



National Association  
of Federal Credit Unions  
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NAFCU | Your Direct Connection to Advocacy, Education & Compliance

July 29, 2016

Mr. Keith Morton  
Region Four Director  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA 22314

**RE: Comments on the Exam Flexibility Initiative**

Dear Director Morton:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association focusing exclusively on federal issues affecting the nation's federally insured credit unions, I am writing to you regarding the National Credit Union Administration's (NCUA) Exam Flexibility Initiative to modify supervision and examination procedures.

First and foremost, we appreciate the agency's intentions to improve the exam process, which will ideally increase the quality of exams, while simultaneously reducing their burden on credit unions. Although the majority of this letter will focus on common issues and problems related to the exam process, many of our members have experienced positive and productive exams. Additionally, many have noted that the process has improved over the last few years as they have developed a relationship with their examiners. However, a high number of our members still routinely have grievances with the exam process.

**Background**

Examinations are a critical component of our members' relationship with NCUA. Often, it is the only time that credit unions have face-time with agency personnel. Conducted properly, examinations help individual credit unions identify potential problems early, and provide assistance in addressing them. A good examination process is a critical component of a healthy credit union, and as a whole, a healthy industry.

Over the last decade, NCUA has implemented many examination programs that have increased exam efficacy and efficiency, which NAFCU has supported. For example, NCUA implemented a Risk-Focused Examination (RFE) Program in 2002 which used risk-focused supervision procedures that included reviewing off-site monitoring tools and risk evaluation reports. In 2009, NCUA implemented a new national examination and

supervision quality control review process to periodically sample examination and supervision reports from each region. Then in 2012, NCUA established the National Supervision Policy Manual (NSPM), a uniform credit union supervision process for all regions. The NSPM replaced individual regional supervision manuals and policies, helping to ensure credit unions are treated more consistently from region to region. In 2015, NCUA instituted the Small Credit Union Examination Program (SCUEP) for well-run, financially sound credit unions with assets less than \$30 million. By spending less resources on smaller, well-run credit unions, NCUA now has more time to spend on larger and potentially riskier credit unions.

Most recently, on July 21, 2016, the NCUA Board retired two agency performance goals requiring the examination each calendar year of all federally insured, state-chartered credit unions (FISCUs) with more than \$250 million in assets and every federal credit union (FCU). As Chairman Metsger noted, this change will give NCUA regional offices greater flexibility to schedule exams when they are needed, and when they make the most sense, rather than basing them on an “arbitrary calendar-year requirement.”

However, despite these improvements, NAFCU believes the agency can do more to decrease the exam burden for low-risk, well-run credit unions that have a long history of being safe and sound. For purposes of improving such a critical agency program, NAFCU continually seeks member feedback to monitor and identify examination issues. Therefore, we appreciate the opportunity to share this feedback with you.

In seeking stakeholder feedback on the exam process, NCUA posed several questions. Our comments will first address NCUA’s question about concerns with respect to the current examination and supervision program. Next, we will discuss how a better designed appeals process will address many of the common concerns shared by our members. Finally, we will discuss the remaining questions that NCUA posed, specifically regarding an extended exam cycle.

### **What Concerns do Credit Unions Have about the Current Examination and Supervision Program?**

NAFCU used two resources for determining what concerns our members have about the current examination and supervision program. First, on an annual basis, NAFCU surveys our members to gauge the industry’s view of NCUA examinations. We use these results to get a detailed assessment of our members’ experience with their exams, and then we compare the results from previous years in order to determine the program’s trends. A more detailed analysis of our annual survey is attached to this letter in Appendix A.

Second, NAFCU’s compliance experts hear daily about exam problems, concerns, and issues. Over the past two quarters, in anticipation of the exam flexibility initiative working group (Working Group), NAFCU has recorded, aggregated and sorted common member complaints about the exam process. The full list with brief details of each issue is attached to this letter as Appendix B.

Between our annual survey and direct member feedback, NAFCU has identified the following common issues with the exam process:

- Examiners' overreliance on guidance and best practices;
- Absence of sufficient notice; and
- Lack of consistency.

#### Distinction between Regulation and Best Practice

Noted in our list of common exam problems, NAFCU has been hearing more frequently from our members that examiners are requesting documents and issuing findings based on best practice rather than regulatory requirements. Some examiners routinely treat guidance and best practice as if it were part of the regulation. In these situations, if a credit union does not comply with the guidance, then the examiner writes it up as being something roughly equal to failing to comply with the regulation.

NAFCU is becoming increasingly concerned of examiners that misuse and misplace reliance on guidance documents. This becomes even more worrisome in light of the fact that many members believe that examiners have material and guidance documents that are not made publically available.

#### Absence of Sufficient Notice of Examinations

NAFCU has found that there is a direct correlation between examination satisfaction and adequate advance notice. Although many members have positive sentiments toward their examiners and examinations, the process can certainly be disruptive of daily credit union operations. Depending on the size of the credit union being examined, senior officers and staff must set aside a dedicated number of hours to assist the examiners during their onsite visit. In order to simultaneously perform their routine duties and assist onsite NCUA staff, credit unions must be able to plan accordingly.

Unfortunately, a substantial number of our members have told us that insufficient notice is given before an exam date, in some cases, as little as two weeks advance notice. That is clearly not sufficient time to prepare for the substance of an examination, let alone enough time to develop the operational plan that accounts for a business disruption. Accordingly, NAFCU urges NCUA to formally adopt a minimum notice of six weeks prior to an exam, with failure for adequate notice triggering credit union discretion for a rescheduled exam date.

#### Lack of Consistency

NAFCU supports effective exams that are focused on safety and soundness and flow out of clear regulatory directives. However, the examination process, by its very nature, can be inconsistent. For example, related to lack of advance notice of an exam, many of our members have been uncertain as to which business area will receive the most emphasis by

an examiner. While one examiner may find mortgage lending to carry the most importance, another may place emphasis on business lending.

NAFCU believes that maintaining a consistent supervisory and examination environment is important to establish safety and soundness. Notwithstanding changes in regulation, the standards by which a credit union is evaluated during examinations should not change from examination to examination.

Regulators should ensure that their regulations are consistently applied from one examiner to another. Inconsistent application of laws and regulations among examiners increases uncertainty. This increased uncertainty adds another unnecessary layer of difficulty for credit unions to maintain the highest levels of compliance. More should be done to ensure that all examiners treat both regulations and guidance consistently and for the purpose each was issued.

Although NCUA implemented the National Supervision Policy Manual (NSPM) to increase consistency, NAFCU believes that the agency has yet to establish a transparent system that identifies the disputed examination issues, and elevates those findings to a level where the industry can determine if there are systemic problems, or only issues related to particular examiners. If a tracking procedure already exists, then NCUA should make the results of those findings public in a manner that still maintains the requisite level of privacy.

### **A Better Designed Appeals Process Would Address Many Common Concerns**

NAFCU has heard from our members that many of the problems identified above could be resolved through a more streamlined appeals process, which could spur greater utilization and quicker resolutions. In fact, many of our members have said a more robust appeals process would be even more useful than an extended examination cycle.

Although NCUA already has an appeals process in place, NAFCU has found that not many of our members use it. For example, our most recent annual survey found that although two-thirds of respondents believed their Documents of Resolution (DOR) were unjustified, only 9.1 percent of respondents reported that they had contested the results in the last five years. Clearly there is a disconnect between the number of respondents that felt a DOR was unjustified and the number that actually contested or appealed those results. In exploring why so many members do not use the appeals process, NAFCU has heard that many members do not believe the process will yield results, and therefore do not even start the process. Others, we have found, are fearful of potential retaliatory actions, causing a chilling effect that discourages legitimate appeals.

As NAFCU understands, the process for appealing exam findings is the following: first, if an examiner takes an action against the credit union, the credit union can directly contest it with the examiner. If the credit union is not satisfied with the result, then it may contact the supervisory examiner, who reviews the examiner's analysis. If that result is not

satisfactory, then the credit union may send a letter to the regional director. After all these steps have been taken, a credit union may appeal to the NCUA Supervisory Review Committee only if the issue concerns a material supervisory determination, such as a CAMEL Rating of 3, 4, and 5, or the adequacy of a credit union's loan loss reserve provisions, among others. Although NAFCU appreciates that an appeals process exists, we believe that as currently structured, especially as it relates to the first few steps, the appeals process is inadequate.

First, NAFCU has heard that many members do not contest findings because the first step in the process is contesting it with the exam team that issued the finding. However, since these credit unions will likely encounter the same examiners year-after-year, many credit unions feel that it is not in their best interest to contest these findings and possibly sour the relationship with their examiners. Accordingly, NAFCU believes that NCUA should develop an environment where credit unions feel safe to raise disputes with examiners' findings, without the fear of retaliation.

NAFCU believes that an independent appeals process will help ensure timeliness, clear guidance and fairness, free of examiner retaliation, perceived or real. In its 2012 report, NCUA OIG recommended that NCUA establish a national reporting requirement requiring each regional office to regularly provide to the Office of Examination and Insurance specific details on disputed examination issues elevated by credit unions to the Regional Director for a regional determination. The report stated that such a requirement could "include providing information on the number of elevated disputed examination issues, details about the disputed issue and the level of effort needed to resolve it at the examiner level, the outcome of the regional determination, and the length of time it took to close the disputed issue."

NAFCU believes that an independent review by a third party would help create an environment where a credit union feels it can raise an issue without fear of retaliation or affecting its examiner relationship. A third party review would also help provide a quality assurance check on examination results, and subsequently, hold examiners accountable for their findings.

### **How Can NCUA Conduct Future Examinations in Ways that Minimize their Impact on Credit Unions' Operations?**

The remaining questions posed by NCUA revolve around the efficiency and efficacy of an extended exam cycle. In particular, the agency is seeking suggested metrics used to determine eligibility for a longer examination cycle, and ideas on ways to leverage technology.

#### **Low-Risk, Well-Run Credit Unions Should Benefit From an Extended Exam Cycle**

NAFCU has long-advocated that any change in the examination cycle needs to be a part of a comprehensive, well-integrated plan to promptly identify and resolve problems at credit

unions. Relatedly, nearly 90 percent of respondents in our most recent exam survey considered a return to an 18-month exam cycle as a form of much needed regulatory relief. Accordingly, an extended exam cycle is an issue that will have a direct and immediate impact on our members and their ability to mitigate compliance costs and lost-time related to onsite examinations.

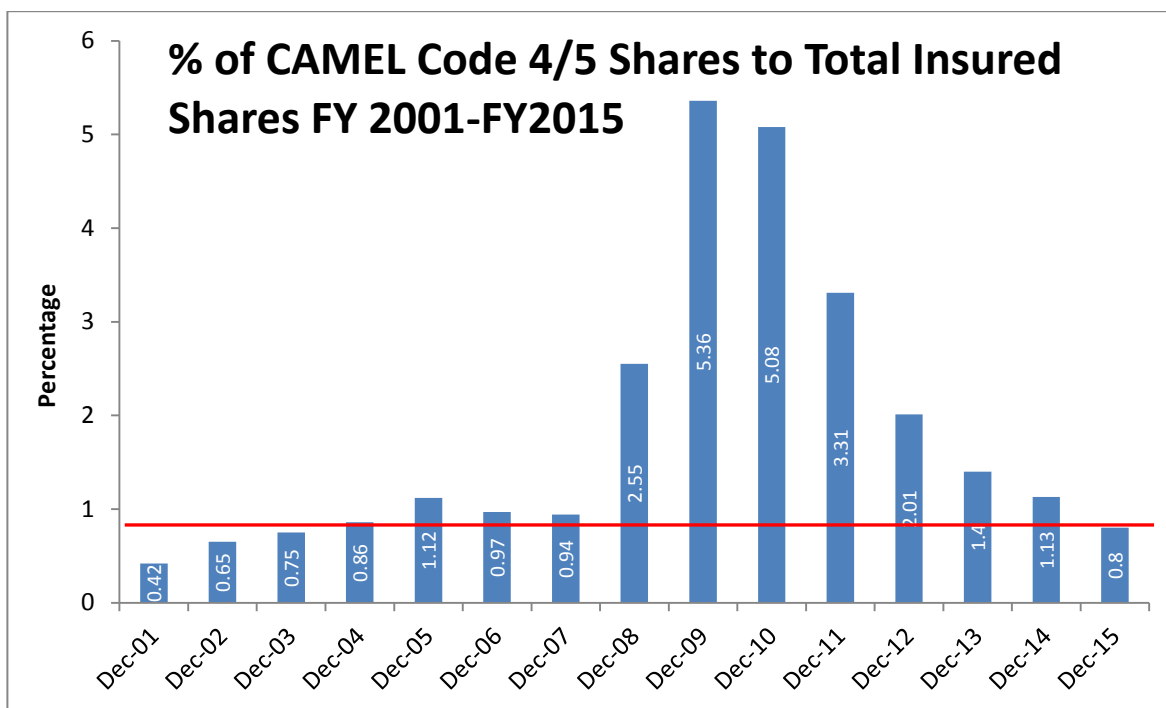
Additionally, NAFCU strongly believes that NCUA's Operating Budget can be reduced with an extended examination cycle. For example, when the agency moved from an 18-month to a 12-month exam cycle in 2008, the Operating Budget required an additional \$6.841 million to cover the addition of 56 additional personnel. At the time, such a move was a prudent response to the financial crisis. It was understandable that economic trends dictated NCUA's decision to increase the frequency of examinations. However, now that the economic environment has returned to normal, the agency's original justification for increased examinations is no longer as valid.

In fact, banks have already had the advantage of extended exam cycles for several months. Congress by law mandates an 18-month examination cycle for banks that are less than \$1 billion in assets. In order to maintain competitiveness with banks, NAFCU strongly urges NCUA to implement an extended exam cycle that provides credit unions with similar flexibility and increased cost-savings.

#### Metrics to Determine a Credit Union's Eligibility for an Extended Cycle

In addition to asking for ways to minimize disruptions to credit unions' operations, NCUA also asks what metrics should be used to determine a credit union's eligibility for an extended cycle. NAFCU believes that such a framework will require criteria so as to not compromise the safety and soundness of the National Credit Union Share Insurance Fund (NCUSIF). As discussed above, in July 2001, the NCUA Board approved an examination scheduling policy that allowed the agency more flexibility in balancing numerous risk factors and priorities with available resources, without compromising the safety and soundness of credit unions. NAFCU believes the criteria by which a credit union is eligible for an extended exam cycle should be based on the same criteria that the agency used in 2001, when it first implemented an 18-month exam cycle for well-run, low-risk credit unions. Among other characteristics, NCUA required a credit union to: (1) have been assigned a composite CAMEL code of 1 or 2 for the past two most recent examinations; (2) have been in operation for at least 10 years; (3) not be operating under an administrative order; and (4) have a track record of maintaining accurate and current books and records.

Additionally, NAFCU believes that industry-wide metrics indicate that the system as a whole is ready for an 18-month exam cycle once again. In fact, as the metrics below indicate, there are approximately the same number of CAMEL Code 4 and 5 credit unions today as there were in the early 2000s, when NCUA first implemented the 18-month cycle.



Accordingly, we believe today's industry-wide metrics warrant an extended exam cycle like the one implemented in the early 2000s.

In the alternative to a default 18-month examination cycle, NAFCU recommends that NCUA offer longer exam cycles for credit unions that are not considered complex. As NAFCU has consistently maintained, the size of a credit union does not determine its complexity. Rather, complexity should hinge on a credit union's portfolio of assets and liabilities.

#### Leveraging Technology to Facilitate and Extended Cycle

NAFCU believes that with an extended time between exams, it would be even more crucial to ensure early identification of any emerging problem in a credit union. NAFCU believes that technological improvements will certainly help in this regard, but should not be a prerequisite to an extended exam cycle.

NAFCU believes that increasing modeling capabilities to better identify outliers and other red flags from credit unions' Call Reports will aid the agency's efforts in extending the exam cycle. Although the agency has cited in the past that it needs to make technological improvements before an extended cycle is implemented, NAFCU notes that such a cycle was implemented in 2001, when the technology available to conduct offsite monitoring was much less robust.

National Credit Union Administration

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Should you have any questions or would like to discuss these issues further, please contact me at (703) 842-2249 or [memancipator@nafcu.org](mailto:memancipator@nafcu.org).

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Emancipator", written in a cursive style.

Michael Emancipator  
Senior Regulatory Affairs Counsel



National Association of Federal Credit Unions | [www.nafcu.org](http://www.nafcu.org)

# ECONOMIC & CU MONITOR

NAFCU's Monthly Report on Economic and Financial Conditions Affecting Federal Credit Unions

## Industry & Economic Briefing

By Curt Long, Chief Economist / Director of Research

**Industry Conditions:** Overall, the credit union industry is healthy and well-capitalized. Net worth, asset quality and the number of CAMEL 4 and 5 credit unions are at or approaching pre-crisis levels. Member and loan growth are at their highest levels in a decade, with the latter driven by a 16 percent surge in vehicle loans versus last year. In preparation for a potential increase in interest rates, credit unions have been shortening the duration of their investment portfolios.

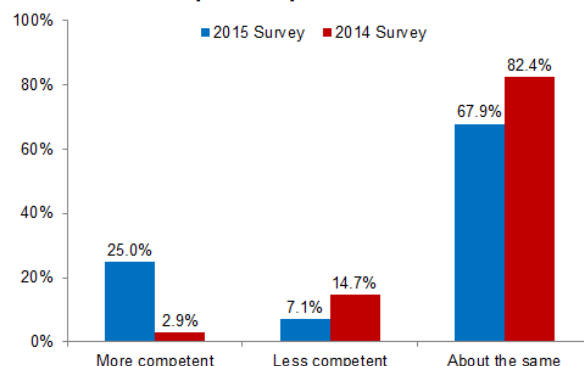
**Economic Conditions:** As has been the case throughout the recovery, economic conditions are improving in fits and starts. Despite consistently strong job gains, wage growth has been muted and consumers are reluctant to spend as a result. The housing market is solidifying, and there are signs that first-time homebuyers are returning to the market. As a result, NAFCU is forecasting originations to grow 13 percent in 2015, but to moderate somewhat next year due to lower refi activity. Auto sales remain strong and should be a source of loan growth for credit unions for the foreseeable future. Inflation has been weak and shows few signs of improving in the near term, but that will probably not prevent the Fed from raising interest rates in September.

## Special Topic: Examinations

Since the onset of the Great Recession, it has been a common refrain that credit unions did not cause the crisis but have felt its effects. One clear example is in the examination process. Various regulations instituted in the Dodd-Frank Act increased the scope and complexity of exams, and NCUA made the decision in 2010 to move from an 18-month exam cycle to an annual one. This required a significant increase in exam staff, leading to less experienced examiners dealing with new regulations. As indicated in previous survey [results](#), many credit unions felt that improvements needed to be made. As this month's *Economic & CU Monitor* survey reveals, there is evidence of progress, but there is still work to be done to create a fair and efficient examination process.

Exams can be taxing on management and staff and disruptive to a credit union's operations. Among survey respondents, the median length for an exam was 10 days, and slightly more respondents indicated that their most recent exam was shorter than in the past (11.8 percent) as compared to those who said it was longer (8.8 percent). Examiners were reported to have provided greater advanced notification prior to exams (median: 60 days in 2015, 40 days in 2014), and more examiners notified respondents which

### How competent is your current examiner compared to previous ones?



area(s) would be the focus of the exam (76.9 percent in 2015, 66.7 percent in 2014). In spite of these improvements, **88.9 percent of survey participants would consider it a form of regulatory relief to return to an 18-month exam cycle.** Given how well capitalized the industry is, not to mention the fact that CAMEL 4 & 5 credit unions represent roughly the same share of the industry as they did prior to the crisis, it begs the question of whether the benefits of annual examinations outweigh the costs.

As NCUA's examination staff has grown more experienced, survey respondents have reported that their examiners are more competent and easier to work with. As compared to last year, **a greater proportion of respondents said that their examiner was more competent than previous ones**, while relatively fewer said that their examiner was less competent (see chart). Similarly, 50 percent of respondents described the working relationship with their examiner as "very easy," which is up from 26.5 percent last year.

Respondents were mixed on reactions to their most recent exam results. While fewer reported having received Documents of Resolution (DORs) this year (29.6 percent in 2015, 43.3 percent in 2014), **a greater share of respondents believed their DOR to be unjustified** (66.7 percent in 2015, 37.5 percent in 2014). Only 9.1 percent of respondents reported that they had contested the results of an exam in the last five years, but half of respondents indicated that they would be more likely to do so if there were an independent appeals process.

Finally, respondents reported that the greatest area of examiner focus in terms of safety and soundness was data security (68 percent) and ALM (44 percent). As for areas related to consumer regulations, the greatest scrutiny was in lending and modification policies (68.2 percent), followed by BSA (18.2 percent). The most common impact of respondents' exams was the need to update or institute new procedures (69.2 percent).

## Appendix B: Common Exam Issues from Previous Two Quarters

Issue	Details
<b>Timing of Requests from Examiners</b>	For a couple of years now, credit unions rather broadly report that they receive less and less time to gather exam documents. Requests used to be sent 4 to 6 six weeks before exams, now we hear more examiners are only providing about 2 weeks. This often requires people to work overtime to gather this information.
<b>Guidance vs. Reg</b>	General sense that NCUA examiners are working off of clear internal guidance or bulletins that are not communicated to the public in supervisory letters, the AIRES questionnaires, or the Examiner's Guide (especially since the Examiner's Guide and AIRES are not routinely kept up to date) <i>As an example, NCUA representative at Annual Conference referenced a bulletin on MBLs and the personal guarantee that has not been publicized outside of NCUA</i>
<b>Unjustified DOR</b>	Many members report a general sense that no matter how well they are doing to comply, the examiner is always "looking for something." While credit unions know no one is doing everything perfectly, (i.e. you're about as close to "perfect" as possible), informal findings based on minor issues that are within the margin of error can become formal DORs at a later exam. When they are doing a great job generally and little minor things are somewhat formalized, it can be viewed as nit-picking, overreaching (since these are sometimes in risk-based decision areas), or just otherwise cause frustration.
<b>Senior Management Compensation</b>	Examiners in a couple of regions take a hard line on loan-related goals even being a component of managerial compensation and document this as a violation of section 701.21(c)(8). These complaints have quieted recently but are an example of a lack of parity across regions.
<b>OFAC</b>	Recent exam findings, examiner seems to be stepping into the credit union's risk-based OFAC policies, seeming to make a judgment without there being clear regulatory guidance on the issue <i>We hear these kinds of stories frequently – examiners coming in with a set idea on a risk-based decision without adequate publically-available regulatory guidance to back it up.</i>
<b>Board Compensation</b>	The examiner took a piece of a legal opinion letter out of context to try to assert that the credit union was in violation of the prohibition against compensating directors because of a \$25 gift card and ornament given as a holiday gift each December. <i>Unofficial conversations with OGC indicate that this is not how this letter</i>

*should have been interpreted.*

**Flood Rule  
(occurs  
occasionally)**

Examiner finds a loan that is in a flood zone, but the credit union does not have flood insurance on the property (one CU mistakenly thought the property was not in a flood zone). The loan agreement does not seem to provide a contractual right to impose flood insurance post-consummation. Examiner offers no solution, credit union has to try to negotiate with the member but could risk the violation coming up repeatedly if the member is not agreeable.

*Example of how sometimes, an identified problem needs some kind of solution presented.*