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July 17, 2014

SENT BY E-MAIL

This letter responds to your Freedom of Information Act (FOIA) request received by this office on June 18, 2014. You initially requested a copy of each response to a Question for the Record (QFR) provided to Congress by the NCUA going back to January 1, 2009. Due to potential search fees that exceeded what you were willing to pay, you agreed to modify your request to go back to January 2012.

Your request is granted in full. Attached are 24 pages of records responsive to the timeframe of your request.

If you have any questions related to your request, please contact this office at 703-518-6540 or by e-mail at FOIA@ncua.gov.

Also enclosed is an invoice for processing your request. Please send your payment, with a copy of the invoice, to the attention of the FOIA Processing Center. Payments are due within 30 days of the invoice date.

Sincerely,

Regina Metz

Regina Metz
Staff Attorney

GC/RM:CS
14-FOI-00072
Attachments

NCUA's Responses to Questions for the Record
House Financial Services Financial Institutions and Consumer Credit Subcommittee
Hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act
February 1, 2012

<u>Question Submitted by Congresswoman Carolyn McCarthy</u>

- **Are uniform classification standards achievable or is there an alternative way to bring consistency to the loan classification process for non-performing loans?**

In response to your question, I would like to emphasize, first and foremost, that commercial lending represents less than 10 percent of all lending activity in credit unions and amounts to $37.2 billion in lending activity on an industry asset base of $961 billion. Additionally, NCUA's response refers to the commercial lending activities of credit unions and not consumer lending activities, as the testimony and related questions focused on commercial loans. NCUA also believes the intention was to discuss non-accrual loan classification approaches, as well.

All of the federal regulators, including NCUA, participated in the development of the 2009 *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts*.[1] This authoritative guidance for credit unions details prudent best practices for commercial loan restructures and refinances. While this guidance is not incorporated in regulation, it provides a flexible prudential framework for financial institutions without creating undue regulatory burden or constraining institutions with varying degrees of risk, complexity, and diversity within their business models and commercial loan portfolios.

NCUA has also issued a Supervisory Letter in January 2010 entitled *Current Risks in in Business Lending and Sound Risk Management Practices*.[2] This supervisory release identified NCUA's evaluation of risk in the industry, and set expectations for appropriate risk-management practices, as well as areas of focus by examiners.

NCUA trains examiners on the job and through formal classroom training on commercial lending practices and techniques. NCUA also makes use of specialized examiners with enhanced commercial loan training in our most sophisticated and largest commercial lending credit unions.

Finally, it is important to emphasize that a classification methodology is primarily a vehicle to ensure that loan valuations are correct for financial statement presentation. Those valuations ensure that users of the financial statements, including investors and depositors, have a transparent view of the true financial condition of a financial institution. Any approach that clouds transparency would prove counterproductive and could have the effect of creating greater uncertainty in the marketplace.

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[1] See http://www.ncua.gov/Resources/Documents/LCU2010-07Encl.pdf as well as NCUA's Letter to Credit Unions 10-CU-07

[2] See http://www.ncua.gov/Resources/Documents/LCU2010-02Encl.pdf as well as See NCUA's Letter to Credit Unions 10-CU-02

Identical Classification for Non-Performing Loans

The classification of a commercial loan is, by nature, judgmental and requires both the financial institution management and examiner to evaluate collectability of a loan under unique circumstances related to that specific loan. Differences between loans, institutional underwriting practices, or even geographic concentration risks can vary significantly from one loan to another and one institution to another. It would be very difficult to apply a rigid set of identical standards across regulators when the conditions affecting the classification of a commercial loan can vary widely. As a result, the judgment of management and the examiner are critical to the effective classification of non-performing loans.

Currently, NCUA places the responsibility on credit unions to establish an appropriate classification policy that meets the complexity, size, and risk profile of the institution's commercial loan portfolio. Credit unions are further expected to consistently apply the methodology.

NCUA instructs examiners to evaluate the rigor and appropriateness of the credit union's methodology given the complexity, size, and risk profile of the institution's commercial loan portfolio. NCUA's evaluation will often include testing on individual credits, which can lead to conflict with management over a classification methodology. As mentioned earlier, NCUA's Letter to Credit Unions that circulated the *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts* provides authoritative guidance to credit unions and examiners alike.

Identical Classification for Non-Accrual Loans

H.R. 3461 also would require the establishment of identical definitions and reporting requirements for non-accrual loans. The creation of "bright line" statutory requirements for financial reporting may grant relief during trying economic periods. Such laws, however, may have the opposite effect in periods of economic growth. Additionally, any legislative changes that could blur the public perception that financial statements are not transparent could result in a negative market effect.

The interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* outlines policy considerations that should govern and inform credit unions' non-accrual and classification decision processes based on the size and complexity of the institution.[3]

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[3] Currently, credit unions have the freedom to develop their own loan grading schematic. NCUA does not impose specific standards on credit unions, but provides guidelines to credit unions in a 2006 Interagency ALLL Policy Statement through an Appendix entitled *Loan Review Systems.* Examiners review a credit union's loan grading system as it provides important information on the collectability of the portfolio for use in a number of areas within the examination process. NCUA realizes loan grading assessments by their very nature involve a high degree of subjectivity. And NCUA has observed that a credit union's ability to estimate identify nonperforming loans and estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, our examiners should generally accept management's assessments when evaluating the appropriateness of the credit union's loan grades, and not seek adjustments when management has effectively incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process; and analyzed all significant qualitative or environmental factors that affect the collectability of the portfolio as of the evaluation date in a reasonable manner.

NCUA's approach provides greater flexibility to credit unions to adapt to changing economic conditions. NCUA's approach also ensures that credit unions maintain autonomy in making loan performance judgments based on all the available facts and circumstances affecting loan collectability and performance.

The establishment of a statutory "bright line" to inform judgments that by their very nature require judgment may permit credit unions to ignore other available information about the borrower in consideration of true loan collectability. Less transparency or incomplete analysis can reduce the reliability of financial statements which could prove destabilizing.

NCUA's existing agency guidance allows for credit union and examiner judgments, but cautions examiners on a number of issues addressed in the proposed legislation. The existing guidance, when appropriately implemented, strikes the appropriate balance for all stakeholders.

Many of the concepts revolving around non-performance and non-accrual are also founded in Generally Accepted Accounting Principles (GAAP). Any legislative changes that conflict with GAAP have the potential to reduce transparency on the financial performance of a financial institution and could result in additional administrative burden of maintaining both a statutory and a GAAP financial statement presentation.

NCUA respectfully submits that the way to achieve consistency in the loan classification/grading, loss provisioning, and non-accrual processes is to strengthen consistent implementation of existing interagency guidance.

NCUA's Responses to Questions for the Record
House Financial Services Financial Institutions and Consumer Credit Subcommittee
Hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act
February 1, 2012

Questions Submitted by Congressman Lynn Westmoreland

- **How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?**

Since 2008, the National Credit Union Administration (NCUA) has disciplined 15 examiners. Of the 15 examiners disciplined, two of them were for not fully utilizing standard agency guidance.

- **How many examiners have had employment terminated since 2008 for performance?**

Since 2008, NCUA has terminated 29 examiners for performance. Of those 29 examiners, 26 were terminations of probationary employees within their first year of federal employment, and three had worked at NCUA for more than a year.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Peter King

- **Recently, NCUA proposed a risk-based capital rule for credit unions over $50 million in assets. This rule would impose a Basel-like capital regime on top of the already stringent statutory capital requirements that credit unions must follow.**

  I have heard a number of concerns from credit unions regarding this proposal. In the proposed rule, the Board indicates that if the rule were applied today only a small number of credit unions would be reclassified as undercapitalized and that these credit unions would collectively have to raise $63 million in order to be adequately capitalized. However, industry groups have estimated that credit unions will have to hold an additional $6.7-$7.3 billion in capital in order to keep the same capital cushion as they currently hold.

  Why is there such a large discrepancy between the Board's estimated impact and the impact credit unions believe they will sustain?

Some trade associations have estimated that the implementation costs could run as high as $7 billion, but NCUA estimates the cost as substantially less. The industry's overstated figures are based on a questionable assumption that every federally insured credit union would seek to maintain its current capital cushion above the regulatory minimum.

For example, if a credit union currently has 13 percent net worth, it has a 6 percent cushion between the 7 percent leverage capital requirement and their actual net worth. If the same credit union's risk-based capital ratio became 13 percent under the proposed rule, industry is suggesting that it needs to add another 3.5 percent in its estimate. This estimate suggests that credit union management holds excess capital for other than an informed understanding of the risk in their balance sheet. As a result, the industry group projected the impact to be between $6.3 and $7.3 billion.

In reality, the decision whether to hold a capital cushion and how large that should be is a business decision that each credit union makes. The proposed rule does not require credit unions to maintain any specific capital cushion above the regulatory minimum standard for being well-capitalized. Additionally, the measure of an individual credit union's capital adequacy should not be based upon maintaining a targeted dollar amount above the regulatory minimum. Proper capital adequacy measurement should be much more granular and based on each credit union's strategic plan and risk profile.

Under NCUA's proposed rule, the overwhelming majority of credit unions would experience no change in their assigned prompt corrective action category. Overall, the proposed rule would only apply to federally insured credit unions with assets of $50 million or more—approximately

2,200 out of about 6,600. As a result, the estimated 4,400 federally insured credit unions below $50 million in assets—two-thirds of all credit unions—are not affected by the proposed rule. No small credit union's capital requirement would be affected by the new rule.

Of the 2,200 credit unions subject to the rule as proposed, nearly half would actually see an improvement in their capital levels relative to their risks. Additionally, because the overwhelming majority of these 2,200 credit unions would experience no change in their prompt corrective action category under NCUA's proposed rule, the rule would not require them to raise any additional capital. Under the proposed rule and using December 2013 data, 92 percent of all federally insured credit unions would remain well capitalized, 5 percent of credit unions that are currently undercapitalized would remain so, and only 3 percent of credit unions would see a reduction in their prompt corrective action category because of the proposed rule.

Collectively, only 201 federally insured credit unions comprise the 3 percent affected by the proposed rule. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital—but only if all 201 choose to maintain their balance sheets' current risk exposure. Alternatively, without raising any more capital, these affected credit unions could reduce their risk-weighted assets; or they could choose a combination of these two strategies.

- **Did NCUA conduct an economic analysis of its proposal before putting this rule out for comment?**

As I mentioned earlier, there are 201 federally insured credit unions in the 3 percent affected by the proposed rule. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital (equivalent to 0.8 percent of assets on average), but only if all 201 choose to maintain their balance sheets' current proportional risk exposure as they continue to grow. This amounts to about one year of earnings for the typical credit union. Alternatively, these affected credit unions could reduce their risk-weighted assets to comply with being well-capitalized under the proposal, or choose some strategic combination of the two.

Since the imposition of Prompt Correction Action requirements, NCUA has worked effectively with those credit unions that experience declines in their capital position through the supervision process. Credit unions that decline from well-capitalized to adequately capitalized are only subject to the statutory earning retention requirement, which can be waived as conditions warrant. NCUA regulations do not establish a time table for a credit union to become well-capitalized.

- **Will you consider conducting additional analysis of this proposal's economic impact before issuing a final rule?**

Yes. NCUA plans to carefully review all comments and to continue to analyze scenarios and issues raised. As NCUA works through the 2,052 comments on the proposed rule provided by stakeholders, we will consider the impact of changes to the rule and address any changes we can make to the supervision process to assist credit unions in adjusting to the revised requirements.

- **Would the Board be concerned if credit unions were forced to reserve $7 billion as a result of this proposal?**

The Board is considering the costs associated with implementing the proposed rule. As discussed above, the $7 billion estimate reaches far beyond the capital improvements contemplated in the proposed risk-based capital rule. NCUA estimates that the 201 credit unions that would drop to adequately capitalized or undercapitalized under the proposed rule would need to raise approximately $633 million in additional capital, which represents approximately 12 months of earnings for the affected credit unions, but only if these credit unions choose to maintain their balance sheets' current risk exposure. Alternatively, without raising any more capital, these affected credit unions could reduce their risk-weighted assets; or they could choose a combination of these two strategies.

- **The Board put this rule out for comment earlier this year and provided stakeholders 90 days to submit their views. When the rule is finalized, credit unions will have 18 months to come into compliance.**

  Why did the Board reject industry representatives' request to extend the comment period? Will you consider giving stakeholders more time to comment on this proposal?

The NCUA Board planned on a 90-day comment period to allow more time than the standard comment period of 30 or 60 days. From the time the NCUA Board issued the proposed rule on January 23 until the close of the comment period on May 28, commenters ultimately had 125 days to review the proposed rule. In all, the comment period was NCUA's second longest in the last two decades and provided ample time for stakeholders to review and provide useful comments.

NCUA received 2,052 letters during the comment period on the risk-based capital rule, the most in the agency's history. The volume and depth of the letters we received, some as long as 47 pages indicate a thoughtful and considered review of all relevant issues. Before finalizing our revised rule on risk-based capital, we plan to carefully analyze and evaluate every comment received.

- **How do you respond to the concerns that credit unions will be asked to implement this new rule in 18 months' time, but small banks will have been afforded nearly nine years to implement Basel III from the time it was first proposed to when it goes into effect in 2019?**

The NCUA Board is committed to re-evaluating the amount of time needed before the final rule goes into effect and has indicated an open mind about extending the implementation period based on the comments received. It will take time for the affected credit unions to amend their risk polices and adjust their balance sheet strategies to comply with the revised regulation. During that same time, NCUA will also need to make major data system changes to accommodate the final risk-based capital rule changes. NCUA will look closely at the impact of implementation timeframes as part of the final rulemaking.

- **Do you have any concerns that credit unions may not be able to raise enough capital quickly enough to maintain the capital buffers under which they currently operate?**

No. First, there is no requirement for a credit union to maintain a buffer above the required regulatory minimum. Most complex credit unions have already accounted for at least some of the additional risk in their balance sheets with additional reserves. The additional capital required equates to about 12 months of average earnings, and some credit unions will choose to reduce their risk profiles.

- **Will you consider giving credit unions more time to come into compliance with this regulation after it is finalized? If not, why not?**

Yes. We continue to analyze implementation capabilities within the credit union system. As part of our review of comments and financial analysis of impact, we will evaluate alternative implementation timelines.

- **Why is the Board proposing a risk-based capital rule that includes features that are more stringent than the requirements on FDIC-insured banks, when the National Credit Union Share Insurance Fund is strong and natural person credit unions are well-capitalized?**

To comply with the Federal Credit Union Act, NCUA is required to update credit unions' risk-based capital standards as financial regulatory capital standards evolve and to be comparable with other federal financial agencies. However, the law also requires NCUA to consider "all material risks" to federally insured credit unions, in contrast to requirements for banks. So while the new Basel III capital accord focuses mainly on credit risk, NCUA's capital standard, to comply with the Federal Credit Union Act, must also account for relevant risks including interest rate and concentration risks. While the proposed rule in some places has a higher risk weight than banks, in other places the risk weight is lower, as is the case with the risk weighting on consumer loans.

The stakeholder feedback received during the comment period will help to inform the NCUA Board's determination of the most appropriate risk weight for each asset type.

- **Some of the proposal's risk weights would be considerably higher than those applied to community banks under the Basel system even though credit unions are more risk averse.**

  How did the Board determine the risk-weighting under this proposal?

While striving for overall comparability with the FDIC's rule, NCUA has proposed several different risk weights, consistent with the law, such as a lower weight of 75 percent for credit unions' consumer loans in comparison to the banking system's risk weight of 100 percent. NCUA also proposed retaining the tiered risk-weight approach from our existing rule to account for higher concentrations in member business loans and mortgage loans. A 2012 report by the Government Accountability Office specifically recommended NCUA address such concentration risk. Similarly, NCUA proposed maintaining tiered risk weights for longer-term investments in order to account for interest rate risk.

Please be assured, as part of the rulemaking process, the NCUA Board will carefully consider the comments received when determining how best to calibrate the final risk weights, including any comments received about the risk weights for real estate loans, agricultural loans, and member business loans. The stakeholder feedback will help to inform us in determining the most appropriate risk weight for each asset type. Further, when issuing the final rule, we will provide further clarity in response to comments as to how NCUA calculated certain risk weights and why those risk weights may, in some instances, differ from the risk weights for federally insured banks.

- **Why does the proposed rule apply higher risk weights for mortgage loans and business loans for credit unions that have higher concentrations of these loans? Is there a comparable requirement under the Basel III rules for small banks?**

The Federal Credit Union Act specifically requires NCUA to consider any material risks in developing a risk-based capital requirement for credit unions, including concentration risk. The Government Accountability Office in reports about NCUA and the NCUA Inspector General in recent material loss reviews have both cited concentration risk as a material risk. As a result, NCUA needed to address these risks in the proposed risk-based capital rule. Basel III represents the bank capital standard, but as noted above it generally does not address concentration and interest rate risks.

- **Why has the NCUA chosen to account for interest rate risk and concentration risk in a capital system as opposed to through supervision and examination which is how it is done now for credit unions and community banks? Is the examination and supervision process currently in place now broken?**

While the new Basel III capital accord focuses mainly on credit risk, NCUA's capital standard, to comply with the Federal Credit Union Act, must also account for any material risks, including interest rate and concentration risks. NCUA maintains strong safety and soundness oversight and appropriate regulation scaled to minimize regulatory burden. However, additional capital serves as a risk-mitigation measure and a deterrent to excessive risk taking, while also providing an individual credit union the discretion to determine the business model that best fits its membership base. Addressing concentration risk through risk-based capital provides flexibility while encouraging appropriate market discipline with our supervised institutions.

Critics contend that because most U.S. credit unions survived the crisis with relatively strong capital, this rule is unnecessary. However, that survival required an infusion of $20 billion from NCUA's Central Liquidity Facility and $6 billion from NCUA's line of credit at the U.S. Treasury. Even with that extraordinary level of assistance, 102 credit unions failed during the economic downturn. Although many of those failed credit unions appeared to have high net worth ratios, they actually lacked sufficient capital to protect against the risks on their balance sheets. Those failures cost the National Credit Union Share Insurance Fund three-quarters of a billion dollars. This cost had to be paid by all surviving credit unions, which as cooperatives, are required by law to share in the losses on a proportional basis.

Had NCUA's proposed risk-based capital rule been in place before the crisis, the $750 million in losses would have been substantially reduced, and several credit union failures could have been avoided.

- **Do you have concerns that these risk weightings could hinder credit union lending to home owners and small businesses?**

The current regulatory framework for credit unions provides many options for an informed management team to continue providing or even increasing service to its members. The current rule has higher risk weights for real estate loans and for member business loans. The current rule also does not curtail either real estate lending or member business lending.

Most credit unions would continue to be well-capitalized under the proposed rule. Only three percent of federally insured credit unions need additional capital to attain adequate levels of risk-based capital. Additionally, many credit unions engaging in these types of lending already carry more than the required leverage ratio in capital.

The relatively small number of credit unions with large concentrations of real estate or member business loans currently pose a risk and potential cost to other institutions through the cooperative credit union system. In other words, these institutions may become a drag across all institutions in small amounts that could more broadly hinder the industry's ability to lend to its members. The proposed risk-based capital rule merely requires institutions assuming greater levels of risk to account for more of it on their own balance sheets instead of transferring costs to other well-capitalized credit unions that are more diversified and less risky. The improved capital standard helps ensure long-term sustainability across the industry. Long-term viability is the most effective means of assuring members have choices in their borrowing decisions.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Ed Royce

- **Related to the proposed risk-based capital rule for credit unions over $50 million in assets, how did the NCUA determine the risk-weighting under this proposal?**

While striving for overall comparability with the Federal Deposit Insurance Corporation's rule, NCUA proposed several different risk weights, consistent with the law, such as a lower weight of 75 percent for credit unions' consumer loans in comparison to the banking system's risk weight of 100 percent. NCUA also proposed retaining the tiered risk-weight approach from our existing rule to account for higher concentrations in member business loans and real estate loans. A 2012 report by the Government Accountability Office specifically recommended NCUA address such concentration risk. Similarly, NCUA proposed maintaining tiered risk weights for longer-term investments in order to account for interest rate risk.

As part of the rulemaking process, the NCUA Board will carefully consider the comments received when determining how best to calibrate the final risk weights, including any comments received about the risk weights for real estate loans, agricultural loans, and member business loans. The stakeholder feedback will help to inform NCUA in determining the most appropriate risk weight for each asset type. Further, when issuing the final rule, NCUA will provide additional clarity in response to comments as to how the agency calculated certain risk weights and why those risk weights may, in some instances, differ from the risk weights for federally insured banks.

- **Why does the proposed rule apply higher risk weights for mortgage loans and business loans at credit unions with higher concentrations of these loans? Do the Basel III rules applying to small banks include a comparable requirement?**

The proposed risk weights reflect material risks that must be accounted for in a risk-based capital system for credit unions. NCUA's existing risk-based net worth standard has higher risk weights for higher concentrations of mortgage loans and member business loans. The Federal Deposit Insurance Act does not include the same requirements for banks.

Specifically, section 216(d) of the Federal Credit Union Act requires NCUA to formulate a risk-based net worth requirement to apply to complex credit unions. The subsection also mandates that the risk-based net worth requirement must "take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized may not provide adequate protection." This includes interest rate risk and concentration risk.

Congress indicated that the design of the risk-based net worth requirement "should reflect a seasoned judgment about the actual risks involved." Congress also encouraged NCUA to "consider whether the six percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks."

- **Have you evaluated the impact of these new capital rules in rural areas, where credit unions often have high concentrations of agricultural and business loans? If so, what were the findings?**

In evaluating the impact of the proposed rules, regardless of the location of the credit union NCUA determined the number of credit unions with higher-risk balance sheets that could experience a decline in their prompt corrective action classification. We then conducted further analysis including extensive "what if" analysis of changes in risk-weights and concentration risk thresholds. Finally, during the comment period NCUA provided credit unions with an online tool to determine their proposed risk-based capital measure to improve understanding of the proposal.

Collectively, there are 201 federally insured credit unions affected by the proposed rule; some of these credit unions operate in rural areas. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital (equivalent to 0.8 percent of assets on average), but only if all 201 choose to maintain their balance sheets' current risk exposure. This amounts to about one year of earnings for the typical credit union. Alternatively, these affected credit unions could reduce their risk-weighted assets to comply with being well capitalized under the proposal, or choose some strategic combination of the two.

Additionally, many credit unions in rural areas would also be eligible for a low-income designation, which would provide an opportunity to raise supplemental capital if needed.

- **You stated at the hearing that these risk-weightings take into consideration the unique characteristics of credit unions? How is this done?**

We adjusted the risk weightings based on our supervisory and loss experiences in the credit union system, as well as historical credit union performance. For example, because of credit unions' historical performance with consumer loans, a lower weight of 75 percent was used in comparison to the banking system's risk weight of 100 percent. Additionally, loss experiences indicate that some federally insured credit unions that have failed had mismanaged real estate portfolio and member business loan concentrations. The proposed rule addresses the concentration risk in these areas as required by the Federal Credit Union Act.

- **Related to small business lending (please provide reasoning if you believe the NCUA does <u>not</u> have the authority to provide regulatory relief), does the NCUA have the authority to allow loans on a 1-4 family dwelling to be excluded from loans counted toward the MBL statutory cap, even if the borrower does not use the dwelling as its primary dwelling, if the dwelling is used as such by any member of the credit union? (For example, Member X obtains a loan on a 1-4 family dwelling and rents it to another member who uses the dwelling as a primary residence. That loan should not count toward the cap.)**

NCUA lacks the authority to allow loans on a 1-to-4 family dwelling to be excluded from the member business lending cap if the borrower does not use the dwelling as a primary residence, even if the dwelling is used as a primary residence by another credit union member. The Federal Credit Union Act provides that an extension of credit that is fully secured by a lien on a 1-to-4 family dwelling that is the primary residence of a member is exempt from the definition of member business loan. NCUA interprets this to mean the dwelling is the primary residence of the borrower. Legislative history of this provision supports this interpretation.

- **Does the NCUA have the authority to allow credit unions, which have a significant proportion of their loans in MBLs for the last five years, to qualify for an exemption from the cap under the "history of primarily making MBLs" provision of the Federal Credit Union Act?**

NCUA has the statutory authority to define if a credit union, which has had a significant proportion of its portfolio in member business loans for the last five years, has a history of primarily making member business loans and would therefore qualify for an exemption from the statutory cap. However, the current regulation defines credit unions that have a history of primarily making member business loans as credit unions that have either 25 percent of their outstanding loans in member business loans or member business loans comprise the largest portion of their loan portfolios, as evidenced by any Call Report or other document filed between 1995 and 1998. The Call Report years noted in the definition reflect the time period leading up to the enactment of the Credit Union Membership Access Act of 1998, in which the "history of primarily making" standard was first included. Based on our interpretation of the 1998 law, the current definition focuses on a credit union's historical behavior during the years leading up to the enactment of the Credit Union Membership Access Act, and seems to make the most logical sense from a timing perspective.

- **Does the NCUA have the authority to eliminate requirements related to construction and development loan limits, and the personal guarantee of a borrower, which are not required under the Federal Credit Union Act?**

Yes, NCUA does have the authority to eliminate regulatory provisions that are not required by statute, including requirements relating to construction and development loans and the personal guarantee of the borrower requirement.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Robert Pittenger

- **Why has NCUA increased its overall budget size over the past seven years? During the past several years other agencies have had to tighten their belts, and it seems odd to see an agency not related to defense grow at six percent or more some years. Would NCUA please provide the committee with a detailed financial analysis supporting these increases over the seven-year period?**

In response to the recent financial crisis, NCUA's budgets over the past several years have increased. The NCUA Board made several responsible policy changes, each of which affected NCUA's budget needs.

There were two significant policy changes impacting the budget. The first eliminated the 18-month exam cycle and replacing it with an annual exam cycle with CAMEL code 3, 4, and 5 credit unions receiving even more frequent supervisory attention. The second had NCUA conduct annual insurance exams for state-chartered credit unions with assets over $250 million in assets rather than the previous $500 million asset threshold.

These new policies responded to material loss reviews by the independent NCUA Inspector General. The Inspector General's postmortem analyses of credit union failures found serious threats had developed at credit unions between examinations under the previous 18-month exam cycle. Failures could have been prevented and losses would have been significantly reduced with timelier onsite visits to detect and address material issues earlier.

These new policies required increased examiner hours, an expanded workforce needed to execute the necessary supervision tasks, and higher travel costs. However, the policy decisions worked as intended. NCUA minimized credit union failures and associated losses to the National Credit Union Share Insurance Fund.

By taking these actions, NCUA protected surviving credit unions and their members from paying for higher losses. The total 2009–2012 budget increase amount of $59.0 million prevented up to $1.1 billion in further losses credit unions would have had to pay for credit unions that were on the brink of failure.

The share of assets held in credit unions with CAMEL code ratings of 3, 4 or 5 increased nearly fourfold from historical norms during the height of the crisis. At the same time, the need to provide increased supervision of troubled credit unions increased NCUA budgets and outlays. Specifically, during the crisis the share of natural-person credit union assets associated with troubled CAMEL code 4 and 5 ratings more than quadrupled over historical norms, to a high point of more than 5 percent of industry assets—more than $50 billion held in troubled credit unions.

Such combined failures could have overwhelmed the Share Insurance Fund and devastated the entire industry had NCUA not immediately dealt with the problems. NCUA enhanced supervision, while struggling credit unions stepped up and worked hard to improve their operating efficiencies. As a result of collective action by both the industry and regulators, coupled with a steady economic recovery, overall credit union metrics are improving today and the entire system is more resilient.

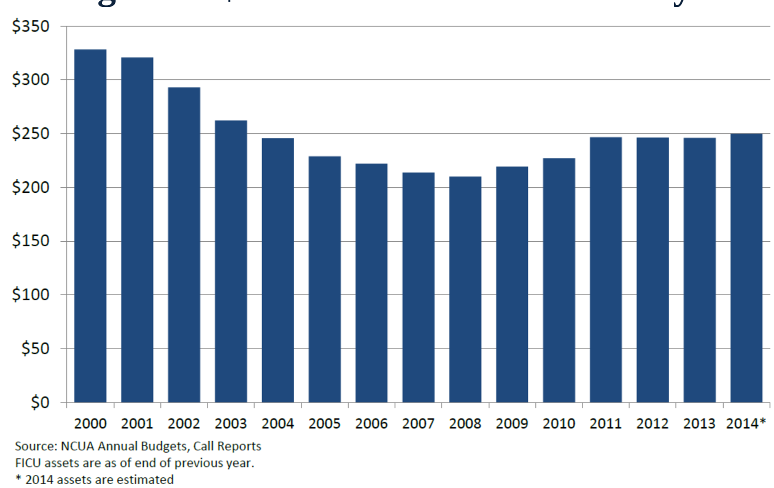
Continued vigilance and supervision are necessary to help return as many troubled credit unions to higher CAMEL ratings as possible, and prevent future losses to the Share Insurance Fund. NCUA's 2014 budget and those of recent years were a necessary means to accomplish the agency's statutory mission and maintain consumer confidence in the credit union system.

NCUA's budgets reflect core strategic goals which are consistent year-over-year in the agency's Strategic Plan. This plan focuses on maintaining a healthy credit union system and Share Insurance Fund to accomplish the agency's statutory mission and ensure continued consumer confidence in the credit union system.

During the expansionary economic cycle that occurred just before the recent recession, NCUA staff had decreased, even as the credit unions were growing in both size and complexity. Additionally, the NCUA budget remained essentially flat from 2001 to 2007. As the recent recession began and the number of troubled credit unions grew alarmingly, NCUA increased its budget. It is worth noting that any budget savings credit unions derived from those pre-recessionary years were dwarfed by more than $900 million in actual natural-person credit union losses that surviving federally insured credit unions paid for through the Share Insurance Fund from 2008 to 2012.

Looked at another way, for the last three years NCUA's budget expressed as a share of industry assets has remained essentially flat at just under $250 per $1 million of federally insured credit union assets. This ratio fell dramatically from $330 per $1 million in 2000 to a low point of $210 per $1 million. The chart below illustrates this point more clearly.

NCUA Budget Per $1 Million in Credit Union System Assets



Because of the dire situation, and similar to FDIC and other regulators of financial institutions, NCUA was forced to increase its budget to deal with these critical issues. Financial regulatory budgets have tended to be counter-cyclical. That is, when the economic cycle turned down, financial regulators staffed up. These increases, although necessary, also compounded the financial burden on many credit unions as they were facing mounting charge-off losses and weak earnings. So, rather than implementing immediate large budget increases similar to actions taken by other financial institutions regulators (some over 80 percent per year), NCUA strategically spread out necessary budget increases over multiple years. This approach steadily rebuilt NCUA resources at a measured pace to help minimize the funding burden on credit unions during the recession.

In addition, the NCUA Board has taken the approach that the budget is <u>not</u> intended to be strictly counter to economic cycles, thus only rising when crises occur. The Board is focused now on building optimum capacity when the economy and the industry is performing relatively well, in order to ensure long-term safety and soundness, and to keep pace with growing credit union complexity. By contrast, the counter-cyclical approach to reducing the budget during times of improved credit union performance would be like to laying off firefighters between fires. The NCUA Board's approach is intended to ensure the necessary resources are in place before the next crisis, which puts NCUA in the best position to reduce the risk of major losses in the future.

- **While I am back in the district, I still hear a number of complaints about the examination process. Whether this is a community bank or credit union—both believe the examiners are out of touch and are only there to do harm. Would you please explain the NCUA examination appeals process? Also, why do credit unions feel the agency's appeals process is inadequate and how many credit unions have been able to successfully appeal examiner decisions in the last year, last five years, and last seven years? Finally, how does the ombudsman function in terms of the examination process—especially in regards to representing the interests of credit unions? Would you please explain the NCUA examination appeals process?**

NCUA has a multi-level appeals process consisting of informal and formal appeals avenues. Because we believe many concerns can be efficiently and effectively addressed with additional communication, the purpose of our appeals structure is to encourage immediate dialogue with the individuals most closely associated with local credit unions. We encourage credit unions to discuss concerns openly with their examiners and supervisory examiners, and most concerns are successfully handled in this way.

NCUA also realizes the importance of a formalized, independent appeals process for those instances where credit unions do not believe they are being adequately heard. Credit unions may therefore appeal formally in writing to their regional director within 30 days of receiving final reports. Upon receipt of an appeal, a regional director will conduct a review of the facts and respond formally in writing.

Additionally, Congress enacted the Riegle Community Development and Regulatory Improvement Act (Riegle Act) in 1994.[1] Section 309 of the Riegle Act required, among other

[1] See Public Law 103-325, §309(a), 108 Stat. 2160.

things, that NCUA and the federal banking agencies each establish an independent appellate process to review material supervisory determinations. Specifically, the Riegle Act required the NCUA to establish "an independent intra-agency review process for material supervisory determinations, appoint an Ombudsman, and develop an alternative dispute resolution program." In response, the NCUA Board established a Supervisory Review Committee, created an Ombudsman position, and issued an alternative dispute resolution program policy statement.[2]

The Supervisory Review Committee is comprised of three independent members of the NCUA's senior staff, as appointed by the Chairman. The committee reconsiders and makes recommendations on material supervisory determinations. Supervisory determinations are limited to:

- Appeals of composite CAMEL ratings of 3, 4, and 5 and all component ratings of those composite ratings;
- The adequacy of Allowance for Loan and Lease Loss funding determinations; and
- Loan classifications on loans that are significant as determined by the appealing credit union.

Credit unions may appeal Supervisory Review Committee decisions to the NCUA Board within 30 days of receiving the Supervisory Review Committee's decision.

To protect credit unions from reprisals, NCUA has a zero-tolerance retaliation policy. Examiners may not take action against a credit union for using any formal or informal appeal channel. If a supervisor discovers an examiner retaliated with unreasonable action against a credit union, that examiner will face disciplinary action. In addition to the appeal information outlined above, credit unions are provided contact information for NCUA's Office of General Counsel, Office of Examination and Insurance, and Office of the Inspector General as a part of every examination. Finally, NCUA has continuously maintained a zero-tolerance policy pertaining to retaliation.

In 2012, after conducting nationwide Listening Sessions with stakeholders NCUA took additional steps to enhance credit union management access to informal appeals process. We made changes to the examination report to include direct access information for the examiner-in-charge, the field examiner, and the regional office for each credit union. We also placed field manager and examiner-in-charge contact information on the credit union online portal for each credit union. In addition, we changed the examination cover page to outline the steps and all options for the informal and formal appeals process, and incorporated those steps and contacts into the examination report cover documents.

- **Also, why do credit unions feel the agency's appeals process is inadequate and how many credit unions have been able to successfully appeal examiner decisions in the last year, last five years, and last seven years?**

[2] See 61 FR 11433-34 (March 20, 1996). Section 309(e) of the Riegle Act envisioned the use of alternative dispute resolution methods to resolve claims against insured credit unions for which NCUA has been appointed conservator or liquidating agent; actions taken by NCUA in its capacity as conservator or liquidating agent; and any other issue for which the NCUA Board determines that alternative dispute resolution would be appropriate. See NCUA Rules and Regulations at 12 CFR §709.8(c).

While we do not track the number of informal appeals resolved with credit unions, we know that very few are not able to be resolved at the lowest levels.

Frequently, we receive indirect information that credit unions fail to appeal an examination issue because they fear retaliation. However, there is no evidence of retaliation, despite our continued outreach during the last several years to obtain more information about such concerns. We maintain a very aggressive communication expectation with our examiners and field supervisors. Our informal conflict management process encourages immediate communication and resolution at the earliest possible time and with the individuals with the greatest working relationship and institutional knowledge (the examiner-in-charge and field supervisor). We believe the vast majority of issues and concerns raised are resolved early in the process and before they become formal appeals.

During the last year, NCUA's Supervisory Review Committee has considered no appeals. For the last five years between 2010 and 2014, there have been seven appeals, and for the last seven years between 2008 and 2014, there have been eight appeals. None of the exam appeals have been decided in favor of the credit union. The years are based on the dates the examination appeal was received, not when the final decision was rendered.

- **Finally, how does the ombudsman function in terms of the examination process—especially in regards to representing the interests of credit unions?**

In a Board Action Memorandum approved by the NCUA Board on March 13, 1995, the Board established an Ombudsman position. In the memorandum, the Board stated that the Ombudsman position would be held by an existing NCUA employee appointed by the Chairman; the functions of the position would be collateral to the appointee's current duties; and the Ombudsman would report to the Board. In addition, the Board authorized the appointee to act independently of NCUA program functions and to have access to agency records. The Board further authorized the Ombudsman to keep confidential any information and material obtained as a result of investigating complaints.

NCUA's Ombudsman investigates complaints and recommends solutions. These complaints must relate to regulatory issues that cannot be resolved at the operationally at the regional level. The Ombudsman assists in resolving problems by helping the complainant to define options and by recommending actions to the parties involved, but the Ombudsman cannot at any time decide on matters in dispute or advocate the position of the complainant, NCUA or other parties.

The Ombudsman does not handle any matter:

- subject to formal review as set forth in NCUA regulations or NCUA interpretative rulings and policy statements;
- involving an enforcement action where a notice of charges has been filed;
- in litigation;
- involving a conservatorship or liquidation; or
- within the Inspector General's jurisdiction.

The Ombudsman will make recommendations to appropriate agency officials for systemic changes to deal with recurring problems revealed through investigations.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Mick Mulvaney

- **Mr. McKenna, I understand that the National Credit Union Administration (NCUA) releases audits, financial statements and data regarding its operating budget, the National Credit Union Share Insurance Fund (NCUSIF), Central Liquidity Facility (CLF), and the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). These reports only show aggregated figures instead of line-by-line or other breakdowns of expenditures. In the interest of budget transparency, I am curious to know why NCUA releases only aggregate figures and not more specific, line by line details regarding these expenses? Would you please share a more detailed breakdown of the NCUA operating budget and above-referenced accounts with this Committee?**

NCUA formulates the agency's Operating Budget using zero-based budgeting techniques in which every expense must be justified each year. The budget is formulated from input provided by NCUA program offices, vetted through the Executive Director, and presented to the NCUA Board for approval annually at the November open Board meeting. The Operating Budget is subsequently adjusted at the open Board meeting each July based on a mid-year financial analysis. Based on this analysis, funds may be returned to the credit unions in the form of reduced credit union assessments the following year.

A portion of the Operating Budget is reimbursed from the National Credit Union Share Insurance Fund through the Overhead Transfer Rate. The share of the Operating Budget paid for by the Share Insurance Fund is also presented to the Board for approval at the open November Board meeting.

The Temporary Corporate Credit Union Stabilization Fund follows a similar budget formulation and presentation process with its annual budget presented to the Board at the December open Board meeting.

NCUA is committed to budget transparency. The annual budget, mid-year adjustment, and Overhead Transfer Rate are formally presented to the Board by Board Action Memorandums. The memorandums, as well as transcripts and videos of the open Board meetings, are available on at www.ncua.gov. In addition, NCUA posts NCUA budget and supplemental material, providing additional budget detail.

All of NCUA's funds are included in the President's Budget. The budget for the Central Liquidity Fund Budget is presented in the President's Budget as part of the annual discretionary budget.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Scott Garrett

- **I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations or statutory language that restrict FSOC voting members (the Agencies' principals) from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NPD) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD. Do the Agencies support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on a NPD.**

Your first question asked if are there rules, regulations or statutory language that restrict FSOC voting members from meeting with firms that are under consideration for a non-bank systemically important financial institution designation. There are no such restrictions. Member agencies are allowed to make their own determinations about meetings. Many member agencies have chosen to limit discussions with firms under Stage 3 consideration on topics related to designation. The purpose of these limitations is to ensure member agencies are receiving the same set of information. NCUA has followed this process.

The designation process gives firms the opportunity for a hearing after the Notice of Proposed Designation and prior to a vote on designation. This timing is appropriate because after the Notice of Proposed Designation the firm is provided with the FSOC brief and therefore has an opportunity to discuss and rebut key arguments.

Finally, you asked whether the Agencies would support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity. NCUA believes the process is working effectively. A firm under consideration recently requested the opportunity to meet with the voting members. In order to maintain consistency with the process laid out in the rule, they decided to hold a joint meeting between the firm and the FSOC Deputies. This meeting provided the firm with an opportunity to make their key arguments in person.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Michael Fitzpatrick

- **I hear a lot of concerns from credit unions about the NCUA budget. In 2014, the NCUA proposed a 6.7% budget increase over last year, and that this is at least the fifth year in a row that the agency's budget has increased over 5%. This seems to be contrary to many areas in government where agencies are tightening their belts and facing cuts. It is my understanding that a majority of the budget is funded through assessments on credit unions, meaning that these budget increases are taking more money from institutions that might otherwise use it to make an auto loan or a home loan to a family who needs it.**

  In order to better understand the agency's budget and the need for these increases, please share with us line-by-line or other further detail breakdowns of the agency's expenditures for both 2013 and 2014, including the operating budget and any funds under the agency's control. Is this detailed information shared with credit unions, either at the time when the budget is released, or at the end of the year. If not, why not? Wouldn't great transparency be a good thing when the agency is asking for increases?

NCUA operates on a calendar-year basis for its budget and collects fees from federal credit unions with assets over $1 million to fund the agency's operations. The NCUA Board sets these rates annually in an open meeting. NCUA uses the operating fees to pay the costs of regulating federal credit unions. For 2014, the Board approved an 18.4 percent decrease in the fee rate.

The NCUA budget fulfills two statutory responsibilities. First, it protects the safety and soundness of the credit union system. Second, it seeks comparability in pay and benefits for NCUA employees compared with other federal financial services regulators. To ensure we have the resources needed to protect safety and soundness, we must follow a fundamental principle: As credit union assets grow, the NCUA budget needs to grow as well. In particular, as credit unions grow larger and more complex, exam hours to supervise credit unions will increase. In response to the 2008 financial crisis, the NCUA budget increased commensurately with credit union asset growth. That said the NCUA budget as a share of credit union assets is lower now than in the year 2000.

NCUA takes the stewardship of its budget very seriously. The 2014 budget reflects the demands of a $1.1 trillion industry, a changing regulatory environment, and our determination to fulfill NCUA's mission while making prudent use of available resources. NCUA continues to properly compensate staff who keep NCUA running and keep credit unions safe and sound. We also need to achieve pay comparability with all federal financial agencies, so we can attract and retain qualified employees. While NCUA employees did not receive a base salary increase for the past two or three years, the 2014 budget reflects the compensation negotiated in NCUA's current collective bargaining agreement.

The NCUA Board approves the annual operating fund budget during the November open Board meeting each year. The Board revisits the budget in July when it makes adjustments based on actual year-to-date spending. Funds are often returned to the credit unions the following year in the form of reduced credit union assessments.

All open Board meeting videos and transcripts are available at www.ncua.gov, including supplemental material about the NCUA Budget to provide greater transparency. Below is a summary of the 2013 budget, actual 2013 spending, and the 2014 Budget:

Category	2013 Budget	2013 Actual	2014 Budget
Employee Pay and Benefits	$ 183,601,304	$ 177,728,300	$ 194,632,214
Travel	27,861,782	27,163,125	28,514,578
Rent, Communications & Utilities	5,296,397	4,870,829	5,615,191
Administrative	13,610,236	11,712,633	15,393,236
Contracted Services	21,017,372	20,978,025	24,135,077
Total	$ 251,387,091	$ 242,452,912	$ 268,290,296

Although the NCUA budget increased by 6.7 percent in 2014 over the prior year, for the last three years NCUA's budget expressed as a share of industry assets has remained essentially flat at just under $250 per $1 million of federally insured credit union assets. This ratio fell dramatically from $330 per $1 million in 2000 to a low point of $210 per $1 million. The chart below illustrates this point more clearly.

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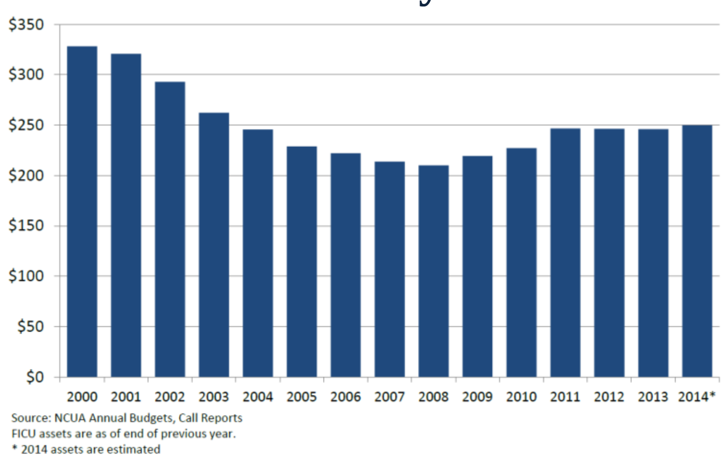

In addition, NCUA posts monthly highlights of its Operating Fund on its website. NCUA is committed to maintaining transparency in its budget and spending to remaining an effective steward of its resources.