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## **Congressional Testimony**

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**House Financial Services Committee  
Tuesday, April 8, 2014**



## Congressional Testimony

### Introduction

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, the National Credit Union Administration appreciates the invitation to provide its views on the agency's recent regulatory and supervisory activities and their effects on federally insured credit unions, consumers, and the financial services marketplace.

I am Michael J. McKenna. I have worked for NCUA in various capacities since 1989, including as a staff attorney, Senior Policy Advisor, Deputy Executive Director, and Deputy General Counsel. Since August 2011, I have served as NCUA's General Counsel. In this role, I have the responsibility for managing all legal matters affecting NCUA.

As a starting point, I want to emphasize that NCUA understands the need to strike a proper balance between implementing the safety and soundness considerations required by the Federal Credit Union Act and minimizing the bottom-line impact for the credit unions we regulate and insure. NCUA has a tailored program designed to mitigate compliance costs and improve the examination process for all credit unions. Rather than adopting one-size-fits-all regulations, NCUA focuses the agency's rules on risk and asset size.

In the invitation to testify, the Committee asked NCUA to review the agency's recent regulatory and supervisory activities. The invitation also asked several questions related to the use of cost-benefit analyses in rulemakings, the effects of rulemakings on the marketplace, the access of consumers to products, and the agency's rulemaking procedures.

To answer these questions, this testimony will provide general background about NCUA, its rulemaking process, and recent regulatory activities. This testimony will also highlight recent developments affecting NCUA's rulemakings and explore how rules affect product availability. Additionally, this testimony will briefly detail NCUA's examination process, which seeks to limit compliance costs for small, non-complex credit unions.

Finally, this testimony will discuss the agency's ongoing efforts to reduce regulatory compliance requirements and address emerging risks. Since the inception of NCUA Board Chairman Debbie Matz's Regulatory Modernization Initiative in 2011, the NCUA Board has approved six rules to reduce regulatory burdens and four targeted rules to mitigate safety and soundness concerns. These four rules also exempt two-thirds of all credit unions from regulatory requirements. The ongoing success of the initiative demonstrates NCUA's commitment to reducing compliance requirements and adopting flexible rules targeting risk to ensure the continued safety and soundness of the credit union system.

## NCUA's Mission

NCUA's primary mission is to provide, through regulation and supervision, a safe and sound credit union system, which promotes confidence in the national system of cooperative credit. NCUA performs this important public function by:

- Examining all federal credit unions.
- Participating in the supervision of federally insured, state-chartered credit unions in coordination with state regulators.
- Insuring individual accounts at federally insured credit unions up to \$250,000 and joint accounts up to \$250,000 per member.

As required by the Federal Credit Union Act, NCUA serves as the administrator of the \$11.6 billion National Credit Union Share Insurance Fund.<sup>1</sup> In this role, NCUA provides oversight and supervision to 6,554 federally insured credit unions. Of these credit unions, NCUA directly supervises the 4,105 federal credit unions that the agency chartered.

Currently, federally insured credit unions represent 98 percent of all credit unions and serve 96.3 million credit union members.<sup>2</sup>

## Rulemaking and Review Processes

In developing new rules and revising existing ones, NCUA follows the requirements of the Federal Credit Union Act and other applicable laws. NCUA's unique rolling three-year review of every NCUA regulation also guides many of the agency's regulatory efforts.

### *Regulation Review*

Since 1987, NCUA has followed a well-delineated and deliberate process to continually review its regulations and give the public the opportunity to comment. NCUA conducts a rolling review of one-third of all its regulations each year, meaning that the agency reviews all of its regulations at least once every three years. This process ensures that NCUA's regulations are up-to-date, effective, and reflect the current environment.

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<sup>1</sup> Congress established the National Credit Union Share Insurance Fund in 1970 as part of the Federal Credit Union Act (P.L. 91-468) and amended the Share Insurance Fund's operations in 1984 (P.L. 98-369). The fund operates as a revolving fund in the U.S. Treasury under the administration of the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state-chartered credit unions that request federal insurance. Funded by federally insured credit unions, the Share Insurance Fund is backed by the full faith and credit of the United States.

<sup>2</sup> NCUA does not oversee approximately 133 state-chartered, privately insured credit unions. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

This long-standing regulatory review policy helps to ensure NCUA's regulations:

- Impose only the minimum required burdens on credit unions, their members, and the public.
- Are appropriate for the size of the credit union regulated by NCUA.
- Are issued only after full public participation in the rulemaking process.
- Are clear and understandable.

This rolling review is fully transparent. On its website every year, NCUA publishes the list of the applicable regulations up for review that year and invites public comment on any or all of the regulations.<sup>3</sup>

### ***Rulemaking Considerations***

NCUA recognizes the importance of minimizing the compliance costs associated with new rules, particularly for small, non-complex credit unions. Therefore, the agency will not engage in formal rulemaking unless there is a clear need for a rule.

Before engaging in formal rulemaking under the Administrative Procedure Act, NCUA conducts an analysis about the need for and impact of a potential rule and the associated costs and benefits. NCUA also gathers information from stakeholders, including comments received as part of NCUA's rolling regulatory review and interactions with credit unions, trade associations, state regulators, and other interested parties. NCUA additionally performs extensive research on applicable topics related to a potential rule.

Occasionally, NCUA issues an advance notice of proposed rulemaking in the *Federal Register*. In this notice, the agency identifies its initial analysis on a particular subject without imposing any proposed requirements. NCUA uses this procedure as a tool for gathering public comments and information before committing to a regulatory direction. For example, NCUA issued advance notices of proposed rulemaking in 2011 and 2012 before proposing regulations on emergency liquidity and derivatives. These notices informed the development of the proposed rules.

When updating or issuing new rules, NCUA complies with the applicable statutes. For example, NCUA follows the Administrative Procedure Act to ensure proper public input. NCUA also adheres to the Plain Writing Act to make certain that the agency's rules are clear and understandable. NCUA additionally follows the requirements of the Paperwork Reduction Act to estimate paperwork compliance costs.

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<sup>3</sup> See <http://www.ncua.gov/Legal/Regs/Pages/Regulations.aspx>.

## *Evaluating Costs and Benefits*

NCUA strives to ensure that the agency's rulemakings are reasonable and cost-effective.

Many of NCUA's regulations strengthen the safety and soundness of the credit unions the agency supervises. These safety and soundness regulations are designed to reduce the likelihood of credit union failures and, in doing so, protect the National Credit Union Share Insurance Fund from losses. Any loss to the Share Insurance Fund is ultimately borne by surviving credit unions, which may be required to pay increased premiums. As member-owned cooperatives, this means the members who are the owners and customers of the credit unions may ultimately repay these costs. As the developments of the last decade have demonstrated, the cost of regulatory inaction can result in failures that impose a greater cost to credit unions than the cost of action.

When considering regulatory changes, the NCUA Board considers both the direct and indirect potential costs, as well as the potential benefits. Direct costs include any expenses credit unions are likely to incur in complying with the rule. These costs might include the additional time spent collecting data, reporting, and training staff, as well as the need to acquire new software or services. Indirect costs might include higher lending rates or fees, lower rates on share deposits, or other unintended constraints on credit union activities for their members.

The NCUA Board also uses the public comment process to gain insight on potential costs and unintended consequences directly from the credit unions the agency supervises and insures. A good example of this process is NCUA's final rule on emergency liquidity. The proposed rule applied to all federally insured credit unions with more than \$50 million in assets. The public comment period yielded a number of important comments from credit unions about the compliance requirements associated with establishing emergency lines of credit.

Based on this information, the NCUA Board reconsidered the balance between costs and benefits for credit unions between \$50 million and \$250 million in assets. In the final rule, the NCUA Board exempted these credit unions from establishing emergency lines of credit. Instead, the NCUA Board only required these credit unions to develop contingency funding plans that clearly set out strategies for meeting emergency liquidity needs.

As noted above, the benefits associated with NCUA's rules are primarily derived from addressing and mitigating risks in order to reduce the likelihood of credit union failures. By mitigating failures, NCUA protects the Share Insurance Fund and, in so doing, limits the financial burdens placed on surviving credit unions, which bear the costs of any failures.

The collapse of five corporate credit unions during the financial crisis best illustrates this point. To date, credit unions have paid \$4.8 billion in assessments and experienced \$5.6 billion in losses in the form of contributed capital.<sup>4</sup> These costs reduced credit union earnings and capital and, as a result, may have decreased interest paid on share deposits, increased loan rates, and constrained credit union services for their members.

### *Effect on the Marketplace*

In addition to the services credit unions offer their members, independent research has shown that credit unions provide benefits to non-members by creating competition in the marketplace. This results in better loan rates for consumers in markets with robust credit union participation.<sup>5</sup>

In developing or devising any rule, the NCUA Board and staff will consider the effect on the credit union system and the broader financial services marketplace. Credit unions are an important part of the nation's financial services infrastructure. As member-owned cooperatives, credit unions focus on serving their members. According to the Federal Reserve's *Financial Accounts of the United States*, credit union loans accounted for 8.4 percent of all lending by U.S. chartered depository institutions at the end of 2013, an increase of 1.1 percentage points since 2009.

NCUA is not aware of any regulatory action the agency has taken that has eliminated the availability of permissible products for credit union members. NCUA closely monitors lending trends and maintains open lines of communication with stakeholders. If it is determined that a rule is having unintended adverse consequences, such as decreasing the availability of financial services products, NCUA staff would immediately notify the NCUA Board and offer alternatives.

### *Public Awareness and Input*

NCUA is committed to providing transparency in the rulemaking process. NCUA publishes every proposed and final rule in the *Federal Register*. NCUA also notifies the Office of Management and Budget of items for inclusion in the Administration's "Unified Agenda" every six months.

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<sup>4</sup> NCUA is actively working to mitigate the assessments that credit unions need to pay by holding accountable those Wall Street firms that sold faulty mortgage-backed securities to the five failed corporate credit unions. Since 2011, NCUA has recovered more than \$1.75 billion through the agency's legal actions. These recoveries, combined with improving legacy asset performance, have continued to improve the outlook of projected loss estimates. NCUA remains committed to holding accountable those that contributed to the corporate credit union failures. At the end of 2013, NCUA had 15 lawsuits pending against Wall Street firms. In addition, [NCUA filed suit against 13 banks](#) in 2013 alleging violations of federal and state antitrust laws by their manipulation of interest rates in the London Interbank Offered Rate system.

<sup>5</sup> See, for example, Feinberg, Robert M., "The Determinants of Bank Rates in Local Consumer Lending Markets: Comparing Market- and Institution-Level Results," *Southern Economic Journal* 70 (2003), 144-156.

Every proposed rule is released for a comment period, typically 60 days, which provides sufficient time for public review and input. In some instances, if a proposed rule is particularly complex, a longer comment period may be provided. This is the case on risk-based capital; the comment period will close 125 days after the rule was proposed. After the comment period closes, NCUA carefully reviews and summarizes all comments.

The NCUA Board generally makes changes to proposed rules based on the comment letters received from credit unions, the general public, and other interested parties. Often, it is the comments of credit unions that most directly affect the content of the agency's final rules. The process of soliciting and carefully considering comments on proposed rules has resulted in better regulations.

## **Recent Regulatory Activities**

Under NCUA's ongoing Regulatory Modernization Initiative, the agency seeks to update and streamline existing regulations to reduce compliance requirements or expand the powers of credit unions, consistent with the law and without jeopardizing safety and soundness. Overall, NCUA also seeks to issue and enforce flexible, calibrated, and risk-focused regulations that take into account the size of the credit union to minimize regulatory obligations, where possible.

### ***Rulemaking Overview***

In recent years, NCUA's regulatory activities can generally be classified as:

- Enhancing the system's safety and soundness in response to the lessons learned from the recent financial crisis or the identification of growing potential risks.
- Implementing the requirements of statutes like the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Addressing recommendations made by the Government Accountability Office or NCUA's Office of the Inspector General.
- Providing regulatory relief both through rulemaking and other actions, such as supervisory guidance, policy statements, and streamlined examinations.
- Clarifying technical issues.

In 2013 and 2014, the NCUA Board approved 17 final rules. Of these rules, one rule was required by the Dodd-Frank Act, five rules provided regulatory relief, and four rules addressed safety and soundness matters. Seven rules were technical or clarifying. Figure 1 summarizes these 17 rulemakings by each of these categories.



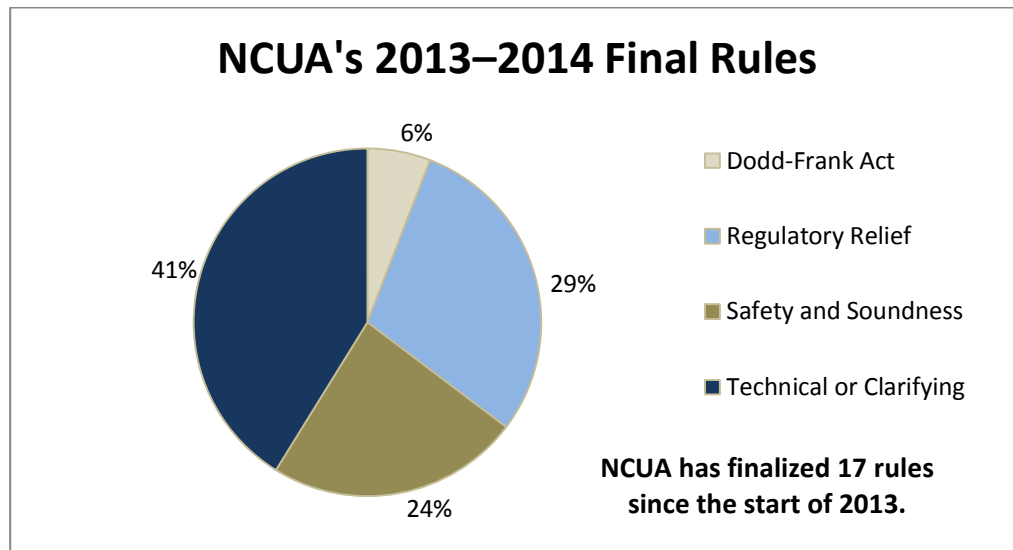


Figure 1

Stated another way, 70 percent of NCUA’s recent final rules have provided regulatory relief or greater clarity without imposing new compliance costs. In the four instances where a new rule created a compliance cost under the Paperwork Reduction Act, NCUA has worked to minimize the burden on credit unions in complying with the new rule.

### *Remaining Financial Crisis Responses*

Since the financial crisis of 2007 through 2009, NCUA has issued several rules designed to enhance safety and soundness. The agency has two planned post-crisis rulemakings remaining. One is the agency’s risk-based capital rule; the other is a proposed rule requiring capital planning and stress testing for federally insured credit unions with assets exceeding \$10 billion. Both proposed rules would mitigate risks to the Share Insurance Fund.

The NCUA Board proposed the risk-based capital rule on January 23, 2014. The extended comment period on this proposed rule, one of the longest in NCUA’s history, will close May 28. Under the proposed rule, only the 3 percent of federally insured credit unions that take higher risks would be required either to reduce those risks or to hold more capital. However, credit unions would not be required to hold capital at a level above the risk-based well capitalized threshold, as some stakeholders have stated. The proposed risk-based capital also exempts two-thirds of credit unions, those with less than \$50 million in assets, because they are not considered complex. Based on losses from several larger credit unions incurred during the past crisis, a final risk-based rule will be critical to protecting against future losses.

Likewise, stress tests are forward-looking measures. NCUA’s proposed stress testing rule is designed to determine whether a credit union is holding an adequate capital position to survive adverse scenarios and to allow credit unions to make adjustments before a crisis

hits. The proposed rule would bring affected credit unions in line with changes made by the Dodd-Frank Act, which requires certain financial services entities with more than \$10 billion in assets to conduct annual stress tests.

Under the proposed rule, a credit union that fails a stress test would be required to develop a capital enhancement plan to demonstrate how it would meet minimum stress test capital ratios. Before taking action on a capital plan submitted by a federally insured, state-chartered credit union, NCUA would consult with the state regulator. A credit union that passes the test would benefit from the analysis by identifying potential improvements in its enterprise risk management system. Currently, only 4 of the 6,554 credit unions that NCUA regulates and insures would have to take any action under this proposed rule.

NCUA's Office of National Examinations and Supervision would oversee the stress testing, which would be based on scenarios issued each year by the Federal Reserve. The comment period for this proposed rule ended at the end of 2013, and the NCUA Board anticipates approving a final rule later this year.

## **Recent Developments Impacting Regulation**

A number of legislative and administrative developments have impacted NCUA's regulatory program in recent years.

### ***Statutory Requirements***

The enactment of the Dodd-Frank Act in 2010 resulted in all federal financial services regulators, including NCUA, adopting a number of reforms aimed at addressing regulatory shortcomings and preventing future financial crises.

NCUA has acted diligently to implement the required reforms applicable to credit unions. For instance, in September 2010, the NCUA Board approved a final rule making permanent the \$250,000 per account limit on share insurance coverage. In December 2012, the NCUA Board adopted a final rule to require new standards for judging the creditworthiness of investments. To date, NCUA has finalized ten actions related to the Dodd-Frank Act.

In recent years, NCUA has also participated in a number of interagency rulemakings. These rulemakings relate to actions required by the Dodd-Frank Act or other laws enacted by Congress. NCUA greatly appreciates the cooperative relationships which have been strengthened with other agencies as a result of these joint rulemakings. Currently, NCUA

has several joint agency rulemakings pending, including proposed rules on flood insurance, and appraisal management companies.<sup>6</sup>

### ***GAO and OIG Recommendations***

NCUA has additionally acted on regulatory matters in response to the recommendations of the Government Accountability Office and NCUA's Office of the Inspector General. In January 2012, GAO released a report, *Earlier Actions Are Needed to Better Address Troubled Credit Unions*.<sup>7</sup> The report recommended that NCUA make changes to the agency's prompt corrective action rule, including updating risk-based capital standards for credit unions.

Additionally, NCUA's OIG has issued multiple material loss reviews for failed credit unions from 2009 to the present. These reviews have included recommendations for NCUA to prevent future losses, including strengthening safety and soundness regulations including the agency's risk-based capital rule. As noted earlier, NCUA issued its proposed rule on risk-based capital on January 23, 2014.

### ***Executive Order 13579***

On July 11, 2011, President Obama issued Executive Order 13579 requesting that independent agencies take steps to ensure regulations are cost-effective and designed to promote economic growth and job creation. While NCUA already met or exceeded the Executive Order's key principles, NCUA Board Chairman Matz announced the agency's Regulatory Modernization Initiative in September 2011. Under the initiative, NCUA is working to eliminate or streamline ineffective or overly burdensome regulations. Additionally, NCUA is developing targeted regulations that address high-risk activities.

Some of the actions taken by NCUA under the Regulatory Modernization Initiative include:

- Permitting eligible credit unions to use basic derivatives to hedge interest rate risk.
- Simplifying the process for credit unions to receive a low-income designation.
- Streamlining Community Development Revolving Loan Fund loan applications.
- Easing the reporting of troubled debt restructurings to keep people in their homes.

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<sup>6</sup> Although the Dodd-Frank Act requires NCUA to issue the proposed joint agency rule on minimum requirements for appraisal management companies, NCUA will not be able to enforce it. Presently, NCUA is the only federal financial institutions regulator lacking the necessary authority to examine third-party vendors for safety and soundness and compliance with laws and regulations. NCUA has asked Congress to provide vendor authority under the Federal Credit Union Act to mitigate this regulatory blind spot.

<sup>7</sup> See GAO-12-247 available at <http://www.gao.gov/assets/590/587409.pdf>.

Through the Regulatory Modernization Initiative, NCUA is also adopting rules to address new risks and update outdated or insufficient rules. Such rules address lessons learned during the recent crisis. Recent actions related to this objective include final rules to:

- Mitigate interest rate risk.
- Plan for emergency liquidity.
- Enhance the risk transparency of credit union service organizations.
- Protect buyers of loan participations.

## **Reducing Regulatory Burdens**

In addressing regulatory burdens, credit unions sometimes raise concerns stemming from other regulators such as the Financial Crimes Enforcement Network, which sets the standards for compliance with the Bank Secrecy Act. NCUA has no ability to provide regulatory relief in these instances. However, NCUA does work to reduce regulatory burdens where possible, including by targeting rules and examinations for small credit unions and increasing the number of credit unions with the low-income designation.

### ***Small Credit Unions***

NCUA aims to target the agency's regulations to risk and asset size, rather than adopting one-size-fits-all rules. In this regard, NCUA is particularly sensitive to the impact that rulemakings have on small, non-complex credit unions.

These credit unions have limited resources to comply with new regulations. In fact, for credit unions with less than \$50 million in assets the median number of employees is 3.5 full-time equivalent staff. Because they do not pose substantial risk exposure to the Share Insurance Fund, NCUA exempts small, non-complex credit unions from new NCUA rules or eases compliance costs for them whenever feasible.

For example, at the start of 2013, the NCUA Board approved a final rule that updated the definition of a small credit union from the former threshold of less than \$10 million in assets to the new threshold of less than \$50 million in assets. As a result of this regulatory change, two-thirds of federally insured credit unions are exempted from the risk-based net worth regulatory requirements under NCUA's existing prompt corrective action rule. Credit unions with less than \$50 million in assets are also exempted from the requirement to adopt and implement interest rate risk policies. In addition, 2,270 more credit unions became eligible for assistance from NCUA's Office of Small Credit Union Initiatives, including access to free training sessions and consulting services.

Since adopting the new asset threshold for defining small credit unions, NCUA has finalized a rule on emergency liquidity for credit unions. This scaled regulation places the smallest burden on credit unions with less than \$50 million in assets.

Going forward, the NCUA Board will continue to consider the \$50 million asset threshold for additional regulatory relief when issuing rules for credit unions. NCUA plans to revisit this threshold in 2015 and then every three years to ensure that the level accurately measures the size of small, non-complex credit unions in a rapidly changing marketplace.

### *Low-Income Credit Unions*

Low-income credit unions play an important role in their communities and are often the only federally insured institutions serving underserved and unbanked populations. These credit unions can promote greater financial security for their members. Growth in the number of credit unions with the low-income designation could provide additional opportunities for investment in local economies.

To qualify as a low-income credit union, a majority of a federal credit union's membership must meet low-income thresholds based on 2010 Census data. Under the Federal Credit Union Act, the low-income designation offers several benefits including:

- Eligibility for Community Development Revolving Loan Fund grants and low-interest loans.
- Ability to accept deposits from non-members.
- Authorization to obtain supplemental capital.
- Expanded member business lending authority, which increases access to capital for small businesses and helps to diversify credit unions' portfolios.

In August 2012, NCUA Board Chairman Matz announced an initiative to significantly streamline the application process for federal credit unions to secure a low-income designation. In February 2013, NCUA expanded the initiative as a result of an agreement with the National Association of State Credit Union Supervisors and state regulators to expedite the approval process for federally insured, state-chartered credit unions.

By the end of 2013, NCUA's initiative to simplify the low-income designation process resulted in 1,986 credit unions across the country carrying the designation, nearly double the number from when the initiative began. Together, these credit unions have 20.1 million members and \$177.9 billion in assets.

## **Supervision of Credit Unions**

NCUA continues to use a risk-focused approach when conducting examinations of credit unions. In addition, NCUA utilizes an annual examination program. Begun in 2009 and fully phased in by 2012, this program requires annual examinations of all federal credit unions regardless of asset size, and all federally insured, state-chartered credit unions with more than \$250 million in assets. The program allows NCUA examiners to identify and work with credit unions to correct issues earlier to avoid greater costs to the Share Insurance Fund later on.

To decrease the amount of time spent on exams in small credit unions, NCUA has conducted expedited exams since 2012 at credit unions with under \$10 million in assets and which are financially and operationally sound. These very small credit unions pose limited exposure to the Share Insurance Fund. The streamlined examinations focus on pertinent areas of risk found in these types of institutions, such as lending, recordkeeping, and auditing. This shortened exam process also allows the smallest credit unions more time to focus on serving their members.

Additionally, NCUA is now in the process of applying the streamlined examination program for credit unions with assets between \$10 million and \$50 million. When implemented, this program will further reduce the examination requirements for eligible credit unions.

## **Conclusion**

NCUA appreciates the need to strike a proper balance between the Federal Credit Union Act's safety and soundness requirements and minimizing the regulatory burdens of credit unions. To do this, NCUA has in place a calibrated regulatory program designed to mitigate compliance costs. NCUA also aims to target the agency's regulations to risk and asset size, rather than adopting one-size-fits-all rules.

To further reduce regulatory burdens, NCUA remains committed to continuing its rolling three-year review of the agency's rules. This program ensures that NCUA's regulations reflect and keep up with marketplace realities. NCUA will also continue efforts to streamline examinations for small, non-complex credit unions. Finally, NCUA is committed to working with Congress and other stakeholders to explore other ways to improve NCUA's rules and the examination process.

I look forward to answering any questions the Committee may have.