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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 2022

DATE: March 4, 2022

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 2022 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 seven Top Challenges facing the NCUA, four of which we also reported last year and three of which are new. The three new Challenges are ensuring readiness in a pandemic environment, supporting diversity in the credit union industry, and managing human resources. The seven Top Challenges are:

1. Economic Outlook in a Pandemic Environment
2. Cybersecurity and IT Governance – Protecting Systems and Data
3. Risks Posed by Third-Party Service Providers
4. Managing Interest Rate Risk and Liquidity Risk
5. Industry Consolidation and Challenges Facing Small Credit Unions
6. Supporting Diversity in the Credit Union Industry
7. Human Capital and Planning for the Future Workforce

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.

[1] Reports Consolidation Act of 2000, 5 U.S.C. § 3516.

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

cc: Executive Director Larry D. Fazio
Deputy Executive Director Rendell L. Jones
General Counsel Frank S. Kressman
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 2022.

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 Draft Strategic Plan 2022-2026, the NCUA plans to implement initiatives related to its mission of protecting the system of cooperative credit and its member-owners through effective chartering, supervision, regulation, and insurance, and its vision to strengthen communities and protect consumers by ensuring equitable financial inclusion through a robust, safe, sound, and evolving credit union system.

AGENCY CHALLENGES

Economic Outlook in a Pandemic Environment

After several years of solid growth, the economy entered a recession at the start of 2020, caused by the COVID-19 pandemic. In the span of two months, the U.S. lost nearly 22 million jobs and the unemployment rate rose to 14.7 percent. Thanks to swift intervention by the federal government and the Federal Reserve, the downturn was short-lived. By mid-2020 the economy was once again growing, and the unemployment rate began to decline. The development and distribution of effective vaccines starting in late 2020 also provided significant support for economic activity. By January 2022, 19.1 million jobs had been added back to nonfarm payrolls and the unemployment rate had fallen to 4.0 percent.

A consensus of forecasters expects continued strong economic and job growth and declining unemployment over the next two years as the economy continues to recover from the effects of the pandemic. The unemployment rate is projected to return to its pre-pandemic level of 3.5 percent in early 2023 and hold there through the end of the year. Inflation reached a four-decade high in late 2021 and experts predict it will likely remain elevated in the months ahead; however they also believe that if interest rates rise and the current supply chain bottlenecks begin to ease, price pressures should alleviate later this year.

Interest rates are expected to rise as the Federal Reserve removes monetary adjustments and economic conditions strengthen further.

In late 2021, the Federal Reserve began to taper large-scale asset purchases and is on track to cease those purchases altogether. Analysts expect other short-term interest rates, which largely determine the interest payments credit unions make, to increase over the next two years. Longer-term rates, which largely determine the interest payments credit unions receive, are also expected to rise. Private-sector forecasters expect the 10-year Treasury rate to rise from 1.76 percent in January 2022 to 2.5 percent by the end of 2023.

While the near-term outlook for the U.S. economy is generally positive, there are several risks on the horizon that could impede or stall the economy's forward momentum. COVID-19 remains the biggest risk. While the ongoing pandemic is not expected to derail the economy, it will continue to influence all aspects of economic activity. Each successive surge in infections has been less disruptive to the economy thanks to the availability of vaccines, medications, and therapies, and activity has been quick to rebound once case numbers have peaked. This will likely remain true going forward, but every new wave of positive COVID-19 cases threatens to stall the recovery in labor force participation and prolong the supply chain disruptions that are hindering production, contributing to inventory shortages, and boosting prices across a wide range of goods.

Persistently high inflation also poses a significant risk to the economy in the near term. Higher-than-expected inflation for a prolonged period could spur Federal Reserve policymakers to raise the federal funds target rate more aggressively than currently expected. Tighter credit conditions typically constrain consumer and business borrowing and spending and cause economic growth to slow. If short-term rates rise more than long-term rates, the yield curve will flatten, putting downward pressure on credit union net interest margins.

In addition, the consumer confidence index edged down 0.6 points in February 2022. The decline was prompted by weaker expectations for economic growth in the year ahead. The portion of consumers planning to purchase a home, car, or major household appliance or spend money on vacations in the next six months also fell, and as mentioned above, concerns about inflation have increased. In fact, confidence declined to the lowest level in the past decade with the sentiment index declining 4.4 points in February 2022, almost 20 percent below its year-ago level.

Inflation, rising interest rates, declining confidence in economic policies, worsening views of long-term economic prospects, continues to weigh on confidence. With such a dire economic outlook, individuals and businesses may not be able to meet their debt obligations to financial institutions. Loan defaults may increase as pandemic-related economic pressures continue, which may cause credit unions to struggle. The NCUA should continue to stand ready to fulfill its mission to maintain financial stability in the credit union industry, and to identify and mitigate risks through examinations. The NCUA should also prepare for credit union failures in the event that losses overwhelm credit unions. Further, through its supervisory processes, the NCUA should review credit unions' adherence to government Guaranteed Loan Program requirements and identify fraud, operational, legal, and reputational risks that may affect the safety and soundness of the credit union industry.

Cybersecurity and IT Governance – Protecting Systems and Data

Cybersecurity continues to be a critical risk facing the financial sector. Credit unions increasing use of technology is making the credit union system more vulnerable to cyberattacks. Cyberattacks can affect the safety and soundness of institutions and lead to the failure of credit unions, thus causing losses to the NCUA's Share Insurance Fund. Despite increased spending on cybersecurity, credit unions are encountering difficulties in getting ahead of the increased frequency and sophistication of cyberattacks. The prevalence of malware, ransomware, distributed denial of service attacks, and other forms of cyberattacks are causing challenges at credit unions of all sizes and will require ongoing measures for containment. As the U.S. Government Accountability Office (GAO) noted in March 2021, "IT systems supporting federal agencies and our nation's critical infrastructures are inherently at risk."[2] Threat actors are increasingly willing and able to conduct cyberattacks with the potential to disrupt critical operations, access sensitive information, and threaten economic well-being. In a single four-month period during FY 2021, the Cybersecurity and Infrastructure Security Agency issued at least three emergency directives and/or alerts regarding threat actors who gained access to and/or exploited government agencies, servers, and national infrastructure.[3]

NCUA management has recognized the importance of developing a robust and resilient program for dealing with threats to the security, integrity, and availability of the NCUA's systems and sensitive data. The Agency's focus is to advance consistency, transparency, and accountability within its cybersecurity examination program. In 2020, the NCUA began piloting the Information Technology Risk Examination for Credit Unions (InTREx-CU), which aligns with the IT and cybersecurity examination procedures used by the Federal Deposit Insurance Corporation, the Federal Reserve System, and some state financial regulators to ensure consistent approaches are applied to community financial institutions. In 2021, the NCUA continued to integrate this tool into its cybersecurity reviews with the goal of deploying the tool systemwide in late 2022 or early 2023.

To ensure the NCUA remains vigilant in protecting its systems and data, the Office of Inspector General (OIG) has an audit in the OIG 2022 Work Plan 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 network. Our audit would review the Agency's software that collects, aggregates, categorizes, and analyzes log data and incidents and events generated throughout the organization's technology infrastructure. The audit would also review the security-related incidents and events reports that could signal potential security issues based on failed logins and malware and other possible malicious activities.

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[2] U.S. Government Accountability Office, High Risk Series: Federal Government Needs to Urgently Pursue Critical Actions to Address Major Cybersecurity Challenges (GAO-21-288; March 24, 2021).
[3] CISA Alert AA20-352A, Advanced Persistent Threat Compromise of Government Agencies, Critical Infrastructure, and Private Sector Organizations (December 17, 2020, revised April 15, 2021).

In its FY 2020 NCUA Financial Report (also referred to as the Performance and Accountability Report), the NCUA reported the results of its annual Federal Information Security Modernization Act (FISMA) assessment using the CyberScope automated system as required by OMB.[4] The OIG annually evaluates the NCUA's implementation of FISMA information security requirements and the effectiveness of the Agency's information security program on a maturity model scale.[5] The OIG contracted with CliftonLarsonAllen, LLP (CLA) to conduct the FY 2021 independent evaluation and, on November 22, 2021, issued the report titled, National Credit Union Administration Federal Information Security Modernization Act of 2014 Audit—Fiscal Year 2021 (Report #OIG-21-09).

We 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. However, as stated in its Performance and Accountability Report, management recognized that cybersecurity threats and other technology-related issues continue to be of interest and concern to the NCUA as increasingly sophisticated cyberattacks 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 CUSOs

The NCUA must also be able to address risk posed by third-party vendors, including credit union service organizations (CUSOs). Currently, the NCUA does not have the authority to manage the risks associated with these organizations and has requested the Congress consider legislation to provide the Agency examination and enforcement authority over third-party vendors and CUSOs.

The NCUA was granted some authority in 1998 to deal with the Y2K changeover, but that authority expired in 2002. Since then, the OIG, the Financial Stability Oversight Council, and the Government Accountability Office have all reported that this authority must be restored.

Currently, the NCUA may only examine CUSOs 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).

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[4] OMB Memorandum M-21-02, Fiscal Year 2020-2021 Guidance on Federal Information Security and Privacy Management Requirements.
[5] Pub. L. No. 113-283, § 3555, 128 Stat. 3073 (2014).

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 also 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.

While there are many advantages to using these service providers, the concentration of credit union services within CUSOs and third-party vendors presents safety and soundness and compliance risk for the credit union industry. In his May 2021 written testimony before the U.S. House of Representatives Committee on Financial Services, NCUA Board Chairman Harper testified that the top five credit union core processor vendors provide services to approximately 87 percent of total credit union system assets and that the top five CUSOs provide services related to nearly 96 percent of total credit union system assets. He noted a failure of even one of these vendors represents a significant potential risk to the Share Insurance Fund.

In Report #OIG-20-07, Audit of the NCUA's Examination and Oversight Authority Over Credit Union Service Organizations and Vendors, we determined that the NCUA needs authority over CUSOs and vendors to effectively identify and reduce the risks vendor relationships pose to credit unions in order to protect the Share Insurance Fund. Although the NCUA conducts CUSO reviews, there is currently nothing in the Federal Credit Union Act that provides the NCUA with the authority to supervise CUSOs 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 CUSOs and vendors that can cause significant financial hardship, or even failure to the credit unions that use them. Between 2008 and 2015, CUSOs contributed to more than $300 million in losses to the Share Insurance Fund.

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

Managing Interest Rate Risk and Liquidity Risk

Although the pandemic continues to impact credit union performance, the credit union system remained on a solid footing in 2021.

Improving economic conditions and low interest rates contributed to increased loan growth and helped bolster loan performance.

Loan forbearance programs and income support from federal stimulus payments and extended unemployment insurance benefits also helped maintain low credit union delinquency rates. Share growth moderated as the year progressed but remained elevated relative to pre-pandemic levels, reflecting the boost to household income from federal relief payments earlier in the year. The surge in shares since early 2020 has weighed impacted the net worth ratio but overall, credit unions have remained well-capitalized.

Credit unions must continue to manage and mitigate interest rate risk to be successful. On the liability side of the credit union balance sheet, deposit interest rates have fallen since the start of 2020 but are poised to rise over the next two years as the Federal Reserve removes monetary adjustments. Credit unions will continue to face pressure to offer competitive deposit interest rates to avoid deposit attrition, as many members have several financial institution alternatives and can move funds quickly across institutions. Of the nearly 20 percent of households using a credit union as their primary financial institution, 56 percent also use a bank for some type of financial service. As previously mentioned, the consensus forecast suggests longer-term interest rates will also rise over the next two years. In the near term, however, they will generally remain lower than in the years leading up to the 2020 recession. A prolonged period of relatively low interest rates also poses risks on the asset side of the credit union balance sheet. Credit unions that rely primarily on investment income may find their net income remaining low or falling. To address this concern, credit unions could add longer-term and higher-risk assets to their portfolios.

In November 2015, we issued OIG Report #OIG-15-11, which determined that NCUA assessed sensitivity to market risk under the "L" (Liquidity Risk) in its CAMEL[6] 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” (Sensitivity to Market Risk) rating 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. The NCUA Board approved a Notice of Proposed Rulemaking on January 14, 2021, to add an “S” (Sensitivity to Market Risk) component to the existing CAMEL rating system and redefine the "L" (Liquidity Risk) component, thus updating the rating system from CAMEL to CAMELS to better capture a credit union’s sensitivity to market risk and to improve interest rate risk clarity and transparency. This change is expected to be completed in 2022.

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, and

[6] On November 13, 1979, the Federal Financial Institutions Examination Council implemented the Uniform Financial Institutions Rating System, commonly referred to as CAMEL. Based on UFIRS, NCUA developed the Early Warning System to assign credit unions an overall rating, eventually adopting the CAMEL Rating System in October 1987. The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.

increasing non-interest expenses. If current consolidation trends persist, there will be fewer credit unions in operation and those that remain will be considerably larger and more complex. Although large credit unions tend to offer more complex products and services and make more complex investments, these complex institutions will pose management challenges for the institutions and the NCUA, since consolidation increases the risks posed by individual institutions to the Share Insurance Fund.

Additionally, although credit union membership continues to experience strong growth overall, about half of federally insured credit unions had fewer members at the end of 2021 than a year earlier. All credit unions need to consider whether their product mix is consistent with their members' needs and demographic profile. For example, in some areas, to be effective, credit unions may need to explore how to meet the needs of an aging population, a growing Hispanic population, or an increasing consumer population more comfortable with utilizing digital services.

The NCUA must continue to promote financial inclusion to better serve a changing population and economy. In 2022, the OIG is hopeful that the NCUA will 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. Minority communities and businesses have suffered significantly during the pandemic. 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. From the OIG's 2022 Work Plan, we recently began an audit of the NCUA's Minority Depository Institution Program. We plan to review the NCUA's actions to preserve and promote MDIs and assess the Agency's achievement of the MDI Program's goals.

Human Capital and Planning for the Future Workforce

A significant management challenge for the NCUA is maintaining a well-trained, sustainable workforce while facing challenges in retirement eligibilities, succession planning, and training. As of this writing, the NCUA has 1150 employees located in the Central Office and three Regional Offices across the country, and 35 percent of NCUA employees (407 employees) are eligible to retire within 5 years. The NCUA faces retirement rates of nearly 61 percent for executives and 55 percent for supervisors over that same period. Finding appropriate successors who can lead the Agency and employees who have the requisite skills and expertise is essential to ensuring that the NCUA can continue to achieve its mission effectively, especially given the significant investments in, and time required for, credit union examiner certification.

A key factor in meeting this challenge is providing a work environment where employees feel safe while they continue to perform their work. Employees are the NCUA's most valuable asset, and the safety and well-being of its workforce has been brought to the forefront during the COVID-19 pandemic.

We reviewed the NCUA's work posture during the COVID-19 pandemic and issued Report #OIG-21-10, Audit of the NCUA's Covid-19 Work Posture, where we assessed the Agency's pandemic-related decisions and determined them to be both timely communicated to staff and effective in design regarding staff health and safety.

In addition to hiring well-qualified examiners, the NCUA should hire cybersecurity specialists and experts in capital markets, commercial lending, consumer financial protection, and payment systems. The Agency's success depends greatly on its ability to plan, recruit, retain, and develop a capable workforce that includes these areas of expertise. We reviewed the NCUA's hiring practices and in the January 2022 Report #OIG-22-01, Audit of the NCUA's Hiring Practices, determined that the Agency complied with applicable federal laws and substantially complied with regulations and its own policies and procedures. We also determined the NCUA's hiring processes facilitated the efficient selection of high-quality candidates.

Human capital plans must also ensure that institutional knowledge and experience are passed on, and that the Agency is less dependent on specific individuals. Workforce training and development takes a significant investment of resources, but the use of several tools can ensure that the NCUA maintains a vital, experienced staff. For example, data analytics can help the Agency identify training gaps. Job sharing, rotational details, and micro-assignment opportunities can be used to promote career development. Mentoring programs can prepare employees for management positions. To supervise federally insured credit unions properly, all staff must receive the training necessary to develop their skills and abilities to identify and mitigate risk; however the NCUA will need to continue to review and revise its training curricula to respond to emergent industry trends and highlight regulatory and other changes.

Human capital challenges may arise when NCUA employees and contractors are expected to return to the office after working under a maximum telework policy for an extended period. The Agency will be challenged to respond to a workforce that has adapted to productively working from home and wanting to retain increased telework flexibilities.

Because the NCUA is a relatively small agency with nationwide responsibilities, changes in the workforce—such as the retirement of management and senior employees—must be accounted and planned for to avoid undue disruption to Agency functions. The need for succession and human capital planning was highlighted this past year when the Agency saw a 340 percent increase in the number of retirements in leadership positions in 2021 (17) versus just 5 in 2020. The NCUA's workforce is changing and evolving and the Agency will need to continue to make critical investments in its human capital. This includes providing the Agency's workforce with new training, developing and mentoring the next generation of agency leaders, and continuing to foster a diverse and inclusive environment.