NCUA
National Credit Union Administration

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Remarks of Debbie Matz
Chairman
National Credit Union Administration Board

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NATIONAL CREDIT UNION ADMINISTRATION

Remarks

It's so nice to have the opportunity to speak with such a large group of credit union volunteers. So, before I get to my speech, I first want to commend each and every one of you for your dedication.

I have always believed that volunteers are the heart and soul of the credit union community. You are also the conscience of your credit unions. You ensure that your credit unions have sound policies, reliable recordkeeping, accurate financial reports, and—most important—strong internal controls to protect against fraud. You are your credit union's first line of defense against potential losses.

And, you have led your credit unions diligently, from the Great Recession into a remarkable recovery.

You might recall that some industry analysts suggested financial institutions might never fully recover to the strong operating levels we saw before the financial crisis began in 2008. But today, I am very pleased to report that the credit union system has fully recovered.

State of the System: Credit Unions have Recovered

Credit unions' key metrics have returned to pre-crisis norms.[1] It is truly amazing to see how much the metrics have improved since the second quarter of 2009, after I came on as Chairman.

For example, when you compare the middle column to the right column, you can see nationwide:

- Return on assets has tripled (from 27 basis points to 81 basis points).
- Loan growth has more than doubled (from 4.0 percent to 10.6 percent).
- Delinquencies have been cut in half, back to pre-crisis levels (from 1.6 percent to 0.7 percent).
- Charge-offs have likewise been reduced to pre-crisis levels (from 1.2 percent to 0.5 percent).
- Membership growth is even more robust than before the crisis (up from 1.4 percent to 3.2 percent).

This tremendous turnaround is the result of three primary factors:

[1] Chairman Debbie Matz's presentation slides are available online at http://ncuagov.ncua.lan/News/Press/SP20151007Matz-Directors-Roundtable.pdf.

- Steady recovery of the U.S. economy;
- Prudent leadership by credit union volunteers and management; and
- Strong regulation and supervision by NCUA.

Our corporate credit union system resolution saved $50 billion in losses and prevented thousands of credit union failures.

Our reallocation of resources shortened exams in small credit unions, dedicated more specialists to large credit unions, and increased exam frequency from 18 months to 12 months to detect problems earlier.

What may be most significant to volunteers, a regulation that clarified directors' fiduciary duties took effect in 2011. While we appreciate that directors are volunteers, we believe it is essential that each director understands how to read an income statement and balance sheet. The regulation requires directors without basic financial knowledge to be able to understand their credit union's income statement and balance sheet within six months after election.

To make this as easy as possible to do, NCUA provides free online training. However, as you probably know, you don't have to get certified. You are not going to be tested by any NCUA examiner.

Forward-Looking Risks

Now that the crisis is behind us, NCUA is focusing on forward-looking risks. Today I'd like to discuss four such risks with you:

- Interest rate risk;
- Cyber threats;
- Capital outliers; and
- Aging membership.

Interest Rate Risk

Each year, I send a letter to all credit union Chairmen and CEOs describing NCUA's supervisory priorities. By now, you probably know that interest rate risk is our primary concern. And this concern is shared by all federal financial regulators.

However, within the credit union system, interest rate risk is actually higher than in the banking industry—and it's even higher than before the crisis.

While most credit unions managed through interest rate hikes in the past, not every credit union is as well positioned today. Net long-term assets have risen from 25 percent of assets 10 years ago, to 33 percent of assets today. This is a concern because credit unions now have less flexibility to adjust to rising rates.

Let's look at the different effects on credit unions during recent cycles in which interest rates rose.

The blue bars are unrealized gains and losses; the red line is 30-year mortgage rates. You can see spikes in long-term interest rates in 2006 through 2008 caused credit unions to book unrealized which averaged around $1 billion. But when long-term rates rose in 2013, the unrealized losses were even steeper.

With that rise in long-term interest rates, unrealized gains of $2.7 billion swung to unrealized losses of $2.4 billion. That's more than a $5 billion swing from positive to negative. Seeing this slide was an "ah-ha" moment for me—and I hope it is for you. These unrealized losses could foreshadow actual losses if future rate hikes compress net interest margins.

While no one can predict for certain when and by how much rates will rise, many experts predict that by 2017, the federal funds rate will reach nearly 300 basis points. NCUA examiners are urging credit unions to shock their balance sheets with interest rate hike assumptions up to 300 basis points, and plan ahead.

We've also prepared a new Interest Rate Risk Resources page on our website at NCUA.gov to help you prepare for changes in interest rates.

When you visit this page, you'll find a huge amount of information including videos, charts, rules and guidance. If you click "See More" under any icon, you'll find even more compelling reasons to be concerned about interest rate risk.

Since this is part of your fiduciary duties, here are some questions you could ask management about interest rate risk:

- How is management measuring the credit union's interest rate risk exposure?
- What have they learned from shock testing?
- Should they consider changing the credit union's balance sheet, product pricing, or investment strategy to avoid excessive interest rate risk?
- How should the credit union's interest rate risk policy be updated to reflect the Fed's new interest rate forecast?
- What internal controls ensure the credit union will follow the board's interest rate risk policy?

If the answers suggest that interest rate risk may be exceeding your board's tolerance, NCUA's interest rate risk guidance describes several risk mitigation options. Choosing an appropriate risk mitigation option would reduce the shock of rising rates and increase your credit union's chances of survival in the future.

Cyber Threats

The next risk is outside the areas of expertise for many of us: cyber threats.

To understand cyber threats, we first need to understand the different types of hackers. We are already familiar with cyber thieves who hack into a large retailer or financial institution. Thieves' ultimate goal is to steal money.

But, the new types of hackers are much more dangerous—cyber terrorists. What makes cyber terrorists different from cyber thieves is their objective: Terrorists want to cripple or destroy critical infrastructure in the United States. We know many cyber terrorists are connected to hostile nations. We also know they're targeting smaller institutions to break into larger payment systems—with the goal of bringing down the entire U.S. financial system.

The different types of hackers have at least one thing in common: They're targeting credit unions—often as an entry point into larger systems.

So, what can you do?

Use the New Cyber Security Assessment Tool

NCUA, along with the other financial regulators, is a member of the Federal Financial Institutions Examination Council. Because cyber security is such an enormous challenge and one that we all face as regulators, we are working together to assist financial institutions and to develop supervision strategies.

As you may know, we recently sent a comprehensive tool, called the Cyber Security Assessment Tool, to all credit unions and banks. This tool has one goal: to help you evaluate whether your cyber security preparedness is aligned with your risk.

The tool is designed for financial institutions of all sizes and sophistication levels, but at first it may seem overwhelming. We are trying to provide as much information as possible. We recently held a webinar for the industry that was very well attended. If you didn't participate, I encourage you to listen the webinar, which is posted on our website. During the course of the webinar, many questions received from credit unions were answered.

Make Sure Your IT Staff and Vendors Keep Your System Secure

This includes strong password policies, proper patch management, employee training, and network monitoring. If you don't know what these terms mean, it's not too late to get educated. NCUA's Cyber Security Resources site is a good place to start.

Learn Cyber Security Best Practices in Meetings with Professional Groups
Links to national forums are posted on our Cyber Security Resources site.

If IT is outside your comfort zone, here are some questions you could ask about cyber security:

- What are the potential vulnerabilities of hackers using the credit union as an entry point to gain access to larger interconnected systems?
- Has staff done due diligence to evaluate cyber security of every vendor and every payment system with which the credit union has a digital relationship?
- How should you consider changing cyber security protocols based on guidance from FFIEC?
- How will you prepare for an examination with the FFIEC Cyber Security Assessment Tool in 2016?

Capital Outliers
The next forward-looking risk—capital outliers—is caused by only a few credit unions—but it could hurt all of you.

A few aggressive credit unions are taking excessive risks without holding sufficient capital to cover those risks. If those credit unions ultimately suffer losses, all credit unions—including yours—will have to pay.

To address this problem, NCUA proposed a revised risk-based capital rule in January—after listening carefully to your comments. Before I discuss the rule, let's put the underlying issue of capital adequacy into perspective.

Throughout the past year, credit union officials often asked me, "Since we've recovered from the crisis, why do we need a new rule on risk-based capital?"

It's a great question. The answer is simple: It's required by law. The Federal Credit Union Act requires NCUA's risk-based capital standards to be "comparable" with the federal banking agencies. The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve issued new risk-based capital rules in 2013—so, we have already fallen two years behind.

However, that's not the only good reason why we're updating our rule. Risk-based capital is also good public policy. It's designed to fix the problem of capital inadequacy at high-risk outliers in the credit union system—and do so before the next crisis occurs.

Credit unions' statutory net worth requirement of 7 percent of assets fails to recognize the difference between low-risk assets and high-risk assets. The net worth ratio is a lagging indicator, based on historical performance.

So as we analyze credit unions' historical performance, the numbers on this slide may look shocking to you. In the last 10 years, 192 credit unions failed. Yet 24 months before they failed, their average net worth ratio was over 12 percent. Officials in those credit unions believed they had more than enough net worth to account for their risks. But clearly, holding net worth over 12 percent still wasn't enough.

Today, surviving credit unions hold average net worth of 10.9 percent. If history repeats itself, we will see more high-risk credit unions fail.

Now don't get me wrong: I am not saying each credit union needs to have net worth over 12 percent. What I am saying is that each credit union needs to have enough capital to account for its own risks. A well-designed risk-based capital rule should do exactly that.

Unfortunately, NCUA's existing risk-based capital rule is not well designed. It has not been substantially updated since 2002, so it has not kept up with the growing sophistication of credit union assets over the past decade. A well designed rule would have helped more credit unions avoid capital losses—and reduced losses to the Share Insurance Fund which all of your credit unions had to pay.

After considering more than 2,000 comments, we made many significant changes in the second risk-based capital proposal.

Credit Unions with Assets up to $100 Million are Exempt from the Risk-based Capital Rule
Keep in mind that the banking agencies' risk-based capital rules don't exempt any banks. The $100 million threshold would exempt 76 percent of credit unions from this new risk-based capital rule, but it would cover nearly 90 percent of all assets in the credit union system.

The 10 Percent Risk-based Threshold to be Well-Capitalized is Lower than the Original Proposal
The original proposal would have required 10.5 percent to be well-capitalized.

Interest Rate Risk has been Removed from all Risk Weights
Our newly proposed investment risk weights focus only on credit risk, similar to the banking agencies. And we're going to supervise interest rate risk rather than proposing another rule.

Key Risk Weights are Significantly Lower than Our Original Proposal.
In fact, several risk weights for credit unions are even lower than FDIC's risk weights for banks. Capital in corporate credit unions and loans to credit union service organizations have been lowered to 100 percent. Most real estate loans are weighted at just 50 percent. Member business loan weights are structured so credit unions with a congressional exemption from the MBL cap won't have to change their business model.

With all of these changes, credit unions covered by the new rule should see their capital buffers actually increase.

The new rule targets outliers holding assets of nearly $14 billion—more than the entire Share Insurance Fund.

Finally, to follow our statutory mandate to design a risk-based system “comparable” to the banking system, our effective date will be timed to coincide with full phase-in of FDIC’s rule in 2019.

Now I know you will also be happy to hear this: My intent is for risk-based capital to be the last significant safety and soundness rule change for the foreseeable future.

Aging Membership

Speaking of the future, if the trend of aging membership continues, many credit unions may have no future. At last count, the average age of credit union members was over 47 years old. This is critical because the peak borrowing years are between ages 25 and 44. This means the average member has already past the prime borrowing years.

You all know that a credit union cannot survive without lending. Credit unions must attract members who are younger than the current peak borrowers.

Young demographics are huge potential markets: 33 percent of the U.S. population is under age 20. Yet, younger demographics are underserved by credit unions. For example, members between ages 18 and 24 account for just 9 percent of all credit union membership.

Why are college students and young workers not sticking with credit unions? Surveys of credit union members typically find a correlation between age and satisfaction. Older members tend to value a personal touch and stability in their institutions—two qualities that are traditional strengths of credit unions. But, younger people place more value on convenience—which they often find in other institutions.

To attract the borrowers of tomorrow, you need to offer the latest technology today. Today’s young people may never visit a branch. They expect to receive a full range of financial services on their laptops, tablets and smartphones. They expect to open accounts and receive loan approvals online. They expect to make all their deposits electronically, and make all their payments through their digital wallets. They expect immediate service, 24/7—wherever they are, on whatever device they are using. If you don’t offer what they expect, young people take their business elsewhere.

To develop new strategies to serve this new generation, here are some questions to ask management:

- How can the credit union reach more members in their prime borrowing years? Many credit unions try to reach young adults through their parents—but how many young adults listen to their parents?

- How will young people learn that the credit union can help secure their future? For example, do young members understand what makes credit unions unique from other institutions? Do they appreciate credit unions' member ownership, not-for-profit structure, and volunteer boards?

- How can the credit union use the technology needed to attract younger members? For example, how user-friendly is your credit union's website? Can users find what they're looking for in one click?

- What new media can the credit union use to reach young people? Is your credit union still placing most of its ads in newspapers, newsletters and brochures? Young, tech-savvy consumers get information delivered to them in new ways, most often as part as digital conversations. Your credit union needs to connect to these potential members in their own domains.

For instance, if your credit union has a visible presence on Facebook, Twitter and YouTube, you can speak to young people in their own language. You can become part of the conversation in their spheres of influence. The more young members you can reach this year, the more likely your credit union will not just survive, but thrive for years to come.

Year of Regulatory Relief

NCUA cannot help you reach young members. But, we can help you thrive in other ways—by removing regulatory burdens and providing you with more time to serve your members.

If you have not heard me say it before, let me say it here: NCUA is making 2015 the Year of Regulatory Relief. We are proposing or finalizing regulatory relief in at least six areas. Let's go through these areas one-by-one.

Supplemental Capital

First, we are writing a supplemental capital rule for risk-based capital. Under current law, NCUA could count certain forms of debt as supplemental capital for the risk-based capital ratio. For example, subordinated debt could be issued to members and non-members—but it would be uninsured.

I understand the need for supplemental capital in certain circumstances. As part of modernizing risk-based capital, I am committed to counting supplemental capital in full. The proposed rule should be released for comments this fall. The effective date would coincide with implementation of risk-based capital in 2019.

But, not everyone should have to wait until 2019 to benefit from supplemental capital. That's why I created a working group to focus on low-income credit unions that can already raise and count secondary capital. One goal was to increase access to secondary capital for low-income credit unions. In April, we achieved that goal through changes to our National Supervision Policy Manual.

Since we streamlined the low-income designation process, the number of low-income credit unions has more than doubled. Low-income credit unions are exempt from the member business lending cap and restrictions on non-member deposits—that is real regulatory relief.

Field of Membership

Second, we are providing regulatory relief by expanding fields of membership. In the past, we had to manually approve every association a federal credit union wanted to add to a field of membership. That was a burdensome process for everyone.

That's why in April, we finalized a rule designating 12 categories of associations that federal credit unions can automatically add to their fields of membership. I encourage you to consider which associations fit your field of membership, and take advantage of this opportunity.

To explore other ways federal credit unions could expand, I created a second working group to recommend options for more inclusive fields of membership. While many field of membership restrictions are statutory, we're not waiting for Congress to act. Later this fall, we're going to propose rule changes within NCUA's legal authority. The rule changes will be designed to broaden community charters, enhance occupational charters, and streamline processes for federal credit unions to add new members.

Fixed Assets

Third, we've eliminated the 5-percent fixed-asset cap. We all know an over-concentration in fixed assets has caused some credit unions to fail. But as you run your credit union, there are certain expenses you can't avoid. Eventually, you will need new computers, new systems and new facilities.

Now with no regulatory limit on fixed assets, decisions like these are yours to make—and yours alone. Your credit union's board of directors now has the freedom to set your own fixed-asset limit appropriate for your operations.

Securitizing Assets

Fourth, we plan to permit qualified credit unions to securitize their own assets. This would not apply to every credit union, because to successfully do securitize assets, you need very large economies of scale. Our final rule would permit the largest credit unions to tap new sources of liquidity and reduce interest rate risk by converting fixed-rate assets into cash.

Member Business Lending
Fifth, we plan to finalize a proposed rule to ease restrictions on member business lending. We are moving away from a prescriptive approach toward a principles-based approach that will give credit unions more flexibility.

Rather than NCUA establishing non-statutory business loan limits, you will have the freedom to set your own limits under the law. Decisions about whether to require a personal guarantee on each business loan will be made by loan officers, not regulators.

When the new rule takes effect, credit unions will no longer need to ask NCUA for business loan waivers. Our modernized business-lending rule will reflect the fact that you know your members better than we do.

Small Credit Union Asset Threshold
Finally, by raising the definition of "small" up to $100 million in assets, we've opened the door for more than three out of every four credit unions to be considered for even more regulatory exemptions. Our intent is to allow low-risk credit unions to spend less time reviewing unnecessary regulations and more time serving members.

These six initiatives are my priorities for NCUA—and for you—in this Year of Regulatory Relief.

Communication Channels

Before I open up to questions, I want to touch on ways we can keep in touch.

I wish I could speak with volunteers every month, because you're such an important audience. However, you can keep up with what NCUA is doing every month, through our newsletter, *The NCUA Report.*

The NCUA Report explains what we are doing and why, in plain English. And you don't have to hunt for it on our website.

You can sign up at no charge for automatic e-mail delivery from our NCUA Express e-mail service. In addition to *The NCUA Report*, you can sign up for Letters to Credit Unions, Regulatory Alerts, and a host of other information. You can choose to receive all NCUA e-mails, or select only the information in which you're most interested. To sign up, just go to NCUA.gov, type NCUA Express in the Search window, then click the first link.

Please encourage all your directors and managers back home to sign up for NCUA Express as well.

Conclusion

In the end, we all share common goals: ensuring the safety and soundness of credit unions, and protecting the 101 million federally insured members.

Let's work together to achieve our goals. If you have any questions or comments about any NCUA initiative, I would really like to hear from you. Now it's your turn to talk. Thank you for listening.