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National Association of Federally-Insured Credit Unions

November 30, 2020

The Honorable Rodney E. Hood, Chairman
The Honorable Todd M. Harper, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Budget Briefing Presentation

Good morning Chairman Hood and Board Member Harper:

My name is Curt Long and I am the Chief Economist and Vice President of Research at the National Association of Federally-Insured Credit Unions (NAFCU). I want to thank the National Credit Union Administration (NCUA) Board for its leadership and ongoing commitment to ensuring a safe and sound credit union system and improving the lives of over 122 million credit union members across the country. A strong, independent NCUA is always one of NAFCU's key priorities and NAFCU supports the NCUA Board's transparency surrounding the budget. NAFCU applauds the NCUA for being a leader among financial services regulators in publishing a detailed, draft budget, hosting an open budget hearing, and providing an opportunity for feedback from the industry to improve the efficient use of credit union dollars. Nonetheless, the agency should continue to find ways of adapting to the changing environment and transitioning to new supervision and examination methods that do not result in significant year-over-year budget increases.

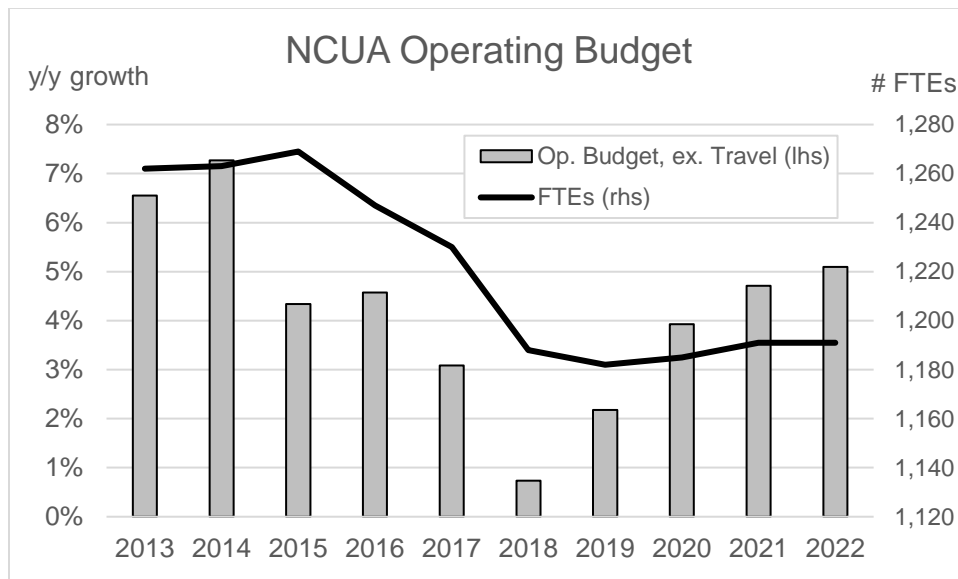
NAFCU encourages the NCUA to continue an ongoing, agency-wide commitment to managing its funds in a prudent and transparent way that uses cost savings as a learning opportunity and not a rationale for future budget increases. Below, NAFCU outlines several recommendations to improve the efficiency of its budget, including:

1. Preserving the strength of the National Credit Union Share Insurance Fund (SIF) and avoiding unnecessary assessments on credit unions;
2. Continuing to pursue exam modernization efforts and identify cost-saving opportunities in the transition to primarily virtual exams;
3. Achieving a reasonable and tailored budget for cybersecurity expenses; and
4. Supporting financial inclusion through the NCUA's new Advancing Communities through Credit, Education, Stability, and Support (ACCESS) Initiative with a focus on enhancing field of membership (FOM) and other growth opportunities.

General Comments

The NCUA crafts its annual budget to execute the agency’s mission, goals, and strategic objectives. The 2021 and 2022 proposed Budget Justification clearly outlines projected expenditures for important agency programs and initiatives. NAFCU commends the agency on realizing savings in its day-to-day operations in 2020 and encourages the NCUA to utilize lessons learned from the pandemic and forced virtual examination posture to achieve long-term budget reductions. Absent the reductions due to the COVID-19 pandemic, NCUA’s budget continues to increase year over year. The projected budget increases for 2022 signify that the agency is headed in the wrong direction with respect to operating an efficient budget.

The 2021 proposed Operating Fund Budget is \$315.6 million, which represents a decrease of \$0.3 million, or 0.1 percent, compared to the 2020 Board-approved budget. However, this reduction is entirely due to travel-related savings. Moreover the 2022 estimated Operating Budget balloons to \$341.8 million, which would represent an increase of \$26.2 million, or 8.3 percent, from the 2021 budget should it be approved as proposed. This also represents a 44 percent increase in only a decade while the credit union industry is on pace to consolidate by 31 percent over that same timeframe. The 2022 budget increase is partly due to a rebound in travel costs, which grow by \$10.8 million. But while the pandemic is clearly responsible for volatility in the travel budget, non-travel costs have been increasing at a steadily accelerating pace, exceeding 5 percent annual growth in the proposed 2022 budget. The credit union industry remains focused on the efficient use of resources and encourages the NCUA to do so as well by achieving year-over-year budget reductions.



With respect to full-time equivalents (FTEs), the Operating Budget for 2021 requests a net increase of five FTEs from the 2020 Board-approved levels. Since 2018, the level of FTEs has been relatively flat. NAFCU applauds the NCUA for maintaining steady staff levels, but when combined with the consolidation in the number of credit unions, this should provide conditions suitable to keeping Operating Budget growth much lower than its current path. NAFCU once again implores the agency to conduct a cost-benefit analysis for each new FTE along with a robust cost-

benefit analysis for each new program and initiative within the Operating Budget, with a goal of achieving the types of budgetary efficiencies that will arrest the upward drift in expenditures.

NAFCU and its member credit unions also remain concerned about growing expenses related to contracted services. This portion of the operating budget continues to see one of the largest percentage increases in 2021, totaling \$47.8 million or a 10.3 percent increase compared to 2020. In 2022, the NCUA proposes to further increase this category of expenditures by 11.8 percent. Although NAFCU strongly supports the agency's efforts to modernize its examination and supervision solution by transitioning to the Modern Examination Risk Identification Tool (MERIT), this goes beyond the projected 9.3 percent increase in contracted services expenses for MERIT outlined in the 2020 and 2021 Budget Justification. Incremental increases like this, although relatively minor on their own, compound an already growing annual budget. As NAFCU outlined last year, contracted services comprise a considerable portion of the NCUA's Operating Budget and the agency should work to find cost-effective means of training existing staff to conduct certain activities to minimize reliance on contracted services and reduce the size of this budget.

Although the agency continues to point to a decline in the relative size of the NCUA budget compared to the balance sheets at federally insured credit unions, industry asset growth alone does not mean the budget is more efficient. Considering the NCUA examines and supervises credit unions, not assets, NAFCU encourages a commitment to evaluating opportunities for cost-savings and budget reductions year-over-year. To clearly demonstrate this commitment to the prudent management of credit union dollars, the NCUA should always engage in cost-benefit analysis as it looks at existing and future programs. Most importantly, this year NAFCU recommends the agency focus on implementing lessons learned from the pandemic and holistically improving key supervisory elements to find economies of scale and other efficiencies in the 2021 and 2022 proposed budgets.

Preserve the Strength of the SIF and Avoid Unnecessary Assessments

Regarding the fund in general, NAFCU applauds the NCUA's steps to sell the taxi medallion loans under management by the Asset Management and Assistance Center (AMAC) in a single transaction early in 2020, as it has proven to bolster the SIF. As NAFCU's SIF Committee pointed out prior to the sale, the unusually large taxi medallion portfolio would strain agency resources and pose a risk to the credit union community so long as it remained under management by AMAC. While NAFCU did not anticipate a global pandemic at the time we offered this advice, we believed that retaining the portfolio in the hopes of extracting a higher sales price presented unnecessary risks, and recommended that the agency divest the portfolio at the earliest opportunity so long as it received a fair price.

Recent NCUA Board meetings have featured discussions of expanding the agency's statutory authorities over the SIF, including the ability to charge premium assessments when the equity ratio exceeds 1.3 percent. NAFCU opposes such changes as the SIF's historical record shows that they are unnecessary. NAFCU supports a 1.3 percent equity ratio and opposes discretionary premiums should the equity ratio fall below 1.3 percent. If the NCUA is required to charge a premium should

the equity ratio falls below 1.2 percent due to extraordinary share growth, then NAFCU urges the NCUA to implement a lengthy restoration plan.

Moderate recessions have not precipitated large premium assessments in the past. While the entire industry once more finds itself facing a low-interest rate environment, it should be noted that absent other changes, increasing the equity ratio of the fund today would place greater downward pressure on the equity ratio in the future. In order to maintain a stable equity ratio, the SIF's annual investment income must be sufficient to cover, among other things, the difference between the equity ratio and credit unions' one percent capitalization deposit. All else equal, raising the equity ratio widens this gap, placing greater downward pressure on the equity ratio.

Furthermore, NAFCU believes that the agency should clarify how discretionary premium assessments interact with credit union capital levels and other goals the agency has stressed, such as investments in cybersecurity and financial technology. If the NCUA insists that more authorities are needed to manage the fund to withstand the impact of a moderate recession, or if a moderate recession is no longer the proper standard, NAFCU would appreciate the opportunity for public comment or a hearing on this matter. In the near term, the NCUA should also evaluate its authority to provide credit unions with additional investment authorities to help manage the large share growth they have experienced this year.

Identify Cost-Savings Opportunities in Examination Modernization Initiatives

NAFCU appreciates the NCUA's prioritization of its examination modernization initiatives, including the Virtual Examination Program to further standardize examinations and relieve burdens. The NCUA should also use this opportunity to move toward lengthening the exam cycle for all healthy, well-run credit unions.

The COVID-19 pandemic has required the agency to conduct virtual exams and begin gathering more information for the transition to primarily virtual exams within the next five to ten years. Considering the cost savings from 2020 due to reduced travel expenses, the NCUA should quickly pivot to more virtual exams going forward, and incorporate lessons learned to achieve reductions by cutting unnecessary travel and other expenses.

The \$6 million in surplus 2020 travel funds should not immediately be allocated for travel costs in 2021. Instead, this is an opportunity to determine how much travel is ideal for examiners and credit unions, reduce costs by cutting travel expenses across the board, and transition to more offsite, virtual examinations as the infrastructure has already been set up because of the COVID-19 pandemic. Examiners and the agency overall have seen that much of the day-to-day work can be achieved remotely and should be moving forward, as many industries rely on more and more remote workers. Although NAFCU's members support continued in-person interaction with examiners during the exam process instead of a fully virtual exam posture, some efficiencies can be achieved with respect to the amount of travel required for examiners. The third largest portion of the NCUA's Operating Budget is travel expenses, so considering the lessons learned from 2020 regarding the extent to which supervisory and examination operations can be conducted offsite, NAFCU urges the NCUA to cut travel across the board on a go-forward basis.

NAFCU strongly supports the NCUA's commitment to modernizing its examination process and hopes to see the agency leverage advancements in technology to reduce the length of exams, improve consistency, and reduce the overall burden on credit unions. Virtual examinations have the potential to enhance consistency in the examination process by implementing standardized protocols for examiners and improving the overall quality of the examination process for all parties. Responses to a November 2020 NAFCU survey on agency examinations were mixed on the topic of consistency. While some reported few or no concerns, others said exam consistency is a significant problem and leveled pointed criticisms.

Despite delays due to the COVID-19 pandemic, NAFCU is also pleased to see advancements in the implementation of the Enterprise Solution Modernization (ESM) program, which includes the replacement of the Automated Integrated Regulatory Examination System (AIRES) with the new MERIT system. This new platform could ultimately provide cost savings for both credit unions and examiners, but its implementation does not come without substantial investment. NAFCU is pleased to learn that the bulk of examiner workforce training for the new MERIT system has already been funded in 2020 and new training requiring significant travel expenses will not be required in 2021. NAFCU looks forward to this new system providing substantial efficiencies and helping the agency to transition to primarily virtual examinations. The agency should continue to find ways to achieve cost savings to its Capital Budget as it rolls out MERIT in addition to keeping credit unions informed of the progress of the rollout.

NAFCU appreciates the agency's attention to our calls for additional updates regarding the progress of its exam modernization initiatives. Formal updates at NCUA Board meetings are extremely helpful for the credit union industry to remain apprised of the agency's efforts. In these public updates, it is important that the NCUA delineate what success looks like for the agency so that credit unions understand potential expectations and responsibilities. NAFCU urges the agency to continue this trend throughout 2021 and beyond as some initiatives will be nearing finalization while others remain ongoing.

Continue to Ensure Consistency and Transparency in Examinations

NAFCU appreciates the recent Interagency Rule on Supervisory Guidance (Interagency Rule) which clarifies the role of supervisory guidance as distinct from formal rulemaking as it does not create legally binding obligations on credit unions. This is a positive step in the right direction, but more remains to be done because credit unions continue to experience increases in examination burden. NAFCU's credit union members report inconsistencies and uncertainty in the NCUA's examination processes and procedures. The agency should ensure that the spirit of the Interagency Rule is applied to its examinations and that examiners are not substituting examination findings and changes in the examination process for public rulemaking under the *Administrative Procedure Act*. Unofficial policy guidance is not equivalent to a statute, regulation, order, or clearly unsafe or unsound practice and credit unions should not receive findings or documents of resolution for violations of any supervisory guidance.

NAFCU reiterates its call to improve accountability and reduce examination burden by adopting a formal feedback mechanism. As the agency undertakes its exam modernization initiatives, the industry would greatly benefit from a feedback mechanism akin to the Federal Deposit Insurance

Corporation's (FDIC) Post-Examination Survey, which applies to all FDIC-supervised institutions. The NCUA should institute a similar survey, the results of which would be sent to the NCUA's Ombudsman, to allow for candid feedback on issues like examination fairness, consistency, and overall burden. Such a survey could help to improve overall accountability and promote transparency within the agency's examination function.

Again, NAFCU appreciates the Interagency Rule and understands the delicate balance between the agency's dual roles as a regulator but is concerned that NCUA examiners will continue to take an overly risk-averse approach to examinations. Given the economic downturn and continued uncertainty due to the pandemic, NAFCU urges the NCUA to prioritize flexibility and transparency in its examination process so that credit unions may safely emerge from this difficult time. A key element of this approach includes working to provide consistency and clarity in the examination processes and procedures, especially with respect to areas of heightened risk, such as cybersecurity.

Ensure Appropriately Tailored Cybersecurity Expenses

NAFCU's member credit unions continue to identify cybersecurity as a top concern for their institution. According to the results of NAFCU's 2020 Federal Reserve Meeting Survey, on average 7.2 percent of credit unions' current operating budgets is devoted to cybersecurity, a 225 percent increase in average spending over 2015. Over the next three years, 94 percent of responding credit unions intend to further increase spending in information technology (IT) and 66 percent expect to increase the number of full-time employees devoted to compliance related to information technology requirements. Spending on additional IT staff is also the most common expected staff investment according to respondents. The magnitude of credit union investments in cybersecurity demonstrates the industry's successful adaptation to the current threat landscape—but these investments, much like the NCUA's own, must take into consideration the marginal benefit of each additional dollar of security. As the National Institute of Standards and Technology has frequently opined, companies need to evaluate cybersecurity risk management needs on a cost-benefit basis.

Fortunately, the NCUA appears to recognize that cost-effective cybersecurity depends, to a certain extent, on harmonization of standards and leveraging already available resources. In 2020, the NCUA shifted its priority from administering Automated Cybersecurity Examination Tool (ACET) maturity assessments to evaluating critical security controls. NAFCU supports this change in focus. Now that the agency has a better understanding of the industry's cyber maturity across different asset tiers, the critical security controls should provide a familiar and more streamlined approach for assessing the industry's security posture and cyber hygiene. Likewise, the Information Technology Risk Examination solution for Credit Unions (InTREx-CU) pilot offers a promising avenue to develop more consistent cybersecurity exams that builds upon the work done by other federal banking agencies. Considering that only one-quarter of respondents to NAFCU's August 2019 Economic & CU Monitor survey indicated that their last three cybersecurity examinations were "very consistent," NAFCU appreciates all efforts to foster greater consistency within the examination process.

Although NAFCU expects the NCUA's cyber-related examination initiatives to have a positive effect on the industry, we ask that the agency provide a more descriptive accounting of how their benefits will be assessed in the long term to better inform the agency's future cybersecurity expenditures. Likewise, additional analysis regarding certain cybersecurity related investments described in the budget justification would give credit unions greater confidence that improvements to the agency's overall security posture are cost-effective. For example, the Continuous Diagnostic and Mitigation (CDM) project is described as improving the agency's overall "situational awareness;" however, there is little information provided to compare this improvement against the agency's existing capabilities.

As we have noted in prior years, NAFCU is concerned that some of the agency's proposed investments in cybersecurity improvements, however well-intentioned, may be decoupled from results-based metrics, and may continue to drive costs disproportionately, resulting in yearly budget increases. Even though the agency must prioritize the security of its information systems, IT expenses encompass a significant share of the agency's growing budget for contracted services. While many of these expenditures are necessary to ensure the integrity of NCUA IT systems, NAFCU asks that the agency provide additional detail regarding whether security-related expenses associated with MERIT, InTREx-CU, and ongoing *Federal Information Security Management Act* (FISMA) compliance are mainly one-time costs, which reflect the need to upgrade systems, or ongoing costs. If they are ongoing, the NCUA should describe the metrics or processes it uses to determine whether IT or cybersecurity related costs are proportional to the agency's overall risk tolerances.

Despite our budgetary concerns, NAFCU appreciates the agency's transparency in cybersecurity related matters. The recent cybersecurity briefing delivered during the NCUA Board's October meeting, along with the promulgation of useful guidance responding to COVID-related cybersecurity threats, continues to help inform the industry of the agency's priorities and concerns. As an association, we have also found it easy to work with NCUA staff to better understand the agency's cybersecurity initiatives, and we thank Johnny Davis Jr. in particular for his availability as a resource to NAFCU and all credit unions.

To reduce budgetary pressure, NAFCU recommends the agency explore additional opportunities to leverage existing cybersecurity expertise from other regulators through the Federal Financial Institutions Examination Council (FFIEC). Utilizing such resources or finding new ways to collaborate with fellow regulators could help eliminate overlap and knowledge gaps within the agency that may be hard to fill. To the extent that the agency may be contemplating the pursuit of additional examination powers through legislative changes, we believe the industry deserves greater transparency regarding the budgetary impact of such a proposal, regardless of its merits.

Support Financial Inclusion Through NCUA's New ACCESS Initiative

NAFCU thanks the NCUA for its continuing commitment to financial inclusion and supports the mission of the NCUA's new ACCESS Initiative. The ACCESS Initiative's goal to expand access to credit, financial literacy education, financial stability and employment for communities most in need is important and NAFCU looks forward to seeing the results of the \$250,000 budgeted for contracted services related to the ACCESS Initiative. Chairman Hood's unyielding focus on

financial inclusion has proven to be critically important during this difficult economic time. NAFCU is optimistic about the ACCESS Initiative helping to close the gap that leaves many communities unserved and underserved. Expanding access to credit and ensuring that all communities have access to credit union services not only improves financial inclusion in our country, but it also strengthens the credit union industry.

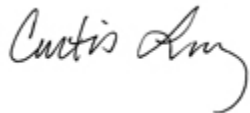
To that end, the NCUA's Office of Credit Union Resources and Expansion (CURE) must be well funded to ensure it has the ability to support low-income designated credit unions, minority credit unions, and any credit union seeking to expand its field or membership or to pursue these designations. Approving pending FOM expansions and considering additional methods for modernizing the agency's FOM requirements are critical to expanding credit unions' reach to the populations that need them most. NAFCU urges the NCUA to commit to pursuing these goals by guaranteeing that CURE be sufficiently funded to undertake them. The NCUA should closely evaluate its proposed budget to ensure that appropriate funding is devoted to helping credit unions emerge from this pandemic strong and equipped with the tools they need to continue growing.

Conclusion

Today's briefing highlights the agency's commitment to improving budget transparency and stakeholder engagement, which is of upmost importance considering the current economic circumstances. Although NAFCU has made several recommendations for ways to improve the efficiency of the agency's budget, the importance of this opportunity to provide recommendations in a public forum should be underscored as it is essential to ensuring a strong, growing credit union system. NAFCU applauds Chairman Hood and Board Member Harper, as well as the hard work of the NCUA staff in preparing this budget justification and other budget materials for today's hearing. NAFCU values the NCUA's day-to-day commitment to the stewardship of credit union member funds and looks forward to continuing the conversation regarding the agency's budget.

Thank you for the opportunity to appear before you today and I welcome any questions you may have.

Sincerely,

A handwritten signature in cursive script that reads "Curt Long".

Curt Long
Chief Economist and Vice President of Research