National Credit Union Administration
Office of Examination & Insurance

September 3, 2015

Paul C. Gentile, President/CEO
Cooperative Credit Union Association
845 Donald Lynch Blvd.
Marlborough, MA 01752-4704

Dear Mr. Gentile,

Chairman Matz asked me to respond to your letter dated August 19, 2015, regarding NCUA's annual examination program. Thank you for recognizing NCUA's efforts to provide responsible regulatory relief to credit unions. In your letter, you suggest further relief would come from extending the examination cycle up to 18 months for all federally-insured credit unions.[1]

NCUA's regulation and supervision of credit unions is designed to protect the safety and soundness of America's credit unions and enforce the applicable laws and regulations protecting consumers and the integrity of the financial system. Within the context of these important objectives, NCUA welcomes stakeholder input on ways the agency can improve and prudently streamline the examination process. When the NCUA Board votes to publish its draft multi-year Strategic Plan in January 2016, all stakeholders will have an opportunity to provide any such recommendations they have.

Examination Cycle

I would like to take this opportunity to respond to some of the specific points you make in your letter and provide some considerations that must be part of the dialogue on the examination cycle. As you acknowledge, any change in the examination cycle would need to be part of a comprehensive, well integrated plan to promptly identify and resolve problems as recommended by GAO and NCUA's Inspector General, as well as to compensate for the risk associated with an increase in time between examinations.[2] This would involve:

[1] Please note the examination cycle is determined by the applicable state regulator for federally-insured state-chartered credit unions, except those with assets greater than $250 million routinely examined by NCUA.

[2] Various NCUA and banking agency studies covering the 1970s through the early 1990s demonstrate a correlation between extended exam frequencies and an increase in problem institutions and failures. Uncertainty in estimating the impact of less frequent exams is very large. However, NCUA evaluated credit union CAMEL rating performance from 2001 to 2007 - pre-2008 recession and during NCUA's 18-month examination scheduling program. This review identified a 20% increase in the probability of a CAMEL 1 or 2 rated credit union being downgraded when the time between exams was greater than 14 months, as compared to those where the time between exams was 14 months or less. In addition, the loss severity in the event of failure for credit unions that are downgraded increases by over 40%.

- Addressing **workforce management** needs. NCUA needs sufficient contingency capacity to manage through the entire economic cycle, not just staff to good economic conditions. We learned this lesson the hard way in 2008. The agency made the mistake of cutting staff in the years leading up to the Great Recession. NCUA cut 71 full-time equivalent staff (FTEs) between 2001 and 2008. To keep costs down, the agency had a smaller exam force, cut back to 18 months between exams, and had fewer office staff analyzing Call Reports. The result was that the agency was unable to identify many credit unions' problems soon enough to save them from losses.

  Experienced, well-trained examiners are not a readily available commodity, and are in particularly high demand during an economic downturn. It takes at least 3 to 4 years of training and experience to develop a seasoned examiner. Thus, it is too late to start hiring once economic disruptions emerge. Further, maintaining contractors on retainer or outsourcing examinations in a crisis are neither practical nor suitable given the inherently governmental nature of this work.

  As you note, emerging issues require examiner education and training. With an extended time between exams, it would be even more crucial to ensure diligent identification and resolution of any emerging problems in credit unions. Additional examiner training also becomes increasingly important as the complexity of credit union operations increases due to a rapidly evolving financial services landscape and additional authorities being provided as part of Chairman Matz's Regulatory Modernization Initiative. Chairman Matz has often said that NCUA needs to keep up with the industry that we supervise. So our training program and corresponding staffing levels need to keep pace with credit unions' expanding member service opportunities.

- Enhancing **data and modeling capabilities** to support off-site monitoring. I would note that off-site supervision is only as good the data it is based on. The agency experienced increased data quality concerns with Call Report information under the 18-month examination cycle. In fact, review of the accuracy of the Call Report during examinations has long been a required procedure, even for risk-focused examinations. Having said that, in 2016 the agency plans to begin evaluating a comprehensive reorganization of the Call Report. The goals of this reorganization are to streamline the Call Report for credit unions not involved in complex activities, eliminate data no longer needed, and expand the data collected to address increasing authorities of credit unions as well as to support improved off-site supervision. We will formally include credit unions in this process. NCUA's Offices of Examination and Insurance and the Chief Economist will also be working to update red flag reports and risk triggers, along with developing more sophisticated risk modeling techniques.

- Using **new technology and techniques to improve the AIRES examination platform.** The platform AIRES is built on is at the end of its life cycle. Therefore, NCUA must invest in updating this platform to maintain its functionality, and for the past year has been identifying the requirements and specifications to achieve this. In updating AIRES, we can leverage new technology and techniques to make the exam process more efficient and effective. For example, the agency is exploring expanded capabilities related to evaluating the quality of a credit union's loan and investment portfolios, conducting pre-examination planning more efficiently, and reducing data entry by examiners.[3] The new AIRES would integrate the secure file transfer solution (portal) slated to be deployed in early 2016. If funding is approved by the NCUA Board, the new AIRES will enable examiners to conduct more examination steps off-site, reducing on-site time at medium to large credit unions by as much as half. This will increase the quality of exams, lower travel costs, reduce any disruption for credit unions caused by exams, and improve the quality of life for examiners.

- Designing a **prudent framework for the examination program**, so as not to compromise the safety and soundness of the credit union system. As you note in your letter, a key consideration in designing any such program would be the criteria to determine which credit unions are eligible for an extended examination cycle. As one reference point, your letter correctly points out that Congress by law mandates an annual examination for banks, only allowing an 18-month exam for institutions with less than $500 million in assets[4] that also meet additional sound performance criteria.[5] Thus, large institutions must still be examined annually.

  NCUA does have broader authority over its examination cycle, and credit union performance during the recent recession was better than banks. However, I am obliged to note that the share insurance fund was imperiled during the recent recession, not just from corporate credit union losses but also from over a dozen large consumer credit unions that were on the brink of failure. It was only through extraordinary government intervention on both fronts that greater losses to the credit union system were avoided. Further, the failure of even one $500 million credit union would cost more than a decade's worth of any savings from an 18-month exam cycle.

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[3] This will necessitate credit unions providing some additional data beyond what is included in the current AIRES share and loan download file specifications.

[4] While there are various bills to increase this asset threshold to as high as $1 billion, this legislation has not been enacted.

[5] As you know, a credit union's financial condition can quickly change. Consider that since 2010 there have been 26 credit unions that caused a loss to the insurance fund that were rated a CAMEL 1 or 2 within 24 months prior to failure - 8 of which were not due to fraud.

Also, the bank asset threshold must be put in context to the loss absorbing capacity of the different funds. Banks with less than $500 million in assets hold total insured deposits of 9.5 times the size of the deposit insurance fund, which would fall to 4.8 times once the deposit insurance fund reaches the target level of 2.0 percent set by FDIC. By comparison, at NCUA's target equity ratio for the share insurance fund of 1.3 percent, total insured shares in credit unions with less than $500 million in assets are 24.4 times the size of the insurance fund.[6]

Small Credit Unions

I appreciate your concerns related to the burdens on small credit unions. The trend in consolidation of small institutions spans back several decades and is the result of many factors. While most of these factors are beyond NCUA's control, the agency has acted where it could. NCUA adopted a streamlined examination for credit unions with less than $50 million in assets, reducing time to allow resources to be reallocated to larger credit unions. The new small credit union exam procedures (SCUEP) include additional fraud detection techniques given small credit unions' inherent challenges of maintaining segregation of duties with limited staff. The annual frequency of the exam is an important component in deterring fraud and complementing the more narrow scope of SCUEP exams. NCUA has also scaled regulations based on the size and complexity of the credit union, exempting small credit unions from several regulations. In addition, the NCUA Board may soon finalize an increase to the Regulatory Flexibility Act threshold to provide even more institutions with special consideration in the rulemaking process.

Federally-Insured State-Chartered Credit Unions

As insurer of federally insured state-chartered credit unions, NCUA relies on examination work performed by state regulators in the majority of federally insured state-chartered credit unions. NCUA routinely conducts examinations only in those federally insured state-chartered credit unions that pose an elevated risk to the Share Insurance Fund either due to size, complexity, or negative financial performance. In addition, the agency works closely with state regulators to jointly conduct virtually all examinations of federally insured state-chartered credit unions to avoid duplication of work.[7]

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[6] An asset threshold of $500 million would represent 2.5 to 5 times greater exposure for the share insurance fund. For an exposure proportional to the deposit insurance fund, the asset threshold for credit unions would need to be $150 million.

[7] I would note most state banking agencies participate in an examination program under which certain examinations are performed on an alternating basis by the state agency and the FDIC or Federal Reserve. NCUA employs a targeted supervisory program for state-chartered credit unions with less than $250 million in assets. The annual joint NCUA and state regulator exams for state-chartered credit unions with $250 million or more in assets has a sharing of responsibility analogous to FDIC's approach to alternating exams of state banks.

Overhead Transfer Rate

In terms of the overhead transfer rate, the methodology is designed to be neutral with respect to charter choice. To achieve this, NCUA assigns an imputed value to the work done by state regulators supervising federally-insured state-chartered credit unions. In the methodology, the imputed state regulator value reduces the overhead transfer rate, and the amount is calculated on the same cost basis as the work NCUA performs supervising federal credit unions. In 2011, NCUA contracted with PricewaterhouseCoopers to independently review the overhead transfer rate methodology. PricewaterhouseCoopers found the methodology was reasonable and favored neither federally chartered nor state-chartered credit unions.

Please note the examination frequency, as well as the size of NCUA's budget, does not drive the rate that is set as the overhead transfer rate. Rather, it is the relative distribution of spending within the budget that is one of many factors affecting the overhead transfer rate calculation.

Conclusion

I recognize the potential advantages to adopting an extended exam cycle for healthy credit unions, such as devoting more resources to an improved examination experience and focusing on weaker institutions, which you articulate in your letter. However, there are various open questions on the efficacy of an extended exam cycle and the need for more dialogue on this subject.

Thus, at this time it is best to prioritize building out the improved systems and processes I have noted above, and finalizing and incorporating the various regulatory relief measures the agency is working on. Please keep in mind, given a finite period of time there is a limited amount of organizational capacity to make such changes. The agency has already put in motion many initiatives that will improve the examination process, which will take time and resources to complete and that would be critical aspects of the foundation upon which the NCUA Board might consider extending the examination cycle.

Please feel free to contact me if you have any questions.

Sincerely,

Larry Fazio

Larry Fazio
Director
Office of Examination and Insurance

cc: Chairman Matz
Vice Chairman Metsger
Board Member McWatters