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National Association of Federally-Insured Credit Unions

November 21, 2023

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 2024-2025 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 2024-2025 Staff Draft Budget Justification and to deliver remarks on the draft budget at the November 16, 2023, 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 138 million credit union members across the country. Additionally, we appreciate the hard work of the NCUA staff in preparing 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 emphasized before, the NCUA's dedication to credit unions should motivate them to aim for annual budget reductions rather than increases, especially in these economically uncertain times. NAFCU, its credit unions and members, are keen to observe how the NCUA will adapt and modernize moving forward, ensuring judicious use of credit union funds.

General Comments

The NCUA's budget continues to increase, and this 2024-2025 draft budget once again overlooks opportunities to incorporate more efficient processes with potential cost-savings. In fact, the 2024 Operating Budget would increase by 11 percent and the 2025 Operating Budget would increase by nearly 10 percent, similar to the increases seen in last year's 2023-2024 final budget. In contrast, the average annual budget growth in the eight years prior to 2020 was a much more restrained 3.8 percent. Continuing on this trajectory of substantially increased budgets is unsustainable and will have serious consequences for the credit unions that fund the NCUA. These increases are occurring at a time when the number of credit unions continues to shrink and will only serve to hasten consolidation. NAFCU urges the NCUA to restrain its spending going forward and look for cost savings wherever possible.

The draft budget calls for a total of 28 new positions in 2024 including 11 new positions and 17 positions previously unfunded but authorized within the total NCUA staffing plan. These positions are spread throughout the NCUA offices and the 2024-2025 Staff Draft Budget Justification fails to provide any explanation of the need for the pre-authorized positions. Although NAFCU appreciates the NCUA's commitment to ensuring a well-functioning agency, the NCUA should not avoid an explanation of newly funded positions simply because they were authorized in the staffing plan. For those positions that were "overhires", they should not simply be grandfathered into the next budget. This practice of overhiring, absent a clear and demonstrable need for immediate additional staff support outside of the budget cycle, should not continue. In instances in which new positions are funded in the budget, whether new or previously authorized, the NCUA should honor its commitment to transparency by reevaluating the need for new positions and justifying them to their credit union stakeholders. NAFCU also agrees with Vice Chairman Hauptman that the agency should have a more regular process for evaluating vacant positions and whether those positions must be filled or the responsibilities of that full-time equivalent could be dispersed among existing staff without overburdening those staff.

Furthermore, the increase of 13 specialist and supervisory examiner positions for consumer compliance is completely unwarranted. Credit unions are member owned cooperatives with a focus on maintaining strong relationships with their members and communities. The NCUA has justified the need for these consumer protection examiners by equating consumer financial protection with safety and soundness. While these two purposes may be linked, they are not synonymous, and if the NCUA seeks to increase the number of consumer protection examiners, it should justify that increase on its own merits. NAFCU objects to insinuations that, if not for additional NCUA consumer protection examiners, the credit union industry would be at risk, or that credit union members need protection from their financial institution. Additionally, the NCUA notes that this increase is intended to address an increase in the number of large, complex credit unions. Consumer financial protection examinations of large complex credit unions are the purview of the Consumer Financial Protection Bureau (CFPB or Bureau), and the NCUA should not attempt to emulate the Bureau in this role, which risks creating unnecessary and duplicative exam processes. Credit unions have been, and continue to be, capable of complying with consumer financial protection laws without the onerous costs associated with a massive increase in NCUA examiners specifically devoted to that purpose.

Finally, the draft budget's inclusion of a \$10.7 million increase from the 2023 budget for contracted services, largely to support the Model Examination and Risk Identification Tool (MERIT), is of significant concern for NAFCU and its members. The proposed budget for contracted services in 2023 continues to grow, with a proposed budget of \$70.1 million in 2024. NAFCU reiterates its calls for increased controls on spending and for the NCUA to provide regular updates on the status of MERIT to provide greater transparency into the NCUA's second largest expense, which shows no signs of decreasing.

NAFCU recommends that the NCUA embrace the importance of cost-efficiency and prudent financial management by cutting unnecessary budget items like the addition of dozens of new

examination staff. More specifically, NAFCU offers the following recommendations to enhance the efficiency of the NCUA's 2024-2025 budget:

1. Preserve the strength of the National Credit Union Share Insurance Fund (SIF) without overburdening credit unions with exorbitant Operating Fees and return surplus cash from the Operating Fund to credit unions;
2. Continue to prioritize offsite examination activities, revise the threshold for extended examination cycles to achieve further efficiencies, and provide greater transparency for expenses related to the Modern Examination and Risk Identification Tool;
3. Eliminate the proposed addition of dozens of new specialized examiners that are not justified by a measurable industry need; and
4. Adopt a more transparent and accountable methodology for tracking and evaluating the efficacy of cybersecurity and IT-related expenses.

Industry Conditions

The credit union industry is strong and well-capitalized. As of June 30, 2023, the industry's net worth ratio was closing in on 11 percent and had risen over 40 basis points from a year prior. CAMELS rated 4 and 5 credit unions represented just 0.3 percent of total industry assets, a figure that is roughly half its pre-pandemic level. Thanks to strong loan growth in 2022 and rising investment yields, credit union net interest margins are up 40 basis points versus a year ago.

Nevertheless, credit unions are facing significant challenges. Rising rates have driven up credit union cost of funds, and this trend will likely persist in 2024 even if market rates decline. Fee income as a percent of assets is down by 25 basis points from 2019, and with pressure on fees coming from multiple angles, the threat of further erosion looms. The normalization of delinquency rates in combination with adoption of the current expected credit loss accounting standard has precipitated a steep increase in provision for credit loss expenses. Meanwhile, credit unions face the constant challenges of meeting the needs of their members with limited resources.

Despite these challenges, the SIF is in a strong position. The equity ratio as of June 30 exceeded the agency's forecast and was comfortably above the statutory minimum. Only two credit unions failed in the first half of 2023, and losses to the fund were minimal. The performance of the SIF stands in contrast with the Federal Deposit Insurance Corporation (FDIC) Deposit Insurance Fund (DIF), which anticipates \$3.2 billion in losses due to recent bank failures. There is an additional \$19.2 billion estimated cost attributable to uninsured deposits that will be addressed through a special assessment on banks.

NAFCU is encouraged by the sound standing of the SIF. However, given that 62 cents of every dollar in the agency's budget comes from the SIF, the continuing health of the fund depends upon a cost-conscious NCUA.

Operating Fee

NAFCU's member credit unions are justifiably concerned with the sharp increase in the proposed Operating Fee. The proposed Operating Fee rate for 2024, would increase 19.59 percent compared to the rate in 2023. Many credit unions function on tight margins and an abrupt increase in the operating fee can place undue financial strain on these entities. As the final 2024–2025 budget is prepared for consideration by the NCUA Board, it is imperative that the Chief Financial Officer takes into account the well-being of the very institutions they oversee. We urge the CFO to credit the maximum surplus cash possible to the operating fee, thereby alleviating some of the burdens these credit unions face and ensuring that they continue to serve their communities effectively and efficiently.

Exam-Related Expenses

NAFCU applauds the NCUA for proposing a reduction, albeit modest, in travel spending in 2024. NAFCU urges the NCUA to continue to utilize hybrid examinations and work to increase the proportion of examination activities conducted offsite and maintaining a more limited onsite presence. The expenses for future travel should be carefully evaluated through a cost-benefit analysis, weighing the advantages of enhancing the agency's virtual examination procedures now against the costs of dispatching examiners nationwide for face-to-face evaluations.

Exam Modernization

NAFCU supports the NCUA's dedication to updating its examination methods and commends the agency for taking the lead among banking regulators in embracing a modern examination system. Although NAFCU appreciates the deployment of MERIT to all NCUA examiners in the fall of 2021, yet again, the proposed costs associated with MERIT remain high and troublingly opaque. Funding for contracted services for 2024 represents the second largest budget increase, proposed to increase by \$10.7 million compared to 2023, for a total of \$70.1 million. This number is poised to further spike in 2025 with a 37.2 percent jump from original estimates, to \$71.6 million. A significant share of the budget for contracted services would finance ongoing information technology infrastructure support including the fourth year of funding for operations and maintenance of the MERIT system, which replaced the legacy Automated Integrated Regulatory Examination System (AIRES) in 2021.

During the October 19, 2022, public budget briefing, NCUA staff indicated a willingness by the agency to provide regular updates to credit unions on the progress of the MERIT program and explain any cost overruns to its credit union stakeholders. The 2024-2025 Staff Draft Budget Justification fails to explain these costs and merely lists funding to address new and evolving risks, tools used to identify and resolve them, new operations and maintenance costs associated with recent capital investments, and price inflation for core agency business operation systems. Furthermore, the NCUA provided no updates on the status of the MERIT program throughout 2023, leaving stakeholders in the dark about one of the largest expenses paid for by credit unions. NAFCU requests that the NCUA make a concerted effort to lower costs associated with MERIT and contracted services in general, and provide credit unions with a cost estimate that can be relied upon. Furthermore, NAFCU reiterates its request 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.

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. Although NAFCU was pleased with the small reduction in the proposed 2024 travel budget, we urge the NCUA to make these reductions the rule, not the exception. The 2025 proposed travel budget includes a relatively small increase owing to expected inflation and a national training conference planned for 2025 for NCUA employees. Although inflation and external factors are out of the agency's control, the NCUA should work to offset these increases by adopting 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 with appropriate supervision of systemic risk. Extending the exam cycle for well-run, low-risk credit unions can offer benefits to both credit unions and the NCUA. A lengthier interval between exams would allow the NCUA to allocate resources more effectively. Instead of spending unnecessary time on institutions that have consistently shown compliance and stability, they can focus on those that may present a higher risk or need closer monitoring.

This would not only result in cost savings but also ensure that potential issues in the system are identified and addressed more promptly. Furthermore, extended cycles would reduce operational disruptions for these credit unions, enabling them to better serve their members without the frequent pauses and resource allocations that regular exams demand. At a minimum, the agency should seek to maintain parity with the extended exam threshold for banks by raising its threshold to \$3 billion. The current \$1 billion threshold is outdated and has not been reevaluated since its implementation in 2017.¹ NAFCU appreciates Vice Chairman Hauptman's concern about the proportion of insured shares that would be included in this increased threshold, but balance sheet complexity and asset size alone should not be a reason for more frequent exams. A well-run, low-risk credit union below \$3 billion should be able to "earn" an extended examination cycle and NAFCU urges the NCUA to make this change to its exam procedures.

Regional Specialist Examiners and Supervisors

Although NAFCU is a strong advocate for the modernization of the NCUA's examination workforce, the proposal in the 2024 budget of an increase of 27 specialist and supervisory

¹ NCUA, "Exam Flexibility Initiative Report" (October 2016).

examiner positions is excessive and unwarranted. Although the new specialist positions are offset by a reduction of 22 general examiner positions, the 5 supervisory positions are not, and such a large change in the examination workforce is excessive and signifies a dramatic shift over a relatively short span of time. The NCUA should not attempt to transition the entire examination workforce from generalist examiners to specialist examiners over the course of two or three years, as this is likely to lead to inefficiencies and a potentially less experienced cohort of examiners, while placing increased financial burden on the credit unions who fund the NCUA.

The NCUA has justified this proposed increase to meet the recommendations of a 2021 cross-agency working group and ensure compliance with the Bank Secrecy Act (BSA) and consumer financial protection laws. Despite this focus, BSA compliance was not listed as a supervisory priority by the NCUA in 2023 after many years of inclusion and therefore suggests that the agency is not seeing significant deficiencies in credit union compliance with BSA requirements. Although NAFCU has previously heard from its members that examiners often lack the specific BSA expertise necessary to provide consistent exams for compliance with BSA requirements, the budget does not specifically note the number of BSA specialists it seeks to hire and there may be a need to reassess the actual BSA examiner needs of the agency. Without clear justification, stakeholders in credit unions are left with unanswered questions and concerns about the direction in which the NCUA is headed. More broadly, the NCUA has failed to make the case that regulatory compliance and consumer protection is a problem within the credit union industry.

Although staffing at the NCUA is currently below its 2015 levels, the credit union industry itself has witnessed a swift consolidation in the years since. With fewer credit unions for the NCUA to examine, credit unions may understandably question why the NCUA is proposing a greater number of examiners to scrutinize a reduced number of credit unions. The agency owes it to credit union stakeholders to provide clearer explanations for such decisions. Even despite a growing number of insured shares, the NCUA regulates and examines credit unions and not assets, so the agency must be careful not to equate complexity with asset size. NAFCU is opposed to adding new positions, due to the lack of justification for the positions and the financial burden on credit unions.

Enhance Transparency Around Cybersecurity and IT Related Expenses

NAFCU supports efforts to improve the security and performance of the NCUA's IT systems. However, the NCUA should differentiate similar IT expenses shared across multiple capital projects. The NCUA's budget justification notes that the proposed 2024 budget includes over \$20 million for the cost of compliance with various federal IT security standards, of which \$4.3 million is budgeted for capital investments. The capital project description for one of these investments, titled "Executive Order on Improving the Nation's Cybersecurity (EO)," notes that the agency will continue to support adoption of cloud-based solutions for "certain storage resources." A separate capital project, titled "IT Infrastructure, Platform, and Security Refresh," appears to have a similar objective: "migrate new data and infrastructure components to the cloud."

Given that cloud migration costs can be significant, and multiple capital projects appear to involve cloud related projects, the NCUA should separately disclose cloud technology costs in its budget to improve transparency and provide greater insight about the extent to which these specific costs are driving overall IT expenditures. Separation of cloud costs would also allow credit unions to more accurately track the share of the budget devoted to security improvements under the EO, such as adoption of multi-factor authentication. As noted in the NCUA's most recent FISMA audit, the NCUA still faces an open recommendation for implementing multi-factor authentication dating back to its FY 2021 FISMA audit.

Small Credit Unions, Minority Depository, and Financial Inclusion

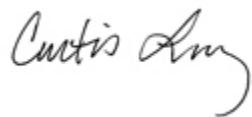
NAFCU applauds the NCUA for the persistent dedication shown through the Small Credit Union and MDI Support Program. This initiative evinces a strong understanding of the essential roles that small credit unions and MDIs play, particularly in serving underserved communities. By pledging dedicated resource hours in the proposed 2024 budget and ensuring field staff can efficiently conduct the vital task of supporting these institutions, the NCUA reinforces its commitment to the resilience and sustainability of these credit unions. NAFCU is pleased to see the emphasis on raising awareness, expanding support opportunities, and forging partnerships, which all are crucial for the growth of these entities.

Additionally, NAFCU supports the inclusion of funding for the Office of Credit Union Resources and Expansion (CURE) Process Automation to better facilitate the process for credit unions submitting field of membership modifications and new charter requests. As we move forward, NAFCU suggests that the NCUA continues to engage in open dialogues with stakeholders to identify any latent challenges and to explore innovative approaches that could bolster the effectiveness of these programs. Further, expanding the pool of grants and diversifying training modules can be instrumental in ensuring that these credit unions remain competitive and robust in a rapidly evolving financial landscape.

Conclusion

NAFCU urges the agency to carefully consider and adopt the detailed suggestions outlined above in its final 2024-2025 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