National Association of Federal Credit Unions

Testimony of

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on Behalf of

The National Association of Federal Credit Unions

"The Dodd-Frank Act: Impact on Small Business Lending"

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Introduction

Good morning, Chairman Walsh, Ranking Member Schrader and members of the Subcommittee. My name is Mark Sekula and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the Executive Vice President, and Chief Lending Officer for Randolph-Brooks Federal Credit Union (Randolph Brooks), headquartered in Live Oak, Texas.

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 65.4 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 the Dodd-Frank Act's impact on small business lending.

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 credit unions fill today for nearly 93 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 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 services at the lowest possible cost.

Randolph-Brooks FCU and Business Lending

In line with it's mission to 'improve the economic well-being of those within its field of membership', Randolph-Brooks began offering government backed SBA loans in 2006. We were recognized by the SBA as the 7(a) Small Lender of the Year in 2009. We are a Preferred Lender with delegated authority and an Express lender which aids in quicker than normal loan turnaround. Since our program's inception, the portfolio has grown to $23.7 million in total loan amounts (as of 5/31/11) and has $18.4 million in outstanding principal. Randolph Brooks participates in the SBA 7(a) and SBA 504 loan programs. 7(a) eligible use of funds include purchasing commercial real estate, equipment, inventory, working capital, etc., while the 504 loan program is limited to the purchase of real estate and heavy equipment.

Utilizing any SBA loan guaranty program requires meeting stringent government regulations. Determining overall applicant eligibility to participate in an SBA program is nearly as important as determining the applicant's creditworthiness. Failing to meet certain eligibility criteria may preclude the applicant from participating in an SBA guaranteed loan program. Eligibility criteria includes among other things: size restrictions, eligible and ineligible types of business, use of proceeds, credit standards, and meeting a 'credit elsewhere' test.

Our SBA loan volume has diminished from the early years. It is noteworthy that we are still experiencing increases in net loans and net loan dollars. Much of the decrease can be associated

with the overall economic downturn the nation as a whole has experienced. However, Randolph Brooks has also scaled back to some extent as a response to comments from the SBA and its examinations. On one hand the SBA vigorously encourages granting small loans to qualifying businesses, yet, on the other the agency matter-of-factly states that a lender's status with SBA can be rescinded or imperiled if these higher risk loans default. The SBA provides a Lender Portal and a lender 'score' derived from SBA's Credit Risk Assessment Model. While this information is useful, it would be more beneficial for a lender to see how they compare to other lenders with *similar* loan portfolios. Our 'score' is derived by averaging other lenders', mostly large 7a loans, with our small SBA Express loans. The blending of all lenders with varying portfolios to arrive at a 'score' dilutes the true picture as one cannot compare a small SBA unsecured working capital line of credit with a large SBA loan secured with commercial real estate. Clearly the two loans are different and should have different evaluation processes. If this evaluation process is not changed, it may eventually eliminate all small loans from lenders portfolios. We have requested that the SBA via the Office of Credit Risk Management address this deficiency so the playing field is leveled and more accurate information is dispensed to participating lenders so that they can more accurately determine the soundness of their respective SBA loan portfolios. We hope that the Small Business Committee will be able to help in this regard.

The Impact of Dodd-Frank on Credit Unions and Business Lending

It is widely recognized by leaders on Capitol Hill and in the Administration that credit unions did not cause the economic downturn. Still, credit unions continue to be some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. There are many consumer protections already built into the *Federal Credit Union Act*,

such as the only federal usury ceiling on financial institutions and the prohibition on pre-payment penalties that other institutions have often used to bait and trap consumers into high cost products.

Despite the fact that credit unions are already heavily regulated, were not the cause of the financial crisis, and actually helped blunt the crisis by continuing to lend to credit worthy consumers during difficult times, they are still firmly within the regulatory reach of a number of provisions contained in the *Dodd-Frank Act*. While many may be well-intentioned, these additional requirements in the *Dodd-Frank Act* have created an overwhelming number of new compliance burdens, which will take credit unions considerable time, effort, and resources to resolve.

As not-for-profit cooperatives that cannot turn to capital markets to raise funds, the capital of a credit union comes from its members and is returned to them. Resources expended to comply with new burdens result in fewer resources available to make the next loan or offer a better rate.

We applaud recent efforts by the Obama Administration and the House of Representatives to tackle excessive regulations that hamper the ability of an industry to create jobs and aid in the economic recovery. With a slew of new regulation emerging from the *Dodd-Frank Act*, such relief from unnecessary or outdated regulation is needed now more than ever by credit unions.

Still, there are a number of provisions in Dodd-Frank that will have a direct or indirect impact on small business lending by credit unions.

One of the most direct impacts will likely come from Section 1071 of the *Dodd-Frank Act*. This provision creates a data collection system for small business lending similar to *Home Mortgage Disclosure Act* (HMDA) for financial institutions requiring them to collect and report information to the Consumer Financial Protection Bureau (CFPB). Section 1071 requires every financial institution (broadly defined as anyone who engages in a "financial activity") to inquire of any businesses applying for credit whether the business is a small business and women or minority-owned.

Given that credit unions serve a defined field of membership, individual credit unions' information, in comparison to other lenders, could be skewed when compared to others, as credit unions can only serve those in their field of membership. Credit unions are chartered to serve their members, thus regulatory data collection that is intended for institutions that can serve anyone that comes into the doors and would necessarily paint a broad brush should not be imposed on credit unions. Further, while we acknowledge that taken on its own, Section 1071 is a well-intentioned provision, when added with other laws and regulations, this new compliance burden is just another drop in the new and growing overall cost of compliance bucket emerging for credit unions from Dodd-Frank.

The financial institution must also maintain a record and report it to the CFPB (along with other related information about the application). The information must be made public in accordance with CFPB regulations. These provisions are effective on the CFPB transfer date (currently scheduled to be July 21, 2011), yet implementing regulations will not be issued until *after* that date, leaving financial institutions with no compliance guidance on the effective date. While the CFPB has indicated that compliance will not be mandatory on July 21, Congress should consider delaying the effective date of this provision until such time as implementing regulations take effect giving

financial institutions the guidance that they need to carry out the goal of this provision. Moreover, Section 1071 gives the CFPB considerable discretion to establish the requirements, define the scope, provide for exemptions, and protect the privacy of individuals. We believe it is critical that Congress ensures that the CFPB narrowly interprets this discretionary authority.

The Dodd-Frank Act also includes a section (Section 1100G) that says the CFPB must evaluate as part of its regulatory flexibility analysis the impact that its actions have on "small entities" (which includes "small organizations"). We believe that credit unions meet the definition of a "small organization" as defined in Title 5, Section 601 of the U.S. Code as "any not-for-profit enterprise which is independently owned and operated and is not dominant in its field…"

We would urge Congress to ensure that the CFPB abides by this Congressionally-mandated standard, and does not try to narrow the definition of "small entity" in the future in order to strengthen its authority over credit unions. We believe this authority could be enhanced by Congress strengthening the cost-benefit analysis requirement for rule-writing that would allow institutions to rebut the need for rules based on cost thresholds.

Numerous Additional Provisions of Dodd-Frank will also Impact Credit Unions

While not the subject of this hearing, the biggest impact from the *Dodd-Frank Act* on credit unions will likely come from the new price controls on debit interchange, which will have a negative impact on the entire business model of credit unions. For credit unions with business lending programs, the price controls on debit interchange may force them to revise or even scale back their business lending because they would have to re-allocate resources to pay for costs associated with their debit card program.

In addition to the debit interchange price cap provision, the creation of the new Consumer Financial Protection Bureau (CFPB) is potentially problematic. The Bureau will have rule-writing authority over credit unions of all sizes, and examination and enforcement authority for those above an arbitrary threshold of $10 billion. NAFCU has consistently opposed efforts to include credit unions, regardless of size, under the new CFPB. As not-for-profit cooperatives owned by the people they serve – their members – credit unions have different motives in serving their members than for-profit financial service entities. Unfortunately, despite numerous hearings on regulatory reform in the last Congress, credit unions were ultimately included in the jurisdiction of the new CFPB without a single hearing to examine whether or not they should be covered by the CFPB.

While we were pleased to see the Financial Stability Oversight Council (FSOC) granted some "veto" authority over some proposed CFPB rules if they are found to create safety and soundness concerns, we believe the current veto authority does not go far enough. NAFCU supports legislation proposed by Representative Sean Duffy, H.R. 1315, to modify the threshold needed for the FSOC to veto a proposed CFPB rule, and that clarifies the standard of what can be considered in making the determination. We believe this approach to make it a majority of the FSOC (minus the CFPB Director) is a positive step that ensures safety and soundness concerns do not take a back seat in this new regulatory environment.

NAFCU is pleased to see H.R. 1121, legislation introduced by House Financial Services Committee Chairman Spencer Bachus to create a 5-person commission to govern the CFPB. We believe a 5-person Board has benefits over one single director. Moving forward under the law that is in place at

this time, however, NAFCU believes that the CFPB must have a Senate confirmed director before the official transfer date. We support legislation (H.R. 1667) which would delay the transfer date until a confirmed director is in place. Lawmakers, their constituents, and every entity under the CFPB deserve a fair and open process in which candidates that may head the new agency are properly vetted.

While the ability to prevent unfair and deceptive practices is important, we are concerned that the CFPB's authority under Unfair and Deceptive Acts or Practices (UDAP) could amount to a blank check for it to delve into any number of areas that create new regulatory burdens or hurdles for credit unions that make it harder to lend. It may be prudent for Congress to require joint-rulemaking with functional regulators when the CFPB wishes to write new rules using its UDAP authority.

Additionally, while it is important for the CFPB to hear consumer complaints, we believe it is important that the CFPB create safeguards for ensuring that consumer complaints remain confidential and that institutions do not face reputation risk due to unsubstantiated claims.

The Regulatory Environment Impacting Credit Unions and Small Business Lending

The environment around regulatory reform has led regulators to make changes that impact credit unions and may cause them to tighten their lending to small business. As noted above, the SBA has told us to tighten up our lending practices despite an excellent track record. The net result of this "scoring" approach by the SBA discourages smaller SBA loans and encourages lenders to focus on bigger loans.

Practices by other regulators have had an impact as well. Last year, the National Credit Union Administration (NCUA) issued a rule to amend the agency's Regulatory Flexibility Program (RegFlex) as it relates to business lending. The new rule requires a personal guarantee for all credit union member business loans (MBLs). Unfortunately, this proposal will make credit union MBLs significantly less attractive to members and it will likely become more difficult to retain those members' deposits if credit unions cannot offer competitive loans.

NAFCU believes, and has told the NCUA, that requiring a personal guarantee for all MBLs is unnecessary given the underwriting policies that RegFlex credit unions already have in place. This is true for two reasons. First, RegFlex credit unions, as part of sound lending practices, still require personal guarantees in many situations. Second, other factors, most notably the borrower's equity may be more useful than a personal guarantee in predicting or ensuring repayment.

Neither the proposed rule, nor the final rule provided sufficient justification for the change in policy. At a time when the federal government is attempting to increase access to credit for small businesses, this decision is counterproductive.

The NCUA could have written a more narrow rule that addresses safety and soundness concerns without eliminating the exemption altogether. For example, NAFCU recommended a more narrow exemption that would have given credit unions a blanket waiver of the personal guarantee in situations where the borrower has invested a significant amount of its own money in a project. This recommendation is based on the simple fact that projects with a significant amount of investor

equity are generally more likely to be repaid. The final rule, however, forces credit unions to treat all loans equally, which simply does not make sense. The purpose of underwriting is to determine the risk of the loan and offer a price and terms accordingly. A personal guarantee is an important term for the borrower and it is one which the credit union should have the ability to waive if certain standards are met. We urged the NCUA Board to reexamine this issue and consider some sort of sliding scale where safe loans that meet certain criteria can still be approved without a personal guarantee. We hope Congress will exercise its oversight in this regard as well.

The NCUA's changes to the RegFlex program and the SBA's directive to tighten lending standards are symptomatic of a much larger issue that Congress must address if it is serious about encouraging lending. Currently, there is a very strong disconnect between Congress, the administration and other policy makers that wish to spur lending and the functional regulators that oversee financial institutions. On the one hand, we sit in this hearing today discussing ways to encourage small business lending. On the other hand, the NCUA explicitly creates barriers to new lending – by regulation and the exam process – and implicitly warns credit unions against making any loans that the agency may deem as risky. Forced to choose between these two conflicting objectives, Randolph-Brooks must, of course, follow the directive of the NCUA. In short, any Congressional goal to promote lending will never be successful when the functional regulators are not on the same page.

Conclusion

In conclusion, the ink is barely dry and credit unions are already being negatively affected by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* [P.L. 111-203]. In addition to the

debit interchange price caps, credit unions will feel a host of new compliance burdens from the CFPB, including data collection from small business loans as part of Section 1071. The costs of complying with these new requirements add up. Furthermore, regulators from the SBA to the NCUA have taken steps in this new environment that could serve to discourage aspects of business lending. We urge Congress to use its authority to find ways to help ease these burdens, including oversight of provisions found in Section 1100G, and enacting changes to improve the CFPB.

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