Testimony of

America's Community Bankers

on

"H.R. 3206, Credit Union Charter Choice Act"

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Financial Services Committee

of the

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and

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Chairman Bachus, Ranking Member Sanders, my name is Laurie Stewart and I am the President and CEO of Sound Community Bank in Seattle, Washington. I currently serve on the Credit Union Committee of America's Community Bankers. More important to this discussion, in 2003 Sound Community Bank was created when CU of the Pacific converted from a credit union to a mutual savings association. Currently, Sound has $214 million in assets and five offices in the Puget Sound area. We are proud of our dedication to the communities we serve and the people who reside there. As a mutual savings bank we take a long view towards our role in and contribution to the community.

I am pleased to be able to come before the Subcommittee today on behalf of ACB to discuss H.R. 3206, the Credit Union Charter Choice Act. ACB strongly supports this legislation, and we applaud Congressman McHenry and his cosponsors for introducing it. The issue of charter choice is important to the overall structure of our nation's financial services sector. ACB believes in charter choice for all financial institutions. This fundamental policy position applies to banks, thrifts, and credit unions alike. When an institution is able to change charters to the one that best fits the needs of its members and community, our financial system will be stronger and healthier. Institutions and their communities change over time. The charter that was best for an institution 50 years ago may not be the best choice now. By allowing charter conversions we allow our financial system to evolve and grow stronger. Unfortunately the National Credit Union Administration (NCUA) does not share this view. Its recent actions have significantly obstructed the ability of credit unions to convert to a mutual bank charter.

The History of NCUA Authority

The actions of the NCUA are clearly contrary to the intent of Congress as expressed in the 1998 Credit Union Membership Access Act (CUMAA). Prior to the passage of the CUMAA, the NCUA had the authority to approve a detailed plan of conversion and disclosures sent to members regarding a conversion vote.[1] On March 4, 1998, the NCUA amended its pre-CUMAA conversion regulations to require a converting credit union to print on the cover of its disclosure three disclosures drafted by the NCUA. These disclosures said: 1) the institution will no longer be controlled by a one-member, one-vote basis; 2) the institution would lose its tax exempt status and might incur increased costs; and 3) the board members of the institution may be compensated. [2]

Following years of obstruction of credit union conversions by the NCUA, in late 1998 Congress made it clear that credit unions should be allowed to convert to a mutual bank charter without interference from the agency. Congress was so concerned by the NCUA's behavior that it went to great lengths in the CUMAA to ensure that the NCUA could not obstruct future conversions by stripping its authority to approve the transaction and by limiting its powers in the conversion process. The new law limited the NCUA's authority, saying that the NCUA must write rules governing the conversion process that "are consistent with rules promulgated by other financial regulators…." In addition, Congress took the extra step to clarify that rules governing conversion votes "shall be no more or less restrictive than that applicable to charter conversions by other financial institutions." Unfortunately, as I will detail in my testimony, the NCUA

[1] Memorandum of Amici Curiae filed by America's Community Bankers, Independent Community Bankers of America, and State Associations in Community Credit Union v. National Credit Union Administration. August 9, 2006.

seems to have ignored this mandate from Congress. The NCUA has promulgated rules that are not only more restrictive than those of other financial regulators, but actually conflict directly with the rules of the Office of Thrift Supervision (OTS) for conversions to stock form by mutual institutions.

In addition to the burdensome rules crafted by the NCUA, its behavior has proven to be an effective obstacle to converting credit unions. The NCUA's practice of essentially gagging converting credit unions from communicating with their members, while emboldening opposition groups, finding hyper technical reasons for not approving the process used by credit unions, and dragging the process out over unreasonably long periods of time has created a *de facto* barrier to successful credit union conversions. The NCUA's actions have taken the conversion process back to how conditions were prior to CUMAA's passage in 1998. That is why ACB believes that H.R. 3206 is a necessary and timely piece of legislation. It will restore balance, certainty and fairness to the conversion process for credit unions.

NCUA's Conversion Rules

One of the first and most critical parts of H.R. 3206 is that it forces the NCUA to re-examine its current conversion rules and revise them to conform to the requirements of the 1998 law. For the first five years after the passage of CUMAA the NCUA had conversion rules in place that allowed the small number of credit unions that wanted to convert to do so without great difficulty. Then, in less than a year's span, from February 2004 to January 2005, the NCUA promulgated rules that basically reinstated its March 1998 rules and made it increasingly difficult for the conversion process to be fair or achievable. The rules force credit unions to

[2] Id.

make essentially the same biased disclosures that were required in 1998. The new rules are not only speculative, outside of the NCUA's jurisdiction, and in conflict with the charter conversion rules of other financial regulators, but also ensure that a credit union's members receive biased information.

The new rules even go beyond the 1998 regulations that Congress found were too onerous. In the 1998 rules the NCUA intentionally did not require a credit union to state whether it would convert to stock ownership. It stated at the time that "credit unions should not be required to include information that may not apply to their transaction."[3] In 2004 the NCUA promulgated rules that affirmatively required a credit union to state whether or not it intended to convert to stock ownership, and in the process contradicted itself.

Among other things, the 2004 rules require a converting credit union to:

1) Disclose speculative information about any economic benefit a director or member of senior management would receive in connection with the conversion, including any potential stock benefit if the resulting mutual bank eventually converts to a stock institution;
2) Speculate that members could have lesser voting rights in the resulting mutual institution than the credit union and that members could lose their voting rights if the institution later converts to stock; and
3) Affirmatively state whether the resulting mutual institution plans to convert to a stock institution.

These rules are inherently flawed and violate the 1998 CUMAA because they are speculative and require the board of a credit union to comment on actions over which it will have

[3] Ibid. Pg. 24

no control and cannot have knowledge of because those decisions will be made by the resulting institution. Converting to a stock institution would be proposed by the board of directors of the mutual bank and voted upon by the members/depositors of that bank. The credit union board can have no knowledge of such a future action, or know how depositors in the resulting bank might vote. Furthermore, this disclosure directly violates a provision in the OTS rules - 563(b).120 - that prohibits disclosure of a proposed stock conversion until a conversion plan is adopted by a mutual bank's board of directors. That rule was put into place to protect members of a mutual bank from professional investors who would attempt to usurp the interests of long-time depositors. The rules imposed by the NCUA, requiring the credit union board to speculate on matters over which it has no control or knowledge, serve no purpose other than to bias the credit union's members against conversion.

Even more egregious are the requirements of the January 2005 conversion rules promulgated by the NCUA. Like those in 2004, the 2005 rules clearly violate the 1998 CUMAA because they have absolutely no parallel in OTS or OCC regulations. The 2005 rules require specific, boxed disclosure language to be included in all communications the credit union has with its members. The exact wording of the disclosure is dictated in the rulemaking. It says:

> The National Credit Union Administration, the federal government agency that supervises credit unions, requires [insert name of credit union] to provide the following disclosures.
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> 1. OWNERSHIP AND CONTROL. In a credit union, every member has an equal vote in the election of directors and other matters concerning ownership and control. In a mutual savings bank, **ACCOUNT HOLDERS WITH LARGER BALANCES USUALLY HAVE MORE VOTES AND, THUS, GREATER CONTROL**.

2. EXPENSES AND THEIR EFFECT ON RATES AND SERVICES. Most credit union directors and committee members serve on a volunteer basis. Directors of a mutual savings bank are compensated. Credit unions are exempt from federal tax and most state taxes. Mutual savings banks pay taxes, including federal income tax. If [insert name of credit union] converts to a mutual savings bank, these **ADDITIONAL EXPENSES MAY CONTRIBUTE TO LOWER SAVINGS RATES, HIGHER LOAN RATES, OR ADDITIONAL FEES FOR SERVICES.**

3. SUBSEQUENT CONVERSION TO STOCK INSTITUTION. Conversion to a mutual savings bank is often the first step in a two-step process to convert to a stock-issuing bank or holding company. In a typical conversion to the stock form of ownership, the **EXECUTIVES OF THE INSTITUTION PROFIT BY OBTAINING STOCK FAR IN EXCESS OF THAT AVAILABLE TO THE INSTITUTION'S MEMBERS.**

4. COSTS OF CONVERSION. The costs of converting a credit union to a mutual savings bank are paid from the credit union's current and accumulated earnings. Because accumulated earnings are capital and represent members' ownership interests in a credit union, the conversion costs reduce members' ownership interests. As of [insert date], [insert name of credit union] estimates **THE CONVERSION WILL COST [INSERT DOLLAR AMOUNT] IN TOTAL**. That total amount is further broken down as follows: [itemize the costs of all expenses related to the conversion including printing fees, postage fees, advertising, consulting and professional fees, legal fees, staff time, the cost of holding a special meeting, conducting the vote, and any other expenses incurred].

This required disclosure is speculative, outside the jurisdiction of the NCUA, and serves little purpose other than to bias the credit union's membership against conversion. For example,

rates will not necessarily change because the institution is no longer a credit union. There is no reason to assume that all resulting mutual institutions will elect to lower savings rates and increase rates for loans and other services upon conversion. The required disclosure about rates is designed solely to create a bias in the minds of members. Furthermore the required disclosure that executives in a stock institution profit from gaining more stock than other members is not accurate. The OTS requires mutual institutions that convert to stock institutions to first offer shares to all eligible account holders as of a specified date. This means that members of a mutual bank have a priority to purchase all the stock they desire before other investors. In addition, OTS regulations limit the aggregate percentage of stock that may be purchased by an institution's officers and directors.

A credit union converting to a mutual bank has no control over a stock conversion. Such a conversion can only be approved by a vote of the mutual bank's depositors. Requiring speculation about a future conversion from a mutual to stock form serves no purpose other than to create a bias against conversion. Last year, in Community Credit Union, et al.. v. National Credit Union Administration, a Texas federal magistrate found in his ruling that the NCUA rule requiring this disclosure contradicts current OTS regulations. A copy of this ruling is included as an appendix to this testimony.

The McHenry bill requires that NCUA regulations be based on fact, not speculation; pertain solely to areas where the NCUA has jurisdiction; and not conflict with the rules of other financial regulators. This is a common sense approach and ACB strongly supports it.

NCUA Gag Order

The McHenry bill also addresses the virtual gag order that the NCUA places on converting credit unions. Let me be clear, nowhere is there an explicit prohibition on credit

unions communicating with their members. However, the NCUA has made it known that they will treat communications with credit union members that are not approved by the NCUA as violations of the proper methods and procedures for a conversion vote, and therefore grounds to overturn a vote in favor of conversion. This was seen most recently in the attempted conversion of DFCU in Detroit, Michigan. Because of the NCUA's position on communication during a conversion, a credit union is left with both hands tied behind its back. The NCUA's system creates a one-sided debate where conversion opponents are free to attack the credit union, its management and its directors, while the credit union is unable to respond. When this gag order is combined with the unnecessarily long time the NCUA takes to approve disclosure, it results in a 90-day window where conversion opponents can mobilize a coordinated campaign to communicate with credit union members and bias them against conversion before the credit union leadership has even had a chance to explain why it supports changing to a mutual savings bank structure.

An appropriate analogy that might help members of the Subcommittee understand what the NCUA puts these credit unions through would be a Congressional campaign. Imagine that you were locked in a difficult campaign and your opponent was constantly taking out attack ads against you. Every day there would be new ads, mailings, billboards, and picketing. However, you would be required to have FEC approval before you can respond to any of your opponent's attacks. Imagine if they told you that they might be able to approve your ads or media comments within a few weeks, but they can't make any promises. In the meantime, you were forced to sit by helplessly while your reputation and character are attacked. That is what this process has become for converting credit unions.

In the most recent attempted conversion, DFCU was, in effect, prohibited from talking

with its members while the Michigan Credit Union League and another activist groups waged a public relations war. The NCUA blocked DFCU from telling its members about its desire to convert, leaving members confused and bewildered about why there was so much controversy. The NCUA relies on an overly broad interpretation of its own authority in order to advance its anti-conversion agenda. The McHenry bill fixes this by simply saying that the NCUA cannot require a converting credit union to submit all member or press communication for NCUA approval. We believe that it is appropriate for the NCUA to review balloting and other such materials; however, it should not be allowed to switch from credit union regulator to credit union censor during the conversion process.

Regulatory Foot Dragging

Another problem that we have seen in the past few years is that the time required to approve the necessary disclosures becomes increasingly long. When my credit union converted, the time to approve disclosures was roughly 30 days. However, with the conversions of two credit unions last year, and the attempted conversion of DFCU this year, the approval process took close to 90 days. This foot dragging, when combined with the virtual gag order put on converting credit unions, serves one purpose. It allows conversion opponents to spend more time attacking a credit union that is unable to defend itself. H.R. 3206 resolves this problem by simply putting a time limit on how long the approval process can take. In the past, a 30-day approval period worked well, and we think it is reasonable to use that timeline for future conversions.

Uncertainty

H.R. 3206 also addresses another principal method that the NCUA has been using to

obstruct conversions. The NCUA has inserted uncertainty into the conversion process to such an extent that most credit unions now believe the conversion process is not worth pursuing. Assuming that a credit union manages to run the gauntlet that the NCUA and conversion opponents have created, the NCUA has started to identify hyper technical reasons to overturn a successful vote. Last year in Texas, Omni American Credit Union and Community Credit Union both had conversion votes that topped 70% approval. The NCUA refused to approve the vote because it disagreed with how a single piece of paper was folded. Nowhere in the NCUA's rules did it specify how paper was to be folded; however, in order to prevent a conversion the NCUA fabricated new requirements and arbitrarily imposed them on these two credit unions after the initial mailings were sent. This was a blatant attempt to overturn a conversion because the NCUA had run out of options.

The Texas credit unions had the will and resources to fight the NCUA's protectionism. A federal magistrate found that the NCUA's "determination was not only inconsistent with its own regulations, but under all the circumstances, it was arbitrary and capricious." The threat of the NCUA creating a technicality to overturn months of work and hundreds of thousands of dollars in costs makes credit unions very hesitant to go through with a conversion. If there is no certainty that the affirmative vote of members will result in a conversion, there is little reason to go through the process. The Credit Union Charter Choice Act provides this certainty by establishing a minimum threshold in order for the NCUA to overturn a successful vote. This allows the agency to overturn a conversion based on fraud or knowingly false misstatements by the credit union, but not for hyper technical reasons.

The Conversion Process

I also want to take a moment to address some of the recent rhetoric I have heard about the credit unions that want to convert, and the mutual bank structure to which they are converting. As the association that represents the vast majority of the mutual savings banks in the country, ACB believes it is essential that the Subcommittee have complete and accurate information regarding mutual institutions. The NCUA and critics of credit union conversions have depicted credit union executives who desire to convert as greedy insiders seeking to enrich themselves. This is simply not true. First, it is ironic that the credit union executives who are painted by the credit union trades as selfless and dedicated cooperative executives suddenly become fraudsters looking to fleece their members of millions of dollars. These executives, like me, are merely looking to find the charter that enables them to best serve their members. A mutual bank is also a cooperative structure focused on its members and communities.

The credit union portrayal of mutual institutions ignores three of the most important characteristics of the mutual charter – independence, commitment to service, and a focus on community stakeholders, not stockholders. Mutuals take a long view of what is best for their community, and their commitment to the best interests of the towns, neighborhoods and villages they serve is reflected in the wide variety of civic activities in which they engage.

I also want to deal head on with the credit union assertion that when a credit union switches to a mutual charter, members lose control over their institution. This is simply not true. The NCUA and conversion opponents have repeatedly and incorrectly implied that credit union members will automatically be disenfranchised upon conversion to a mutual savings institution. These assertions are not supported by fact or law. First, mutual savings institutions by their very nature are cooperatively organized and controlled by their members/depositors. Mutual savings associations have the freedom to adopt a one vote per member provision. This flexibility

allows converting credit unions to retain their existing voting structure if the membership so desires. Many mutual savings bank charters also provide one vote for every $100 deposited with a cap on the total number of votes given to any one member.

Second, much like with credit unions, the net worth of a federal mutual savings association chartered by the OTS never belongs to the officers and directors of the federal savings association, except to the extent that person is a depositor in the institution.

Third, the members of a mutual savings association must approve all charter amendments and any subsequent conversion to the stock form of ownership. The OTS has established very detailed regulations regarding the conversion of mutuals to stock form. A conversion to stock requires the affirmative vote of a majority of the total outstanding votes of the mutual institution. This is a higher standard than the member vote required for the conversion of a credit union to a mutual savings institution.

The NCUA and credit union trade associations also like to assert that there is a tremendous windfall to the executives and directors of the resulting institution. This is not a true statement. The conversion from a credit union to a mutual institution involves no transfer of net worth to insiders. Furthermore, like credit union executives, the compensation of mutual executives will be determined by the institution's board of directors.

Furthermore, the NCUA also incorrectly presumes that a credit union's conversion to a mutual savings institution will inevitably be followed by a subsequent conversion to the stock form of ownership. This erroneous assumption is also reflected in the disclosure language that the NCUA requires all converting credit unions to provide to their members.[4]

[4] The NCUA requires all converting credit unions to provide the following disclosure language, including capitalization and bold print: Conversion to a mutual savings bank is often the first step in a two-step process to convert to a stock-issuing bank or holding company. In a typical conversion to the stock form of ownership, the **EXECUTIVES OF THE INSTITUTION PROFIT BY OBTAINING STOCK FAR IN EXCESS OF THAT AVAILABLE TO THE INSTITUTION'S MEMBERS.**

Subsequent conversion to a stock institution is not certain, it is only an option. More than two-thirds of credit unions that have converted remain in mutual form, just like Sound Community Bank. If a conversion from mutual to stock form is proposed, before it can occur a plan of conversion must be adopted by a two-thirds vote of the mutual institution's board of directors. In addition, the institution's members must approve the plan of conversion by a majority of the total outstanding votes.[5]

There are currently 750 mutual banks in this country, some of which are over 170 years old. We recognize the right of mutual banks to consider converting to a stock form. There are many reasons that the board of directors of a mutual institution may decide to convert to stock ownership. The reasons may include the need for capital to grow or add new products or services. If a conversion is proposed, the federal and relevant state banking regulators have a well-established conversion process that has evolved over the years. The bank regulators have adopted a process that provides safeguards against unjust enrichment of insiders and is fair to depositors of the mutual institution and the communities they serve.

Captive Regulator

I also want to address a concern raised by the financial motivation of the NCUA in credit union conversions. Because of the structure of the National Credit Union Share Insurance Fund (NCUSIF) the NCUA has a powerful motive to prevent credit union conversions. Currently, 60% of the NCUA's operating budget comes from interest earned on deposits held in the NCUSIF. According the National Association of State Credit Union Supervisors (NASCUS) the departure of the two Texas credit unions last year cost the NCUA $850,000 in FY 2005 and will

[5] 12 C.F.R 563b.125, 12 C.F.R 563b.225(a)-(b). State laws may prescribe a higher percentage of votes before a state chartered

cost an estimated $5.1 million during the typical term of an NCUA board member. The NCUA clearly has a material interest in preventing credit union conversions. We believe that common sense legislation, such as H.R. 3206, will reduce the ability of the NCUA to act in a self interested and abusive manner.

I also think that it is important to highlight an issue that should be of great concern to the Subcommittee. The behavior of the NCUA on the issue of credit union conversions is both unprofessional and troubling because it is indicative of a regulator that is highly conflicted and captive to its industry. The NCUA's string of recent defeats in federal court indicate that it is interested first and foremost in promoting the credit union industry, rather than being a safety and soundness regulator. One federal judge even said that the NCUA "cannot act like a rubber stamp or cheerleader" for credit unions. Such behavior threatens the safety and soundness of our financial system. The last time our nation saw a financial regulator behave in a fashion similar to the NCUA was the Federal Home Loan Bank Board in the 1980's, and we all know the costly result of that captive regulator.

I understand the implications of making such accusations of a financial regulator; however, ACB believes that this issue is too important to ignore. The comments and actions of the NCUA staff indicate that they have become too closely aligned with the credit union industry, and deserve close scrutiny from this Subcommittee. As an example, in the most recent conversion case the credit union media and trade associations allegedly received copies of letters addressed to DFCU and its attorneys before DFCU or its attorneys did. These leaks of what are intended to be confidential communications are a symptom of a regulator whose priority is aiding the credit union industry, not regulating it. Another example is the comments by NCUA

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savings association may convert to stock form.

staff responsible for overseeing the conversion process indicating that they believe all conversions are motivated by greed, and that "Without question, credit unions offer a better deal for consumers than the banking industry…." Such a biased attitude cannot possibly allow NCUA staff to oversee conversions in a fair and impartial manner.

Conclusion

In conclusion, Mr. Chairman, ACB is a strong supporter of charter choice and the mutual form of ownership. Credit unions should have the ability to adopt the mutual charter if doing so meets the strategic interests of the institution and its members. We are concerned that the NCUA, through regulatory fiat, has effectively stopped credit union conversions. Under the guise of disclosure and consumer protection, it has made a credit union charter a prison sentence rather than a right, whereby no one can escape once they take a credit union charter. The actions of the NCUA have effectively stripped the credit union member of the right to vote on the conversion process. This is wrong, and we urge the Congress to pass H.R. 3206, which will ensure that like all other businesses in America, credit unions have the freedom to choose the charter that best fits the needs of their members and communities.