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National Association of Federally-Insured Credit Unions

October 28, 2022

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

RE: Proposed 2023-2024 Budget

Dear Chairman Harper, Vice Chairman Hauptman, and Board Member Hood:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I appreciate the opportunity to provide written comments on the 2023-2024 Staff Draft Budget Justification and to deliver remarks on the draft budget at the October 19, 2022, public budget briefing. NAFCU would like 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 133 million credit union members across the country. Additionally, thank you to the NCUA staff who prepared this budget justification and other budget materials. NAFCU supports the NCUA Board's transparency surrounding the budget and applauds the NCUA for publishing a detailed draft budget.

As NAFCU has previously stated, the NCUA's commitment to credit unions should spur efforts to achieve year-over-year budget decreases and not increases, especially through incorporating lessons learned from the COVID-19 pandemic. NAFCU, its credit unions, and their members are all eager to see the ways in which the NCUA will stay nimble and modernize in the future, all while being prudent in the expenditure of credit union dollars.

General Comments

NAFCU commends the agency for utilizing the $18 million in savings achieved in 2022 to offset the costs of planned contracted services spending in 2023 but continues to stress the need to fully adopt lessons learned in its approach to travel and examinations to achieve long-term budget reductions. Savings aside, the NCUA's budget continues to increase, and this 2023-2024 draft budget once again overlooks opportunities to incorporate more efficient processes with potential cost-savings. In fact, the 2023 Operating Budget would increase by 9.6 percent and the 2024 Operating Budget would increase by over 10 percent. Comparatively, the average annual budget growth in the eight years prior to 2020 was a much more restrained 3.8 percent, and NAFCU urges the NCUA to rein in the recent trend of substantially increased budgets.

Additionally, the draft budget calls for a total of 25 new full-time equivalents (FTEs) in 2023, the bulk of whom would be hired for "critical areas necessary to operate as an effective federal financial regulator capable of addressing emerging issues." Although NAFCU appreciates the NCUA's commitment to ensuring that credit unions are prepared to address emerging issues, the draft budget fails to adequately explain or justify these additional positions.

Finally, the draft budget's inclusion of an $11.1 million increase from the 2022 budget for contracted services for the Model Examination and Risk Identification Tool (MERIT) is of significant concern for NAFCU and its members. In a March 2021 letter to Senator Patrick Toomey, Chairman Harper indicated an estimated cost of $18.9 to $37.9 million for MERIT.[1] The proposed budget for contracted services in 2023, the bulk of which would be spent on MERIT, has now ballooned to $65.6 million. This represents an astonishing 80 percent increase from the 2022 budget. For the single year spend on a project to nearly double the initial estimate is troubling for credit unions that are mindful of every dollar spent. NAFCU is concerned that without some controls on spending, MERIT will continue to significantly increase in cost to the detriment of the credit union industry.

NAFCU recommends the agency focus on implementing lessons learned from the pandemic and not ignoring the achievements that have been made towards cost-savings. More specifically, NAFCU offers the following recommendations to enhance the efficiency of the NCUA's 2023-2024 budget:

1. Preserve the strength of the National Credit Union Share Insurance Fund (SIF) without overburdening credit unions with exorbitant Operating Fees and return excess cash from the Operating Fund to credit unions;
2. Continue to pursue exam modernization efforts, including a hybrid, virtual and in-person exam posture;
3. Reduce costs associated with MERIT and provide realistic estimates for completion and maintenance;
4. Achieve greater transparency regarding cybersecurity expenses; and
5. Continue to support financial inclusion initiatives and engage in open communication and timely resolution of issues through the newly established Office of the Ombudsman.

Industry Conditions

A review of the past two-and-a-half years demonstrates the strength of the credit union system. The COVID-19 pandemic impacted the industry in severe and unexpected ways, but credit unions weathered it through skillful and prudent management. Today, delinquency rates are near all-

[1] NCUA Chairman Todd Harper, *March 19, 2021, Letter to Senator Patrick Toomey*.

time lows, net worth is rising, and a smaller share of industry assets are located in troubled credit unions than when the pandemic began.[2,3]

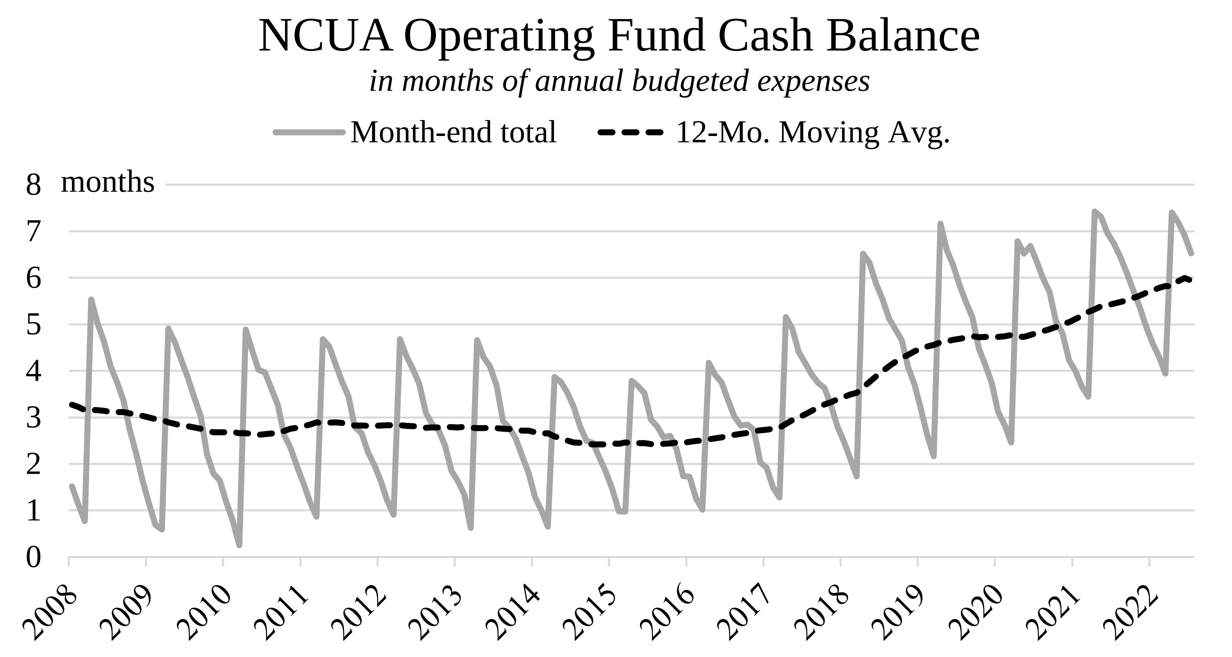
The NCUA's management of the SIF corroborates this view. The loss reserve as a percent of total insured shares is near its lowest level in recent history.[4] Low provision for loss expenses are supporting an improved outlook for the SIF, and agency staff reported at a recent NCUA Board meeting that the equity ratio is expected to finish the year at 1.3 percent, which would represent a four basis point improvement over 2021.[5] This year is shaping up to be a typical one with very few credit union failures. Just three credit unions failed in the first half of the year, and losses to the SIF totaled only $13 million.

Although there are few threats to the SIF from within the credit union industry, misguided regulatory overreach has the potential to seriously harm credit unions and the SIF. A recent report indicates that the Consumer Financial Protection Bureau (CFPB) plans to issue new interpretative guidance related to Regulation E that would further shift the liability for peer-to-peer (P2P) payments fraud to credit unions.[6] Although credit unions are committed to supporting consumer payment choice, the costs borne by credit unions stemming from payments related fraud cannot be sustained without limit. Credit unions are particularly sensitive to new regulatory expectations that alter financial institution liability under Regulation E. If this regulatory shift occurs, credit unions and their member-owners would suffer greater exposure to fraud-related losses. Over time, mounting fraud losses could threaten individual credit unions and, eventually, the SIF. NAFCU urges the NCUA to educate the CFPB on the harm that this reinterpretation would have on credit unions and, in the interest of the safety of the SIF, to push back.

As part of the NCUA's Operating Fee methodology, the NCUA can adjust the share of the budget funded by the Operating Fee based on an analysis of the agency's future cash flow requirements compared to past years' collections that were not spent as planned. Any projected surplus cash from past years' fee collections not required to finance agency operations can accordingly be used to lower the Operating Fee share of the proposed budget. NAFCU was extremely pleased to see the NCUA justify the Operating Fund cash needs and facilitate a return of excess cash to federal credit unions, resulting in a 23.7 percent reduction in Operating Fees. Nevertheless, NAFCU notes that the Operating Fund cash balance as of August 31, 2022, of $168.4 million was nearly identical to the balance one year ago. As a percentage of the agency's budget, this amount represents a much larger cushion than was customary through 2016. NAFCU urges the agency to

[2] NCUA 5300 Call Report Aggregate Financial Performance Reports (FPRs).
[3] For troubled credit unions, see *Distribution of Assets by CAMELS Code*, NCUA Board Briefing, Share Insurance Fund Quarterly Report (September 22, 2022), https://www.ncua.gov/files/agenda-items/share-insurance-fund-board-briefing-20220922.pdf.
[4] As of June 30, 2022, loss reserves in the Share Insurance Fund represented $10 per $100,000 in total insured shares. The average over the prior 10-year period was $27 per $100,000 in insured shares.
[5] Id.
[6] See Ackerman, Andrew, "Consumer Bureau to Push Banks to Refund More Victims of Scams on Zelle, Other Services," The Wall Street Journal (July 19, 2022).

carefully scrutinize cash needs and to provide a refund to credit unions in the amount of any surplus, directly or via a credit against 2023 budget expenses.



Source: NAFCU analysis of NCUA *Operating Fund Financial Highlights*

Exam-Related Expenses

In 2022, as has been the case since the beginning of the pandemic, travel expenses were unusually low, again saving the agency and the industry money. But now, just as in 2021, the agency assumes that the need to travel will increase in 2023 and has proposed to increase its travel budget by nearly 30 percent to reflect 75 percent of pre-pandemic levels of spending. The agency states that it "will continue to seek to contain travel costs by use of offsite exam procedures and virtual options for training when suitable." Travel was an available option without meaningful restrictions for the majority of 2022 and yet travel expenses remained low and the NCUA was able to accomplish its goals. NAFCU questions why, when reduction in travel did not negatively impact agency operations over the past three years, the NCUA would choose to only use offsite examination procedures and virtual training "when suitable" instead of adopting the opposite approach—mostly offsite examinations with limited onsite presence. The increase in proposed 2023 travel costs should be scrutinized using cost-benefit analysis that considers the benefit of focusing on improving the agency's virtual exam process now versus the cost of sending examiners across the country for in-person exams.

Exam Modernization

NAFCU strongly supports the NCUA's commitment to modernizing its exam process and applauds the agency for being a leader among the banking regulators in adopting a modern examination system. Although NAFCU appreciates the deployment of MERIT to all NCUA examiners in the fall of 2021, coupled with additional capital investments in 2022 to address rollout issues and allow for continued enhancements, it is becoming clear that the costs associated with MERIT lack meaningful limitations and metrics for measuring sufficient expenditures for continued maintenance. NAFCU requests that the NCUA make a concerted effort to lower costs associated with MERIT and provide credit unions with a cost estimate that can be relied upon. Furthermore, in light of a colloquy between NCUA staff and public commenters during the October 19, 2022, public budget briefing, NAFCU requests that the NCUA provide regular updates to credit unions on the progress of the MERIT program and that it explain any cost overruns to its credit union stakeholders. In the interest of transparency, the NCUA should also include in its budget justification the specific reasons for such a wide variation in anticipated cost estimates for MERIT operations.

Virtual Exams

NAFCU supports the NCUA Virtual Examination project and supports the use of more virtual exams, but also recognizes the value of in-person interactions. Therefore, a hybrid approach that maintains some in-person meetings is in the best interest of credit unions, the agency, and the agency's budget. The agency should reconsider its proposed travel budget because of the effectiveness of offsite examinations over the past several years. The third largest portion of the NCUA's Operating Budget is travel expenses, so considering the lessons learned from 2020, 2021, and 2022 regarding the extent to which supervisory and exam operations can be conducted offsite, NAFCU urges the NCUA to cut travel across the board going forward. NAFCU was encouraged by the NCUA's willingness to reconsider the draft travel budget at the October 19, 2022, public budget briefing. NAFCU urges the staff to act on these assurances and as staff reassesses its initial travel budget, the NCUA should adopt efficiencies created by reduced travel budgets over the past several years and cut travel unless absolutely necessary in future budgets.

Exam Flexibility Initiative

NAFCU supports a strong, safe and sound credit union system and appropriate supervision of systemic risk is critical and urges the NCUA to continue its work to achieve the goals of the Exam Flex Initiative considering many well-run, low-risk credit unions that qualify have still not been cycled onto an extended exam.

To better achieve its goal of reducing burdens on credit unions during the exam process, future virtual exams should be deployed on an 18-month or longer extended cycle for all low-risk, well-run credit unions, regardless of their size. At a minimum, the agency should seek to maintain parity with the extended exam threshold for banks by raising its threshold to $3 billion.

Regional Specialist Examiners

NAFCU appreciates the NCUA's commitment to ensuring its examiners have the necessary expertise and qualifications to understand emerging issues of concern for the credit union industry. However, NAFCU is concerned about the dramatic increase in the number of specialist examiners, with the number of general examiners reduced by 10 and the number of specialist examiners increased by 20 for a net increase of 10 FTEs. Although we appreciate efforts to modernize the NCUA workforce, the creation of two new programs, for regional consumer compliance specialists with eight new positions and regional bank secrecy specialists with six new positions, seems substantial and hasty. Until the release of this draft budget, the NCUA had not expressed a need for specialists focusing on consumer compliance issues and it has failed to demonstrate that such a need exists.

NAFCU requests specificity on which areas of consumer compliance warrant these additional positions and why the NCUA believes it is currently unequipped to address them. Furthermore, the addition of six supervisory specialists intended to "manage the broader array of regional specialists" appears to be a solution in search of a problem. It is unclear to NAFCU why the current level of specialist supervision is inadequate and no explanation is provided in the budget justification. In terms of adding FTEs, NAFCU suggests that the NCUA implement a gradual increase over the next few years to better use existing resources and weigh the costs and benefits of additional FTEs.

Transparency Regarding Cybersecurity Expenses

A significant portion of the NCUA's proposed budget provides funding for cybersecurity related improvements designed to enhance the agency's overall security posture and compliance with laws applicable to a government entity's handling and protection of data. NAFCU supports efforts to strengthen the NCUA's cybersecurity and resilience to security threats, but requests that the NCUA seek to measure, through transparent metrics, the added value of new cybersecurity investments included in each budget cycle. The 2023 budget notes several efforts, including the implementation of multi-factor authentication, creation of a zero-trust architecture, and migration of certain databases to a secure cloud provider. Given that these are all tangible actions, the industry would benefit from a periodic update regarding the industry's accomplishment of each of these efforts and their discrete costs.

IT security expenditures also comprise a significant share of the budget for contracted services. The budget justification document lists three subcategories within this area, which include "enhanced secure data storage," "information security programs," and "security assessment services." NAFCU requests that the NCUA provide additional description of "information security programs" and also share during periodic cyber briefings any updates about the agency's usage of security assessments to identify areas for improvement. Contracted services also cover technical support for examination and cybersecurity training programs. NAFCU asks that the NCUA separate these costs so the industry can better understand the relationship between cyber specific training costs versus those incurred as part of general examiner training.

Within the Office of Examination and Insurance, additional contracted services funds are allocated to a broad range of services: enhancements to the Automated Cybersecurity Evaluation Toolbox (ACET), cybersecurity research and advisory services, and expert support to help automate internal manual processes. Additional clarity related to cybersecurity "research and advisory services" would be appreciated to better understand how these expenses are contributing to either the agency's security posture or that of the industry. Additionally, given that the ACET serves as a voluntary self-assessment tool, it would be helpful to know how proposed enhancements will improve credit union ease of use and what share of credit unions have requested feature improvements to support their usage of the tool.

During the October 19, 2022, public budget briefing, the NCUA requested additional comment on what metrics it might use to assess the efficacy of its cybersecurity investments. As an initial matter, NAFCU would be interested in learning what metrics the NCUA already does use—if any—for different components of its cybersecurity program.

In the NCUA's previous 2022-2023 Budget Justification, the agency included a "performance benchmark for investment" description for each project listed in the capital projects appendix. In the 2023-2024 Budget Justification, this category has been omitted without any comment or explanation. In the previous budget justification, a particular type of metric—Return on Technology Infrastructure Investment (ROTII)—was used to define success for the NCUA's IT infrastructure, platform, and security refresh project.[7] A description of the ROTII stated that "to gauge the benefit of the investment, the cost of acquiring the new system can be compared to an estimate of the economic loss that will be prevented by improved system performance." Is the agency still using this type of metric to assess cybersecurity investments? If so, has the agency generated some estimate of the economic loss that would be prevented? If the NCUA is no longer using the ROTII to measure the success of cybersecurity investments, NAFCU asks that the NCUA explain why it has discontinued use of the ROTII and whether the agency has considered alternative metrics.

As noted during NAFCU's testimony during the October 19, 2022, public budget briefing, the use of a single, all-encompassing metric for assessing the performance of cybersecurity investments may not be feasible. Accordingly, NAFCU would appreciate additional information about the types of evaluation metrics that might already be used for different cybersecurity projects. For example, the NCUA recently revealed that the new Information Security Examination (ISE) program would contribute additional hours to the exam work program. Does the NCUA evaluate the efficacy of investments targeting the cyber exam program in terms of the ability to reduce work hours or FTE footprint by improving efficiency or automation?

For investments targeting the NCUA's internal cybersecurity, does the agency assess how new services or staffing contribute to positive changes in internal risk assessment scores? NAFCU does not expect the NCUA to provide granular or sensitive metrics about every aspect of its cybersecurity program, but a general indication of the agency's progress would be welcome—particularly if the agency already employs metrics. If the NCUA does not use metrics to assess the

[7] NCUA, 2022-2023 Budget Justification, 88.

efficacy of its cybersecurity investments, then it may be worthwhile to invite separate comment on how the agency might achieve greater transparency in this domain.

The NCUA also asked during the October 19, 2022, public budget briefing how frequently the agency should provide periodic updates about the agency's progress towards implementing cybersecurity related enhancements and projects. The NCUA suggested that more frequent updates would correspond with greater cost for the agency. NAFCU understands that dedicated briefings demand resources and staff time. However, NAFCU would expect that progress reports regarding the NCUA's implementation of certain cybersecurity related projects are already being communicated to the NCUA Board to determine compliance with Executive Order 14028, Improving the Nation's Cybersecurity. An appropriate public briefing schedule could potentially be accomplished at minimal cost if it aligns with the periodic status reports the Board already expects to receive from the NCUA CIO. While it may be necessary to redact certain information provided directly to the Board, a summary of general progress towards Executive Order compliance and cybersecurity project completion would be welcome to the extent these reports can be prepared with little additional effort.

The NCUA has also indicated that the public can review the agency's compliance with federal data security standards by reading the annual audit report required under the Federal Information Security Modernization Act (FISMA). While the annual audit may provide a point in time overview of the agency's overall progress towards FISMA compliance, it does not always quantify progress made towards addressing open findings.[8] Without a clear sense of whether the agency is meeting project milestones for improving cybersecurity, it is difficult to assess—even in general terms—the efficacy of the NCUA's cybersecurity investments. NAFCU understands that certain information must be redacted in the FISMA audit for security purposes but asks that the Board consider offering general information about whether agency is on track to close open issues identified in prior years' audits—particularly those where NCUA management has provided an expected completion date. General progress reports would allow interested stakeholders to better understand how new cyber investments allocated during each budget cycle correspond with the agency's timely implementing of FISMA audit recommendations.[9]

Financial Inclusion

NAFCU applauds the NCUA's ongoing commitment to financial inclusion and supports the efforts of the NCUA's ACCESS Initiative. Additionally, NAFCU supports the addition of one new position in the Office of Minority and Women Inclusion to support its mission of promoting diversity,

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[8] *See e.g.*, FY 2021 Independent Evaluation of the National Credit Union Administration's Compliance with the Federal Information Security Modernization Act of 2014 (OIG Report No. OIG-21-09, November 22, 021, Appendix III, 18 (2021), *available at* https://www.ncua.gov/files/audit-reports/oig-audit-compliance-fisma-2021.pdf. The NCUA's auditor has determined that several recommendations dating back to 2018 remain open.

[9] *See e.g., id*. at 18 (noting that for one audit recommendation, 2018-10, the agency had missed its scheduled completion deadline of November 20, 2020); *see also* Recommendation 10, FY 2018 Independent Evaluation of the National Credit Union Administration's Compliance with the Federal Information Security Modernization Act of 2014 (OIG Report No. OIG-18-07, October 31, 2018).

equity, inclusion, and accessibility. NAFCU also views support for small credit unions to be part and parcel of the constant fight for financial inclusion and is pleased to see this priority included in the draft budget. Providing additional staff hours through the Small Credit Union and Minority Depository Institution Support Program will provide these uniquely situated credit unions with the resources to help the underserved. The NCUA should also continue to provide educational webinars and assist credit unions with the identification of grants and other financial resources to help members experiencing financial hardship.

Organizational Changes

NAFCU applauds the NCUA's proposed creation of a new, distinct Office of the Ombudsman with dedicated staff and resources to facilitate better communication with stakeholders regarding the NCUA's processes and more effective resolution of issues. The NCUA has historically been transparent and accessible to stakeholders, but NAFCU appreciates the continued dedication of the agency toward openness and responsiveness. NAFCU strongly supports the creation of the Office of the Ombudsman and is encouraged by the NCUA's intent to increase outreach and engagement with credit unions, external stakeholders, and other regulatory agencies through an independent office. NAFCU is pleased to see the addition of two FTEs for the Office of the Ombudsman in the draft budget.

Conclusion

NAFCU urges the agency to carefully consider and adopt the detailed suggestions outlined above in its final 2023-2024 budget. NAFCU thanks the NCUA Board and recognizes the NCUA staff's hard work in preparing this budget justification and other budget materials. If we can answer any questions or provide you with additional information, please do not hesitate to contact me at 703-842-2276 or clong@nafcu.org.

Sincerely,

Curt Long
Chief Economist and Vice President of Research