmember bank, and what that means is that we are regulated by our State regulator, the Office of Financial and Insurance Regulation, and a Federal regulator, the FDIC. These are both very strong, competent regulatory agencies. Each of them takes their responsibilities for regulating us and all the other State banks in Michigan, regulating both our compliance, consumer protection, and our safety and soundness operations, they take it very seriously and it is a system that works very well.

I think, in fact, it is a model that should be strongly considered when we deal with the 94 percent, a strong, competent, well-funded State regulator as well as a strong, competent, well-funded Federal regulator. And I might add that when I talk about funding in both of those instances, in our case in Michigan, it is our industry that funds that through either FDIC premiums or examination fees for a State regulator.

Senator CRAPO. Thank you. Let us just start over here, if any of the other members of the panel want to speak. We just have a couple more minutes in my timeframe, so please try to be as succinct as you can. But if you would like to make a comment, please do.

Mr. HOPKINS. Thank you. I would just echo that I would agree with Mr. Johnson. The one thing to keep in mind, also, is that the examiners are coming in from—and I have had an OCC examined bank and FDIC—they are very well trained. They are certified. They have to take a lot of testing. They take it very serious, and I can tell you, after 25 years of banking, when they come in, they

are very prepared to make examinations and they can be harsh if you don't follow the rules to the letter of the law.

So I would agree that that 6 percent that is unregulated needs to find a place to be regulated, whether that is an additional arm through this new agency or through the FTC. I think there is opportunity there. But I think that the banking regulators do an adequate job.

Senator CRAPO. Mr. Michael.

Mr. MICHAEL. I generally concur with the statements that were made. Clearly, there are consumers that need protection that are not receiving it right now and there is a need to extend protection to those individuals and we need to find a way to do it. But we are very heavily regulated as it is right now and adding an additional layer of regulation would be very problematic. As an example, it would lead to dual examinations for my credit union from both Consumer Protection Agency and my prudential regulator. I would recommend that we look at using the current prudential regulators to provide that type of examination and supervision.

Senator CRAPO. Thank you. Mr. Templeton.

Mr. TEMPLETON. Thank you, sir. Actually, our Federal regulator, the NCUA, has already put the first foot forward. They have already created that office internal to our regulator, so we are moving toward consumer protection within the prudential regulator. And as the gentleman said, I think when you are talking about federally insured depository institutions, the regulators are in place to take care of safety and soundness and also financial consumer protection within that. They know the businesses. It is one more element. It will be very cost effective. You are not going to have a big education curve. You are not going to have a training curve. But more importantly, you are not going to have one hand saying, do something, and another hand over here saying, do something different, which could very easily be in contrast with each other. The nondepository institutions, I think that is a whole another ballgame, though. Thank you.

Senator CRAPO. Thank you. Mr. Skillern.

Mr. SKILLERN. I would concur with the bankers that, in general, the small banks are well regulated by both their State and primary regulators. I would also disagree, though, that the Federal regulators have done their job well currently. Countrywide, Washington Mutual are both regulated by the OTS. Their subprime predatory lending harmed consumers and collapsed their banks. Wachovia, a national bank regulated by the OCC, crashed itself on exotic mortgage lending. The Federal Reserve has failed to enforce its rules. I am currently in a fight with the OCC to enforce the rules on Santa Barbara Bank and Trust around their refund anticipation loan loss. It is just not happening.

So the Federal regulators have lost credibility on their willingness and ability to enforce the existing consumer laws. I do believe that a separate agency with that focus brings standardization of how those rules are applied, can expand it to those agencies that are not covered, and hopefully try to reduce the seemingly conflict of interest that the existing Federal regulators have of enforcing consumer laws.

Senator CRAPO. Thank you. My time is up. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you very much for holding this hearing. It is very timely, at least from my perspective, coming from Colorado, where we have had a bank failure in rural Colorado, in Weld County that I wanted to talk to you about a little bit. I want to thank everybody here for your testimony. I think it is a very good reminder that we need to be very careful about how we think about our financial institutions in this country because they are not all the same and not all of them contributed to the situation that we now find ourselves in.

With respect to “too-big-to-fail,” which people have talked about, from the point of view of the people living in Northeast Colorado who lost what to many people would seem was a very small bank, that bank was too big to fail for them. It has affected the entire region, because commodity prices are where they are, in this case particularly dairy prices. It has become incredibly hard to find replacement credit for the farmers and for the ranchers that are there.

I wonder—we have asked the people administering the TARP whether or not they are taking into account those sorts of circumstances as they think about the distribution of the TARP money, and I wonder if any of you have a perspective on how well or how poorly TARP is being administered when it comes to small banks, to rural banks, community banks. The application process is an onerous one. The requirements for deposits are tough. I am just curious whether you think we are getting done what we need to get done with respect to TARP.

Mr. JOHNSON. Why don't you go ahead?

Mr. HOPKINS. Thank you. In my opinion, the TARP has helped to pick winners and losers. The big banks, particularly the largest 19, have all been chosen as winners in this game, because even though they were technically broke, they have been bailed out. The smaller community banks, if you were not a one or two rated with a CAMELS rating in the bank, you cannot qualify for the funds, and that does make that kind of an unfair advantage of being to the large banks.

So I do know of a couple of banks that have had some financial difficulties around the country because of the areas they are located in and they have applied for the funds and been denied because the credit quality in that area is difficult. And obviously raising private capital in today's market is difficult.

Senator BENNET. Mr. Johnson.

Mr. JOHNSON. To some degree, we are kind of guessing about what the criteria are and how the process goes because it has never been made public exactly what the criteria is to determine at Treasury and at the agencies in terms of their recommendation to Treasury and then Treasury's decision about who is going to be approved for CPP money under the TARP program and who isn't. So that is problematic to begin with.

But beyond that, it is our contention that there—like there are many, many viable homeowners that we should take action to save them and keep them in their homes and banks are working with

small businesses and with farmers to determine who are those viable small businesses and who are the viable farmers so that we can do whatever we can to keep them in business, so should the Treasury and the Federal regulators of depository institutions work very hard at determining who are the viable banks and make sure that they have access to capital so that we close no more banks than we need to.

Now, clearly, there are going to be banks that fail and there will be others that will fail. But only the ones that deserve to fail should be the ones that fail, and if there are viable banks that are not being, through accounting treatment and through regulatory fiat that was designed in a different time and place and isn't as applicable in today's world as it should be, the regulators have the capability, I believe, of making management assessments and determining who are the viable banks and I believe that they should have access to that capital.

Senator BENNET. Does anybody else have a comment? Mr. Michael.

Mr. MICHAEL. Senator Bennet, just a reminder. The credit unions have never had access to the TARP funds, although there have been some credit unions that expressed a need to have access. But we have been locked out of that opportunity. So we can't comment on the process, other than the fact that we are outside looking in.

Senator BENNET. It would seem to me—that is an interesting point, Mr. Johnson, on the criteria question, because one of the questions that I have had for the administration is shouldn't we take into account the fact that you may have a financial institution—with respect to TARP, a financial institution failing in a region and there simply not being any credit available as part of the way we approach this question, because there is simply no place for anybody to go, at least in that part of my State.

I want to ask you about modifications. You talked earlier about home mortgage loan modifications. Are you seeing—these are people that are still paying on their loans but may not have the income that they had before because they are unemployed. Is that the issue, rather than their home value falling in these regions below what it once was worth?

Mr. JOHNSON. Well, we don't have—we have home values that are falling, but we never had big run-ups in values in the past. So that is—there are some areas of the country where perhaps if a loan is seasoned 5 or 7 years, it may have dropped 20 percent. But it probably went up more than that over that period of time. So if they didn't releverage that home, they are probably in a position where they could refinance, and that is a problem in Michigan, because we never had that big run-up and yet we have still had the big run-down.

We basically have two types of mortgages. We do originate mortgages that we sell to Freddie Mac, although we retain servicing on all of those mortgages, so the point of contact for our customer is still us. Now, we have to follow the Freddie Mac guidelines when we are dealing with delinquencies, nonpayment in that portfolio and that is precisely what we do. We are working very hard to figure out what those guidelines are and are following them and have done a good number of modifications that are now moving into the

second, third month of that program and I think we are going to be saving quite a few of those folks.

But we also have portfolio loans, where we were making loans that did not, for one reason or another, fit in a box with Freddie Mac. And frankly, our approach on those is a rather tried and true one that has worked for us, for our bank, for all the time that I have been there, which is some 40 years, and that is if this home is going to be foreclosed upon, we are then going to have to go through a fairly expensive phase where we get an appraisal. We have to get the folks out of the house. They have some recourse to extend that period of time. But ultimately, we then get possession of the home. We have the problem where the folks have probably not been taking very good care of it for the past several months since they are going to leave, so the value of the home further goes down. We have an unoccupied home in a market that is filled with unoccupied homes at that point.

So very often, the best thing for us to do is essentially sell that house back to the people that already live there. The house is worth what it is worth, and if that means that we take a loss, then we take a loss. We are going to take a loss if we sell it to somebody else, so we might just as well recognize what the value of that home is, and if that family can make a payment based upon that new valuation, then that is the way we proceed.

Everybody wins. The value of the house is higher than it would have been if it had been vacant for 6 months and we keep the folks in the home and we keep a customer on our books.

Senator BENNET. Thank you, Mr. Chairman. Thank you very much for your testimony.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I want to thank all of you for very good testimony and would reiterate what everyone has said. I think having people like you here that represent the type of banks that most of us know well throughout the country is a very good thing, and again, your testimony has been outstanding.

Mr. Johnson, I want to say that as head of the ABA, I very much appreciated your comments about the administration's proposal on too big to fail and I certainly hope that you all will weigh in. It is pretty evident to me that what they have laid out is they want to continue business as it has been over the last year and basically codifying TARP so that they can decide on an *ad hoc* basis which firms will succeed and which will not, and I certainly hope you all will weigh in and certainly appreciate the comments you made in that regard.

I want to change tracks just a little bit, because I think our fellow colleagues here have asked some wonderful questions and you all have highlighted numbers of things. We have not had a hearing here on Fannie and Freddie in a year. It is pretty amazing, actually. One of the organizations doesn't have a CEO. The trillions of dollars of assets, I mean, it is just an amazing thing that this Banking Committee has not had a hearing there.

The former Treasury Secretary had some thoughts about what ought to happen to Fannie and Freddie, and again in this regulation proposal, Fannie and Freddie aren't even addressed, OK. There are some people in the country that would like to see Fannie

and Freddie go away and think for the Federal Government to be in this kind of business is not a good thing.

I see that you guys have these core deposits that are very important to you, and yet the residential industry is basically almost off limits because we have these huge GSEs that basically everybody funnels 30-year mortgages into. I am wondering, in your own communities, and I will ask Mr. Hopkins first, what would be—if these entities did not exist, how would community bankers feel about that? Would that be a huge opportunity for you, instead of having to go to commercial loans for profit making purposes that are very cyclical? Would that be an opportunity or would that be detrimental to you?

Mr. HOPKINS. For our institution, it would be very detrimental because we originate approximately—this year, we are on track, with all the mortgage brokers that have gone out of business, to originate \$250 million worth of mortgage loans, and I don't know how we could sustain that on a going-forward basis with the capital that we have and being only a \$550 million bank as it is. So it is important for us to have access to secondary market funds. It is critical that we have that access because the housing market is a very concentrated industry, and without it, we could not compete with the Bank of Americas and the Wells Fargos and those and I think the market would become a lot more concentrated.

We do service those mortgages. Those customers, for all intents and purposes, don't know that we don't hold the dollars on our books because everything comes out in our name. We are the point of contact.

Senator CORKER. So the fee income in originating those is far more important to you than holding portfolio loans like you do with the commercial real estate?

Mr. HOPKINS. It gets down to the interest risk that you would be taking on by putting on 30-year mortgages versus short-term deposits.

Senator CORKER. And is there a way—and I figured that might be your response, so is there a way for the Federal Government to be involved in hedging that risk for you and yet not taking ownership through these GSEs of the portfolios themselves? Is there a solution there that might make sense without us taking on the risk of credit in the portfolios itself?

Mr. HOPKINS. Well, again, I think it becomes an allocation of capital. We are required to have certain levels of capital and we would eat up our capital very quick. If we were to do 2 years' worth of mortgages, we might be done because our capital ratios would be required, particularly your leverage ratio.

Senator CORKER. And I see, Mr. Hopkins, you are shaking your head in agreement with what he is—

Mr. HOPKINS. Yes. It is really very true. It is one of the few points of access to the capital markets that community banks have, the securitization of residential mortgages, and we get paid—you mentioned fee income, and it is important to note that actually our up-front fee for selling a loan with servicing retained, which is what our bank does and what I understand yours is doing, as well, is really much lower than if we sold the loan with servicing released, which means some other servicer would be doing it.

So because we are in the relationship business, we want to maintain that contact with our customers and are willing to take, frankly, a lower up-front fee for doing that in terms of what we get paid when we sell the loan. But it gives us tremendous access to the capital markets that we wouldn't have otherwise and we are still able to maintain that relationship but have it off our balance sheets.

Senator CORKER. So in seeking a solution to the Fannie-Freddie dilemma that all of us find ourselves in, because if it were actually truly shown on our country's balance sheet, we would have some tough issues to deal with here, we need to figure out a way to deal still, though, with creating liquidity for you to keep this constant access to capital.

Mr. JOHNSON. I think you have hit the nail on the head, is whose balance sheet is it going to be on, and it really can't be on ours, either, because of the capital concerns.

Senator CORKER. So let me go back to the community bankers—and thank you for those answers—back to the community bankers. What relationship change has occurred at all over the last year with correspondent banks, the folks that you deal with that are sort of one tier up that are your correspondent lenders? Has there been much of a change there?

Mr. HOPKINS. Yes, there has. Access to the secondary market, selling to them, has dried up. In most cases, they have canceled contracts, *et cetera*. So Fannie Mae and Freddie Mac right now are about the only game in town if you are a community bank trying to get access to the secondary markets.

Senator CORKER. So the regionals upstream from you that typically would have provided liquidity—and I could name names, but I won't—those folks who we are up here constantly talking to about making loans and they are constantly telling us that they are making more loans than they made in the past, those folks, as far as their correspondent relationship, from your perspective, that has gone away for you?

Mr. HOPKINS. Well, that has gone away in that respect and also in the second respect, is I really don't want to turn my best customers over to them and give them the primary relationship. If I send the mortgage to one of the large banks, I have lost that relationship because the only way I can do it is selling that service released, which means they have the contact with the customer.

Senator CORKER. Since you represent all of these folks, do you have any comments there?

Mr. JOHNSON. Well, I guess the only experience I have is really within my own bank directly that I can speak with a great deal of authority on. We continue to have a Fed funds line, which is an overnight borrowing facility which we have for liquidity purposes, but we very, very rarely use. We used to have those lines with two correspondent banks and now we have them with one.

Senator CORKER. On a scale of one to ten, I mean, is that a major issue with each of you individually or is that a minor issue? Is that an issue for us to pay attention to here or is that an issue that there are bigger fish to fry?

Mr. JOHNSON. Well, to be perfectly honest, most banks fail in an immediate sense because of liquidity rather than because of asset



quality problems. Maybe I am getting a little far afield here, but liquidity is always a very important discussion when we have our regulators into our banks, but it is even more so in a time of stress to the industry like this. The availability of—you really have to deal with on-balance sheet liquidity and off-balance sheet liquidity and lines from other banks are a critical component of that off-balance sheet liquidity. It is deserving of some attention.

Senator CORKER. Mr. Chairman, I thank you. My time is up. I apologize to the other witnesses. There are a number of things—I would like to just reiterate what I think Mr. Hopkins said earlier, and that is I think the regulators—and we have had them into our office numbers of times—I think they are helping, as they always do, create self-fulfilling prophecy by virtue of the way they are dealing with our institutions. We have talked to them. I know that you all have probably talked to them. But I just hope that all of us will keep in mind that I think what Mr. Hopkins said was—the regulators are clamping down and helping make this recession more severe than it otherwise would have been. But anyway, thank you very much. I wish I had more time. I appreciate it.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

I would agree with that assessment, Senator Corker. I think the regulators are a bit paranoid at this point in time and they don't want to have any failure on their watch. I think that is probably human nature, but I think we need to put pressure on them to make sure they use common sense in their regulation.

A couple of questions. I will just start with you, Mr. Hopkins. It deals with agriculture. It deals with agriculture operating loans specifically, on the ground. What has been the impact of the economic downturn on your availability of dollars for ag-operating loans?

Mr. HOPKINS. We have adequate dollars available for ag-operating loans, and for the most part, most of our ag producers have done quite well. We are in a heavy crop area and the corn and soybean prices have been quite good.

The problem we are seeing with some of our operators is the input costs over the last 12 to 24 months have increased dramatically. We feel at some point the commodity prices will come down more. We are seeing some real pressure on our livestock producers. Those are the people that I think we are seeing some real pressure on right now and I think it will be more so going forward over the next 12 to 24 months.

Senator TESTER. Do you have much dairy in your region?

Mr. HOPKINS. We don't have a lot of dairy in our region anymore. We did at one time, but we do not have a lot in our area.

Senator TESTER. OK. How about land acquisition? I don't know if you give any loans out for land purchase or not, but how are the dollars for that?

Mr. HOPKINS. We have adequate dollars available for lending for land acquisition also. Probably the concern there is that we have had a rapid spike in land prices over the last 5 years—

Senator TESTER. Yes.

Mr. HOPKINS. —and so that does concern us.

Senator TESTER. OK. Commercial real estate, and I am sorry I missed your testimony. I got called to the floor, so I apologize for that. I wish I could have heard it all. So I will just kind of go by your titles about what I think you know, and if somebody wants to jump in, they can.

This is for Mr. Johnson. I really heard from many of the bankers back in Montana that there is a concern about the commercial real estate sector and actually heard some of it back here, too. They are predicting that may be the next domino in the credit crisis and could impact the Rocky Mountain West in a very negative way. Do you have any perspective or thoughts on that, on the commercial markets and where they are at and where they are headed?

Mr. JOHNSON. Yes. I think it is probably a fair observation. Exactly how bad it gets and how long it lasts is sort of the unknown there. My perspective from Michigan is, you know, the one thing about high unemployment is that its effects are fairly predictable and its effects are very, very broad and very deep. We are, to some degree, a fairly active commercial real estate lender. We show up on the radar screen of our regulators for additional scrutiny in that regard, which we have so far successfully satisfied them.

But when people don't have jobs anymore or they don't have as much income in the family as they had before and they are not shopping as much, that begins to affect retail and the impact, you know, you go by shopping centers and once the vacancy rate starts getting above 10 percent, you know that there is going to be stress on the value of those properties.

Really, you have to approach that from a bank perspective—first of all, you have to hope that you are well capitalized, and if, in fact, you are well capitalized, then you are going to be able to work with those businesses and essentially keep those commercial real estate enterprises open the same way that you would work with a homeowner or a small business person. Just sort of dig your nails into the ledge and hold on as long as you can.

Senator TESTER. And this is directed to both of you, Mr. Johnson and Mr. Michael. From your perspective, is the economic downturn as it applies to commercial or even private residences, homeowners, are rural areas being more impacted than urban areas, or is it about the same, or is it being less impacted?

Mr. MICHAEL. Well, I would probably comment that probably the areas that are most heavily impacted are those that sit between rural and urban, the exurbs, and that is what I would define Stockton as being, and that is the area—the one that sits on the fringe is the one that is really getting trashed right now.

Senator TESTER. OK. Regulators—and I don't want to spend a lot of time on this. Senator Corker talked about it a little bit. There has been some talk about combining OCC and OTS and FDIC and portions of the Fed and maybe coming up with a regulator that is more inclusive, less gaps. What are your thoughts on that? I will just ask Mr. Hopkins for your perspective on that, if we were to do something like that.

Mr. HOPKINS. We believe in a strong dual banking system, so we do believe that the competition amongst the regulators, just as it does with competition amongst banks, does make for stronger banks and stronger regulators.

Senator TESTER. We are going to maintain the dual charters?

Mr. HOPKINS. Maintain the dual charters.

Senator TESTER. But we will combine the ones at the Fed level?

Mr. HOPKINS. If they combine the ones at the Fed level, we ask that they consider keeping a separate division to help with the OTS, because those institutions do focus on home lending and that is still their charter and mission.

Senator TESTER. OK. And this can go to either one. There was a point in time not too many years ago—I know for a fact two-and-a-half years ago—interest-only loans were very, very common. Low down payments, no down payments, were reasonably common. Has that changed?

Mr. HOPKINS. From the banking perspective, I am not sure they were available. That really came from the unregulated financial institutions that were selling into the secondary market.

Senator TESTER. Well—

Mr. HOPKINS. So that has changed because those lenders are no longer around.

Senator TESTER. OK. I actually was, in fact, from a bank offered an interest only, no down loan to buy a house in Washington, DC. Could I still get that loan?

Mr. JOHNSON. Not from my bank.

Mr. HOPKINS. Not from my bank.

Senator TESTER. You know my balance sheet.

[Laughter.]

Senator TESTER. What about down payments? Down payments, have they gone up, and by how much have they gone up? I am talking about a requirement. It used to be, it seems like, in the good old days—if they were, in fact, good old days—a down payment was pretty substantial on a home. Where is it at now?

Mr. JOHNSON. Well, generally speaking, in our bank, it hasn't changed all that much—

Senator TESTER. What were your requirements?

Mr. JOHNSON. Generally 20 percent. We had some programs that we participated in that were very, very focused that were able to have lower down payments, but it did not combine everything. It wasn't a low down payment and a negative amortization and this and that.

Senator TESTER. All right.

Mr. HOPKINS. We have—the programs typically are the 20 percent down, but we do have the FHA programs which are 3.5 percent down, but they are very strictly underwritten—

Senator TESTER. OK.

Mr. HOPKINS. —as to income and credit.

Senator TESTER. One last question and then I will go, and thank you, Mr. Chairman, for the latitude. Oftentimes, particularly young couples that went in, they have been looking to buy their first home. This is a few years back—3, 4, 5 years back—and they needed, \$100,000, \$150,000. We are talking Montana here, so you know what I mean. It is probably similar to where you are at, Mr. Hopkins, where that is a decent home. And they would come in for the loan and the bank would say, you are eligible for \$200,000. Is that still going on, or did it ever go on in your neck of the woods?

Mr. HOPKINS. Not to my knowledge. It didn't happen at our bank.

Senator TESTER. OK.

Mr. JOHNSON. It didn't happen at our bank, but that did happen in our market from nondepositories, and those are some of the loans that we are—I mean, those people are now coming in and talking to us and we are not able to save all of them.

Senator TESTER. Yes. Well, I certainly appreciate your perspective on the programs. I am sorry I didn't ask a whole bunch of questions to the other witnesses. It doesn't mean you are not very, very important.

I once again apologize for not being here for the testimony, because this is very important. You guys are critically important, and I will tell you what I tell my community bankers. You need to be regulated, but you are not the ones that caused the problem. The same thing with the credit unions, too, I might add. You are not the ones that caused the problem. The Wall Street people were the ones, and quite honestly, the "too-big-to-fail" is something that I personally have a great disdain for, whether it is in banking or whether it is in agriculture or whether it is in energy or whether it is in food, whatever. We need to rethink some of these operating systems we have in this country. Thank you for the work you do.

Chairman JOHNSON. I want to thank the witnesses once again for traveling so far to be here today.

I look forward to working with the Members of the Banking Committee in the coming weeks as we continue to consider measures to capitalize the banking sector and our economy as a whole.

This hearing is now adjourned.

[Whereupon, at 3:49 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

**PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON**

It is no exaggeration to say that our economy is currently experiencing extraordinary stress and volatility. As Congress and the Administration look at corrective policy changes, I am pleased to hold this hearing today to take a closer look at the role smaller financial institutions, specifically community banks and credit unions, play in our economy, especially in many rural communities. Throughout our Nation's economic crisis there has often been too little distinction made between troubled banks and the many banks that have been responsible lenders.

There are many community banks and credit unions that did not contribute to the current crisis—many rural housing markets that didn't experience the boom that other parts of the country did, and community lending institutions didn't sell as many exotic loan products as other lenders sold. Nonetheless, small lending institutions in rural communities and their customers are feeling the effects of the subprime mortgage crisis and the subsequent crisis in credit markets. Jobs are disappearing, ag loans are being called, small businesses can't get the lines of credit they need to continue operation, and homeowners are struggling to refinance.

Smaller banks play a crucial role in our economy and in communities throughout our Nation; we need to be mindful that some institutions are now paying the price for the risky strategies employed by some larger financial institutions.

In coming weeks, the Banking Committee will continue its review of the current structure of our financial system and develop legislation to create the kind of transparency, accountability, and consumer protection that is now lacking. As this process moves forward, it will be important to consider the unique needs of smaller financial institutions and to preserve their viability as we come up with good, effective regulations that balance consumer protection and allow for sustainable economic growth.

I would like to welcome our panel of witnesses, and thank them for their time and for their thoughtful testimony on how small lending institutions in rural communities have been affected by our troubled economy. I would also like to thank Senator Kohl for his interest in today's hearing topic. I will now turn to Senator Crapo, the Subcommittee's Ranking Member, for his opening statement.

**PREPARED STATEMENT OF SENATOR MIKE CRAPO**

Many community banks and credit unions have tried to fill the lending gap in rural communities caused by the credit crisis. Even with these efforts, it is apparent that many consumers and businesses are not receiving the lending they need to refinance their home loan, extend their business line of credit, or receive capital for new business opportunities. Today's hearing will assist us in identifying these obstacles.

As we began to explore options to modernize our financial regulatory structure, we need to make sure our new structure allows financial institutions to play an essential role in the U.S. economy by providing a means for consumers and businesses to save for the future, to protect and hedge against risk, and promote lending opportunities. These institutions and the markets in which they act support economic activity through the intermediation of funds between providers and users of capital.

One of the more difficult challenges will be to find the right balance between protecting consumers from abusive products and practices while promoting responsible lending to spur economic growth and help get our economy moving again. Although it is clear that more must be done to protect consumers, it is not clear that bifurcating consumer protection from the safety and soundness oversight is the best option. If that is not the best option, what is and why? It is my intention to explore this topic in more detail with our witnesses. Again, I thank the Chairman for holding this hearing and I look forward to working with him on these and other issues.

**PREPARED STATEMENT OF JACK HOPKINS**

PRESIDENT AND CHIEF EXECUTIVE OFFICER,  
CORTRUST BANK NATIONAL ASSOCIATION, SIOUX FALLS, SOUTH DAKOTA,  
ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

JULY 8, 2009

**Introduction**

Mr. Chairman and Members of the Subcommittee, thank you very much for the opportunity to testify today on the state of community banks in rural America.

My name is Jack Hopkins and I am the President and CEO of CorTrust National Bank Association in Sioux Falls, SD. I am testifying on behalf of the Independent Community Bankers of America (ICBA) and I serve on ICBA's<sup>1</sup> Executive Committee. I am a past President of the Independent Community Bankers of South Dakota and have been a banker in South Dakota for 25 years. I am pleased to present ICBA's views on the state of credit conditions in rural America.

CorTrust is a National Bank with 24 locations in 16 South Dakota Communities and assets of \$550 million. Eleven of the communities have less than 2,000 people. In seven of those communities, we are the only financial institution. The smallest community has a population of 122 people. CorTrust Bank is currently one of six authorized servicers in the State of South Dakota for the first-time homebuyers program and one of the leading South Dakota lenders for the U.S. Department of Agriculture (USDA) Rural Housing Service home loan program.

Today's testimony will briefly provide the community bank perspective on credit conditions in rural America and offer recommendations for the Members of this Subcommittee to consider to ensure the availability of vital credit to our rural communities.

### **The Financial Crisis**

As the financial crisis spread and deepened last fall many people wondered what the impact of the worst economic recession since the Great Depression would be on rural America. At the outset, it is important to note, community banks played no part in causing the financial crisis and have watched as taxpayer dollars have been used to bail out Wall Street investment firms and our Nation's largest banks considered "too-big-to-fail." During this same time period, dozens of community banks have been allowed to fail while the largest and most interconnected banks have been spared the same fate due to government intervention.

Mr. Chairman, community banks did not cause the current financial crisis, fueled by exotic lending products, subprime loans, and complex and highly leveraged investments. The sharp decline in the U.S. housing markets and the distressed credit markets triggered a ripple effect throughout the entire economy and that continues to strain households and businesses.

### **Community Banks' Role in the Rural Economy**

Community banks play an important role in the Nation's economy. There are approximately 8,000 community banks in the U.S. and the vast majority of these are located in communities of 50,000 or fewer residents. Thousands of community banks are in small rural communities.

According to the SBA Office of Advocacy, insured institutions with less than \$1 billion in assets make 31.3 percent of the total dollar amount of small business loans of less than \$1 million, even though they hold only 11.5 percent of industry assets. This is important since small businesses represent 99 percent of all employer firms and employ one-half of the private sector workforce. Small businesses are significant in rural America since many farmers and/or their spouses have off-farm jobs. In addition, the more than 26 million small businesses in the U.S. have created 70 percent of the net new jobs over the past decade. Community banks are small businesses themselves and specialize in small business relationship lending.

Commercial banks extend approximately 53 percent of non-real-estate loans to the farm sector and 38 percent of the real estate credit. Community banks under \$1 billion in assets make over 60 percent of all agricultural loans extended by the commercial banking sector. Worthy of note, community banks under \$500 million in assets extend over 50 percent of all agricultural credit from the banking sector.

### **Aite Study**

The Aite Group LLC released a study,<sup>2</sup> conducted with the assistance of the ICBA, in March 2009, on the impact of the financial crisis on community banks. The study drew several conclusions regarding the ability of community banks to continue serving their customers during the financial crisis.

Although the current financial crisis is impacting all financial institutions, most community banks are well-positioned to overcome new challenges, take advantage

<sup>1</sup>ICBA represents 5,000 community banks throughout the country. Community banks are typically independently owned and operated and are characterized by personal attention to customer service and are proud to support their local communities and the Nation's economic growth by supplying capital to farmers and ranchers, small businesses, and consumers.

<sup>2</sup>Impact of the Financial Crisis on U.S. Community Banks, New Opportunities in Difficult Times, March 2009, Christine Barry and Judy Fishman, Aite Group LLC, Boston, MA. 773 community banks were surveyed in February, 2009, for this study.

of new opportunities, and reclaim some of the deposits lost to larger institutions over the last decade.

Despite most community banks' lack of participation in subprime lending, the implications of larger bank activities have had an impact. Of the 773 community banks surveyed, 73 percent stated they have seen an increase in their traditionally low loan delinquencies and charge-offs since the start of the crisis. The significant growth in quarterly net charge-offs for the industry is being driven primarily by the largest banks.

Fifty-five percent of bankers stated they have seen an increase in deposits as a result of new customer acquisition. Only 17 percent are challenged by customers withdrawing deposits from their institutions.

Community banks are still lending and 40 percent have seen an increase in loan origination volumes over the last year, while 11 percent believe the financial crisis has "significantly curtailed" their lending ability. In several cases, decreases in community bank lending activity, when it has occurred, is not the result of a lack of funds or financial instability, but rather part of a reaction to mixed messages coming from the U.S. government. While these banks are told by policy makers to lend money, they also feel the agencies are dissuading them from lending by putting them through overzealous regulatory exams. Moreover, an economic contraction, by definition, means fewer loans will be originated.

Even though some community banks are faced with new lending challenges, they are still lending, especially when compared to larger banks. In fact, while the largest banks saw a 3.23 percent decrease in 2008 net loans and leases, institutions with less than \$1 billion in assets experienced a 5.53 percent growth.

The financial crisis and new documentation requirements are also causing some banks to change processes and reexamine their credit evaluation practices. While most community banks have not strayed from traditional prudent lending and underwriting practices, 81 percent have tightened their credit standards since the start of the crisis. Of banks surveyed, 20 percent described this tightening as significant. Banks with more than \$100 million in assets have been the most likely to tighten their credit standards, while only 15 percent of banks with less than \$100 million in assets have done so. In most cases, tighter standards often means focusing greater attention on risk management and requiring more borrower information prior to making lending decisions.

### **Small Business Lending**

The prolonged recession, turmoil in the financial markets, and procyclical bank regulatory policies continue to jeopardize credit availability for many small businesses in urban and rural areas. Community banks are well-positioned and willing to lend to small businesses especially during these challenging economic circumstances. ICBA strongly supports President Obama's and Congress' recent initiatives to bolster small businesses loan programs included in the American Recovery and Reinvestment Act of 2009. Small businesses will help lead us out of the recession and boost needed job growth. Therefore, it is important to focus on the policy needs of the small business sector during this economic slowdown. SBA lending must remain a viable and robust tool in supplying small business credit.

The frozen secondary market for small business loans continues to impede the flow of credit to small business. Several programs have been launched to help unfreeze the frozen secondary market for pools of Small Business Administration (SBA) guaranteed loans, including the Term Asset-Backed Securities Loan Facility (TALF) and a new SBA secondary market facility. The TALF, implemented by the Federal Reserve and U.S. Treasury, was intended to extend billions in nonrecourse loans to holders of high-quality asset-backed securities (ABS) backed by consumer and small business loans in a bid to free up the frozen ABS market.

Specifically, the TALF program for SBA secondary market loan pools is very close to success. Unfortunately, one program obstacle requiring third-party direct competitor primary dealers to be middlemen has completely stalled the program. SBA loan poolers will not turn over their customers to their direct competitors nor have the primary dealers engaged in the program to date. ICBA recommends either eliminating the primary dealer middlemen in the process or allowing the Federal Reserve Bank of New York to work as the intermediary with the existing SBA loan poolers.

Similarly, the new SBA secondary market program is close to success but the debate over potential additional fees to operate the program has stalled its launch. ICBA recommends using the enacted substantial funded budget authority to run the program in combination with user fees so as not to undermine the program with unworkable double fees.

ICBA believes with these minor adjustments, these targeted SBA secondary market programs will keep money flowing to consumers and small businesses providing

the intended value and results. In addition, government sponsored enterprises and U.S. government loan programs should not reject a loan for the sole reason the property is in a declining market.

#### **The Agricultural Sector—Farm Income**

Many rural lenders have been quite concerned that a global recession would lead to fewer exports of U.S. agricultural products, thereby reducing markets and income for American farmers, and causing a ripple effect up and down Main Street. The agricultural sector was fortunate that at the outset of this severe recession, in which unemployment figures continue to march toward double digit levels, U.S. net farm income had reached a record high of nearly \$90 billion for 2008.

This followed the \$87 billion level reached in 2007 and a 10-year average (1999–2008) of \$65 billion. However, production expenses also increased dramatically during the past 2 years, and although expenses are projected to be approximately 9 percent lower this year, net cash income is also projected to fall to \$71 billion. While still above the 10-year average, 2009 net farm income will be 18 percent less than last year's record level, according to USDA's Economic Research Service.

#### **Perspective on Agricultural Credit**

ICBA agrees with various economists who have noted there is an ample amount of credit available to the agricultural sector for credit worthy borrowers. However, there are several problem areas of concern that warrant continued monitoring. For example, the dairy industry has been hard hit by lower prices and high feed costs which have also impacted the livestock sector. In addition, there are several States where farmers have been impacted by drought conditions that will threaten yields and farm income.

In recent testimony before the House Agriculture Committee, the Federal Reserve Bank of Kansas City stated that despite some increasing risks in agriculture, ample credit appears available at historically low interest rates.<sup>3</sup> In addition, recent data from the FDIC indicates farm loans (non-real-estate) and farm real estate loans increased collectively by \$8 billion for the period ending March 31, 2009, compared to March 31, 2008.

#### **ICBA's Agriculture-Rural America Committee Input**

ICBA conducted a conference call last month with its Agriculture-Rural America Committee to further assess credit conditions. This committee consists of 25 agricultural bankers from every region of the U.S. representing virtually every agricultural commodity grown in the country.

A number of these bankers stated they had no classified agricultural loans. This is in part due to several areas of the country having excellent crops during the past 2 years, allowing farmers to increase their cash reserves or pay down their lines of credit. Some bankers have seen a significant increase in agricultural loans and have seen little deterioration in their agricultural portfolios but are concerned higher input costs will reduce farm income. Some community banks have picked up agricultural loans as larger banks have cut back their lines of credit. Land values have remained steady for highly productive farm land although sales have slowed considerably.

Land values for less productive farmland have fallen 5 to 10 percent in some areas. Some banks have tightened underwriting standards, including taking a stronger collateral position, slightly shortening loan maturities, or requiring greater documentation from borrowers. The dairy, cattle feeding, and cow-calf sectors are areas experiencing stress.

Several bankers stated they are concerned with the potential for their regulators to second-guess their desire to make additional loans and some bankers are under pressure from their regulators to decrease their loan-to-deposit ratios. In addition, several bankers stated their regulators do not want them to use Federal Home Loan Bank (FHLB) advances as a means of funding their loans. The regulators are suggesting FHLB advances are not as "stable" as core deposits. Bankers disagree, noting it is quite easy for depositors to withdraw funds in search of higher yields in the stock market, which has risen rapidly in recent months, or in shopping for higher rate Certificates of Deposit (CD) at other institutions.

The real issue, bankers believe, is that regulators do not want to be in a secondary security position behind the FHLB if there are widespread bank failures. FHLB advances have become an important source of funding for community banks that must be allowed to continue.

<sup>3</sup> Jason Henderson, Federal Reserve Bank of Kansas City before the Subcommittee on General Farm Commodities and Risk Management, April 1, 2009, page 2.



A number of bankers also complain about a very harsh examination environment from field examiners and believe there is a “disconnect” between the public statements from policy makers in Washington and the treatment of local banks during examinations. This bolsters the findings of the Aite study.

At least one banker relayed to other committee members when he called the regulator to inquire about receiving TARP funds he was questioned as to why he needed the money. When he explained he wanted to supplement his capital position and also make more loans, the regulator told him the agency didn’t want banks making more loans in this environment. This attitude has led many community banks to conclude there is reluctance to extending TARP money to community banks and that the program was primarily designed to assist large, troubled banks. Community banks in danger of failing would not be eligible for TARP funds.

In addition, many banks have concluded TARP funds are an expensive source of capital both in terms of the dividend cost as well as the administrative costs.<sup>4</sup> There is also the risk requirements will be changed after banks receive funding and new conditions will be imposed.

Generally, the bankers’ conclusions are that ample credit is available for credit-worthy borrowers; they would like to make more loans; and they’re concerned about heavy-handedness from their regulators going forward. It is important to repeat: community banks remain very well-capitalized and are in a good position to assist with new borrowing needs as the economy strengthens. While, there are some sectors of agriculture that are struggling; the agricultural portfolios at many rural banks strongly contribute to each bank’s overall income and stability.

One limiting issue is that regulators recently required community banks to increase their capital levels. Previously, regulators increased community bank capital levels from 8 percent to 10 percent. Now the regulator requires a 12 percent capital level for all banks that have commercial real estate loan volumes three times their level of capital (*e.g.*, \$30 million in commercial loans and \$10 million of capital). Obviously, the regulators believe commercial real estate loans are more vulnerable in the current economic climate. For example, many banks in northern Colorado exceed this threshold due to the region’s fast growth in recent years. However, since capital is leveraged approximately 10 times for new lending, a \$2 million increase in capital reduces the amount of lending the bank is able to provide by \$20 million. Many rural bankers believe this new requirement is unnecessarily restrictive.

#### **Federal Reserve Bank Agricultural Surveys**

Several of the Federal Reserve District banks (Kansas City, Dallas, Chicago, Minnesota, and Richmond) conduct quarterly agricultural surveys of bankers in their regions. A summary of these surveys follows.

The Federal Reserve Bank of Kansas City<sup>5</sup> notes the average return on assets (ROA) and equity (ROE) at agricultural banks steadily declined in 2008. ROE at ag banks last September declined to 7.6 percent and ROA declined to 0.8 percent. Yet, these returns were much stronger than returns at other commercial banks. Contributing to the decline in ag bank profits were lower interest rates which have dropped significantly below 2006 levels. At smaller banks, delinquency rates on agricultural loans actually declined. Delinquency rates and net charge-offs on agricultural loans remain well below other types of loans and help explain the relative strength of agricultural banks. The delinquency rate on all types of loans and leases in the third quarter of 2008 was almost triple the rate of agricultural loans. Ag banks report ample funds for operating loans.

Banks have tightened lending standards to preserve capital and manage risk arising from the economic downturn. Collateral requirements rose almost 20 percent above year-ago levels but this increase does not appear to have severely restricted loan activity as farm real estate accounted for approximately 17 percent of the collateral used for the Nation’s farm operating loans. Bankers report deteriorating loan quality as livestock profits were elusive and margins declined for the crop sector. Carry-over debt appears to be rising as more ag banks report an increase in operating loan renewals and extensions during the fourth quarter. In response to rising risks, banks reduced the length of operating loans to approximately 12 months.

Rising job losses from the recession pose a risk to deposit growth because people could lose their income stream and tap savings for household needs. Ag banks are

<sup>4</sup> The cost of TARP funds includes a 5 percent dividend payment for the first 5 years increasing to 9 percent after 5 years. On an after tax basis, ICBA estimates the cost would be 7.5 percent the first 5 years and 13.5 percent after the first 5 years.

<sup>5</sup> The Kansas City region, the Tenth Federal Reserve District, includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico and the western third of Missouri.

increasing their use of USDA guaranteed farm loans. Continued deterioration in the agricultural economy could further erode the creditworthiness of borrowers. Farmland values edged down in the fourth quarter.

The Federal Reserve Bank of Minneapolis<sup>6</sup> reports farm income, capital expenditures, and household spending decreased in the first quarter. Loan demand was flat and collateral requirements increased. Banks reported no shortage of funds and interest rates decreased from the fourth quarter of 2008. Survey respondents expect decreases in income and capital expenditures during the second quarter. Dairy producers are hard hit as the price of milk has fallen to below breakeven levels. Most respondents from Wisconsin report below average income for their borrowers. One quarter of Minnesota respondents reported above average income, but 49 percent reported below average income. Producers are responding to lower spending by reducing capital equipment spending. Approximately 25 percent of respondents reported lower levels of loan repayments and 19 percent reported higher levels. Twenty-five percent saw higher renewals or extensions and only 8 percent saw lower levels.

The Federal Reserve Bank of Dallas<sup>7</sup> includes the States of Texas and portions of New Mexico and Louisiana, a region impacted by a severe drought. Many ranchers are unable to reach a breakeven point, forcing livestock liquidations. The dairy industry is suffering from large losses. The outlook for crop production, due to the lack of moisture, remains bleak. Eighty-four percent of bankers report loan demand remains unchanged or has decreased compared to last quarter.

The Federal Reserve Bank of Chicago<sup>8</sup> reports sale of farms were below the levels of the prior year. Bankers anticipate declines in land values during the second quarter. For the second quarter of 2009, respondents expect higher loan demand for operating loans and USDA guaranteed loans. As of April 1, District interest rates had reached historically low levels with the level for operating loans at the lowest since the early 1970s. The average loan-to deposit ratio was 76 percent, or 4 percent below the desired level. As land values have stalled, cash rental rates for farmland increased 7 percent for 2009. Twenty-one percent of bankers reported more funds for lending were available than a year ago and 9 percent reported fewer funds were available.

Bankers expect the volume of non-real-estate farm loans to grow during the second quarter compared to year ago levels and expect higher FSA guaranteed loan demand. They expect farm machinery, grain storage construction, feeder cattle, and dairy loan volumes to decrease.

The Federal Reserve Bank of Richmond's<sup>9</sup> fourth quarter 2008 survey reported the demand for farm loans was little changed from its sharp drop off in the third quarter, which bankers attributed to variations in commodity prices and production costs. Lenders expressed concern about escalated feed costs which had reduced profits for livestock production. Requests for loan renewals or extensions increased at a quicker pace. Agricultural lenders reported that farm loan availability turned positive, and collateral requirements eased slightly from third quarter levels. Reports also indicated interest rates for agricultural loans moved lower across all categories. Compared to third quarter levels, rates for intermediate-term loans decreased 34 basis points and rates for operating loans moved down 28 basis points. In other categories, interest rates for long-term real estate loans fell 19 basis points (bp), and interest rates for feeder cattle loans dropped 10 bp.

In the fourth quarter, 75 percent of lenders reported that they had actively sought new farm loans, up slightly from last quarter's reading of 73 percent. Fourth quarter land prices were slightly below the previous quarter and considerably lower than year ago levels. Bankers expected farm loan volumes in the first quarter of 2009 to continue a downward trend led by further weakness in the demand for dairy and feeder cattle loans.

### **National Agriculture Risk Education Library Survey**

In an effort to better understand what is happening in the agricultural economy, a survey<sup>10</sup> was conducted in January 2009 by the Extension Risk Management

<sup>6</sup>The Minneapolis Federal Reserve serves the six States of the Ninth District: Minnesota, Montana, North and South Dakota, 26 counties in northwestern Wisconsin, and the Upper Peninsula of Michigan.

<sup>7</sup>The Federal Reserve Bank of Dallas covers the Eleventh Federal Reserve District, which includes Texas, northern Louisiana, and southern New Mexico.

<sup>8</sup>The Chicago Fed serves the Seventh Federal Reserve District, a region that includes all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

<sup>9</sup>The Federal Reserve Bank of Richmond, (Fifth district) comprises Maryland, the District of Columbia, Virginia, North Carolina, South Carolina, and most of West Virginia.

<sup>10</sup>This survey can be accessed at: <http://www.agrisk.umn.edu/Library/Display.aspx?RecID=3971>.

Education Regional Centers and the Center for Farm Financial Management at the University of Minnesota, funded through the USDA CSREES Risk Management Education Program. Twenty-three hundred agricultural professionals responded to the survey, whose respondents represented various agricultural disciplines: Lenders: 21 percent; educators: 43 percent; crop insurance representatives: 7 percent; consultants: 6 percent—elevators, cooperatives, marketing brokers, and nonprofits: 22.5 percent.

Currently, 63 percent of respondents stated that 10 percent or less of the producers they work with are experiencing financial stress, with 15 percent indicating that less than 2 percent of the producers they work with are currently experiencing financial stress.

In the next 3 years, however, more than 28 percent of respondents expect at least 30 percent of their agricultural clients will experience financial stress. Seventy-five percent of respondents expect 11 percent or more of producers will experience financial stress in the next 3 years.

Twenty-six percent of lenders think the probability is very high that producers will experience financial stress in the next 3 years. Fifty-four percent of lenders expect the probability of financial stress to be “high.”

It is particularly interesting to note the reasons stated for expected financial stress in agriculture over the next 3 years. The first five reasons given were: Price/input cost margins; price volatility; negative cash flows; inadequate business planning; and lack of financial planning skills. Tightening credit availability was sixth on the list of thirteen reasons and was cited as having “moderate” impact. The lowest rated factors expected to have an impact on farm financial stress were rising interest rates and declining land values.

#### **Farm Credit System Considerations**

The Farm Credit System (FCS) is a government sponsored enterprise (GSE) that, unlike other GSEs, competes with private sector lenders at the retail level. The financial crisis has proven that not only do GSEs have the implicit backing of the Federal Government; they also have the explicit backing of the Federal Government. Just like the Nation’s largest banks, they would not be allowed to fail in times of financial difficulty. The FCS, as a competitor with community banks, also has unique advantages—it can typically raise funds cheaply in the government debt markets and FCS institutions have numerous tax advantages enabling them to offer lower rates than commercial banks.

This has led to FCS entities “cherry picking” prime farm loans from community banks as FCS institutions seek the very best customers from bank portfolios. Allowing this practice, unintended by Congress, can discourage community bank involvement in the agricultural sector, reducing the amount of resources and institutions available to farmers.

The performance numbers of the FCS indicates this as well. Compared to commercial ag banks’ ROE of 7.6 percent and ROA of 0.8 percent for September 2008, FCS associations’ ROE for the same time period was 10.85 percent and associations’ ROA was 1.70 percent.

Community banks serving agriculture should receive the same tax benefits as FCS associations. In this century, it no longer makes sense to provide billion-dollar and multibillion dollar FCS institutions tax advantages over much smaller commercial lenders to compete for the same customers. The benefit of equalizing the playing field will accrue to the end-user—the farmers and ranchers.

#### **Administration’s Regulatory Reform Proposals**

ICBA supports the administration’s goals of making the overall financial system more resilient and less vulnerable to “too-big-to-fail” institutions that were a key factor in the recent financial turmoil. The administration’s proposal offers community banks both constructive measures ICBA will support and those ICBA will oppose.

The proposal addresses a longtime ICBA priority by dealing with the risks created by “too-big-to-fail” institutions. It is a good, strong step in the right direction but Congress needs to go further. ICBA is pleased the administration decided to maintain the dual banking system. This will allow the maintenance of Federal and State bank charters and allow the concerns of community banks to be heard, rather than to be drowned out by the larger and more complex financial institutions.

#### **ICBA Recommendations to Congress**

While it is difficult to predict accurately what will happen in the economy in the next two or three quarters, we believe Congress can have a positive influence by making a number of key policy choices. ICBA recommends:

1. Provide additional funding for USDA direct and guaranteed farm loans. Prior to the July congressional recess, Congress passed and the President signed the supplemental appropriations bill which added \$400 million of direct operating loans, \$360 million in direct ownership loans and \$50 million in guaranteed operating loans. There may be a need even more for guaranteed operating loans and Congress should closely monitor loan demand in these important programs. These programs assist borrowers who cannot obtain credit elsewhere and are an important backstop for farmers who need temporary assistance until they are able to graduate to commercial credit.
2. Enhance USDA's Business and Industry (B & I) loan program. Congress added significant new money for USDA's rural development efforts as part of the recently enacted economic stimulus package (P.L. 111-5). The new funding would allow an additional \$3 billion of business and industry loans in addition to \$1 billion of loans provided as part of USDA's regular budget. However, the funds to provide \$3 billion in new B & I loans will expire October 1, 2010. It will be important for USDA to aggressively market the program to lenders and provide adequate information in order to utilize these new funds.

Even more importantly, the B & I program needs to be enhanced (at least for the new funding) by: (A) implementing no more than a one percent origination fee; (B) increasing guarantees on loans under \$5 million from the current 80 percent level to 90 percent—perhaps even 95 percent on smaller loans; and (C) not eliminating the low document application as USDA appears to be on the verge of doing for smaller loans. These changes would help ensure the program is attractive for lenders and their customers and will ensure Main Street rural America has the resources necessary to ride out any storms on the horizon that could result from stress in the agricultural sector.

3. Ensure that the FCA does not proceed with its Rural Community Investments Proposal. This proposal poses significant new risks to the FCS and its borrowers and should not be adopted. The proposal appears to be illegal and was never considered or authorized by Congress. It allows FCS to extend credit, mislabeled "investments," for a vast array of purposes never intended by Congress. These purposes include extending credit for nonfarm business financing, apartment complexes, construction projects and virtually any other purpose. This wide nonfarm reach of FCS institutions will move FCS lenders further away from serving farmers and ranchers—the specific reason it was created and granted GSE tax and funding privileges.
4. Ensure the regulators not unduly restrict lending by community banks. Regulators can have a major impact on the ability of lenders to extend credit particularly if they engage in unduly harsh examinations at the local level. Many community banks believe this is occurring. Members of Congress should interact with regulatory agencies and stress the need to allow the banking sector to work with rural customers during difficult financial times that may lie ahead. Such regulatory flexibility allowed many farmers and small businesses to survive the turbulent times of the 1980s farm crisis but was the result of clear and strong messages sent by Congress.
5. Avoid unintended consequences resulting from imposing new requirements on the banking sector. In recent months there have been various proposals aimed at bank recipients of TARP funds that would impose unnecessary costs and regulatory burdens on banks. Such proposals have included requiring commercial banks to write down principal and interest on troubled loans as the first option to consider when restructuring loans. Bankers already work with their customers and utilize a wide variety of options to keep customers in business. Washington should allow community banks to work with borrowers in troubled times without adding to the costs and complexity of working with customers.
6. Support the Administration's proposals on systemic risk and dual banking charters. It is important to prevent "too-big-too-fail" banks or nonbanks from ever threatening the collapse of the financial system again. Community banks support the dual system of State and Federal bank charters to provide checks and balances, which promote consumer choice, and a diverse and competitive financial system that is sensitive to financial institutions of various complexity and size

### **Conclusion**

Thank you, Mr. Chairman, for the opportunity to testify today. As stated several times in the written testimony, community banks continued conservative and prudent lending practices during the last several years and have worked with borrowers and even increased lending during this latest period of economic contraction.

In addition, thousands of community banks are providing loans to farmers, ranchers, and small businesses at historically low interest rates. ICBA urges the Banking Committee to consider the recommendations provided in the testimony to enable the community banking sector to do even more to serve our rural communities. ICBA looks forward to working with the Senate Banking Committee as these proposals move through Congress.

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**PREPARED STATEMENT OF FRANK MICHAEL**

PRESIDENT AND CHIEF EXECUTIVE OFFICER,  
ALLIED CREDIT UNION, STOCKTON, CALIFORNIA,  
ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

JULY 8, 2009

Chairman Johnson, Ranking Member Crapo, and Members of the Financial Institutions Subcommittee, thank you very much for the opportunity to testify at today's hearing on "The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities" on behalf of the Credit Union National Association (CUNA). CUNA is the Nation's largest credit union advocacy organization, representing over 90 percent of our Nation's approximately 8,000 State and Federal credit unions, their State credit union leagues, and their 92 million members.

My name is Frank Michael, and I am President and CEO of Allied Credit Union in Stockton, California. Allied Credit Union is a small institution with \$20 million in assets and approximately 2,600 member-owners.

Originally my credit union's field of membership was limited to Greyhound bus drivers but it has grown to include employees served by a variety of labor union locals, those who live, work, worship, or attend school in the incorporated and unincorporated areas of Stockton, California, and employees of a number of companies outside of Stockton proper.

I also serve as Chair of CUNA's Small Credit Union Committee—which is charged with monitoring issues affecting small credit unions that operate in both urban and rural settings.

I am honored to be here to speak to you about the present state of small credit unions in rural communities, the obstacles these institutions are encountering, and the effects of recent legislation on these institutions.

**Credit Unions Stand Apart From Other Financial Institutions**

I would like to emphasize that while I am here to represent the views of "small" credit unions, credit unions are generally very small by banking industry standards: The average credit union has roughly \$110 million in total assets whereas the average banking institution is 15 times larger with \$1.7 billion in total assets.<sup>1</sup> (The median size credit union has just \$15 million in total assets and the median size bank is about 10 times larger with \$146 million in total assets).

It is also important to stress that credit unions—rural, urban, large, and small—did not contribute to the subprime meltdown or the subsequent credit market crisis.

Credit unions are careful lenders. And, as not-for-profit membership cooperatives the overriding operating objective at credit unions is to maximize member service. Incentives at credit unions are aligned in a way that ensures little or no harm is done to the member-owners. As we have seen, the incentives outside of the credit union sector are aligned in a way that can (and often does) cause harm to consumers. In the case of toxic mortgages such as subprime mortgages, entities operating outside of the cooperative sector focused on maximizing loan originations (specifically fee income from those originations) even though many of the loans originated were not in the borrower's best interest.

Further, credit unions hold most of their loans in portfolio. In recent years, 70 percent of credit union mortgage originations have been held in portfolio—only 30 percent have been sold into the secondary market. In the broader credit union loan portfolio the percentage held is even higher. The maintenance of this ownership interest means that credit unions care deeply about what ultimately happens to the loans they originate—they care if the loans are paid back. The subprime crisis, in contrast, has been closely linked to lenders who adopted the originate-to-sell model. These lenders cared little about repayments because the quality of the loans they sold became someone else's problem.

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<sup>1</sup> Financial data is as of March 2009. Credit union data is from the NCUA, bank data is from the FDIC.

In the end these structural and operational differences translated into high asset quality at credit unions.<sup>2</sup> Annualized first quarter 2009 net charge-offs at credit unions were equal to 1.11 percent of average loans outstanding. In the same period, banking industry net charge-offs were 1.94 percent.

Delinquency rates—a forward-looking indicator of credit quality also highlights the credit union difference. As of March 2009, 60+ day dollar delinquency rates on credit union loans were 1.44 percent. In contrast the banking industry's 90+ day dollar delinquency rate was 3.88 percent—over two-and-one-half times higher than the credit union norm despite an additional 30 days of collection efforts. High asset quality helped to keep credit union capital ratios near record levels. At the end of March 2009 the aggregate credit union net worth ratio was 10 percent—substantially higher than the 7 percent regulatory standard that institutions need to be considered “well capitalized.”

Strong asset quality and high capital kept most credit unions “in the game” while the other lenders pulled back and significantly tightened loan underwriting standards. Overall, loan growth rates at credit unions have remained comparatively high. In the year ending March 2009, credit union loans grew by 6 percent—a rate of increase that is well above the 2 percent to 3 percent growth credit unions usually see in consumer-led recessions and a stark contrast to the 3 percent decline in bank loans over the same timeframe.

Real estate loans at credit unions grew by nearly 9 percent in the year ending March 2009, while banking industry real estate loans declined by approximately 2 percent. Business loans at credit unions grew by nearly 16 percent in the year ending March 2009, whereas commercial loans at banking institutions declined by 3 percent.

Importantly, credit union pricing continues to reflect a strong, long-standing consumer-friendly orientation. According to Datatrac, a national financial institution market research company, credit union average loan rates have remained far lower than those in the banking arena and credit union average yields on savings accounts have remained far higher than those in the banking arena. The pricing advantage to credit union members is evident on nearly every account that Datatrac measures. In the aggregate, CUNA economists estimate that the credit union pricing advantage saved credit union members \$9.25 billion in 2008 alone.<sup>3</sup> This makes a significant difference to tens of millions of financially stressed consumers throughout the Nation.

While credit unions have generally fared well, they are not immune from the effects of the financial crisis. Of course, the “too-big-to-fail” issue roils many small credit unions, including those operating in rural areas. In addition, there are some natural person credit unions, especially in States such as California, Florida, Arizona, Nevada, and Michigan that are experiencing serious financial stresses, including net worth strains, primarily as a result of the collateral effects of their local economic environments.

Within the credit union system, the corporate credit union network has been particularly hard hit as credit market dislocations saddled several of these institutions with accounting losses on mortgage-backed and asset-backed securities.

There are currently 28 corporate credit unions, which are owned by their natural person credit union members. Corporate credit unions are wholesale financial institutions that provide settlement, payment, liquidity, and investment services to their members. The powers of corporate credit unions differ from natural person credit unions. For example, the mortgage backed and asset backed securities that are permissible investments for corporate credit unions and not generally permissible for natural person credit unions.

For the most part, the problematic securities were tripled-A rated at the time the corporate credit unions purchased them. However, as a result of the impact of the economy on the securities, and the mortgages and other assets underlying the securities, the National Credit Union Administration (NCUA) has projected substantial credit losses relating to these securities.

<sup>2</sup>High credit union asset quality is doubly impressive given the exemplary record of credit union success in serving those of modest means. For example, credit union mortgage loan delinquency and chargeoff rates are very low compared to other lenders. At the same time Home Mortgage Disclosure Act (HMDA) statistics consistently show that lower income and minority borrowers in the market for mortgages are substantially more likely to be approved for a loan at a credit union. HMDA data also shows that compared to other lenders, a greater percentage of total credit union home loans are granted to low/moderate income consumers.

<sup>3</sup>This estimate does not include the procompetitive effects credit union pricing has on banking institutions. Several recent studies indicate that the credit union presence causes other institutions to price in a more consumer-friendly fashion, saving consumers several billions of dollars annually. See Feinberg (2004) and Tokel (2005).

The recently enacted, “Helping Families Save Their Homes Act of 2009” gave NCUA additional tools with which to assist credit unions in dealing with costs related to Corporate Credit Union stabilization actions. We applaud the Banking Committee’s leadership on that issue, and thank Congress for acting expeditiously to address these concerns. These stabilization efforts permit credit unions to continue to provide high levels of membership service while reducing the immediate financial impact on credit unions and ensuring the maintenance of a safe and strong Nation Credit Union Share Insurance Fund.

### **Rural Credit Unions Are Playing a Vital Role in the Economic Recovery**

Rural credit unions are unique in many respects.<sup>4</sup> There are nearly 1,500 U.S. credit unions with a total of \$60 billion in assets headquartered in rural areas. These institutions represent 19 percent of total credit unions and 7 percent of total U.S. credit union assets.

Rural credit unions tend to be small—even by credit union standards. On average, rural credit unions have just \$39 million in total assets (making them about one-third the size of the average U.S. credit union and one-fortieth the size of the average U.S. banking institution.)

In addition, nearly one-quarter (23 percent) of rural credit unions operate with one or fewer full-time equivalent employee. Over half (54 percent) of rural credit unions are staffed by five or fewer full-time equivalent employees.

These differences mean that even in good times, rural credit unions tend to face challenges in a way that larger credit unions do not. Pressures on the leaders of these small credit unions are great because they must be intimately involved in all aspects of credit union operations. Their small size, without the benefits of economies of scale, magnifies the challenges they face. Competitive pressures from large multistate banks and nontraditional financial services providers each increasingly provide substantial challenges. Greater regulatory burdens, growing member sophistication, loss of sponsors, and difficulties in obtaining training and education also loom large for most of the Nation’s small credit unions.

A bad economy can make things even worse. Small credit unions have very close relationships with their members. And member needs increase dramatically during recessions: They experience more personal financial difficulty; job losses mount; retirement funds dwindle; debt loads balloon; divorce rates rise. Small institutions come under tremendous pressure as they attempt to advise, consult with, and lend to these members.

Despite these substantial hurdles rural credit unions are posting comparatively strong results: Their loan and savings growth rates are nearly identical to the national credit union norms. Their delinquency rates are nearly identical to the national average and their net chargeoff rates are about one-half the national credit union norm. They posted earnings declines, but also reflected stronger earnings results and report higher net worth ratios than the national credit union averages.

### **Rural Credit Unions Face Growing Concerns**

Although small, rural credit unions are relatively healthy and continue to play a vital role in the Nation’s economic recovery, that role is being threatened. There are several concerns raised by small credit unions—and rural credit unions in particular—that deserve mention.

#### *Regulatory Burden and Reregulation.*

The credit union movement is losing small institutions at a furious pace—about one per day. Many of these are rural credit unions. The rate of decline does not seem to be slowing and most observers expect the pace to accelerate. The declines do NOT reflect failures but arise from voluntary mergers of small institutions into larger institutions. If you ask small institutions, they will tell you that one of the larger contributors to this consolidation is the smothering effect of the current regulatory environment.

Small credit union operators believe that the regulatory scrutiny they face is inconsistent with both their exemplary behavior in the marketplace and with the nearly imperceptible financial exposure they represent. A large community of small credit unions, free of unnecessary regulatory burden, benefits the credit union movement, the public at large and especially our rural communities. As the Subcommittee considers regulatory restructuring proposals, we strongly urge you to con-

<sup>4</sup>For purposes of this analysis “rural” areas are defined as non-MSA counties, consistent with OMB definitions. This definition includes 64 percent of U.S. counties and 16 percent of the total U.S. population. Of course, many credit unions that are headquartered in urban areas have branches in rural areas. These institutions are not included in our analysis because financial results are not available at the branch level.

tinue to keep these concerns in the forefront of your decision making. Moreover, we implore you to look for opportunities to provide exemptions from the most costly and time-consuming initiatives to cooperatives and other small institutions.

Both the volume of rules and regulations as well as the rate of change in those rules and regulations are overwhelming—especially so at small institutions with limited staff resources. Additionally, rural credit unions, like all credit unions, play “by the rules.” Yet, they correctly worry that they will be forced to pay for the sins of others and that they will be saddled with heavy additional burdens as efforts to reregulate intensify.

Nevertheless, while others in the financial services community call for the Administration to back down on plans to create a separate Consumer Financial Protection Agency (CFPA), CUNA President and CEO Dan Mica met with Treasury Secretary Geithner last week to discuss the administration’s financial regulatory overhaul legislation. In that meeting, Mr. Mica signaled our willingness to work with the administration and Congress, to maintain a seat at the table and to continue the conversation to obtain workable solutions. Credit union member-ownership translates to a strong proconsumer stance but that stance must be delicately balanced with the need keep our member-owned institutions an effective alternative in the marketplace.

Of course, any new legislation and regulation comes with possibility of unintended consequences, and credit unions are particularly sensitive to the unintended consequences of otherwise well-intentioned legislation, especially given an issue that has arisen with respect to the Credit Card Accountability Responsibility and Disclosure Act (CARD Act).

*Credit Card Accountability, Responsibility and Disclosure Act*

CUNA supports the intent of the CARD Act to eliminate predatory credit card practices. Although it will require some adjustments in credit card programs in the next 6 weeks to provide a change-in-terms notice 45 days in advance and to require periodic statements to be mailed at least 21 days in advance before a late charge can be assessed, CUNA supports these provisions and credit unions are diligently working with their data processors to effectuate these changes by the August 20, 2009, effective date.

However, Section 106 of the CARD Act also requires, effective August 20, 2009, that the periodic statements for all open-end loans—not just credit card accounts—be provided at least 21 days before a late charge can be assessed. This means that a creditor must provide periodic statements at least 21 days in advance of the payment due date in order to charge a late fee. Open-end loans include not only credit cards, but also lines of credit tied to share/checking accounts, signature loans, home equity lines of credit, and other types of loans where open-end disclosures are permitted under Regulation Z, the implementing regulations for the Truth in Lending Act. We believe extending the requirements of this provision beyond credit cards was unintended, and ask Congress to encourage the Federal Reserve Board to postpone the effective date of this provision.

If this provision is not postponed and considered further, the implementation of this provision will impose a tremendous hardship on credit unions. Simply put, we do not think credit unions can dismantle and restructure open-end lending programs they have used for decades in order to meet the August 20th deadline.

By way of background, this provision appeared for the first time in the Senate manager’s amendment to H.R. 627. The House-passed bill only applied the 21-day requirement to credit cards and was to be effective in 2010. During the Senate’s consideration of this issue, the 21-day requirement was described as applying only to credit cards.<sup>5</sup> In the weeks since enactment, many began to notice that the provision was not limited to credit card accounts and wondered if it was a drafting error. The confusion over this provision continues, as evidenced by the fact that as recently as June 25, the Office of Thrift Supervision released a summary of the CARD Act which states that the 21-day rule only applies to credit cards.<sup>6</sup>

There is a great deal of uncertainty about this particular provision, which makes it quite understandable that creditors may not even know about the ramifications of this new provision and the changes they need to have in place in 6 weeks.

This provision creates unique issues for credit unions because of their membership structure; as you know, credit unions serve people within their fields of membership who choose to become members. Because of this membership relationship, most credit unions provide monthly membership statements which combine informa-

<sup>5</sup> Remarks of Senator Dodd during consideration of S. Amdt. 1058 to H.R. 627. Congressional Record. May 11, 2009, S5314.

<sup>6</sup> <http://files.ots.gslsolutions.com/25308.pdf>.



tion on a member's savings, checking and loan accounts other than for credit cards. For almost 40 years—since the implementation of Regulation Z—credit unions have been authorized to use multifeatured open-end lending programs that allow credit unions to combine an array of loan products and provide open-end disclosures for compliance purposes. Today, almost half of the Nation's credit unions—about 3,500 credit unions—use these types of open-end programs, which can include as open-end lending products loans secured by automobiles, boats, *etc.*

CUNA is still trying to determine the full impact of the new law if credit unions will have to provide a 21-day period before the payment due date of all open-end loan products. Here are some preliminary compliance problems we have identified:

1. Credit unions will need to consider discontinuing the use of consolidated statements, something they cannot possibly do in the next 6 weeks, because different loans on the statements often have different due dates.
2. In order to comply with the 21-day mailing period, credit union members will no longer be able to select what day of the month they want designate as their due date for their automobile payments, a practice often allowed by credit unions, and no longer may be able to have biweekly payments to match repayments with biweekly pay checks, which helps members to budget.
3. Credit unions may have to discontinue many existing automated payment plans that will fail to comply with the 21-day requirement and work with members to individually work out new plans in order to comply with the law.
4. The 21-day requirement as it applies to home equity lines of credit (HELOCs) may raise contractual problems that cannot be easily resolved.

These complicated changes simply cannot be executed within the next 6 weeks, and CUNA requests that Congress urge Federal Reserve Board to limit the August 20 effective date to the two credit card provisions in Section 106, at least for credit unions.

#### *Credit Union Lending to Small Businesses*

As noted above, credit unions have been able to “stay in the game” while other lenders have pulled back. The credit crisis that many small businesses face is exacerbated by the fact that credit unions are subject to a statutory cap on the amount of business lending they can do. This cap—which is effectively 12.25 percent of a credit union's total assets—was imposed in 1998, after 90 years of credit unions offering these types of loans to their members will no significant safety and soundness issues. CUNA believes that the greater the number of available sources of credit to small business, the more likely a small business can secure funding and contribute to the Nation's economic livelihood.

Currently, 26 percent of all rural credit unions offer member business loans to their members. These loans represent over 9 percent of total loans in rural credit union portfolios. In contrast member business loans account for less than 6 percent of total loans in the movement as a whole. Total member business loans at rural credit unions grew by over 20 percent in the year ending March 2009, with agricultural MBLs increasing by over 12 percent and Non-Ag MBLs increasing 26 percent in the 12 month period. This is strong evidence that rural credit unions remain “in the game” during these trying times. But more could be done.

And more should be done. A chorus of small business owners complains that they can't get access to credit. Federal Reserve surveys show that the Nation's large banks tightened underwriting standards for the better part of the past year. In 2005, an SBA research publication noted that large bank consolidation is making it more difficult for small businesses to obtain loans.<sup>7</sup> Given the fact that the average size of a credit union member business loan is approximately \$216,000 this is a market that credit unions are well suited to serve. And this is a market that credit unions are eager to serve.

Chairman Johnson, you undoubtedly hear a lot of rhetoric surrounding credit union member business lending. However, please allow me to paint a more complete picture of the member business loan (MBL) activity of credit unions.

Member business loans that credit unions provide their members are relatively small loans. Nationally, credit union business lending represents just over one percent (1.06 percent) of the depository institution business lending market; credit unions have about \$33 billion in outstanding business loans, compared to \$3.1 tril-

<sup>7</sup>Small Business Administration. *The Effects of Mergers and Acquisitions on Small Business Lending by Large Banks*. March 2005.

lion for banking institutions.<sup>8</sup> In general, credit unions are not financing skyscrapers or sports arenas; credit unions are making loans to credit union members who own and operate small businesses.

Despite the financial crisis, the chief obstacle for credit union business lending is not the availability of capital—credit unions are, in general, well capitalized. Rather, the chief obstacle for credit unions is the arbitrary statutory limits imposed by Congress in 1998. Under current law, credit unions are restricted from member business lending in excess of 12.25 percent of their total assets. This arbitrary cap has no basis in either actual credit union business lending or safety and soundness considerations. Indeed, a subsequent report by the U.S. Treasury Department found that business lending credit unions were more regulated than other financial institutions, and that delinquencies and charge-offs for credit union business loans were “much lower” than that for either banks or thrift institutions.<sup>9</sup>

The statutory cap on credit union member business lending restricts the ability of credit unions offering MBLs from helping their members even more, and discourages other credit unions from engaging in business lending. The cap is a real barrier to some credit unions establishing an MBL program at all because it is costly to create an MBL program and it is easy to reach the cap in fairly short order—this is especially true for small rural institutions. The cap effectively limits entry into the business lending arena on the part of small- and medium-sized credit unions because the startup costs and requirements, including the need to hire and retain staff with business lending experience, exceed the ability of many credit unions with small portfolios to cover these costs. For example, the average rural credit union that does not now engage in business lending has \$17 million in average assets. At the institution level, that translates to roughly \$2 million in MBL authority which, in turn translates to an average of only nine loans.

The cap is overly restrictive and undermines public policy to support America’s small businesses. It severely restricts the ability of credit unions to provide loans to small businesses at a time when small businesses are finding it increasingly difficult to obtain credit from other types of financial institutions, especially larger banks.

Today, only one in four credit unions have MBL programs and aggregate credit union member business loans represent only a fraction of the commercial loan market. Eliminating or expanding the limit on credit union member business lending would allow more credit unions to generate the level of income needed to support compliance with NCUA’s regulatory requirements and would expand business lending access to many credit union members, thus helping local communities and the economy.

While we support strong regulatory oversight of how credit unions make member business loans, there is no safety and soundness rationale for the current law which restricts the amount of credit union business lending. There is, however, a significant economic reason to permit credit unions to lend without statutory restriction, as they were able to do prior to 1998: America’s small businesses need the access to credit. As the financial crisis has worsened, it has become more difficult for small businesses to get loans from banks, or maintain the lines of credit they have had with their bank for many years.

A growing list of small business and public policy groups agree that now is the time to eliminate the statutory credit union business lending cap, including the Americans for Tax Reform, the Competitive Enterprise Institute, the Ford Motor Minority Dealer Association, the League of United Latin American Citizens, the Manufactured Housing Institute, the National Association for the Self Employed, the National Association of Mortgage Brokers, the National Cooperative Business Association, the National Cooperative Grocers Association, the National Farmers Union, the National Small Business Association, the NCB Capital Impact, and the National Association of Professional Insurance Agents.

We hope that Congress will eliminate the statutory business lending cap entirely, and provide NCUA with authority to permit a CU to engage in business lending above 20 percent of assets if safety and soundness considerations are met. We estimate that if the cap on credit union business lending were removed, credit unions could—safely and soundly—provide as much as \$10 billion in new loans for small businesses within the first year. This is economic stimulus that would not cost the taxpayers a dime, and would not increase the size of government.

<sup>8</sup>All financial data is March 2009. Credit union data is from NCUA; Bank data is from FDIC.

<sup>9</sup>United States Department of Treasury, “Credit Union Member Business Lending.” January 2001.

### Conclusion

In closing, Chairman Johnson, Ranking Member Crapo, and all the Members of this Subcommittee, we appreciate your review of these issues today. Every day, credit unions reinforce their commitment to workers, small business owners, and a host of others in rural communities seeking to better their quality of life by providing loans on terms they can afford and savings rates that are favorable. We look forward to working with you to ensure the credit union system continues to be an important bulwark for the 92 million individuals and small businesses that look to their credit union for financial strength and support.

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### PREPARED STATEMENT OF ARTHUR C. JOHNSON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER,  
UNITED BANK OF MICHIGAN, GRAND RAPIDS, MICHIGAN,  
ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

JULY 8, 2009

Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of United Bank of Michigan, headquartered in Grand Rapids, Michigan. I serve as Chairman-Elect of the American Bankers Association (ABA), and I chair the ABA Community Bank Solutions Task Force, a committee dedicated to finding ways to address problems most acutely affecting community banking during this economic downturn. I am pleased to be here today representing ABA. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the Nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than \$125 million in assets—represent over 95 percent of the industry's \$13.5 trillion in assets and employ over 2 million men and women.

We are pleased to share the banking industry's perspective on the current economic situation in rural America and the effects the recession is having on rural community banks. We strongly believe that community banks are one of the most important resources supporting the economic health of rural communities. Not surprisingly, the banks that serve our Nation's small towns also tend to be small community banks. Less well known is that over 3,500 banks—41 percent of the banking industry—have fewer than 30 employees.

This is not the first recession faced by banks; they have been in their communities for decades and intend to be there for many decades to come. My bank, United Bank of Michigan, was chartered in 1903. We have survived the Great Depression and all the other ups and downs for over a century. We are not alone, however. In fact, there are 2,556 other banks—31 percent of the banking industry—that have been in business for more than a century; 62 percent (5,090) of banks have been in existence for more than half a century. These numbers tell a dramatic story about the staying power of community banks and their commitment to the communities they serve. My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers. We cannot be successful without such a philosophy and without treating our customers fairly.

In spite of the severe recession, community banks located in rural communities have expanded lending. In fact, during 2008—the first year of the recession—loans from banks headquartered outside of metropolitan statistical areas<sup>1</sup> increased by \$17 billion, or 7 percent. Loan growth last year was also reflected in a smaller subset of community banks: farm banks. Lending for these banks expanded by \$4.7 billion, or 9.2 percent, in 2008.

Considerable challenges remain, of course and these trends are not likely to be sustained. While many areas of our country have benefited from strong exports which have helped agricultural exports in particular, other rural areas of the country have not been as lucky. The downturn has continued to impose hardships on small businesses and manufacturers. In my home State of Michigan, we are facing our eighth consecutive year of job losses. The necessary—but painful—restructuring of the auto industry will likely cause this job erosion to continue for some time, leading to a long recovery in these areas. Other rural areas with a manufacturing employment base are also suffering similar problems.

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<sup>1</sup>Metropolitan statistical areas are defined as areas that have at least one town over 50,000 inhabitants.

In this environment, it is only natural for businesses and individuals to be more cautious. Individuals are saving more and borrowing less. Businesses are reevaluating their credit needs and, as a result, loan demand is also declining. Banks, too, are being prudent in underwriting, and our regulators demand it. Accordingly, it is unlikely that loan volumes will increase this year, and in fact, the total loans in rural areas declined slightly in the first quarter.

With the economic downturn, credit quality has suffered and losses have increased for banks. Fortunately, community banks entered this recession with strong capital levels. As this Committee is aware, however, it is extremely difficult to raise new capital in this financial climate. Without access to capital, maintaining the flow of credit in rural communities will be increasingly difficult.

We believe there are actions the government can take to assist viable community banks to weather the current downturn. The success of many local economies—and, by extension, the success of the broader national economy—depends in large part on the success of these banks. Comparatively small steps taken by the government now can make a huge difference to these banks, their customers, and their communities—keeping capital and resources focused where they are needed most.

Importantly, the amount of capital required to provide an additional cushion for all community banks—which had nothing to do with the current crisis—is tiny compared to the \$182 billion provided to AIG. In fact, it takes only about \$500 million in new capital today to bring all banks under \$10 billion in assets above the well-capitalized levels for Tier 1 capital. Even under a baseline stress test, the additional capital needed is less than \$3 billion for all these smaller banks to be well-capitalized. Without new capital, banks under \$10 billion in assets would have to shed nearly \$9 billion in loans to achieve the same capital-to-assets ratio. Simply put, capital availability means credit availability. A small investment in community banks is likely to save billions of dollars of loans in local communities.

Before discussing these points in more detail, I did want to thank Members of the Subcommittee for their tireless support of S. 896, the Helping Families Save Their Homes Act of 2009, legislation that expanded the insurance limits for deposits to \$250,000 for 4 years and expanded FDIC's line of credit with the Treasury from \$30 billion to \$100 billion. Expanding the deposit insurance limit provided additional protection to small businesses, retirees, and other bank depositors that need to protect their payrolls or life-savings. Expanding the FDIC's line of credit helped to reduce banks' expenses, thus preserving resources in communities across this Nation. Without this expanded line, the FDIC would have imposed a special assessment on the banking industry totaling more than \$15 billion dollars. By enacting this expanded line of credit, the FDIC has an additional cushion to rely upon—particularly for working capital purposes necessary to resolve bank failures quickly and to ensure that depositors have immediate access to their money. This increase in borrowing authority enabled the FDIC to make good on its promise to cut the special assessment in half.

The original special assessment would have devastated the earnings of banks, particularly community banks, just at the time funds are needed most in their communities. Of course, the industry still bears a considerable financial burden from both the regular quarterly premiums and the final special assessment. The vast majority of banks that will bear this cost are well capitalized and had nothing to do with the subprime mortgages that led to our financial and economic problems. Yet these banks bear much of the costs of cleaning up the problems created. We will continue to work with you to find ways to reduce the costs imposed on healthy banks and to build a strong base to support new lending as our economy emerges from this recession.

In my statement, I would like to focus on the following points:

- Banks in rural communities continue to lend in this difficult economic environment, but the broadening economic problems will make this more difficult in the future.
- New and expanded programs directed at community banks can help rural America cope with the current downturn, including broadening capital programs to enable participation by a broader cross section of viable but struggling banks. Moreover, regulators should ensure that their regulatory and supervisory responses are commensurate to the risks they are seeing in banks, and that they avoid inappropriate, procyclical responses that make bad situations worse.
- ABA believes that it is critical for this Subcommittee and Congress to focus on creating a systemic regulator, providing a strong mechanism for resolving troubled systemically important firms and filling gaps in the regulation of the shadow banking industry. Such significant legislation would address the principal

causes of the financial crisis and constitute major reform. We believe there is a broad consensus in the need to address these issues.

I will address each of these points in turn.

**I. Banks in rural communities continue to lend in this difficult economic environment, but the broadening economic problems will make this more difficult in the future.**

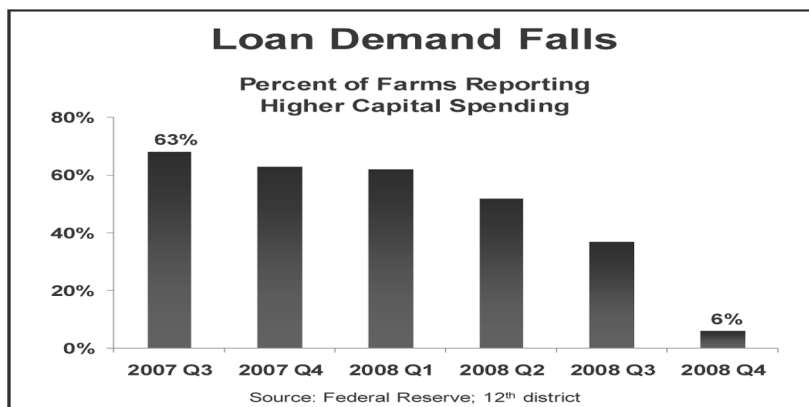
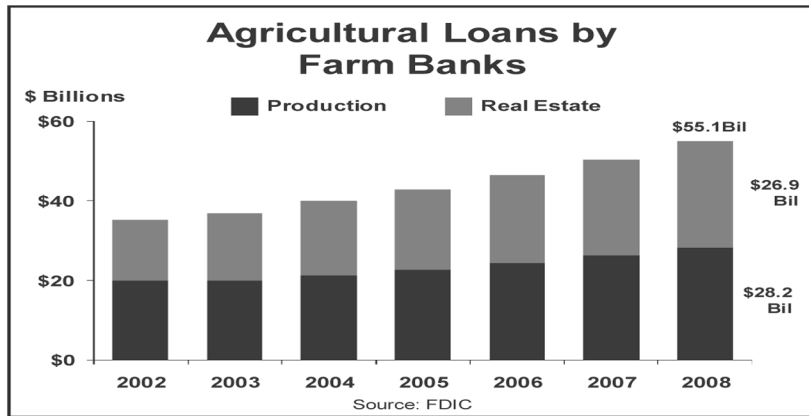
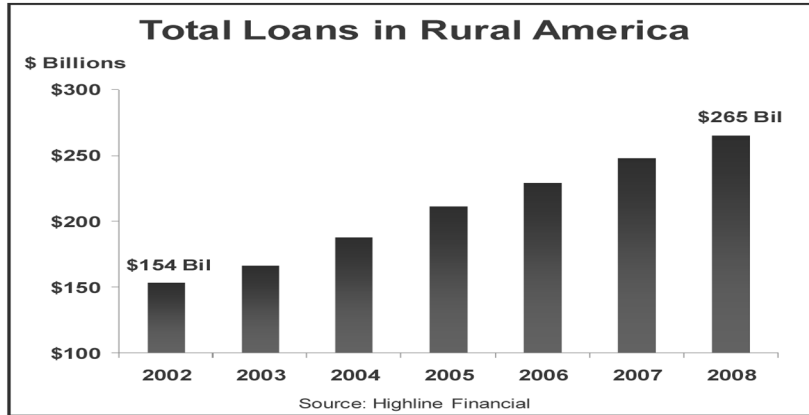
Rural America has been bolstered in recent years by an agriculture sector that experienced one of the longest periods of financial prosperity in history. In 2007 and 2008, American farmers and ranchers in the aggregate enjoyed some of their most profitable years ever. The balance sheet for U.S. agriculture at the end of 2008 (according to USDA) was the strongest it has ever been, with a debt to asset ratio of less than 10 percent. USDA projects that, at year end 2009, farm and ranch net worth will be \$2.171 trillion. This unprecedented high net worth is due in part to a robust increase in farm asset values (mainly farm real estate)—values which have not suffered the dramatic fluctuation as in some sectors during this time of crisis—but the high net worth is equally due to solid earned net worth as farmers used their excess cash profits to retire debt.

However, while the past 10 years may be looked back upon by historians as an era of farm prosperity, not all sectors of the farm economy are doing well in 2009. Pressured by increases in the price of grain, the livestock sector is under considerable financial pressure. Dairy prices have dropped to below break-even levels for many producers, as demand has declined and dairy production continues to increase. The cattle feeding business has lost money for over 24 months. Poultry producers have been hurt by lower prices and by the collapse of the largest poultry integrator in the country in 2008. The hog industry, which was poised to recover from low prices in 2008, has been badly hurt by misguided fears of the H1N1 virus and the subsequent closure of some key export markets.

Fortunately, rural America was well positioned at the beginning of 2009 to face the trying times they have encountered as a result of the economic crisis and other world events. In this environment, we sometimes hear that banks are not lending money. This is simply not true. As the charts on the next page show, bank lending in rural America has risen steadily over the last half-dozen years, and even during the first year of the recession, bank lending in rural areas has increased. As noted above, maintaining an expanding volume of credit will be a considerable challenge this year as the economy continues to weaken.

While overall banks have continued to lend throughout this recession, that does not mean much to an individual borrower having difficulty obtaining financing. In many of these individual cases, however, upon further investigation, it appears that the primary reason for not receiving funding was either that the borrower's financial condition was vulnerable (perhaps weakened by local economic conditions), or the borrower expected to borrow money at prerecession terms when the risk of lending was considerably lower and funds available for lending were more accessible. Of course, every loan application is unique and must be evaluated that way. One thing that has clearly appened is that banks are looking carefully at the risk of a loan and reevaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators.

Against the backdrop of a very weak economy and in light of the troubles in the agricultural sector, it is only reasonable and prudent that all businesses—including banks and farms—exercise caution in taking on new financial obligations. In fact, farmers and ranchers have been very conscious of this financial cycle, and wisely used their excess cash profits to retire debt and to acquire new plant and equipment during the boom years. Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.



## II. New and expanded programs directed at community banks can help rural America cope with the current downturn.

The vast majority of community banks had absolutely nothing to do with the current crisis, yet as their communities have suffered, so have they. In spite of the strong agricultural economy which has helped to shield many parts of this Nation from the recession, the economic decline—and its global impact—will surely be felt over the course of the next several years. There has never been a more important time to put in place solutions that will help all community banks as they manage through this downturn.

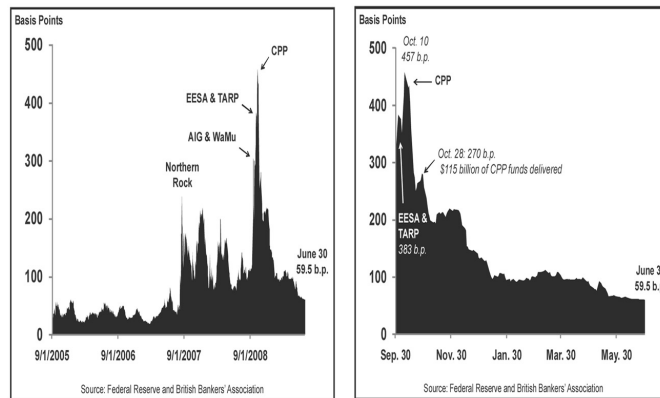
The many programs that have been initiated to calm the markets and provide capital for lending have helped to stabilize financial markets. As an example, the announcement of the Capital Purchase Program on October 14 caused risk spreads to decline from their pinnacle of 457 basis points on October 10 to 249 basis points on October 22, a drop of 45 percent. Clearly, the program to inject capital in healthy banks had a dramatic and immediate impact, and the trends begun then continue to narrow margins even further—back nearly to precrisis spreads. (See the charts on the following page.)

However, the focus of the CPP and other stimulus programs has been on the largest banks and was only slowly made available to smaller banks. The changing nature of this program and the restrictive selection process has meant that banks that could have benefited from the program were unable to do so. As a result, to maintain reasonable capital levels, these banks have been forced to limit, or even reduce, their lending.

As I emphasized at the outset, the amount of capital required to provide an additional cushion for all community banks is small. To reiterate, it takes only about \$500 million in new capital today to bring all banks under \$10 billion in assets above the well-capitalized levels for Tier 1 capital. Even under a baseline stress test to assess future needs, the additional capital needed is less than \$3 billion for all banks to be well-capitalized. Without new capital, banks under \$10 billion in assets would have to shed nearly \$9 billion in loans to achieve the same capital-to-assets ratio. Thus, a small injection of capital goes a long way to keeping credit flowing in rural communities.

### Capital Purchase Program Helped to Reduce Risk-Premium Spreads

*Spread between the 3-month LIBOR and the 3-month Treasury*



Given the continued weakness in this economy and the challenges we will face in the next 18 months, it is a critical time to focus on strategies for helping community banks. ABA recommends that new programs be developed—and existing programs be expanded—to help banks in rural America. Several key changes that are needed include:

- Broadening capital programs to enable participation by a broader cross section of banks.
- Revising the risk-based capital rules to more accurately reflect the risks presented by these investments.

- Avoiding appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards.

*Broaden capital programs to enable participation by a broader cross section of banks*

The Capital Purchase Program (CPP) has been implemented in a way that ignores community banks that are viable but that are experiencing significant—yet temporary—problems. The Capital Assistance Program has not yet been implemented for community banks, but reportedly will apply the same eligibility criteria that have been used with the CPP. The Legacy Loans Program has the potential to help, but the FDIC recently announced a delay in implementing the Legacy Loans Program that calls into serious question its viability outside the possible use in failed bank situations. The Legacy Securities Program is still struggling to get off the ground as well. Program after program either has failed to meet the needs of viable community banks or has languished.

ABA believes that this problem can be solved through several modifications:

1. Permit banks with up to \$1 billion in total assets to participate in the expanded CPP.
2. Publish the eligibility criteria for participating in the CPP and CAP.
3. Provide funding to viable banks that have significant—yet manageable—issues.
4. Revive the Legacy Loans Program and implement the Legacy Securities programs in a way that expands the universe of eligible assets to include trust preferred securities, “real estate owned,” and other real estate-related loans. The programs also should be implemented in a way that avoids effectively shutting small banks out (for example, minimum sizes on asset pools that no community bank could meet).

The comparatively small sums of money that would be invested in these struggling but viable banks would pay big returns for the communities they serve.

*Revise the risk-based capital rules to more accurately reflect the risks presented by banks' investments*

Congress should use its oversight powers to assure that the regulators have rules and regulations that accurately reflect the risks that banks face. For example, banks' investment in mortgage backed securities and collateralized debt obligations are being severely downgraded by ratings agencies, largely due to liquidity issues (not credit or repayment risk). When the investments are downgraded below investment grade, an inappropriately conservative capital charge applies that can cause a risk weighting to go from 100 percent to 1,250 percent, regardless of the performance of the security and regardless of the amount of subordinate positions that will absorb loss before a given bank's position. Mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) are securities whose performance depends on multiple obligors; the default by one borrower is not likely to impact the performance of other borrowers whose debt has been bundled in the security. Despite this—because ratings are based primarily on the probability of loss of the first dollar—any loss in an MBS or CDO adversely affects the rating of the security. This, in turn, can trigger higher capital requirements for banks, regardless of the likelihood that a holder of an interest in the security may be repaid at 100 cents on the dollar. Moreover, the current application of the Uniform Agreement on the Classification of Assets and Appraisal of Securities causes the entire face amount of a debt security with some degree of impairment to be classified, rather than requiring classification only of the portion of the security that reflects potential loss to the banking organization.

ABA believes that two changes will help this situation considerably:

1. Revise the risk-based capital rules to more accurately reflect the risks presented by these investments.
2. Classify only that portion of the security that represents the credit risk-related expected loss on the exposures underlying the security, adjusted for any credit enhancements and further adjusted for recoveries and expected loss severity.

An additional problem related to bank capital is that the risk weighting of debt issued by Fannie Mae and Freddie Mac is too high. Prior to those institutions being placed into conservatorship, the debt was risk-weighted at 20 percent. Given the stated intent of the United States government to support these GSEs, a lower risk weight is appropriate and would help offset to a small degree the adverse impact that the conservatorships had on those banks that invested in Fannie and Freddie stock. The risk weight of GSE debt should be reduced to below 20 percent. The



agencies proposed to lower the risk weight of Fannie and Freddie debt to 10 percent, but this rulemaking has been pending since October of last year.

A third issue related to capital concerns is the extent to which a bank's allowance for loan and lease losses (ALLL) is included in the bank's capital. The agencies' capital rules permit a bank's ALLL to count as Tier 2 capital, but only up to 1.25 percent of a bank's risk-weighted assets. This fails to adequately recognize the loss-absorbing abilities of the entire allowance and creates a disincentive to banks reserving more. Both the ALLL and "core" capital are available to absorb losses. The Comptroller of the Currency recently acknowledged this, stating, "loan loss reserves are a front line of defense for absorbing credit losses before capital must do so. . . . Given their primary, capital-like loss-absorbing function, loan loss reserves should get greater recognition in regulatory capital rules, a result that would help remove disincentives for banks to hold higher levels of reserves."<sup>2</sup>

These changes suggested in response to these three issues would result in a more accurate reflection of the health of institutions. ABA fully supports the system of risk-based regulation and supervision, but when the rules no longer reflect risk, the system breaks down. Our suggestions are intended to address instances where a bank's risk of loss is not fairly reflected in the rules. In the case of downgraded debt securities, the rules can, in extreme cases, threaten the viability of institutions that are directed to raise significant additional capital in a short period of time. It is bad policy to require a bank to raise capital to address the appearance of a shortfall but not the reality of one. When a rule requires more capital than the actual risk to the bank would suggest, the rule should be changed.

*Avoid appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards*

In my role as Chairman-Elect and as chairman of the ABA Community Bank Solutions Task Force, I have heard numerous stories from bankers about issues that are coming up in exams. Banks are being told to write down the value of assets based on the sales prices of assets being dumped on the market at distressed prices. Appraisals of property that are based on comparable sales are particularly problematic when the sales do not involve a willing buyer and a willing seller. Valuations by a banker acting reasonably and in good faith are likely to be more accurate than appraisals in those situations. ABA frequently hears that examiners either are not using FASB-compliant valuation methods or are using "personal formulas" to downgrade or reevaluate portfolio values, even when stated values are supported by timely appraisals. We also hear that examiners are applying new, unpublished, and seemingly arbitrary "rules of thumb" for how much a bank must put in its allowance for loan and lease losses (ALLL). For example, in some cases examiners require 25 percent of every substandard asset; 75 percent of nonperforming assets; *etc.*

ABA believes there are several steps that the regulators should be taking to remedy this situation and we urge this Subcommittee to use its oversight authority to encourage them:

1. Issue written guidance affirming that banks should not use distressed sales values when analyzing "comparables." Guidance should address proper appraisal documentation, particularly where foreclosures or auction sales comprise a majority of the comparable transactions. Moreover, this guidance should state that banks may rely, in appropriate situations, on bank management's judgment about the value of a property.
2. Allow institutions that have rented properties at market rates to exclude them from "nonperforming loans."
3. Apply clear and consistent standards to the maintenance of the ALLL that reflect a realistic assessment of the assets' likely performance.

These changes are necessary to confront the natural inclination of examiners to be conservative in order to avoid the inevitable second-guessing that would arise if a bank were to fail on their watch. We are not suggesting that examiners use forbearance or otherwise relax their examination standards; rather, we are suggesting that the examiners not be harder on banks than circumstances warrant. The regulators can make things worse in their efforts to make things better. Insisting upon punitive, procyclical steps at a time when a bank is working through issues can push an otherwise viable bank over the edge.

There are many more actions that could be taken to help banks throughout this period. ABA would be happy to discuss this further with the Committee.

<sup>2</sup>Remarks by John C. Dugan, Comptroller of the Currency, Before the Institute for International Bankers, March 2, 2009.

**III. Creating a systemic risk regulator, providing a mechanism for resolving troubled systemically important institutions, and filling gaps in the regulation of the shadow banking industry should be the focus of Congressional action.**

One of the most critical needs today is a regulator with explicit systemic risk responsibility. ABA strongly supports having such a regulator. There are many aspects to consider related to the authority of this regulator, including the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and the protections needed to maintain the integrity of the payments system.

ABA believes that systemic risk oversight should utilize existing regulatory structures to the maximum extent possible and involve a limited number of market participants, both bank and nonbank. Safety and soundness implications, financial risk, consumer protection, and other relevant issues need to be considered together by the regulator of each institution.

To be effective, the systemic risk regulator must have some authority over the development and implementation of accounting rules. No systemic risk regulator can do its job if it cannot have some input into accounting standards—standards that have the potential to undermine any action taken by a systemic regulator. Thus, a new system for the establishment of accounting rules—one that considers the real-world effects of accounting rules—needs to be created in recognition of the critical importance of accounting rules to systemic risk and economic activity.

Moreover, there must be a mechanism for the orderly resolution of systemically important nonbank firms. Our regulatory bodies should never again be in the position of making up a solution on the fly to a Bear Stearns or AIG, or not being able to solve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated the crisis.

A critical issue in this regard is “too-big-to-fail.” Whatever is done on the systemic regulator and on a resolution system will set the parameters of “too-big-to-fail.” In an ideal world, no institution would be “too-big-to-fail,” and that is ABA’s goal; but we all know how difficult that is to accomplish, particularly with the events of the last few months. This “too-big-to-fail” concept has profound moral hazard implications and competitive effects that are very important to address. We note Chairman Bernanke’s statement: “Improved resolution procedures . . . would help reduce the “too-big-to-fail” problem by narrowing the range of circumstances that might be expected to prompt government action. . . .”<sup>3</sup>

Finally, a major cause of our current problems is the regulatory gaps that allowed some entities to completely escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

As these gaps are being addressed, Congress should be careful not to impose new, unnecessary regulations on the traditional banking sector, which was not the source of the crisis and continues to provide credit. Thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to nonbanks while they will be rigorously applied—down to the last comma—to banks.

**Conclusion**

I want to thank you, Mr. Chairman, for the opportunity to present the views of the ABA on the challenges ahead for rural communities and the banks that serve them. These are difficult times and the challenges are significant. In the face of a severe recession, however, bankers are working hard every day to assure that the credit needs of our communities are met. As you contemplate major changes in regulation—and change is needed—ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again? Addressing these issues will provide the most constructive avenue to assure that rural communities throughout this Nation will continue to have access to credit by local financial institutions. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our Nation’s banks.

<sup>3</sup>Ben Bernanke, speech to the Council on Foreign Relations, Washington, DC, March 10, 2009.

**PREPARED STATEMENT OF ED TEMPLETON**

PRESIDENT AND CHIEF EXECUTIVE OFFICER,  
 SRP FEDERAL CREDIT UNION, NORTH AUGUSTA, SOUTH CAROLINA,  
 ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

JULY 8, 2009

**Introduction**

Good afternoon, Chairman Johnson, Ranking Member Crapo, and Members of the Subcommittee. My name is Ed Templeton and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President and CEO of SRP Federal Credit Union, headquartered in North Augusta, South Carolina. I have been President and CEO of SRP FCU for the last 22 years. SRP FCU is a community credit union serving over 92,000 members in several counties in South Carolina along the Georgia border. Our membership includes Allendale and Barnwell counties which are some of the most rural in South Carolina. They are also some of the poorest, with over 20 percent of the population in Barnwell and over 35 percent of the population in Allendale living below the poverty level. SRP FCU has a strong presence in these counties, with over 20 percent of the adult population in Allendale and over 50 percent of the adult population in Barnwell being members of SRP FCU.

I currently serve as the Secretary of NAFCU's Board of Directors. I formerly served on the NAFCU Education Committee and was President of the Columbia Chapter of Credit Unions. I received my BBA from Augusta College, graduated from the Georgia School of Banking and the BAI School of Bank Administration at the University of Wisconsin.

NAFCU is the only national organization exclusively representing the interests of the Nation's federally chartered credit unions. NAFCU-member credit unions collectively account for approximately 63.9 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding how the current economic crisis has impacted America's credit unions serving those in rural communities.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the Federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche that credit unions fill today for nearly 90 million Americans. Every credit union is a cooperative institution organized “for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes.” (12 USC 1752(1)). While over 75 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The Nation's approximately 7,800 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—“one member, one vote”—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions, to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, Federal credit union directors generally serve without remuneration—a fact epitomizing the true “volunteer spirit” permeating the credit union community.

Credit unions have grown steadily in membership and assets, but in relative terms, they make up a small portion of the financial services marketplace. Federally insured credit unions have approximately \$856.4 billion in assets as of March 2009. By contrast, Federal Deposit Insurance Corporation (FDIC) insured institutions have \$13.6 trillion in assets. The average size of a Federal credit union is \$97.6 million compared to \$1.647 billion for banks. Almost 3,200 credit unions have less than

\$10 million in assets. The credit union share of total household financial assets is also relatively small, at only 1.5 percent as of March 2009.

Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and the community. While credit unions may have grown, their relative size is still small compared with banks. Even the world's largest credit union, with \$38.7 billion in assets, is dwarfed by the Nation's biggest banks who hold trillions of dollars in assets.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the Credit Union Membership Access Act (CUMAA—P.L. 105-219) a decade ago. In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means . . . [and it] continue[s] to fulfill this public purpose."

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided but also—more importantly—to quality and cost. Credit unions are second to none in providing their members with quality personal financial service at the lowest possible cost.

While the lending practices of many other financial institutions led to the Nation's subprime mortgage debacle, data collected under the Home Mortgage Disclosure Act (HMDA) illustrates the value of credit unions to their communities. The difference between credit unions and banks is highlighted when one examines the 2007 HMDA data for loans to minority applicants with household incomes under \$40,000. According to the 2007 HMDA data, banks have a significantly higher percentage of mortgage purchase loans (20.8 percent), charging at least 3 percent higher than the comparable Treasury yield for minority applicants with household income under \$40,000. Credit unions, on the other hand, had only 4.4 percent of their loans in that category.

#### **Credit Unions in the Current Economic Environment**

While credit unions have fared better than most financial institutions in these turbulent economic times, many have been impacted, through no fault of their own, by the current economic environment. Many credit unions, including smaller ones, have seen an increase in delinquencies and charge-offs in recent quarters. Some of this impact has been regional, depending on local economic conditions.

In particular, the corporate credit union system has felt the biggest impact, and the National Credit Union Administration (NCUA) placed the two largest corporate credit unions, U.S. Central Federal Credit Union and Western Corporate Federal Credit Union, into receivership earlier this year. The passage and enactment of S. 896, The Helping Families Save Their Homes Act of 2009, and the temporary corporate credit union stabilization fund that it created provided important relief to natural-person credit unions in these challenging times. We thank you for work on this matter.

It is also widely recognized by leaders on Capitol Hill and in the Administration that credit unions were not cause of the current economic downturn, but we believe we can be an important part of the solution. As credit unions have fared well in the current environment, there are many that have capital available. Surveys of NAFCU member credit unions have shown that many are seeing increased demand for mortgage loans and auto loans as other lenders leave the market. A number of credit unions are also seeing local small businesses, who have lost lines of credit from other lenders, turn to them for the capital they need.

Credit unions are helping meet those needs in rural areas. Despite the economic downturn, an analysis of NCUA Form 5300 Call Report data shows that credit unions have seen a growth in the percentage of total amount of credit union farm loans to members for the last nine consecutive quarters during the current recession. Additionally, on examination of 2007 HMDA data (the last year that is available) shows that credit union mortgage loans to American Indians grew at an annual rate of 9.23 percent over the previous year and that credit unions had a higher percentage of approved loans to American Indians (75.31 percent) than other types of financial institutions.

The NCUA has been working to assist small credit unions as well. In April, the NCUA Board finalized actions to centralize NCUA's chartering within the Headquarters' Office of Small Credit Union Initiatives (OSCU), thereby creating a national chartering program to reduce regulatory burden on credit union charter applicants. The revisions delegate OSCUI authority to approve and reject new charters,

and require OSCUI's concurrence to revoke new charters. This new process should assist individuals in understanding the process of chartering a new institution and help keep new growth in the credit union industry.

Additionally, many smaller credit unions rely on other credit unions for support and to provide effective service to their respective memberships. Throughout the country small credit union roundtables have emerged for credit unions to discuss operational concerns with like institutions. Larger credit unions also serve as partners for smaller institutions, and perform functions ranging from shared branching to back office operations.

We at SRP FCU are actually expanding at this time in some of the most rural areas of our field of membership, and we are about to break ground on a new credit union branch in Allendale County.

### **Current Challenges**

Credit unions are the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital, among a host of other limitations. There are other statutory limitations on credit unions that hamper their ability to serve their members, including those in rural areas. These include:

*Credit Union Member Business Lending Cap.* The Credit Union Membership Access Act (CUMAA) established an arbitrary cap on credit union member business lending of 12.25 percent of assets in 1998. CUMAA also directed the Treasury Department to study the need for such a cap. In 2001, the Treasury Department released its study entitled "Credit Union Member Business Lending" in which it concluded that "credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions." That same study also found that over 50 percent of credit union loans were made to businesses with assets under \$100,000, and 45 percent of credit union business loans go to individuals with household incomes of less than \$50,000. The current economic crisis has demonstrated the need to have capital available to help our Nation's small businesses, especially in troubling times. Many credit unions have the capital that other lenders do not in this environment, but are hamstrung by such an arbitrary limitation. We are pleased that Senator Schumer has indicated that he plans to introduce legislation to remove this arbitrary cap, and we urge the Subcommittee to support and advance those efforts.

*Underserved Areas.* As the Subcommittee is aware, many rural areas are also underserved. Credit unions play an important role in helping those on whom other financial institutions have turned their backs and left behind. The 1998 Credit Union Membership Access Act (CUMAA) gave the NCUA the authority to allow Federal credit unions to add underserved areas to their field of membership; however, the language was unclear as to what types of charters were permitted to add underserved areas. For an area to be "underserved," CUMAA requires the NCUA Board to determine that a local community, neighborhood or rural district is an "investment area" as defined in the Community Development Banking and Financial Institutions Act of 1994, and also that it is "underserved by other depository institutions." 2 U.S.C. 1759(c)(2)(A).

NAFCU supports making a necessary clarification to the CUMAA that credit unions are able to add underserved areas to their fields of membership, regardless of charter type. In 2005, the American Bankers Association brought litigation against NCUA, arguing that under the plain language of CUMAA (*American Bankers Association, et al., v. NCUA*, No. 2:05-cv-000904 (D. Utah, filed Nov. 1, 2006)), only multiple-common-bond credit unions could add underserved areas to their fields of membership. Up to that point, NCUA had permitted all types of credit unions to add underserved areas to their field of membership. Even though there was legislative history supporting the NCUA interpretation, the case settled out of court, and as a result, NCUA modified its rules to prohibit community and single-sponsor Federal credit unions from adding underserved areas to their field of membership. NAFCU and the credit union community believe that addressing this issue through legislation would clear up the ambiguity surrounding the ability of Federal credit unions to add underserved areas to their fields of membership.

NCUA's current rules do not address how a rural district should be defined for the purposes of adding underserved areas. Recognizing that there was a need to streamline the process for credit unions in rural areas to add underserved areas to their fields of membership, NCUA proposed an amendment to their Chartering and Field of Membership Manual in 2008. NAFCU provided feedback from many of our rural members during the notice and comment period, and we look forward to Congress clarifying this issue and seeing NCUA continue its work to provide streamlined guidelines.

### **Regulatory Reform**

While credit unions have generally performed well in the current economic crisis, we remain concerned that well-intentioned efforts at regulatory reform could ultimately have a negative impact on credit unions and their members. As not-for-profit member-owned cooperatives, credit unions are unique institutions in the financial services arena. We believe that the NCUA should remain an independent regulator of credit unions and are pleased to see that the Administration's proposal would maintain the Federal credit union charter and an independent National Credit Union Administration (NCUA).

NAFCU does support the creation of a Consumer Financial Protection Agency (CFPA), which would have authority over nonregulated institutions that operate in the financial services marketplace. However, we do not believe such an agency should have authority over regulated federally insured depository institutions, and do not support extending that authority to federally insured credit unions. Giving the CFPA such authority to regulate, examine and supervise credit unions that already are regulated by the NCUA would add an additional regulatory burden and cost. Additionally, it could lead to situations in which institutions regulated by one agency for safety and soundness find their guidance in conflict with their regulator for consumer issues. Such a conflict and burden will surely increase compliance costs to credit unions, leading to diminished services to their members. Credit unions already fund the budget for NCUA. Under the Administration's proposal for the CFPA, it also appears that the agency would be funded by the industry, meaning an additional cost burden to credit unions and their 90 million members.

Recognizing that more should be done to help consumers, we would propose that, rather than extending the CFPA to federally insured depository institutions, each functional regulator of federally insured depository institutions strengthen or establish a new office on consumer affairs. Such an office should report directly to the Presidential appointees at the regulator and be responsible for ensuring that the regulator is looking out for consumer concerns in writing rules, supervising and examining institutional compliance, and administratively enforcing violations. Consumer protection offices at the functional regulators will ensure that those regulating consumer issues at financial institutions have knowledge of the institutions they are examining and can provide expertise and guidance on consumer protection. This is particularly important to credit unions, as they are regulated and structured differently than others in financial services. We believe that it is imperative that any regulator examining credit unions should understand their unique nature. This approach would strengthen consumer protection while not adding unnecessary regulatory burdens on our Nation's financial institutions. We are pleased to see that NCUA Board Chairman Michael Fryzel recently announced the creation of such an office at NCUA.

Finally, some have advocated expanding the Community Reinvestment Act (CRA) as part of the regulatory reform effort. NAFCU opposes extending CRA to Federal credit unions. Federal credit unions are already examples of CRA in action. Furthermore, analysis of 2007 HMDA data shows that despite banks and thrifts being subject to CRA requirements, credit unions regularly outperform them in terms of lending to low-income and minority populations. Adding a CRA requirement to Federal credit unions would be a solution in search of a problem.

### **Conclusion**

In conclusion, the current economic crisis is having an impact on credit unions in rural areas, but many are continuing to serve their members well. The enactment of legislation earlier this year, such as S. 896 and the temporary corporate credit union stabilization fund it created, are providing relief, but additional statutory challenges remain. We urge the Subcommittee to support efforts to remove the credit union member business lending cap and to clarify that ability of credit unions of all charter types to add underserved areas. Finally, while there are positive aspects to consumer protection in regulatory reform, we believe that Federal credit unions continue to warrant an independent regulator that handles both safety and soundness and consumer protection matters.

I thank you for the opportunity to appear before you today on behalf of NAFCU and would welcome any questions that you may have.

**PREPARED STATEMENT OF PETER SKILLERN**  
 EXECUTIVE DIRECTOR,  
 COMMUNITY REINVESTMENT ASSOCIATION OF NORTH CAROLINA  
 JULY 8, 2009

Thank you, Senator Johnson, for the opportunity to testify today on lenders, consumers, and the economy in rural areas. I am Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina, a nonprofit community advocacy and development agency.<sup>1</sup>

North Carolina has strong rural and banking sectors. Eighty-five of our one hundred counties are rural and 50 percent of the population lives there.<sup>2</sup> North Carolina has 106 credit unions and 106 banks ranging from the largest bank in the country, Bank of America at \$2.4 trillion in assets, to Mount Gilead Savings and Loan at \$9.8 million.<sup>3</sup>

The current economic stresses for our rural communities and small financial institutions are significant. They are best understood in the context of two long-term trends: (1) a decline in the rural economy, and (2) the consolidation of the financial sector. Our policy recommendations are (1) to reform the broader regulatory financial system for stability, and (2) to invest in rural communities for recovery and growth.

**Rural Economies Are in Long-Term Decline**

The economic crisis facing the Nation impacts North Carolina hard, with the fifth highest unemployment rate in the country at 11.4 percent.<sup>4</sup> It hurts our rural counties harder with 19 counties—such as Scotland, McDowell, and Edgecombe—experiencing unemployment from 14 percent–17 percent.<sup>5</sup> These unemployment rates are years in the making.

Rural North Carolina did not recover from the 2001 recession. Between 2002 and 2005 the manufacturing sectors of textile, apparel and furniture lost more than 88,000 jobs. In the past year more than 22,000 factory jobs were lost, particularly in the factories producing parts for the auto industry.<sup>6</sup> North Carolina still produces more tobacco than any other State, but changes for tobacco and the agricultural sector are dramatically reducing the number of small family farmers.<sup>7</sup> While rural counties in the scenic mountains and coast and the exurbs of our cities have enjoyed net in-migration, 40 rural counties lost population in the past decade. The North Carolina rural population is more likely to be older, poorer and have lower educational attainment. Median rural household incomes are 25 percent lower than in urban areas and poverty rates are 36 percent higher.<sup>8</sup> Due to low wages, rural residents face a housing affordability gap even though home prices on average are lower. As a result, 24 percent of the housing stock in rural areas is manufactured homes compared to 8 percent in urban areas.<sup>9</sup> New home construction often consists of second homes for retirees in the Blue Ridge Mountains and Outer Banks. The foreclosure rate for rural areas has jumped correspondingly with the credit crisis and the increase in unemployment. This recession intensifies a long-term restructuring of the economy in rural communities.

**Small Financial Institutions Are Declining as the Financial Sector Consolidates**

During the economic crisis a number of small banks across the Nation have failed—two in North Carolina in 2009—but far more have been lost through consolidation over time. Nationally, the number of banks with under \$100 million in assets dropped by 5,410 from 1992 to 2008.<sup>10</sup> In North Carolina, rural counties hold 50 percent of the population and 50 percent of bank branches. Yet rural bank branches

<sup>1</sup> For a fuller description, please visit [www.cra-nc.org](http://www.cra-nc.org).

<sup>2</sup> North Carolina Rural Center Data Center, <http://www.ncruralcenter.org/databank/>.

<sup>3</sup> FDIC Institutional Data <http://www2.fdic.gov/idasp/main.asp>.

<sup>4</sup> United States Department of Labor, <http://www.bls.gov/web/laumstrk.htm>.

<sup>5</sup> Bureau of Labor Statistics, <http://data.bls.gov/PDQ/outside.jsp?survey=la>.

<sup>6</sup> North Carolina Rural Center, <http://www.ncruralcenter.org/databank/trendpage—Employment.asp>.

<sup>7</sup> North Carolina Rural Center, <http://www.ncruralcenter.org/databank/trendpage—Agriculture.asp>.

<sup>8</sup> North Carolina Rural Center, <http://www.ncruralcenter.org/databank/trendpage—Income.asp>.

<sup>9</sup> U.S. Census 2000, Units in Structure, Summary File 3, Table H30.

<sup>10</sup> It Takes More Than a Village: The Decline of the Community Bank, Celent, <http://reports.celent.com/PressReleases/200901293/VillageBank.asp>.

hold only 15.7 percent of deposit assets (down from 27 percent in 1996.)<sup>11</sup> Nationally, approximately 4,000 small banks made 100 or fewer mortgages in 2007.<sup>12</sup> In all, these smaller lenders account for 1.8 percent of all national mortgage activity. North Carolina CDFI credit unions are facing declining deposits, higher delinquencies and adverse regulatory pressure to curtail lending. The result could be closures. Small banks are at a competitive disadvantage in terms of pricing, products and geographical service area. Small banks in rural communities are facing a long-term restructuring in the economy and a correspondingly declining share of deposit assets and lending activities.

By contrast, the consolidation of assets and market share of megabanks has increased. In 1995, the top 5 banks had 11 percent deposit share; today, they have nearly 40 percent.<sup>13</sup> In the first quarter, 56 percent of mortgage activity was conducted by four lenders.<sup>14</sup> The consolidation of Country Wide and Merrill Lynch into Bank of America, Washington Mutual into JPMorgan Chase, and Wachovia Bank into Wells Fargo has further consolidated the financial services sector, making institutions that are “too-big-to-fail” even bigger. Ironically, these institutions contributed in part to the credit crisis through unethical, irresponsible business and lending practices.

The collapse of North Carolina’s homegrown Wachovia Bank through exotic mortgage lending and the troubles of Bank of America in Wall Street deals contrast sharply with the stability small banks have provided. As a rule, small banks and credit unions avoided subprime credit and managed their resources well. These local institutions provide stability and diversification in the financial sector. They offer leadership to local civic engagements and credit to small businesses for job creation, mortgages for homeownership, small farm loans for agriculture, affordable deposit and checking services to consumers. The attached map compares bank branch coverage by the seven largest banks compared to all bank branches.<sup>15</sup> Without smaller institutions, many areas would go unserved. By definition these financial institutions are small, but are fundamental economic building blocks to our rural economy. Banking policy and regulatory oversight should support small banks and credit unions as essential to the local ecology of credit and commerce.

#### **Financial Reform Will Help Consumers, Lenders, and Rural Communities**

Consumers in rural and urban areas face similar lending abuses. Rural areas had a higher percentage of subprime high-cost loans than urban areas (17.4 percent compared to 15.5 percent in 2004), although the actual volume is significantly lower.<sup>16</sup> Rural areas have a high rate of Refund Anticipation Loans, which correspond to higher levels of poverty and uptake of the Federal Earned Income Tax Credit. Payday lenders are prevalent in the rural areas of the 35 States that allow this usurious lending. Consumers need better protections from unsound and unscrupulous lending practices.

Harmed by the lack of financial regulatory oversight of other lending institutions, small banks and rural communities will benefit from the needed financial regulatory reform of our system as a whole. Attached to my written testimony are full descriptions of five principles for reform: responsibility, accountability, transparency, equal access and avoidance of conflict of interest. Also included is a discussion of how these six principles apply both to lenders and to the regulatory system.<sup>17</sup> Based on the principles, the Community Reinvestment Association of North Carolina in particular is supportive of the CRA Modernization Act HB 1492 and President Obama’s recommendation for the Financial Product Safety Commission as part of broader reform initiatives. Faced with a rising tide of foreclosures and insufficient loan modification programs, we ask the United States Senate to pass judicial loan modification to manage foreclosure losses for lenders, borrowers, and taxpayers.

Although the problems created by the financial crisis and recession are felt by every community and the solutions needed are national in scope, it would be a mistake to assume that urban and rural communities will shake off the recession with equal speed. The data in my testimony indicates that long-term challenges for small

<sup>11</sup> FDIC Institutional Data <http://www2.fdic.gov/idasp/main.asp>.

<sup>12</sup> FFIEC, HMDA Analysis by CRA-NC.

<sup>13</sup> It Takes More Than a Village: The Decline of the Community Bank, Celent, <http://reports.celent.com/PressReleases/200901293/VillageBank.asp>.

<sup>14</sup> Mortgage Daily, <http://www.mortgagedaily.com/PressRelease051109.asp>.

<sup>15</sup> Finpro, USA Branches, Bank Branch Ownership 03/16/2009 [www.finpronj.com](http://www.finpronj.com).

<sup>16</sup> Carsey Institute, Policy Brief Number 4, Fall 2006. <http://www.carseyinstitute.unh.edu/publications/PB-predatorylending.pdf>.

<sup>17</sup> Developed by the Woodstock Institute, California Reinvestment Coalition, Neighborhood Economic Development Advocacy Project, Community Reinvestment Association of North Carolina.



banks and rural communities are systemic as well as cyclical. North Carolina's economic recovery of the 2001 recession through technology, commerce, and finance masked the lack of recovery in the rural areas. Unless we invest in rebuilding these communities, no banks of any size will thrive.

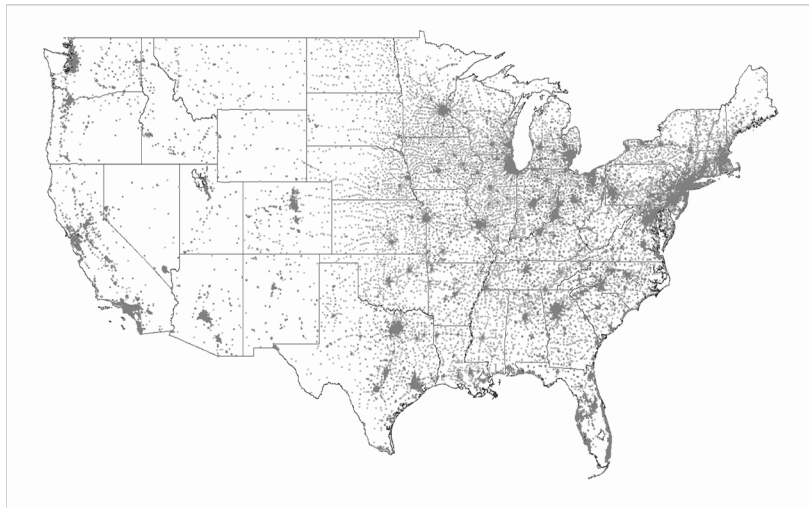
#### **Invest in Rural Communities**

My concluding recommendation to Congress is to expand the Neighborhood Stabilization Program (NSP) both in scale of funding and in scope to include rural areas. NSP funds are to help deal with the consequences of the foreclosure crisis in revitalizing abandoned and foreclosed properties and rebuilding distressed communities. Six billion dollars was committed to NSP for communities. By comparison, \$700 billion was authorized for TARP funding for banks. Please increase the amount of funding for NSP.

NSP rules favor urban areas and exclude rural needs. Nationally 70 percent of foreclosures are in urban areas and 30 percent in rural. In North Carolina no rural area met the NSP needs test due to a lack of concentration. Yet in the aggregate, there are more foreclosures in rural counties than urban counties. This pattern is found in 23 other States such as Georgia, Indiana, New Hampshire, New Mexico.<sup>18</sup> Increased funding and rural inclusion will allow banks to move REOs off their balance sheets in partnership with nonprofits and local governments to rehabilitate the housing stock and rebuild their communities. The future for rural communities and banks is brighter if we recognize and act on the need for financial regulatory reform and investment in our communities through initiatives such as the Neighborhood Stabilization Program.

Thank you very much for your attention.

Branch locations of Top 7 banks (red) overlaid on all banks others (green) as of March 16, 2009



Source: Finpro [www.finpro.com](http://www.finpro.com)

<sup>18</sup>CRA-NC analysis of Table 1: Foreclosure Needs Scores within States by CDBG Jurisdiction—October 28, 2008, Source: Analysis by the Local Initiative Support Corporation provided by the Foreclosure Response project.

**Principles for Financial and Regulatory Reform**

1. *Responsibility*: Financial Institutions must offer financial products and services that are appropriate and suitable to the needs and abilities of the consumers. Regulators must regulate financial institutions so as to ensure that they are providing access to responsible and fair credit and loans.

2. *Accountability*: Financial institutions must refrain from, and be held accountable for, offering harmful financial products and services and engaging in practices that harm individuals and communities. Regulators must be held to high standards for their regulation and oversight of financial institutions and accurately report to the public on a regular basis. Laws and regulations must provide strong enforcement mechanisms to ensure accountability and provide meaningful redress to those harmed by irresponsible actions of financial institutions. Regulators must vigorously enforce these laws and rules. Federal regulations must establish a minimum floor for consumer protections that may be exceeded by States and localities.

3. *Transparency*: Financial institutions must fully, fairly, and clearly disclose all costs, terms and risks of financial products and services and avoid or disclose any conflicts of interests with other financial institutions, actors, or regulators. Regulators must demand transparency from regulated institutions and be transparent about their role in regulating financial institutions.

4. *Avoid conflicts of interest*: Financial institutions must avoid all conflicts of interest with other financial players and regulators. Where potential conflicts are allowed, financial institutions must fully, fairly and clearly disclose the conflict to consumers and regulators. Regulators must be objective in their regulation and oversight of financial institutions, act in the public interest (not the interest of the financial institutions they regulate), and prohibit financial institutions from engaging in conflicts of interest. Regulatory policies and financial practices that create an inherent conflict of interest that could harm consumers or the economy must be prohibited or, at a minimum, closely regulated.

5. *Avoid systemic risk*: Financial institutions must not engage in practices that create unreasonable risk to the financial system. Regulators must provide comprehensive and effective regulation and oversight of financial institutions and activities that create systemic risk to individuals, communities and the economy. Policy-makers and regulators must implement changes in their oversight policies based on the reality that financial institutions that are “too-big-to-fail” are too big to exist.

6. *Equal access*: Financial institutions must offer appropriate and suitable financial products and services to all persons and communities without regard to race, color, national origin, religion, gender, familial status, disability, or sexual orientation. Regulators must monitor whether all persons and communities have equal access to mainstream financial products and services and hold financial institutions accountable by vigorously enforcing nondiscrimination laws and rules.

**RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON  
FROM JACK HOPKINS**

**Q.1.** Mr. Hopkins and Mr. Johnson, both of your institutions are members of the Federal Home Loan Bank system. How do you use the Federal Home Loan Bank to support your bank's lending in your market? Has the current economic crisis and the liquidity crisis affected your use of the Federal Home Loan Banks? Last year, HERA expanded the number of community banks that can use collateral to borrow from the FHLBanks. Has your institution's ability to pledge this collateral been helpful?

**A.1.** Answer not received by time of publication.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL  
FROM JACK HOPKINS**

**Q.1.** Many of my constituents in Wisconsin are expressing frustration in getting a loan from their bank. The complaints have the same theme: they have been banking with the institution for a long time, and they have good credit and financial standing. Yet they still cannot refinance their loan or get a new line of credit. Can you please explain to the committee how the ICBA is working with their member banks to remedy this problem?

Every weekend the FDIC is closing the doors of banks across the country at a record pace. I am concerned about the failure of small rural banks in areas where there is not another bank. The customers in the area might be left unbanked if a larger institution buys the deposits without opening a branch in the community. What are the options for these customers, and how are your members working to keep rural customers connected to the banking system?

**A.1.** Answer not received by time of publication.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM JACK HOPKINS**

**Q.1.** Some have suggested that the Federal Reserve Board's unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers. The problem is that this authority has not been used in a material fashion prior to the credit card rule. Rather than bifurcating consumer protection from safety and soundness, should Congress consider ways to improve the UDAP authority? If so, what options do you recommend?

**A.1.** Answer not received by time of publication.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL  
FROM FRANK MICHAEL**

**Q.1.** I have heard from many small businesses struggling to find lines of credit and keep their doors open. How has the member business lending cap affected the ability of credit unions to make small business loans to their members? Does your organization have any data showing that more small businesses would be served if the member business lending cap was increased by loan size and volume? In the current credit crisis, do you believe that credit

unions are able to provide more loans to small businesses and should the cap be raised?

**A.1.** The member business lending cap has affected the ability of credit unions to make small business loans to their members in two ways. First, many of the roughly one quarter of credit unions that offer business loans are getting sufficiently close to the cap for it to affect their behavior. Long before a credit union actually reaches the arbitrary 12.25 percent cap it must begin to moderate its business lending in order to stay below the cap. Considering the vast majority of credit unions that were not originally grandfathered from the cap, fully 38 percent of credit union business loans outstanding are in credit unions with more than 10 percent of assets in business loans. That means that almost 40 percent of the market is essentially frozen. Another 21 percent of the business loans outstanding in credit unions that are not grandfathered is in credit unions with business loans between 7.5 percent and 10 percent of assets. These credit unions are approaching the territory at which they will need to moderate business lending growth. A total of almost 60 percent of nongrandfathered credit union business loans is in credit unions at or near the cap.

Second, the cap not only restricts the credit unions that are engaging in business lending and approaching their limit, but also discourages credit unions who would like to enter the business lending market. The cap effectively limits entry into the business lending arena on the part of small- and medium-sized credit unions—the vast majority of all credit unions—because the startup costs and requirements, including the need to hire and retain staff with business lending experience, exceed the ability of many credit unions with small portfolios to cover these costs. Today, only one in four credit unions have MBL programs and aggregate credit union member business loans represent only a fraction of the commercial loan market. Eliminating or expanding the limit on credit union member business lending would allow more credit unions to generate the level of income needed to support compliance with NCUA's regulatory requirements and would expand business lending access to many credit union members, thus helping local communities and the economy.

CUNA has produced an estimate of how much additional business lending could be provided by credit unions if the cap were raised to 25 percent of assets. We assume that all current business lending credit unions will hold business loans in the same proportion to the new cap that they currently do to the existing cap, and that they will use one half of the new authority in the first year. Further, we assume that on average credit unions that currently make no business loans will as a group add business loans equal to 1 percent of their assets. Applying these assumptions to second quarter NCUA Call Report data indicates an additional \$12.5 billion in business loans for America's small businesses. Based on this analysis, we conservatively project that credit unions could provide up to an additional \$10 billion of business loans in the first year after the raising of the cap.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM FRANK MICHAEL**

**Q.1.** Some have suggested that the Federal Reserve Board's unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers. The problem is that this authority has not been used in a material fashion prior to the credit card rule. Rather than bifurcating consumer protection from safety and soundness, should Congress consider ways to improve the UDAP authority? If so, what options do you recommend?

**A.1.** While credit unions want to minimize their regulatory burdens, they are also very concerned that consumers are not adequately protected in the financial marketplace. As the question indicates, authority to regulate unfair and deceptive practices is quite broad, but some contend that the consistent failure to use that authority in the past is a major impetus now for the proposed Consumer Financial Protection Agency.

Regarding the separation of the regulation of consumer protection from safety and soundness supervision, CUNA recognizes that there are legitimate concerns. These include financial intuitions being subjected to dual examinations for safety and soundness and for compliance with consumer protection laws. However, we believe those concerns can be addressed by allowing prudential credit union regulators to enforce and examine credit unions for compliance with consumer protection laws, as well as for safety and soundness. The new agency would have rulemaking authority over consumer protection issues. We also believe there should be meaningful coordination among the financial regulatory agencies and the CFPB.

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**RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON  
FROM ARTHUR C. JOHNSON**

**Q.1.** Mr. Hopkins and Mr. Johnson, both of your institutions are members of the Federal Home Loan Bank system. How do you use the Federal Home Loan Bank to support your bank's lending in your market? Has the current economic crisis and the liquidity crisis affected your use of the Federal Home Loan Banks? Last year, HERA expanded the number of community banks that can use collateral to borrow from the FHLBanks. Has your institution's ability to pledge this collateral been helpful?

**A.1.** The FHLBanks have delivered innovation and service to the U.S. housing market for 76 years, and currently have more than 8,100 members in all 50 States and the District of Columbia, American Samoa, Guam, Puerto Rico, and the Northern Mariana and U.S. Virgin Islands. The Federal Home Loan Bank System (FHLBanks) remains viable and strong, despite losses at a number of the Home Loan Banks similar to those incurred by most of the financial services industry due to the economic downturn.

Indeed, without the ability by banks and other lenders to borrow from the Federal Home Loan Banks, the credit crisis of the last year would have been significantly worse. From the outset of the credit crisis, the Federal Home Loan Banks have engaged to ensure liquidity to the financial system. Advances to FHLB Member Banks increased from \$640,681 billion at year end 2006 to \$928,638

billion at year end 2008. This increase of nearly \$300 billion in liquidity went, in large part, to community bank members of the Federal Home Loan Banks. Many small banks rely on the System for term advances to meet day to day liquidity demands. Because the System is a cooperative, members have a vested interest in the prudent lending and operations of the Banks. The result is a liquidity source which is transparent and self monitored. Additionally, the recent GSE reform legislation which combined the regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks has led to a more sophisticated, detailed and experienced regulatory regime for the System and its members.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL  
FROM ARTHUR C. JOHNSON**

**Q.1.** Every weekend the FDIC is closing the doors of banks across the country at a record pace. I am concerned about the failure of small rural banks in areas where there is not another bank. The customers in the area might be left unbanked if a larger institution buys the deposits without opening a branch in the community. What are the options for these customers, and how are your members working to keep rural customers connected to the banking system?

**A.1.** I share your concerns about the consequences of bank failures, regardless of location, but particularly in rural areas. Typically, the failures involve a healthy bank acquiring the deposits and many of the assets of the failed bank. In those situations, the healthy bank is looking to maintain a relationship with the customers—in fact, this is what is attractive to the acquiring bank and the basis for the premium paid to the FDIC for the right to acquire the bank. This financial incentive helps ensure that customers of the failed bank have a stable relationship with the new bank. Moreover, it is typically the case that when branches are closed following an acquisition it is because there is another branch of the acquiring bank nearby that will serve those customers.

In situations where there are fewer branches available to serve customers, advances in technology have significantly helped make this transition smooth. Remote deposit capture, for example, is something that more and more banks are offering to their small business and farm customers. This option has proven especially popular in rural America. Small business customers are able to immediately deposit checks in their accounts from their places of business. As improvements in the technology have driven down costs, banks are able to offer it to smaller and smaller businesses and farms. Of course, there is also the availability of Internet banking which has been widely adopted by rural banks. Finally, electronic filing of financial statements by small businesses and farms is another way that banks can perform financial analysis for loan making purposes over great distances.

ABA works closely with many State and Federal agencies to ensure that credit is available in rural areas, including the United States Department of Agriculture, the Small Business Administration, the Bureau of Indian Affairs, government sponsored enterprises, and all State-sponsored agricultural and rural credit mak-

ing agencies to encourage outreach to our members and their customers.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM ARTHUR C. JOHNSON**

**Q.1.** Some have suggested that the Federal Reserve Board's unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers. The problem is that this authority has not been used in a material fashion prior to the credit card rule. Rather than bifurcating consumer protection from safety and soundness, should Congress consider ways to improve the UDAP authority? If so, what options do you recommend?

**A.1.** Yes, we believe that there are other, more direct ways to improve the consumer protection for financial customers rather than by splitting consumer protection from safety and soundness and creating separate agencies. We support enhancing the consumer protection mission of the current banking agencies, and providing UDAP rulemaking authority which would be jointly exercised. Better enforcement of existing consumer protection laws in the nonbank sector and greater accountability for consumer protection in the mission of all functional regulators is the most effective path to a level playing field and should be pursued before any consideration of new powers is undertaken as part of regulatory restructuring.

If UDAP rulemaking authority is going to be an effective part of consumer protection reform, we need to ensure that its application reaches across all financial institutions uniformly—and, indeed, across all providers of financial products, banks and nonbanks. We recommend the following two steps:

1. First, we support vesting all of the Federal banking agencies with UDAP rulewriting authority to be exercised jointly. Only by a grant of joint authority can we maintain uniformity in any formal regulatory action to impose specific UDAP standards on the different components of the banking system.
2. Second, to avoid inconsistent treatment of consumers by financial institutions outside the jurisdiction of the FFIEC agencies, ABA proposes that the banking agencies' joint UDAP rulemaking be made effective for all nonbank entities providing financial products and services, just as TILA rules reach all nonbank creditors. Also as with TILA, nonbank functional regulators would possess the authority to enforce these rules against those in their respective jurisdictions.

Banks are the cornerstone of reputable financial product and service delivery in their communities. Accordingly, uniformity of regulation and supervision should be based on extending the regulatory standards and supervisory regime covering banks to the underregulated and largely unsupervised nonbank sector.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL  
FROM ED TEMPLETON**

**Q.1.** I have heard from many small businesses struggling to find lines of credit and keep their doors open. How has the member business lending cap affected the ability of credit unions to make small business loans to their members? Does your organization have any data showing that more small businesses would be served if the member business lending cap was increased by loan size and volume? In the current credit crisis, do you believe that credit unions are able to provide more loans to small businesses and should the cap be raised?

**A.1.** When Congress passed the Credit Union Membership Access Act (CUMAA) (P.L. 105–219) in 1998, they put in place restrictions on the ability of credit unions to offer member business loans. Congress codified the definition of a member business loan and limited a credit union’s member business lending to the lesser of either 1.75 times the net worth or 12.25 percent of total assets. Also pursuant to section 203 of CUMAA Congress mandated that the Treasury Department study the issue of credit unions and member business lending.

In January 2001, the Treasury Department released the study, “Credit Union Member Business Lending” that found, among other things:

Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions. In certain instances, however, credit unions that engage in member business lending may be an important source of competition for small banks and thrifts operation in the same geographic areas.

Congress has not revisited this issue since the study came out. The arbitrary member business lending cap placed on credit unions is a detriment to credit unions ability to serve their members and America’s small businesses. A number of credit unions are at or near the MBL cap, and a significant number shy away from business lending programs altogether because of the arbitrary cap and the restrictions it places on the ability to operate a business loan program.

Additionally, the definition of a member business loan has not been updated for inflation in over a decade, meaning the \$50,000 minimum level set in 1998 needs to be updated. Credit union economists have estimated that removing the member business lending cap could help credit unions provide \$10 billion in new small business loans in the first year alone. Removing the credit union member business lending cap would help provide economic stimulus without costing the taxpayer a dime.

Senator Schumer has indicated his interest in introducing legislation to remove this cap and we would urge the Committee to support him in these efforts.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM ED TEMPLETON**

**Q.1.** Some have suggested that the Federal Reserve Board’s unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers. The problem is that this



authority has not been used in a material fashion prior to the credit card rule. Rather than bifurcating consumer protection from safety and soundness, should Congress consider ways to improve UDAP authority? If so, what options do you recommend?

**A.1.** We have concerns about bifurcating consumer protection from safety and soundness as has been proposed with the new Consumer Financial Protection Agency (CFPA). We believe consumer protection can be enhanced in the current system by strengthening UDAP authority and creating consumer protection offices at the functional regulators. One way UDAP could be improved would be to give the FTC more efficient rulemaking authority over non-federal entities, as their process is currently inefficient and hampers their rulemaking.

We would support a CFPA that would have authority over non-regulated institutions that operate in the financial services marketplace, including supplanting the FTC on these matters. However, we do not believe such an agency should have authority over regulated federally insured depository institutions and would oppose extending that authority to Federal credit unions. Giving the CFPA such authority to regulate, examine and supervise credit unions that already are regulated by the NCUA would add an additional regulatory burden and cost to credit unions. Additionally, it could lead to situations where institutions regulated by one agency for safety and soundness find their guidance in conflict with their regulator for consumer issues. Such a conflict and burden will surely increase compliance costs to credit unions, leading to diminished services to their members.

Recognizing that more should be done to help consumers, we would propose that, rather than extending the CFPA to Federal depository institutions, each functional regulator of Federal depository institutions have a new or strengthened office on consumer affairs established. We are pleased that NCUA Chairman Michael Fryzel has proposed such an office for NCUA.

This is particularly important to credit unions, as they are regulated and structured differently than others in financial services, and we believe that it is important that any regulator examining credit unions should understand their unique nature. We believe that such approach would strengthen consumer protection while not adding unnecessary regulatory burdens on our Nation's financial institutions.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM PETER SKILLERN**

**Q.1.** Some have suggested that the Federal Reserve Board's unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers. The problem is that this authority has not been used in a material fashion prior to the credit card rule. Rather than bifurcating consumer protection from safety and soundness, should Congress consider ways to improve the UDAP authority? If so, what options do you recommend?

**A.1.** As the question states, "the Federal Reserve Board's unfair and deceptive practices (UDAP) authority is very broad and could be used to successfully protect consumers." And "this authority has

not been used in a material fashion prior to the credit card rule.” The problem is that the Federal Reserve failed to utilize its authority to issue rules or to enforce existing ones to protect consumers. Changing the UDAP authority will not improve consumer protections as it does not address the underlying and fundamental problem of the Federal Reserve’s regulatory failure to protect consumers.

The Federal Reserve should have greater accountability to Congress and the public in its financial accounting, its policies and programs and the enforcement of consumer protections. Changing the UDAP will not address these needs. Governor Duke suggested in Congressional testimony that the Federal Reserve be required to give a biannual update on consumer protections to Congress. This is a selfdisclosure approach that does not hold the agency accountable. Reform of the UDAP will not resolve the problem of the Federal Reserve failure of will to protect consumers.

The Community Reinvestment Association of North Carolina strongly supports the creation of the Consumer Financial Protection Agency (CFPA) to address the deficiencies of the current regulatory structure in protecting consumers.

*A Single Agency Is More Effective Than Current Fragmented System*

There are currently 12 Federal agencies responsible for consumer protections in the financial sector. The patchwork of regulatory coverage of differing financial institutions and different types of authority and differing agency objectives and capacity make the current system inefficient and ineffective. Among Federal institutions that charter banks, financial institutions may change regulator if they believe another regulator has a lower enforcement threshold. Because Federal charter agencies receive payment from the firms they regulate, agencies lose revenue if firms switch regulators. Regulators have a disincentive to enforce regulations at the risk of revenue loss. A single agency that has a single purpose with the authority of rule writing and enforcement across all financial institutions and products is a significant improvement of the current structure that has multiple enforcement agencies that regulate by the type of lender not the product.

*Bifurcation Places Consumer Protections on Equal Basis With Safety and Soundness*

The two objectives of consumer protection and safety and soundness are complimentary and supportive of each other, but that does not mean that under the current system they are treated equally. Current regulators evaluate products based on safety and soundness, *i.e.*, profitability before evaluation of products for consumer protections. Enforcement actions by the OCC and the FDIC on banks providing payday loans in partnership with payday lenders were conducted based on the lack of oversight of the agents of the bank, not on any ruling that the product at 400 percent interest rate and repeat transactions on a debt trap were harmful to consumers. Regulators have repeatedly stated that safety and soundness is their primary responsibility and has demonstrated that by a lack of material enforcement actions protecting consumers.

An example of this is the Office of the Comptroller's lack of enforcement action against Pacific Capital Bank despite the bank's violation of the OCC's publicized guidelines on its supervised bank agencies that conduct refund anticipation loans. Jackson Hewitt prepares taxes and makes refund anticipation loans with Santa Barbara Bank and Trust (SBBT), Pacific Capital's subsidiary. Jackson Hewitt was found guilty of tax fraud through a number of its franchises. Refund Anticipation Loans made by SBBT were used to facilitate the fraud. Recently, another bank partner Liberty Tax Services was found guilty in a jury trial of violations of the Federal Trade Act, Truth in Lending Act and Cross Debt Collection practices in marketing and originating Refund Anticipation Loans. Yet the OCC has not issued any regulatory actions regarding the bank's operations. Instead, the Office of the Comptroller of the Currency recommended the bank for TARP funding and the bank received \$180.6 million dollars which was used as capitalization for its operations including Refund Anticipation Loans. Unfortunately, Pacific Capital Bank stock has fallen by 90 percent and lost \$7.70 a share including one-time writedowns in the last quarter. This is one example of how Federal regulators have lost credibility that they have the will to protect consumers. This is an example of regulators subordinating profitability over both consumer protection and safety and soundness.

The Community Reinvestment Association of North Carolina asks that the United States Banking, Housing, and Urban Affairs Committee investigate the oversight of Pacific Capital Bank by the OCC and the use of TARP funds to make Refund Anticipation Loans.

By bifurcating consumer protection and safety and soundness, agencies can better achieve both objectives that have been at cross purposes under the current regulatory structure.

*The Consumer Financial Protection Agency Will Strengthen Dual Agency Enforcement*

The current regulatory system has Federal and State regulatory components. Historically Federal agencies did not enforce unfair and deceptive trade practices or provide consumer protections as this was a primarily a State prerogative through the State attorney general of financial regulator. Federal preemption of State regulations through national bank powers allowed institutions operating in States with few consumer protections to operate under jurisdiction of that State rather than the State the borrower lived in. This effectively removed many State consumer protections without putting into place Federal consumer protections or enforcement mechanisms. As an example, North Carolina's usury cap of 36 percent interest rate loans is preempted by any national bank operating in a State with a higher cap, or State chartered banks operating under parity. Thus refund anticipation lenders can make triple digit interest rate loans by partnering with Out-of-State banks.

The CFPA will create national standards that create a baseline of Federal consumer protections. The legislation also allows State agencies to regulate financial institutions acting within their borders. State laws that are stronger are not preempted. Consumer

enforcement capacity is increased by enabling State regulators to enforce Federal standards.

This is a vast improvement over the current turf battle in which Federal regulators prevent State regulators from enforcement of either State or Federal laws, yet which they do not enforce themselves. The OCC sued the New York Attorney General to stop his enforcement of State fair lending laws against national banks. This action was overruled by the recent Supreme Court decision in *Cuomo v. The ClearingHouse Association*. The OCC claims to support fair housing laws, but can not demonstrate that it has enforced fair housing laws against national banks in any public action. The OCC most public action is the lawsuit to stop State enforcement of fair lending laws. The creation of the CFPA will allow for Federal preemption of State law, but not will empower enforcement of consumer protections.

*Fair Lending Laws Will Be Better Served by Consumer Financial Protection Agency*

The GAO July 2009 report *Fair Lending Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts* documents that the fragmented system of multiple agencies, lack of trained staff, and poor data collection have stymied fair lending enforcement. Only eight fair lending cases by Federal regulators have occurred since 2005. Again existing Federal agencies have failed consumers. The CFPA will have trained dedicated staff, systemic data collection and single purpose to be more effective.

*Conclusion—Support the Consumer Financial Protection Agency*

The Community Reinvestment Association of North Carolina supports the creation of the Consumer Financial Protection Agency and rejects the argument that amending the Federal Reserve's authority under the unfair and deceptive trade practices will improve consumer protection.