Written Testimony of George Reynolds
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on behalf of the
National Association of State Credit Union Supervisors
Before the
Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
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NASCUS History and Purpose

Good afternoon, Chairman Bachus, and members of the Subcommittee. I am George Reynolds, Senior Deputy Commissioner for the Georgia Department of Banking and Finance. I appear today on behalf of the National Association of State Credit Union Supervisors (NASCUS), the professional state credit union regulators association. NASCUS represents the 48 state and territorial credit union supervisors, dedicated to defending the dual chartering system for credit unions and advised by the NASCUS Credit Union Council, which is comprised of more than 500 state-chartered credit unions.

In addition to being a state regulator, I am a certified public accountant allowing me to study and understand the accounting standards recommended by the Financial Accounting Standards Board (FASB). Today I have made recommendations on behalf of NASCUS regarding the impact of changes to the accounting standards regarding mutual institutions.

The mission of NASCUS is to enhance state credit union supervision and to advocate policies that ensure a safe and sound state credit union system. We achieve those goals by serving as an advocate for a dual chartering system that recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the introduction of H.R. 1042, the Net Worth Amendment for Credit Unions Act, which amends the definition of net worth to include the net worth of a credit union merged with a surviving credit union. We appreciate the opportunity to provide the Subcommittee with our comments H.R. 1042, and look forward to the successful passage of this Act.

My testimony today is to urge your support of H.R. 1042. This Act amends the Federal Credit Union Act to clarify the definition of net worth for purposes of prompt corrective action.

As an overview, FASB 141 replaces the pooling method of accounting with the purchase accounting method for mergers of mutual enterprises. Without the proposed statutory amendment, the new accounting methodology does not allow the retained earnings of a merging credit union to be added to the retained earnings of a surviving credit union. Ultimately, safety and soundness is an issue because credit unions are discouraged from mergers, even when their regulator recommends them.

While this bill is extremely brief, I cannot overemphasize the criticality of this change to the safety and soundness of credit unions.

Impact of FASB 141 to the State Credit Union System

The FASB is making changes to the accounting standards for business combinations between mutual enterprises, which includes credit unions. The result of these changes is twofold. First, the pooling accounting method will no longer be an acceptable method for accounting for business combinations. Second, purchase accounting will now be used almost exclusively for business combinations.

The impact of H.R. 1042 would be to revise the definition of net worth to include both the retained earnings of the surviving credit union and any other credit union with which the surviving credit union is combined. This would permit capital to be added in a merger transaction and would serve to augment the capital position of the surviving credit union.

I am unable to provide a detailed explanation of purchase accounting versus pooling accounting in this testimony. I do want, however, to outline the serious unintended consequences of this change if the definition of net worth is not changed, as proposed in the bill.

Without the proposed statutory amendment, a merger transaction between two credit unions would not allow the retained earnings of the merging credit union to be added to the retained earnings of the surviving credit union. This will discourage mergers recommended by state regulators. Mergers are a safety and soundness tool regulators use to protect funds deposited by American consumers and to preserve the National Credit Union Share Insurance Fund.

Our Department and other state departments regularly use mergers to combine weak or troubled financial institutions with larger and stronger financial institutions, providing a win-win for both American consumers and the insurance fund. Without the ability to combine the capital of the two institutions, in addition to the assets and liabilities acquired on the balance sheet, there would be a serious disincentive to effect such mergers.

This is particularly important in purchase accounting, which provides for reflecting assets and liabilities acquired at their fair market value. Marking the balance sheet to market while not being able to include acquired retained earnings is a recipe for capital dilution. After a merger, such credit unions might find themselves in a prompt corrective action (PCA) category, which requires certain unintended mandatory regulatory actions, which credit unions would obviously wish to avoid.

If a credit union could not be merged due to PCA concerns caused by the inability to add the capital of the merged credit union, then credit unions in a weakened condition would be more likely to face liquidation or requests for NCUA financial assistance in merger transactions. An increase in liquidations would cause greater reputation risk, a severe loss of confidence for the credit union industry, greater losses to the deposit insurance fund and increased costs to the industry and ultimately to consumers.

Additionally, most credit unions have some deposits that exceed the deposit insurance limit and these members could face the prospect of losing these funds in a liquidation. Stated simply, this is a recipe for disaster. I never want the credit unions that I regulate in Georgia, or the credit unions in any other state to be confronted with this possibility.

In addition to problem institutions, sound credit unions have sought merger partners in order to provide for greater efficiencies of scale, management succession and improved member services. We have been in a period of industry consolidation in credit unions during the past several years. Without these changes credit unions that might otherwise be operating in a safe fashion might not be able to execute optimal business decisions, which would benefit the credit union and its members.

Our Department can cite numerous instances where a problem financial institution was merged with a stronger financial institution with no cost to the deposit insurance fund and the taxpayer. These mergers have been seamless to credit union members and in many cases have resulted in improved levels of credit union services to members.

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H.R. 1042 addresses the concerns with the current definition of net worth. This makes sound business sense and increases the safety and soundness of the credit union industry.

As an accountant, I understand the accounting profession's desire to promote consistency in the accounting for business combinations of all entities including mutuals. However, I continue to have concerns regarding the appropriateness of certain aspects of purchase accounting for business combinations of credit unions, such as the potential for the creation of goodwill, which I do not believe to be appropriate for mergers of mutually held, non-taxable entities. I do recognize that in spite of my reservations, these changes appear inevitable. The statutory changes presented in H.R. 1042 are needed to make certain that the implementation of purchase accounting does not have an adverse safety and soundness impact upon the credit union industry.

Conclusion

In closing, H.R. 1042 proactively addresses the safety and soundness concerns of state regulators. FASB 141 replaces the pooling method of accounting with purchase accounting for mutual enterprises affecting the way capital is counted on a credit union's balance sheet in a merger transaction. To summarize:

1.) H.R. 1042 allows the retained earnings of a merging credit union to be added to the retained earnings of a surviving credit union.
2.) H.R. 1042 alleviates a credit union's Prompt Corrective Action (PCA) concerns in a merger transaction.
3.) H.R. 1042 alleviates safety and soundness concerns of state regulators. Credit unions are no longer discouraged from mergers when their regulator recommends a merger to address safety and soundness concerns.

Chairman Bachus, on behalf of NASCUS, please accept our appreciation for your foresight and steadfastness in your commitment to introduce and pass eventually H.R. 1042.

This concludes my remarks. NASCUS appreciates the opportunity to testify today. We welcome further participation and dialogue. I will now respond to any questions the Subcommittee may have.

Thank you.

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