# Remarks of NCUA Chairman Dennis Dollar
# At 38th Annual Conference and Symposium
# Of the
# National Association of State Credit Union Supervisors
# Vail, Colorado
# September 7, 2003

It is a tremendous honor to be with you again this year at the 38th NASCUS Annual Conference and Symposium. Without question, the working relationship with our state regulatory partners is one of our most valued assets at NCUA. As I have shared with you each year over my past six years on the Board, both at our annual gatherings here at the NASCUS Conference and at the NCUA-NASCUS joint regulators' meetings (as well as in our occasions during the course of a year where we are called upon to meet together on issues of mutual concern), the value of the dual chartering system - as well as its viability - depends upon our realization that we have a common interest and a common calling…the creation of a regulatory environment which emphasizes safety and soundness as our first and foremost priority and which enables the institutions we regulate to fulfill their vision of service to their membership with innovation and creativity so long as that vision is built upon safety and soundness and within the proper confines of applicable federal and state laws and regulations.

Together, with this as our priority, we have accomplished much over the course of the six years we have worked together. We have copied some of your best practices at the state level. You have copied some of ours as well. We have issued at the federal level some of the regulations we have seen work most effectively at the state level. You have brought some of our most effective regulations to the state level as well. Where you have experience or expertise we lack, we have not been hesitant to call on you. You have done the same.

As you have heard me say many times – I know at least six times to this very conference – good regulatory practice is contagious. Of course, so can be bad practice. That is why it is incumbent on us to work together and move forward only the best and most effective of regulatory and supervisory approaches.

Although there will always be issues which by their nature are viewed differently at the state and the federal levels, we have never allowed those issues to divert us from our primary purpose…to ensure that the credit unions we regulate, as well as in our case those we insure, are financially strong, well managed and positioned to be even stronger and better managed in the years and, yes, decades to come.

Despite those few areas of difference in approach or even viewpoint, I know of no state where our working relationship with our state regulatory partners has suffered because of those differing points of view. Safety and soundness remains our top priority, and the results speak for themselves.

Credit unions, both state and federally chartered, are more financially strong than at any time in their history. Net worth is at an all-time high in actual capital dollars, and the net worth ratio of capital to total assets is only slightly lower than it was a little over a year ago solely because of the tremendous growth in deposits…a growth fueled by the confidence the American people have in the safety, soundness and long term viability of their credit unions.

The future of credit unions is bright, partly because of our diligence and our strong working relationship which has created a regulatory environment to allow this level of performance. However, we must be realistic and recognize that it has been the strong management and visionary leadership of America's credit unions that has been the primary driver of this financial strength and tremendous public confidence.

Our charge, even as we work together to ensure that this strong record continues, should be…as is the Hippocratic oath, first to do no harm.

Excessive regulation cannot, by its nature, be effective regulation. Excessive regulation stifles the very vision and creativity in member service necessary to keep credit unions safe, sound and competitive in the years to come. Safety and soundness cannot be separated from the ability to stay competitive in a changing and dynamic financial marketplace. As regulators, we must realize that these two are inexorably intertwined.

However, as regulators, we must also recognize that, just as excessive regulation cannot be effective regulation, the lowering of appropriate regulatory standards and supervisory oversight can neither be effective nor an accepted approach.

It is for that reason that I commend the leadership of innovative state regulators that we have had the privilege of working with, many of you through NASCUS and its leadership, others at times working with us directly on issues of mutual importance, to accomplish some significant victories in the past six years.

RegFlex, Incidental Powers, Prompt Corrective Action, Risk Based Scheduling, Risk Focused Examinations, Member Business Lending Regulations…all were federal initiatives that were made more successful by our cooperation and consultation with our state regulatory partners.

The AIRES platform, the improvement in the state waiver process, the establishment of a safety and soundness determination - rather than an federal

identical model approach - to the “substantially equivalent” definition as it relates to regulations of joint federal and state responsibility…even the overhead transfer issue with its decades-old differences of approach which may never be completely bridged was lowered for the first time in its history two years ago…each of these issues has been moved forward by our working relationship. I would not hesitate to say that the federal-state relationship on each of these issues is stronger than it was just a matter of a few years ago.

Let us continue the progress we have made and let us never allow our occasional differences in approach or even viewpoint to overshadow our considerable potential to be even more effective by working together in cooperation and consultation.

On a couple of specific issues, in this that is perhaps my final address to you in my capacity as Chairman of the NCUA Board, I would like to recommend that our proven record of a successful working relationship likewise be applied. The leadership of the state regulators in this room, along with the innovative state-chartered credit unions represented here today, could be decisive on several of these important issues.

First, I would like to ask your serious consideration of the need for a risk-based approach to the federal Prompt Corrective Action law. The present “one-size-fits-all” approach to PCA gives little incentive for credit unions with a 7% net worth ratio to better manage their risk and creates the at times false impression that a credit union with less than 7% net worth as a percentage of its total assets is not sufficiently capitalized, regardless of the risk profile of the credit union.

We all recognize that every credit union with 7% net worth is does not have the same risk. Neither does every credit union with 10% net worth. The failure of the present PCA law to recognize the individual risk factors in each credit union makes it difficult for credit union management to have regulatory guidance for risk mitigation actions they need to take when their net worth begins to near a troublesome ratio, even as it makes it difficult for us to drive more productive risk management decisions through the supervision process. Presently, PCA is all “stick” applied after the net worth ratio has fallen below a statutorily-prescribed automatic figure. As regulators, we also need an effective “carrot” that we can apply as an incentive to encourage, reward and, yes, if necessary, to provide benefit to a credit union when we have to require them to shift their risk and balance it more appropriately. Credit union managers need that guidance as well…risk based guidance which promotes and does not penalize better risk management.

A change to PCA, of course, requires congressional action. I am under no illusion this will be easy, nor certainly will it be quick. But I am convinced that risk-basing PCA is essential.

Although the structural credit union difference would require different factors and weighting than does the risk-based capital structure of other for-profit financial institutions, the fact remains that risk must be factored into any effective supervision model for financial institutions. In my opinion, credit unions will be stronger ten years from now if their risk management decisions can be evaluated as a part of a risk-based supervisory model. The present PCA law needs to be re-visited to help bring about this risk-based approach.

I encourage your serious evaluation of this issue and, hopefully, you will find it to be an initiative worthy of your support.

Briefly, I would like to also request your consideration of a regulatory proposal we will be presenting at the September NCUA Board meeting to strengthen the disclosure provisions when a credit union is considering conversion to a mutual savings bank, a decision which history tells us is often the precursor to an ultimate conversion to a stockholder-owned, for-profit bank which strips any member who does not have the resources or inclination to buy stock from having the ability to retain any ownership interest in an institution of which they may have been a member-owner for years or even decades.

The federal statutes clearly dictate the voting percentages necessary to convert from a credit union to a mutual savings bank. Our recognition of the inherent ownership rights of members in a member-owned cooperative is also clear. The members of credit unions would not be true member-owners if they could not choose to change the most basic of their institution's governance structure…its charter.

But, in this post-Enron/post-WorldCom age of transparency in corporate governance, why should not the disclosures regarding potential loss of member-ownership rights be as clear and factually accurate as possible. The statutes are clear as to who can vote and how many votes it takes to convert. The right to vote to change a charter is likewise inherent and clear to those who believe in the concept of member-ownership of a financial cooperative.

The disclosures should be equally clear. A member should not lose his ownership interest in a credit union of which he has been a member since he got his first job or bought his first car simply because the disclosures were in such fine print he couldn't read them without his bifocals or in such legalese he could not understand them without contacting his attorney.

We look forward to your comments on this proposal and hope you will work with us to make the conversion process - which has the potential to contribute to the demutualization of the credit union movement as we know it today - as transparent and clear as possible to the member-owners who are being asked to vote to change their credit union to a mutual savings bank.

Converting charters is a member's right…but so is it a member's right to have full and accurate information with which to make that decision.

Lastly, I would like to address one risk management issue that I know is a supervisory concern for us all and which, in this present interest rate environment which has been at a historic low but is now showing clear signs of inching upward, has the potential to become a significant risk management issue for all credit unions. I would like to ask you, as our regulatory partners, to work with us on this issue and we hereby offer to work with you closely to ensure that credit unions not merely endure any upward turn in rates but actually prevail in a changing rate environment.

As we all know, interest rates have fallen over the past year to 45-year lows. We also know that credit unions have experienced vigorous share growth for several years and, as a result of this confluence of events, credit union participation in the mortgage lending arena has increased to historic highs.

Currently, of all credit unions that hold first mortgage loans nearly one in ten have in excess of 25 percent of their assets invested in fixed rate first mortgage loans. This ratio, although certainly not within itself an indicator of a poorly managed mortgage portfolio, has more than doubled in the past ten years. It is highly probable and reasonable to assume that many of those fixed rate loans were originated over the last two years when interest rates were at or near 45-year historic lows. If the risk is not managed effectively, this degree of concentration in fixed, low rate first mortgage loans represents potentially high exposure to rising interest rates. This issue is not one of risk avoidance, but one of risk management.

In keeping with the purpose of the risk focused examination process, NCUA will focus particular attention on the risk management processes utilized by those institutions with higher concentration levels in fixed rate mortgages to measure and forecast their balance sheet risk. Effective risk management requires that long-term implications on the earnings and net worth of the credit union be properly addressed in a credit union's policies and procedures. We encourage your partnership with us in monitoring this emerging issue.

NCUA does not prescribe a fixed maximum percentage of mortgage loans in a credit union's lending portfolio that is applicable to all credit unions. Each credit union has its own individual risk profile and risk tolerance level. However, no regulator should permit an institution to continue an inherently high risk strategy when measures of fair value indicate net worth is approaching a dangerously low or even negative position as measured for plausible interest rate scenarios. The combination of low mortgage loan rates in existing portfolios and the feasibility of higher interest rates in the near future portend a situation where low and/or negative economic value is quite plausible for this kind of risk profile.

Without a doubt, the interest rate environment over recent years has offered credit unions unique member service opportunities. Credit unions have made significant strides in the mortgage lending arena, which have resulted in greater opportunities for enhanced service to members. If managed properly, this is a positive development. However, the potential for exposure to significant risk also exists if not managed properly. The extent of how high rates increase and how fast they get there are not controllable factors. Losses can quickly accumulate when rates rapidly increase and reducing the risk becomes considerably more costly.

While it is essential that credit union management balance the marketplace opportunities of the present with the economic considerations of the future, they must constantly monitor that balance and do so in a safe and sound manner which is appropriate to their ability to manage the risk. Credit unions with an excessive risk profile should be expected to address such exposures in an appropriate and timely manner and manage them on an ongoing basis.

Again, this is a management issue and one which history indicates will be effectively managed because credit union leaders have demonstrated themselves to be conservative by nature and proven in their risk management strategies. The strong financial position of credit unions underscores this fact. I am confident that they have the will and the ability to continue to manage it well even in a changing rate environment. They have been through these environmental changes before. Still, when rates begin to turn after a long period of stability, there are risk management issues which NCUA feels it is incumbent on us as regulators and supervisors to emphasize.

NCUA will be issuing a Letter to Credit Unions on this issue before the end of this month. This letter will supplement the five Letters to Credit Unions we have issued over the past four years on the subject of prudent balance sheet management in the present rate and market environment. The message is one designed to remind credit unions not to become complacent in the management of their first mortgage risk factors. We believe that, together, they provide valuable guidance to credit unions and a supervisory priority for us as regulators.

In closing, let me again say what an honor it has been working with you over the past six years. Together we have accomplished much. Yet much remains to be done. Building upon the foundation of cooperation and consultation we have laid by working together closely in these most recent years, I believe that the NCUA - State Supervisory Authority partnership is today stronger than ever. I am convinced that, if we keep emphasizing our overwhelming number of common interests and priorities rather than our occasional differences of approach or viewpoint, we will see safer, sounder, stronger and more viable American credit unions for not just this generation of members, but for generations to come.

Thank you so much. It has been an honor to be with you again this year.