Office of Inspector General

OIG/JH

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TO: The Honorable Todd M. Harper, Chairman
The Honorable Kyle S. Hauptman, Vice Chairman
The Honorable Rodney E. Hood, Board Member

FROM: Inspector General James W. Hagen

SUBJ: Top Management and Performance Challenges Facing the National Credit Union Administration for 2023

DATE: February 8, 2023

The Inspector General is required by law[1] to provide an annual statement on the top management and performance challenges facing the agency and to briefly assess the agency's progress to address them. We identified the top challenges facing the National Credit Union (NCUA) for 2023 based on our past and ongoing work; our knowledge of the NCUA's programs and operations; and information from the U.S. Government Accountability Office and NCUA management and staff. In determining whether to identify an issue as a challenge, we consider its significance in relation to the NCUA's mission, its susceptibility to fraud, waste, or abuse, and the NCUA's progress in addressing the challenge.

We identified five Top Challenges facing the NCUA as follows:

1. Managing Interest Rate Risk and Liquidity Risk
2. Cybersecurity and IT Governance – Protecting Systems and Data
3. Risks Posed by Third-Party Service Providers
4. Industry Consolidation and Challenges Facing Small Credit Unions
5. Supporting Diversity in the Credit Union Industry

We believe our identification of Top Challenges will be beneficial and constructive for policy makers, including the NCUA and Congressional oversight bodies. We further hope that it is informative for the credit union industry regarding the programs and operations at the NCUA and the challenges it faces.

Information on the challenge areas and related Office of Inspector General work products are found in the attachment. If you have any questions, please contact me or Bill Bruns, Deputy Inspector General.

Attachment

[1] Reports Consolidation Act of 2000, 31 U.S.C. § 3516..

cc: Executive Director Larry D. Fazio
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Director of External Affairs and Communications Elizabeth A. Eurgubian

INTRODUCTION

Below is a brief overview of the NCUA's organizational structure, its mission, and vision, as well as details on each of the identified Top Challenges for 2023.

Organizational Structure

The NCUA is an independent federal agency that insures deposits at all federal and most state-chartered credit unions and regulates federally chartered credit unions. A Presidentially appointed three-member Board oversees the NCUA's operations by setting policy, approving budgets, and adopting rules.

Agency Mission and Vision

In its Strategic Plan 2022-2026, the NCUA states it works to achieve the statutory mission of the credit union system of meeting the credit and savings needs of members, especially those of modest means, and can achieve that objective by advancing economic equity and justice within communities of color, rural places, and underserved areas. NCUA states it must also foster greater diversity, equity, and inclusion within the NCUA, the credit union system, and the broader financial services sector.

AGENCY CHALLENGES

Managing Interest Rate Risk (IRR) and Liquidity Risk

The Federal Reserve adjusts the federal funds rate, which is the benchmark interest rate, based on economic indicators, with the goal of achieving its dual mandate of keeping prices stable and maximizing employment. To address inflation over the last year, the Federal Reserve raised the federal funds rate eight times between March 2022 and February 2023. The most recent rate is nearly five percentage points higher than last year's rate.

The Federal Reserve also started to reduce its holdings of Treasury securities and agency mortgage-backed securities, which is intended to put upward pressure on longer-term interest rates. Interest rates across the maturity spectrum have increased sharply. Between mid-March and mid-December 2022, the interest rate on a 3-month Treasury bill climbed roughly 390 basis points to 4.3 percent and the rate on a 10-year Treasury note rose about 140 basis points to around 3.6 percent.

With downside risks prevailing, the operating environment for credit unions could prove challenging in the year ahead. In a weak economy with rising unemployment and elevated interest rates, credit unions could face reduced loan demand and higher credit risk. Credit unions will need to prepare for the possibility of a downturn. Their ability to manage and mitigate interest rate risk is important to their success.

Deposit interest rates should continue to rise over the next 2 years as the Federal Reserve continues its rate adjustments. Short-term market interest rates increased sharply this year, which may put pressure on credit unions to raise deposit rates to avoid deposit attrition since nearly 20 percent of households that use a credit union also use a bank for some type of financial service. However, because deposits at credit unions and other financial institutions surged during the first year of the pandemic and remained elevated through the third quarter of 2022, institutions faced with an excess of deposits may face less pressure to raise deposit rates.

High levels of interest rate risk can increase a credit union's liquidity risks, contribute to asset quality deterioration and capital erosion, and put pressure on earnings. Credit unions must be prudent and proactive in managing interest rate risk and the related risks to capital, asset quality, earnings, and liquidity. This is particularly the case for those credit unions whose assets are concentrated in fixed-rate long term mortgages that were originated when interest rates were at record lows.

In November 2015, my office issued OIG Report #OIG-15-11, which determined that NCUA assessed sensitivity to market risk under the "L" (Liquidity Risk) in its CAMEL rating and that doing so may have understated or obscured instances of high interest rate risk exposure in credit unions. To improve NCUA's ability to accurately measure and monitor interest rate risk, we recommended to management they modify the CAMEL Rating System by developing an "S" rating (Sensitivity to Market Risk) to better capture a credit union's sensitivity to market risk and to improve interest rate risk clarity and transparency. We also recommended management revise the "L" in NCUA's CAMEL Rating System to reflect only liquidity factors. In April 2022, the NCUA completed the modification and formally began using the CAMELS Rating System, which will help the focus on IRR as a specific rating category separate from liquidity risk.

In addition, in September 2022, the NCUA issued Letter to Credit Unions 22-CU-09, *Updates to Interest Rate Risk Supervisory Framework*, and Supervisory Letter 22-01, *Updates to Interest Rate Risk Supervisory Framework*, which updated the NCUA's supervisory framework for interest rate risk by ensuring that in the near term, examiners will review credit unions' interest rate risk to ensure key assumptions and related data sets are reasonable and well documented and that overall, credit unions' level of interest rate risk exposure is properly measured and controlled to ensure it remains within safe and sound policy limits.

Cybersecurity and IT Governance – Protecting Systems and Data

Cybersecurity risks remain a significant, persistent, and ever-changing threat to the financial sector. Credit unions' growing reliance on increasingly complex technology-related operating environments exposes the credit union system to escalating cyberattacks. Cyberattacks can affect the safety and soundness of institutions and lead to their failure, thus causing losses to the NCUA's Share Insurance Fund. The prevalence of malware, ransomware, distributed denial of service attacks, and other forms of cyberattacks are causing challenges at credit unions of all sizes, which will require credit unions to continually evolve and adapt to the changing threat environment to ensure containment. These trends are likely to continue, and even accelerate, in the years ahead.

The NCUA's supervisory priorities continue to include cybersecurity and the NCUA remains focused on advancing consistency, transparency and accountability within its information technology and cybersecurity examination program. In pursuit of those efforts, the agency has continued to improve and enhance the information security examination program. In October 2021, NCUA released the Automated Cybersecurity Evaluation Tool (ACET) application, which provides credit unions the capability to conduct a maturity assessment aligned with the Federal Financial Institutions Examination Council Cybersecurity Assessment Tool. ACET allows institutions, regardless of size, to measure their cybersecurity preparedness and identify opportunities for improvement.

Building on the success of the ACET, examiners and credit union management will benefit from an updated information technology examination program aligned to current cyber security threats that also contains practical examination guidance and recommendations for addressing cyber security risks. This examination program is part of NCUA's new Information Security Examination application that will include tailored procedures for credit unions of varying size all in one place. This program and application are in final testing and will be implemented in 2023.

To ensure the NCUA remains vigilant in protecting its own systems and data, we contracted with CliftonLarsonAllen, LLP (CLA) to assess how well the agency is preventing and detecting cyber threats. The NCUA network includes firewalls as part of its defense strategy to protect the agency's network. Our audit is reviewing the agency's software that collects, aggregates, categorizes, and analyzes log data and incidents and events generated throughout the organization's technology infrastructure, as well as reviewing the security-related incidents and events reports that could signal potential security issues based on failed logins and malware and other possible malicious activities. We expect to issue CLA's report in spring 2023.

In addition to conducting a security information and event management audit, we contracted with CLA to annually evaluate the NCUA's implementation of FISMA information security requirements and the effectiveness of the agency's information security program on a maturity model scale.[2] On October 26, 2022, we issued CLA's FISMA report titled, National Credit Union Administration Federal Information Security Modernization Act of 2014 Audit—Fiscal Year 2022 (Report #OIG-22-07). CLA determined the NCUA implemented an effective information security program by achieving an overall Level 4 - Managed and Measurable maturity level, complied with FISMA, and substantially complied with agency information security and privacy policies and procedures. As stated in its 2021 Annual Performance Plan, NCUA management recognizes that cybersecurity threats and other technology-related issues continue to be of interest and concern to the NCUA as increasingly sophisticated cyberattacks

[2] Pub. L. No. 113-283, § 3555, 128 Stat. 3073 (2014).

pose a significant threat to credit unions, financial regulators, and the broader financial services sector.

In September 2021, the OIG issued Report #OIG-21-06, *Audit of NCUA's Governance of IT Initiatives.* Results of our audit determined that overall, the NCUA has an effective process for identifying, controlling, prioritizing, and implementing IT initiatives across the agency. By following a formal framework, we are confident the NCUA can produce measurable results toward achieving their IT-related strategies and goals, particularly those related to cybersecurity.

Risk Posed by Third-Party Vendors and Credit Union Service Organizations

Even with the improvements the NCUA has made to its information security examination program, the credit union system remains vulnerable because the NCUA lacks vendor oversight authority. Without this authority, the NCUA cannot accurately assess the actual risk present in the credit union system or determine if the risk-mitigation strategies of credit union service organizations and third-party vendors, which provide much of the industry's information technology infrastructure, are adequate and can effectively protect the system from potential attacks. This regulatory blind spot leaves thousands of credit unions, millions of credit union members, and billions of dollars in assets potentially exposed to unnecessary risks. To address this, the NCUA continues to request comparable authority as its counterparts on the Federal Financial Institutions Examination Council to examine credit union service organizations and third-party vendors.

Although Congress provided the NCUA vendor oversight authority in 1998 in response to concerns about the Y2K changeover, that authority expired in 2002. Since then, the OIG, the Financial Stability Oversight Council, and the Government Accountability Office have recommended that this authority be restored.

Currently, the NCUA may only examine credit union service organizations and third-party vendors with their permission, and vendors, at times, decline these requests. Further, vendors can reject the NCUA's recommendations to implement appropriate corrective actions to mitigate identified risks. This lack of authority stands in stark contrast to the authority of NCUA's counterparts on the Federal Financial Institutions Examination Council (FFIEC).

Activities that are fundamental to the credit union mission, such as loan origination, lending services, Bank Secrecy Act/anti-money laundering compliance, and financial management, are being outsourced to entities that are outside of the NCUA's regulatory oversight. In addition, credit unions are increasingly using third-party vendors to provide technological services, including information security and mobile and online banking. Member data is stored on vendors' servers. The pandemic, which has accelerated the industry's movement to digital services, has only increased credit union reliance on third-party vendors.

On July 14, 2022, the U.S. House of Representatives passed the National Defense Authorization Act (the NDAA) for 2023, H.R. 7900. The NDAA bill provided the NCUA oversight authority over credit union service organizations and vendors, which was the subject of an audit the OIG issued in 2020, OIG-20-07, *Audit of the NCUA's Examination and Oversight Authority Over Credit Union Service Organizations and Vendors*. In that audit, we determined the NCUA needs authority over CUSOs and vendors to effectively identify and reduce the risks vendor relationships pose to credit unions to protect the Share Insurance Fund. Our audit concluded that despite the NCUA's ability to conduct limited credit union service organization reviews, there is currently nothing in the Federal Credit Union Act that provides the NCUA with the authority to supervise credit union service organizations and vendors to hold them accountable for unsafe and unsound practices that have direct and lasting impact on the credit unions they serve. In addition, the audit determined the lack of statutory vendor oversight and regulatory enforcement authority hinders the NCUA's ability to conduct effective reviews of vendors. As a result, the NCUA's Share Insurance Fund is exposed to risk from credit union service organizations and vendors that can cause significant financial hardship, or even failure to the credit unions that use them. Unfortunately, the Senate removed the vendor authority provision in the final bill.

While there are many advantages to using service providers, the concentration of credit union services within credit union service organizations and third-party vendors presents safety and soundness and compliance risk for the credit union industry. In his November 2022 testimony before the U.S. House of Representatives Committee on Financial Services, NCUA Board Chairman Harper testified that the NCUA continues to seek the restoration of its ability to oversee third-party vendors. Chairman Harper stated such a statutory change would provide the NCUA parity with other agencies that supervise and regulate federally insured depository institutions and is critical given the system's increased reliance on third-party vendors and credit union service organizations.

The continued transfer of operations to credit union service organizations and vendors lessens the ability of NCUA to accurately assess all the risks present in the credit union system and determine if current risk-mitigation strategies are adequate. OIG Report #OIG-20-07 confirmed that the NCUA needs comparable authority as its FFIEC counterparts to examine credit union service organizations and vendors.

Industry Consolidation and Challenges Facing Small Credit Unions

Small credit unions face challenges to their long-term viability for a variety of reasons, including lower returns on assets, declining membership, high loan delinquencies, increasing non-interest expenses, and a lack of succession planning for credit union boards and key personnel. If current consolidation trends persist, there will be fewer credit unions in operation and those that remain will be considerably larger and more complex.

To ensure the NCUA continues to help the credit union system grow, my office has started an audit that is reviewing the NCUA's chartering activities. The objectives of the engagement will be to determine whether the NCUA's efforts to streamline its chartering process have made it more efficient and effective for potential organizers interested in applying for a new federal credit union charter, and whether the NCUA has adequately communicated its revised chartering process to potential organizers interested in applying for a charter and operating a federally insured credit union.

In the third quarter of 2022, there were slightly over 700 federally insured credit unions with assets of at least $500 million, 34 percent more than five years earlier. These credit unions represented only 15 percent of all federally insured credit unions but accounted for 81 percent of credit union members and 85 percent of system-wide assets. Large credit unions tend to offer more complex products, services, and investments. Increasingly complex institutions will pose management challenges for the institutions themselves, as well as the NCUA, because consolidation means the risks posed by individual institutions will become more significant to the Share Insurance Fund.

Additionally, all credit unions need to consider whether their product mix is consistent with their members' needs and demographic profile. For example, credit unions may need to explore how to meet the needs of an aging population, a growing Hispanic population, or an increasing consumer population that prefers using digital services. The NCUA must continue to promote financial inclusion to better serve a changing population and economy. For 2023, the NCUA should continue to develop initiatives to create opportunities to promote financial education and financial inclusion and foster an environment where those with low-to-moderate incomes, people with disabilities, and the otherwise underserved have access to affordable financial services.

Supporting Diversity in the Credit Union Industry

Access to the financial system by minority communities is vital to fostering economic prosperity. The NCUA plays an important role to support Minority Depository Institutions (MDIs) that serve and promote minority and low- and moderate-income communities. This work can be enhanced with the NCUA's continued commitment to diversity and inclusion in the federal regulatory process, which is critical for the NCUA to foster greater financial inclusion for all Americans.

In 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). Section 308 of the FIRREA established goals for preserving and promoting MDIs. When enacted, FIRREA § 308 applied only to the Office of Thrift Supervision and the FDIC. In 2010, Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act. Section 367(4)(A) of the Dodd Frank Act amended FIRREA § 308 to require the NCUA, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System to take steps to preserve existing MDIs and encourage the establishment of new ones. In addition, Dodd Frank Act § 367(4)(B) requires these agencies, along with the FDIC, to each submit an annual report to Congress describing actions it has taken to carry out FIRREA § 308.

On June 24, 2015, the NCUA Board issued a final Interpretative Ruling and Policy Statement to establish a Minority Depository Institution Preservation Program. This program was established to achieve the goals of preserving and encouraging MDIs, as § 308 of FIRREA directs. The program reflects the preservation goals of FIRREA § 308, namely to preserve the present number of MDIs; preserve the minority character of MDIs that are involuntarily merged, or are acquired, by following the prescribed "general preference guidelines" to identify a merger or acquisition partner; to provide technical assistance to prevent insolvency of MDIs that are no longer insolvent; to promote and encourage the creation of new MDIs; and to provide for training, technical assistance, and educational programs.

MDIs serve the financial needs of racial minorities because traditional financial institutions have historically underserved these populations. Federally insured credit unions self-designate as MDIs. To do this, a credit union must affirm in the NCUA's Credit Union Online Profile system that more than 50 percent of its current members, eligible potential members, and board of directors are from one or a combination of the four minority categories defined by FIRREA: any Black American, Asian American, Hispanic American, or Native American.

MDIs play a vital role in assisting minority and under-served communities. MDIs are resources to foster the economic viability of these communities by providing banking and credit services. The primary challenge for the NCUA is to measure the effectiveness of its efforts in supporting MDIs. The NCUA plays an important role in preserving and promoting MDIs. In September 2022, we issued a report titled, *Audit of the NCUA's Minority Depository Institutions Preservation Program* (MDIPP) (Report #OIG-22-06) to determine whether the NCUA's MDIPP achieved its goals. Our report confirmed that the NCUA took actions to preserve the present number and minority character of MDIs, provided technical assistance to prevent insolvency of MDIs, promoted and encouraged the creation of MDIs, and provided MDIs with training, technical assistance, and educational programs.

Going forward, we are pleased the NCUA will continue its Small Credit Union and MDI support program, which the agency implemented in 2022 to support and preserve these credit unions. Credit unions with less than $100 million in assets and MDIs are uniquely positioned to improve the financial well-being of underserved communities by offering their members access to safe, fair, and affordable credit and other financial services and products. The NCUA's program focuses assistance on identifying available resources, providing training and guidance, and supporting credit union management in their efforts to address operational matters. We expect the additional benefits of the program to include greater awareness of the unique needs of small credit unions and MDIs and their role in serving underserved communities as preserving small credit unions and MDIs is fundamental to the NCUA's mission.