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National Association of Federally-Insured Credit Unions

November 18, 2019

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

RE: Budget Briefing Presentation

Good morning Chairman Hood and Board Members Harper and McWatters:

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 first want to thank the National Credit Union Administration (NCUA) Board for its strong leadership and continued commitment to helping to improve the lives of over 118 million consumers by ensuring a safe and sound credit union system. A strong NCUA is one of NAFCU's key priorities. NAFCU supports the NCUA Board's efforts to promote transparency and accountability so that credit unions understand just how their dollars are being put to use. NAFCU encourages the NCUA to continue to be the leader among financial services regulators by publishing a detailed, draft budget and soliciting candid feedback from the industry to improve the efficient use of its sizeable budget.

Each year, the NCUA constructs a budget to execute the agency's mission, goals, and strategic objectives. In late October, the NCUA released its 2020 and 2021 proposed Budget Justification. NAFCU commends the NCUA on its continued attention to eliminating duplicity and finding methods to promote efficiency in its day-to-day operations and implementing its longer-term projects. However, NCUA's budget is still increasing year over year.

NAFCU is not suggesting that the agency indiscriminately slash its budget, but is yet again encouraging an ongoing, agency-wide commitment to manage its funds in a prudent and transparent way. Below, NAFCU outlines several recommendations to improve accountability, including:

1. Conducting robust cost-benefit analysis and look-backs for NCUA programs, not just rules;
2. Providing additional information on the NCUA's exam modernization programs;
3. Providing more information on the expiration of the NCUA Guaranteed Notes (NGN) program and potential future dividends or payments to credit unions; and
4. Assessing risk in the system and whether safety and soundness is appropriately balanced with prudent regulation.

Cost-Benefit Analysis to Better Inform Program Efficiencies

In this third year of implementing the agency's strategic goals outlined in the 2018-2022 Strategic Plan, the proposed Budget Justification provides some detail on the development of those priorities most important to the credit union industry. Part of pursuing the agency's core values, namely "integrity, accountability, transparency, inclusion, and proficiency," should include providing credit unions with detailed information to understand how their valuable dollars are being used. Credit union monies should be used to not only promote the safety and soundness of the entire system but also to develop programs and reduce regulatory burdens to allow credit unions to better serve their communities.

To more clearly demonstrate the agency's commitment to the prudent management of its funds, NAFCU urges the NCUA to consistently engage in cost-benefit analysis as it looks at existing and future programs. The agency should also provide the industry with an opportunity to comment on its methodology through the standard rulemaking process. This could be part of, or in conjunction with, the agency's statutorily required Federal Register notice for comment on its budget materials.

Section 212 of the *Economic Growth, Regulatory Relief, and Consumer Protection Act* requires the NCUA to annually publish and solicit comments on a "detailed business-type budget." To better align with the intent of Section 212 and to provide credit unions with more details regarding specific initiatives, their ongoing status, and the metrics by which the NCUA judges the efficacy of its investments, NAFCU recommends the NCUA publish on its website its proposed Line Item Budget along with the Budget Justification well in advance of the Budget Briefing to provide credit unions with a glimpse into the NCUA's cost-benefit analysis strategy for particular expenses as well as the details necessary to provide comprehensive comments on the proposed budget.

The 2020 proposed Operating Fund Budget is $316.2 million, which represents a real dollar increase of $5.2 million, or 1.7 percent from the 2019 Board-approved budget. This also represents a 57 percent increase in only a decade while the credit union industry is on pace to consolidate by 32 percent over that same timeframe. 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.

A cost-benefit analysis for every portion of the NCUA's budget, combined with regular look-backs for the NCUA's programs, could bring the agency closer to achieving such efficiencies. Periodic look-backs at agency programs and rulemakings to determine their efficacy and evaluate potential cost-savings and other efficiencies is in congruence with the Administration's directive to reduce burdens and eliminate duplicity in existing and new regulations. The agency has indicated it would voluntarily follow the spirit of Executive Order 13771 and this is another method through which the agency can alleviate burdens and potentially reduce the size of its 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. As has been said in the past, the NCUA examines and supervises credit unions, not assets. Additionally, although the size of a credit union is a useful measure of its importance to the credit union system, size alone does not determine complexity or riskiness.

In 2018, the NCUA developed the Revised Complexity Index (RCI), which was based on a menu of assets and liabilities that the agency considered to be complex. The agency stated that the RCI "would provide a more accurate methodology… for identifying when credit unions engage in complex activities and defining credit unions as 'complex.'"[1] However, the number of such complex activities across the industry peaked in 2015 and has since declined. Furthermore, the number of credit unions engaging in three or more such activities follows the same pattern, having declined by over 140 since 2015.[2] Despite this decrease in complex activities, the NCUA's Operating Budget has continued to expand over that same timeframe without clear explanation or comprehensive rationale in the form of cost-benefit analysis.

Even though industry consolidation has led to an increase in the number of large credit unions, balance sheet complexity at credit unions does not mandate year-over-year increases in supervisory expenditures to oversee the safety and soundness of a maturing industry. The credit union industry is currently well-capitalized and strong, meaning credit unions can continue providing their members with the highest-quality products and services available in the market. The NCUA should moderate its supervision based on objective indicators, similar to those found in the RCI, as opposed to abstract, intangible risks that may not be consistent across the industry.

NAFCU recommends the agency focus on holistically improving a couple key supervisory elements and evaluating ways to find economies of scale and other efficiencies in the continued operation of its various programs as well as the implementation of new programs and initiatives. These supervisory improvements include examination modernization and cybersecurity enhancements.

Examination Modernization

Considering credit unions continue to struggle with procedural inconsistencies and other exam-related issues, the NCUA should prioritize its examination modernization initiatives, including the Flexible Examination Pilot Program (FLEX) or offsite examination procedures and the Virtual Examination Program to standardize examinations and relieve burdens. NAFCU is also pleased to see significant 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 Modern Examination and Risk Identification Tool (MERIT) system. Successful deployment of this new platform could provide cost savings for both credit unions and examiners.

NAFCU supports the modernization of the agency's legacy AIRES system with a new platform capable of sharing data in real-time. This new platform could provide substantial efficiencies and help to facilitate more virtual examinations. MERIT was originally estimated to cost $20.8 million through 2019, but the agency now estimates that through the remainder of 2019 and in the budget for 2020, total costs for MERIT implementation will reach $36.6 million. This considerable increase of nearly $16 million in additional expenses over the course of the two-year rollout of the new program is alarming.

[1] 83 FR 55467, 55470 (Nov. 6, 2018).
[2] *See* Appendix.

With any program, especially one of this magnitude, NAFCU urges the NCUA to conduct robust cost-benefit analysis as to its projected efficacy. NAFCU and its member credit unions support the implementation of new technologies and systems as well as the accompanying, required staff training; however, credit unions are left asking themselves "at what cost?" Is the NCUA likely to achieve the intended results of its latest new project with larger and larger budgets each time?

The agency should have qualified and trained staff capable of utilizing the new MERIT system as this could save credit unions time and money on the back end of the examination process. Nonetheless, NAFCU encourages the agency to find ways to achieve costs savings as it rolls out its new MERIT program during this year and next and keep credit unions informed of the progress of the rollout. One such opportunity may be a reduction in the proposed $1 million travel budget for training examiners on MERIT.

NAFCU generally 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. For example, NAFCU has strongly supported the FLEX pilot program and continues to support offsite examination procedures; however, the agency has not shared much about the progress of these initiatives. The agency could better inform regulated institutions with a report and more detailed information on the cost savings associated with extended examinations for well-run, low-risk credit unions above $1 billion.

According to NAFCU's October 2019 Economic & CU Monitor survey,[3] the median length between their most recent two exams was 12 months, which was unchanged from the result of our 2018 survey. Fewer than half of our survey respondents with less than $1 billion in assets reported an examination cycle of 18 months or greater. In 2017, the NCUA announced that it expected to fully implement extended exam cycles by this year, yet the evidence from NAFCU's survey indicates that much work has yet to be done. Furthermore, the average number of on-site examiners and the average length of examinations grew slightly in this year's survey as compared to a year ago. Survey respondents from credit unions with under $100 million in assets were the most likely group to report that the time allocated to exams had "increased significantly."

NAFCU has long said that expanding eligibility for extended exams could substantially reduce the agency's operating budget with potential savings to examiner training and travel expenses. With more information about the progress of the initiative, the industry could provide more useful feedback that would help to conserve valuable resources for the entire industry. Additionally, the agency could provide more periodic updates on the research and discovery phase for virtualizing elements of the examination process.

Virtual examinations have the potential to enhance consistency in the examination process by implementing standardized protocols for examiners and improve the overall quality of the examination process for all parties. Over half of the respondents to NAFCU's survey said that exam consistency was at least somewhat concerning, and 43 percent said that their highest priority for exam reform was more consistent application of rules and guidance. At the same time, 59 percent of our respondents said that access to exam-specific guidance was "somewhat

[3] *See* attachment.

challenging," a factor that could potentially worsen misunderstandings or differences of opinion with individual examiners.

In keeping with the agency's core value of accountability, NAFCU hopes to see more in the way of updates in 2020 regarding the progress of these initiatives. Although it appears that the NCUA has overall been headed in a positive direction with its exam modernization initiative, the opaque nature of its actions has left many credit unions asking questions. It is critical that the NCUA delineate what success looks like for the agency so that credit unions understand expectations and their responsibilities.

If credit unions have input into the agency's initiatives, they can better inform the process and hold the agency accountable for reducing examination burden. As the agency undertakes these changes to its examination processes and procedures, 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.

Expiration of the NGNs

Considering that the liabilities associated with the NGN program are set to expire in 2021, the NCUA should promptly provide the industry another update on the legacy asset disposition strategies under consideration and how the NCUA plans to choose among the alternatives. In the interest of accountability, the NCUA should clearly outline the pros and cons of each alternative under consideration as well as the implications for depleted capital holders and the Share Insurance Fund. NAFCU has heard numerous anecdotes of credit unions being approached by third parties seeking to purchase the capital certificates at steep discounts. A briefing or FAQ on this topic would help to clarify the nature of those claims to credit unions.

The Rulemaking Process

As a regulator, the NCUA is both responsible for monitoring the safety and soundness of the credit union system and for creating a functional framework of rules for credit unions to operate. Post-financial crisis, credit unions were subject to regulation that impeded their growth, and NAFCU has worked with the agency and other regulators to lessen that burden. However, in recent years, while the pace of rulemaking has slowed, the burden on the examination side has increased. Although reducing regulation has improved flexibility, NAFCU's member credit unions have found that consistency and certainty have also decreased.

NAFCU urges the NCUA to closely evaluate its examination processes and procedures to understand whether it has been substituting examination findings and changes in the examination process for public rulemaking under the *Administrative Procedure Act*. NAFCU's members continue to provide examples of situations where examiners have used certain unofficial policy guidance as de facto regulation to hold credit unions responsible for certain behaviors and activities that are not clearly prohibited by law. This coupled with ongoing feedback regarding inconsistencies in the examination process raises questions as to the extent to which the agency is circumventing rulemaking through the implementation of tougher, experimental examinations.

NAFCU understands that there is a balance between the agency's dual roles but questions whether the NCUA is taking an overly risk-averse approach to its management of the industry. NAFCU believes that both flexibility and certainty can and should co-exist in this instance and other areas. One such area is cybersecurity enhancements for both the agency's systems as well as the industry at large.

Cybersecurity

NAFCU's member credit unions continue to identify cybersecurity as a top concern for their institution. As such, NAFCU appreciates and supports Chairman Hood's focus on cybersecurity as the financial services industry is becoming increasingly digitized and hackers are becoming more sophisticated. NAFCU also appreciates the recent Board Briefing during the October Board meeting, where agency staff provided updates on new cybersecurity-related activities on which the agency plans to focus its time and resources. The NCUA Board has made it a priority to outline four new goals to enhance consistency in the cybersecurity examination program, encourage due diligence for credit unions in dealing with supply chain service providers, improve operational hygiene and resilience, and ensure the security of sensitive unclassified information.

NAFCU generally supports these principles as well as investments into a strong cybersecurity framework; however, cautions the agency against devoting too many resources without a formal assessment process for its work in this area. NAFCU urges the NCUA to examine whether such investments are serving their intended purpose using robust cost-benefit analysis. Aside from allocating $500,000 to acquire and implement data loss prevention tools and processes, the budget hardly itemizes any cybersecurity-related expenses for 2020 and 2021. NAFCU is concerned that some of the agency's proposed investments into cybersecurity improvements, although well-intentioned, may be decoupled from results-based metrics, and may continue to drive costs disproportionately, resulting in yearly budget increases.

Furthermore, NAFCU requests the agency find more opportunities to leverage existing cybersecurity expertise from other regulators through the Federal Financial Institutions Examination Council (FFIEC). Utilizing such resources to increase collaboration among financial institutions regulators could help to reduce cybersecurity-related expenses by eliminating overlap. NAFCU recognizes and appreciates the NCUA's development of a new, tailored examination program modeled on the Information Technology Risk Examination (inTREx) solution used by the FDIC, the Federal Reserve Board, and state regulators. This program is another opportunity to improve consistency and establish measurable expectations for examinations. 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 potential avenues for improvement of this aspect of the examination process.

Additional Areas of Potential Cost Savings

NAFCU and its member credit unions also ask that the NCUA continue to consider ways to reduce expenses related to contracted services. For the second year in a row, contracted services has seen one of the largest percentage increases as a portion of the 2020 budget, totaling a 13.8 percent increase from 2019. Part of this increase is due to the reclassification of certain technology costs from the administrative budget to contracted services. But then again, in 2021, the agency projects a 9.3 percent increase in contracted services expenses due to systems operations and maintenance support for MERIT.

NAFCU acknowledges the necessity of contracted services in certain instances and fully supports the use of experts to, for example, more quickly complete and propose a rulemaking on subordinated debt. Nonetheless, contracted services comprise a considerable portion of the NCUA's operating budget and it would behoove the agency 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.

Conclusion

Today's briefing marks another year of the agency's commitment to improving budget transparency and stakeholder engagement. Although NAFCU has made several recommendations for ways to improve the agency's accountability in the budget process, the opportunity to provide recommendations in a public forum is incredibly valuable and essential to ensuring a strong, growing credit union system. NAFCU applauds Chairman Hood and Board Members Harper and McWatters, as well as the dedicated NCUA staff, for the many hours spent preparing the budget justification and other budget materials for today's hearing. More importantly, we value the day-to-day commitment to the stewardship of credit union member funds.

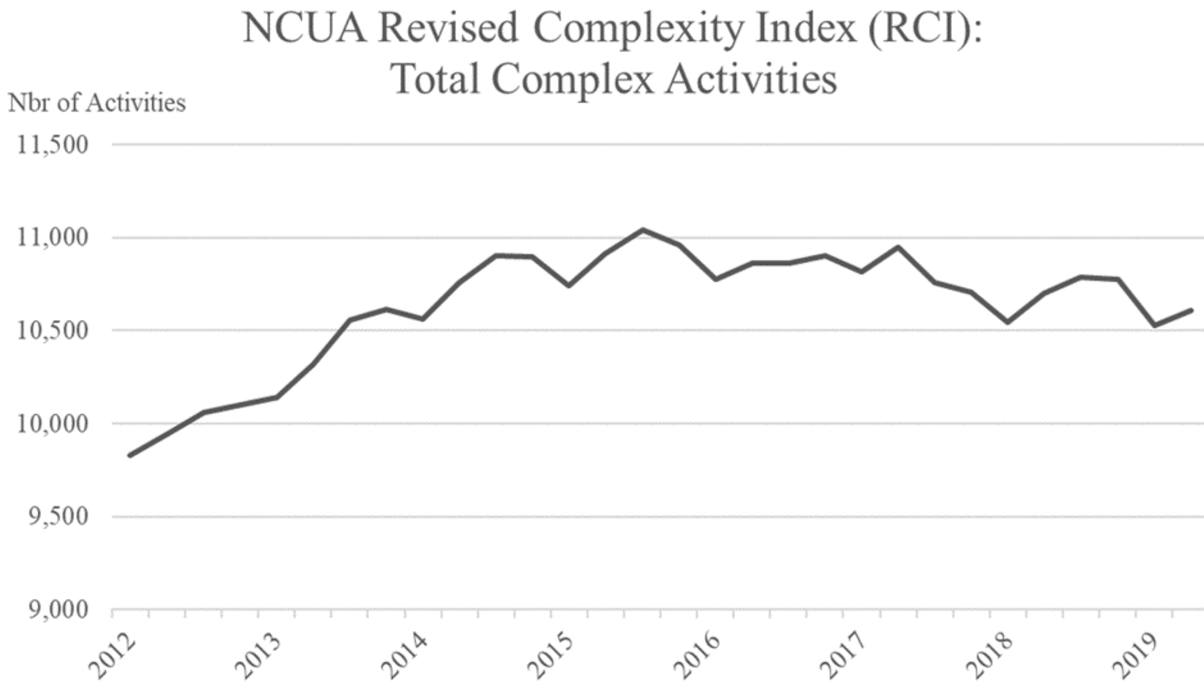
Thank you for the opportunity to appear before you today and I welcome any questions you may have.

Sincerely,

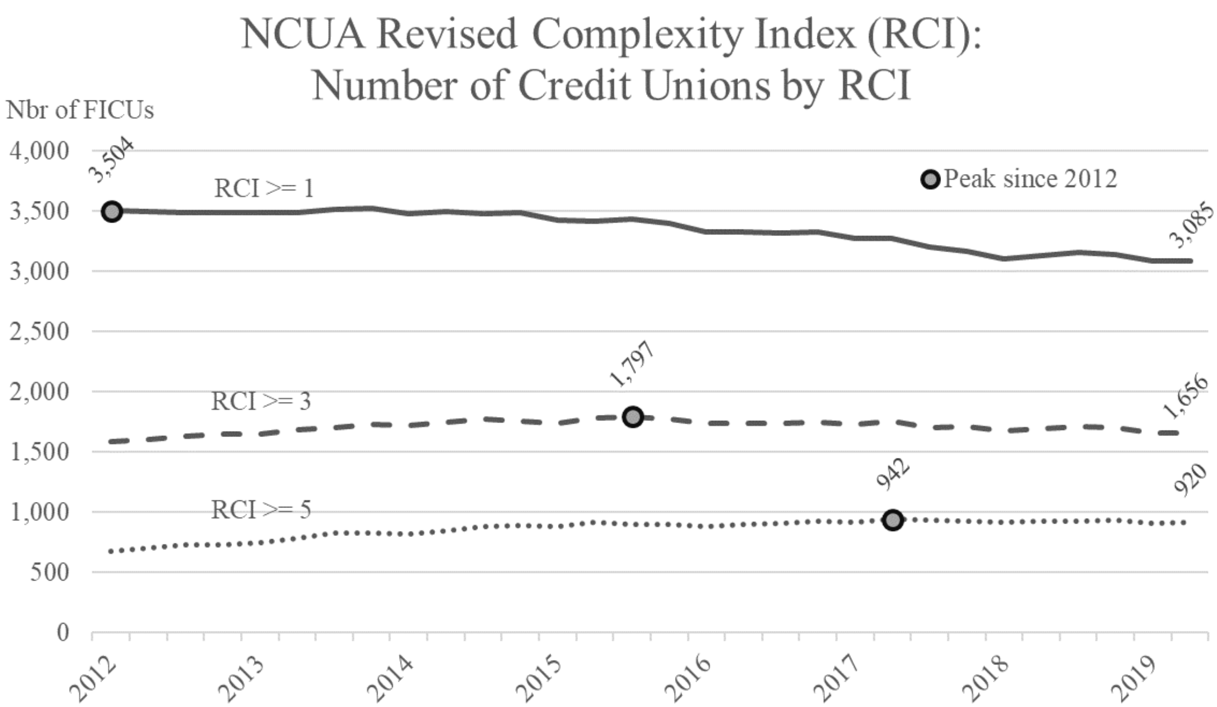
Curtis Long

Curt Long
Chief Economist and Vice President of Research

APPENDIX



Source: NCUA Notice of Proposed Rulemaking 12 CFR Part 702, Risk-Based Capital (83 FR 55467)



Source: NCUA Notice of Proposed Rulemaking 12 CFR Part 702, Risk-Based Capital (83 FR 55467)

ECONOMIC & CU MONITOR

National Association of Federally-Insured Credit Unions NAFCU's Monthly Report on Economic and Financial Conditions Affecting Federally-Insured Credit Unions

Industry & Economic Briefing

By Curt Long, Chief Economist / Director of Research

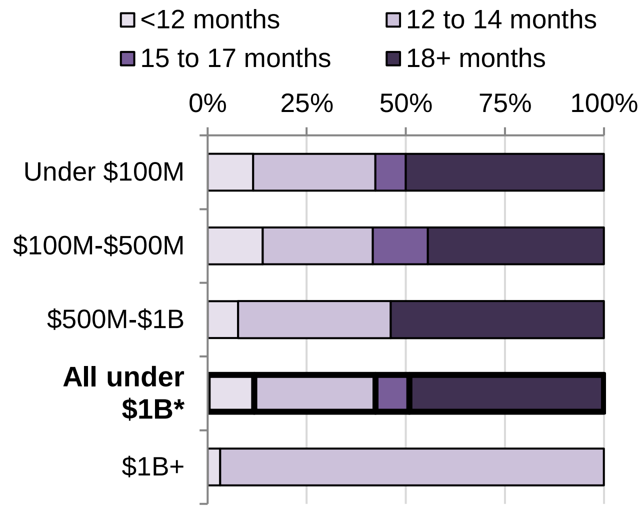
Economic & Industry Outlook: The clouds have parted a bit, as far as the economy is concerned. Among the more notable recent developments, the yield curve is inverted no more. Ten-year yields are now flirting with 2 percent, where a month earlier they were just above 1.5 percent. To the extent that some of that renewed optimism rests on trade developments, those still appears fragile, as negotiations are lately hitting snags over tariffs on agricultural products. But the Fed's three rate cuts have helped to calm fears, as well. And although the FOMC has made it clear that it is pausing those cuts for now, there is a clear easing bias among committee members at the moment, and the next rate hike looks to be a long way off. Meanwhile, the labor market and consumer spending continue to plug along. Although other areas of the economy such as business investment are sagging, consumption appears to be robust enough to keep the economy out of a recession. So long as employers continue hiring, there is no reason to believe that households will stop spending.

NAFCU's Credit Union Sentiment Index declined last month, although the three-month moving average continued to rise. The outlook for growth and earnings improved from the prior month, but the lending and regulatory components each fell. Among those with a positive outlook on earnings, nearly half still cited strong loan growth and loan performance as the chief reason for that optimism. But their overall economic outlook and the interest rate environment were key considerations, as well.

Special Topic: Examinations

For several years, the NCUA has touted several exam modernization initiatives to enhance the effectiveness, efficiency, and quality of its supervisory processes. These initiatives include the Flexible Examination Pilot Program (FLEX); Office of National Examinations and Supervision (ONES) Data Driven Supervision; Shared NCUA-State Regulator Federally Insured, State-Chartered Credit Union (FISCU) Program; the Enterprise Solution Modernization Program (ESM); and Virtual Examination Program. In addition, the NCUA has invested heavily in its new Modern Examination and Risk Identification Tool (MERIT), which is currently being tested at ONES credit unions, and will be deployed at all credit unions later in 2020. Collectively, these programs are intended to reduce examination burden, streamline review processes, and replace legacy toolsets with more efficient and secure technology platforms.

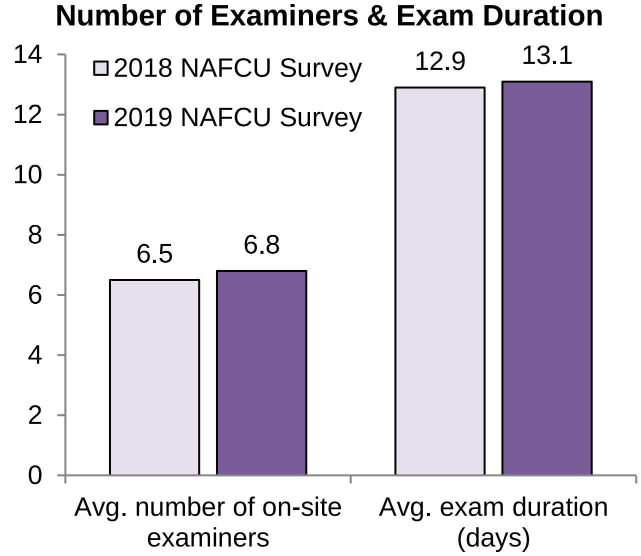
How long was it between your last two examinations?
(Respondents grouped by asset class)



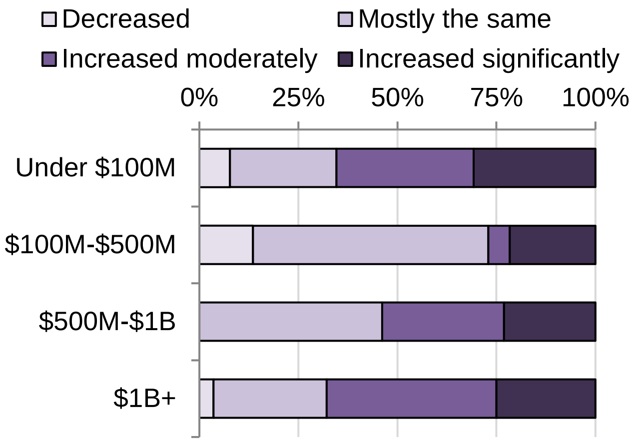
* Survey population fitted to industry by asset class

In this month's survey, credit unions described their examination experiences and identified desired reforms. Most notable among these findings was the fact that when compared with 2018, the median length between exams has remained largely unchanged at 12 months despite the agency's goal of utilizing an extended exam cycle for well-capitalized and well-run credit unions under $1 billion in total assets. In 2017, the NCUA announced that it expected to fully implement extended exam cycles by 2019. Survey results indicate that slightly fewer than half of credit unions with under $1 billion in total assets have an examination cycle of 18 months or greater.

Number of Examiners & Exam Duration



How has the time alotted for completing exams changed in recent years?
(Respondents grouped by asset class)

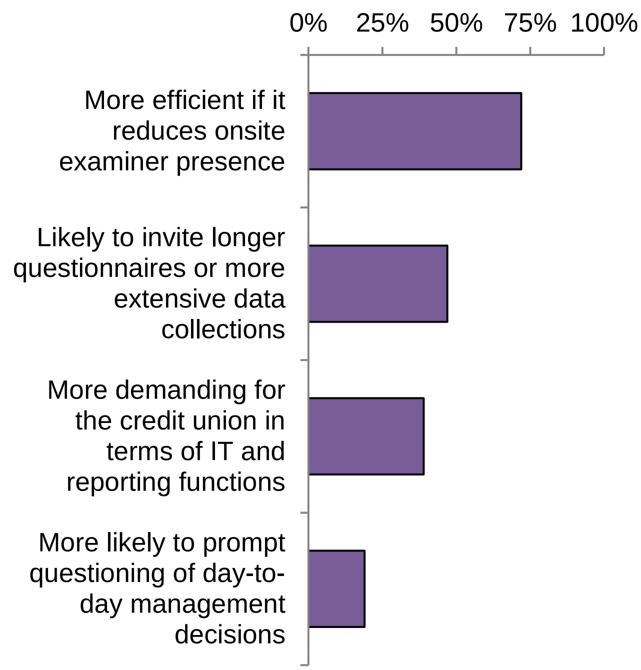


Both the average number of onsite examiners (6.8) and the average length of exams (13.1 days) increased slightly compared with last year's survey results. These findings suggest that the promised efficiencies of virtual examinations and other initiatives have yet to be fully realized. Given that the average staff resource time allocated to examinations has only increased for respondents in recent years, averaging 15.4 days, it has become imperative for NAFCU to seek greater transparency regarding when the NCUA's modernization initiatives will start to deliver tangible results for the credit union industry. Respondents representing the smallest credit unions (under $100 million) were the most likely group to report that the time allotted to exams had "increased significantly." Similarly, 61 percent of credit union respondents with greater than $1 billion in assets reported that the time allotted to exams had increased.

A more immediate concern for respondents was examination consistency. Over half of respondents said that they were at least somewhat concerned with exam consistency and 43 percent said that their highest priority for exam reform was more consistent application of rules and guidance. At the same time, 59 percent of respondents said that access to existing exam-specific guidance was "somewhat challenging," a factor that could potentially worsen misunderstandings or differences of opinion with individual examiners. A strong majority of respondents (77 percent) thought that the NCUA should produce more exam-related guidance, whether in the form of Letters to Credit Unions, risk alerts, or other notices.

Looking to the future, respondents shared their perspectives on potential outcomes of the MERIT examination tool, which will replace AIRES. Respondents were asked what their views were regarding a predominantly electronic, but data dependent model of supervision. Respondents generally expressed an optimistic view of MERIT's future value, but noted concerns related to autonomy and the prospect of greater data collection burdens. In meetings with the NCUA, NAFCU has drawn attention to the need to balance efficient, remote exam capabilities with respect for credit union autonomy and managerial discretion. NAFCU continues to monitor development of continuous supervision processes under ONES and the impact of the rollout of MERIT to ensure that credit unions can make management decisions with the necessary speed and efficiency to ensure long-term financial health.

What are your views on a predominantly electronic, but data dependent model of supervision?
(Multiple responses allowed)



Next Month's Special Topic: Bank Secrecy Act
Survey Deadline: December 6