2017 NAFCU REPORT *on* CREDIT UNIONS


NAFCU

Federal Advocacy, Education & Compliance

NAFCU REPORT ON CREDIT UNIONS

November 2017

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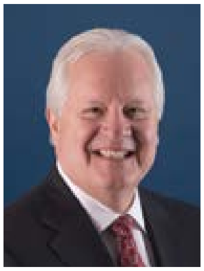
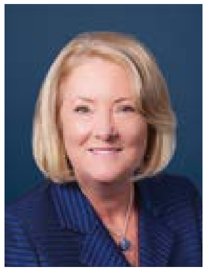
This material was prepared for a meeting between the NAFCU Board of Directors and the Board of Governors of the Federal Reserve System

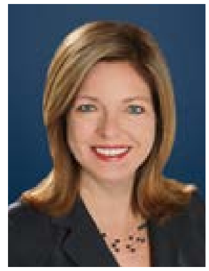
Board of Directors and President and CEO of NAFCU



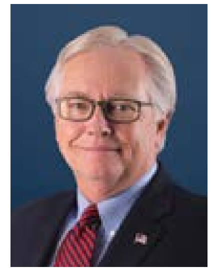
Richard L. Harris
Chair
Region V Director
President/CEO
Caltech Employees
Federal Credit Union
La Canada, CA
Asset Size: $1.6B
Members: 32,146
FOM: Multi-Occupational



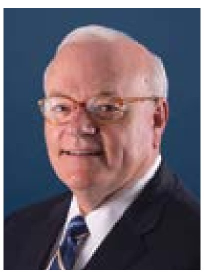
Jeanne Kucey
Vice Chair
Region III Director
President/CEO
JetStream
Federal Credit Union
Miami Lakes, FL
Asset Size: $197M
Members: 21,704
FOM: Community



Debra Schwartz
Treasurer
Director-at-Large
President/CEO
Mission
Federal Credit Union
San Diego, CA
Asset Size: $3.3B
Members: 213,777
FOM: Community

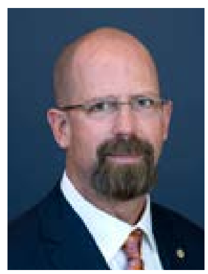


Thomas W. DeWitt
Secretary
Region IV Director
President/CEO
State Farm
Federal Credit Union
Bloomington, IL
Asset Size: $4.0B
Members: 130,598
FOM: Service

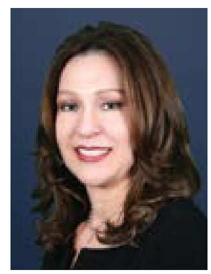


Robert L. Fisher
Director-at-Large
President/CEO
Grow Financial
Federal Credit Union
Tampa, FL
Asset Size: $2.4B
Members: 199,046
FOM: Multi-Occupational

Gary Grinnell
Region I Director
President/CEO
Corning
Federal Credit Union
Corning, NY
Asset Size: $1.4B
Members: 103,797
FOM: Multi-Occupational

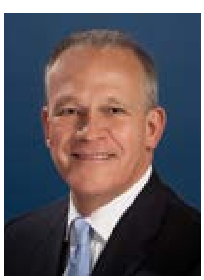


James A. Kenyon
Director-at-Large
President/CEO
Whitefish Credit Union
Whitefish, MT
Asset Size: $1.4B
Members: 54,899
FOM: Community



Jan N. Roche
Director-at-Large
President/CEO
State Department
Federal Credit Union
Alexandria, VA
Asset Size: $1.8B
Members: 77,814
FOM: Multi-Occupational

Charles A. Rutan
Director-at-Large
President/CEO
Southwest Airlines
Federal Credit Union
Dallas, TX
Asset Size: $499M
Members: 50,627
FOM: Multi-Occupational



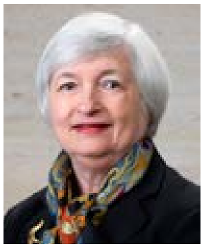
Brian Schools
Region II Director
President/CEO
Chartway
Federal Credit Union
Virginia Beach, VA
Asset Size: $2.2B
Members: 182,422
FOM: Multi-Occupational

Daniel Weickenand
Director-at-Large
CEO
Orion
Federal Credit Union
Memphis, TN
Asset Size: $621M
Members: 62,261
FOM: Multi-Occupational

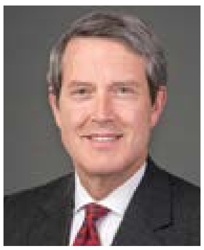
B. Dan Berger
President/CEO
NAFCU
Arlington, VA

FOM is Field of Membership

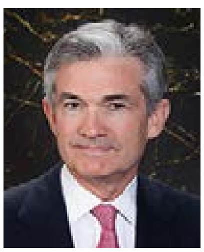
Board of Governors of the Federal Reserve System



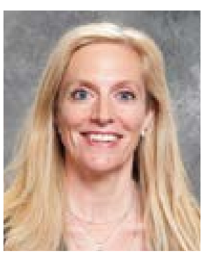
Janet Yellen, Chair of the Board of Governors. Her four-year term as Chair expires February 3, 2018, and her 14-year term as member ends January 31, 2024. She began her term on February 3, 2014. Prior to her appointment, Dr. Yellen was Vice Chair of the Board of Governors, a president of the Federal Reserve Bank of San Francisco and a member of the Federal Open Market Committee. She is professor emeritus at the University of California at Berkeley and has been a faculty member since 1980. She was also chair of the President's Council of Economic Advisers.



Randal Quarles, Vice Chair for Supervision. He took office on Oct 13, 2017, to fill an unexpired term ending January 31, 2018. Prior to his appointment, Mr. Quarles was founder and managing director of the Cynosure Group. Before founding the Cynosure Group, he was a partner at The Carlyle Group. Mr. Quarles served multiple positions in the Department of Treasury, most recently as the Under Secretary of the Treasury for Domestic Finance. He also served as the U.S. Executive Director of the International Monetary Fund, and was a partner at Davis, Polk & Wardwell.



Jerome H. Powell, member of the Board of Governors. He took office on May 25, 2012, to fill an unexpired term ending January 31, 2014. He was reappointed and sworn in on June 16, 2014 for a term ending January 31, 2028. Prior to his appointment, Mr. Powell was a visiting scholar with the Bipartisan Policy Center, where he focused on federal and state fiscal issues. From 1997 through 2005, he was a partner at The Carlyle Group. Mr. Powell also served as Assistant Secretary and as Undersecretary to the Treasury under President George H.W. Bush.



Lael Brainard, member of the Board of Governors. She took office in June 16, 2014, to fill an unexpired term ending January 31, 2026. Prior to her appointment, Dr. Brainard served as Undersecretary of the U.S. Department of Treasury and Counselor to the Secretary of the Treasury. Dr. Brainard also was previously the Vice President and Founding Director of the Global Economy and Development Program, and held the Bernard L. Schwartz Chair at the Brookings Institution. She also served in several staff positions in the Clinton Administration and was a professor of Applied Economics at the Massachusetts Institute of Technology (MIT).

Abbreviations

ACH	Automated Clearing House
AML	Anti-Money Laundering
ANPR	Advanced Notice of Proposed Rulemaking
ATM	Automated Teller Machine
BSA	Bank Secrecy Act
CFPB	Consumer Financial Protection Bureau
CLF	Central Liquidity Facility
CUMAA	Credit Union Membership Access Act
CUSO	Credit Union Service Organization
DoD	Department of Defense
DTI	Debt-to-Income Ratio
EMV	Europay, MasterCard, and Visa
FCC	Federal Communications Commission
FCU	Federal Credit Union
FHLB	Federal Home Loan Bank
FICU	Federally-Insured Credit Union
FISCU	Federally-Insured State Chartered Credit Union
FOM	Field of Membership
FTE	Full-Time Equivalent
GSE	Government-Sponsored Enterprise
HELOC	Home Equity Line of Credit
HMDA	Home Mortgage Disclosure Act
ICBA	The Independent Community Bankers of America
MAPR	Military Annual Percentage Rate
MBL	Member Business Loan
MLA	Military Lending Act
NACHA	National Automated Clearinghouse Association
NAFCU	National Association of Federally-Insured Credit Unions
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NOL	Normal Operating Level
PAL	Payday Alternative Loan
PCA	Prompt Corrective Action
PIN	Personal Identification Number
QM	Qualified Mortgage
RBC	Risk-Based Capital
ROA	Return on Assets
TCPA	Telephone Consumer Protection Act
TIP	Trade, Industry, and Professional
UDAAP	Unfair, Deceptive, or Abusive Acts and Practices

BACKGROUND

The National Association of Federally-Insured Credit Unions (NAFCU), founded in 1967, is the only national trade association focusing exclusively on federal issues affecting the nation's federally-insured credit unions (FICUs). NAFCU provides its members with representation, information, education, and assistance to meet the constant challenges that cooperative financial institutions face in today's economic environment. Membership in NAFCU is direct; there are no state or local leagues, chapters or affiliations standing between NAFCU members and NAFCU's Arlington, Virginia headquarters.

NAFCU Membership

NAFCU's membership consists of the nation's most innovative and dynamic FICUs, having various and diverse membership bases and operations. NAFCU proudly represents many smaller credit unions with relatively limited operations, as well as some of the largest and most sophisticated credit unions in the nation. NAFCU represents 69 percent of total federal credit union (FCU) assets and 64 percent of all FCU member-owners. NAFCU's membership also includes over 100 federally-insured state chartered credit unions (FISCUs).

The Credit Union Universe

Federally Chartered Credit Unions

Federally chartered credit unions obtain their charters from, and are regulated by, the National Credit Union Administration (NCUA). Their member shares (deposits) are insured by the National Credit Union Share Insurance Fund (NCUSIF), which is administered by the NCUA. As of June 2017, there were 3,568 FCUs, with assets of $698 billion and a membership base of approximately 58 million.

Federally-Insured Credit Unions

All FCUs are required to be insured by the NCUSIF. State chartered credit unions in some states are required to be federally insured, while others may elect to be insured by the NCUSIF. The term "federally-insured credit unions" refers to both federal and state chartered credit unions whose accounts are insured by the NCUSIF. Thus, FCUs and FISCUs are subsets of FICUs. As of June 2017, there were 5,696 FICUs, with assets of $1.35 trillion and a membership base of 110 million.

Privately Insured Credit Unions

Private primary share insurance for FISCUs has been authorized in a number of states. Currently there are privately insured credit unions operating in nine states (Alabama, California, Idaho, Illinois, Indiana, Maryland, Nevada, Ohio and Texas). There is only one private insurance company (American Share Insurance of Dublin, Ohio) offering credit unions primary share insurance and excess deposit insurance. Another private insurer (Massachusetts Share Insurance Corporation) offers only excess deposit insurance coverage.

Corporate Credit Unions

Corporate credit unions are credit unions that serve other credit unions. Corporate credit unions provide services such as investment products, advisory services, item processing and loans to their members. As of June 2017, there were 12 corporate credit unions with assets of $22 billion.

NAFCU Research

NAFCU devotes a great deal of institutional resources to keeping its finger on the pulse of its members' operations by surveying its membership regularly. In this report, we reference several research instruments:

Economic & CU Monitor

NAFCU's Economic & CU Monitor is a monthly report based in part on survey responses by NAFCU member credit unions on a special topic. The report includes a review of the survey responses, along with commentary on economic and industry trends.

CU Industry Trends Report

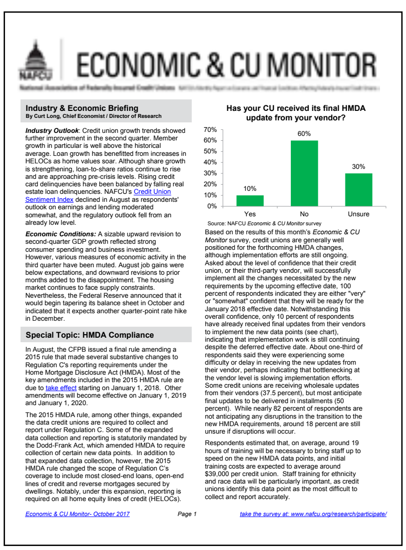
NAFCU's CU Industry Trends Report is a quarterly analysis of trends in the credit union industry, with key financial ratios aggregated by region and asset class.

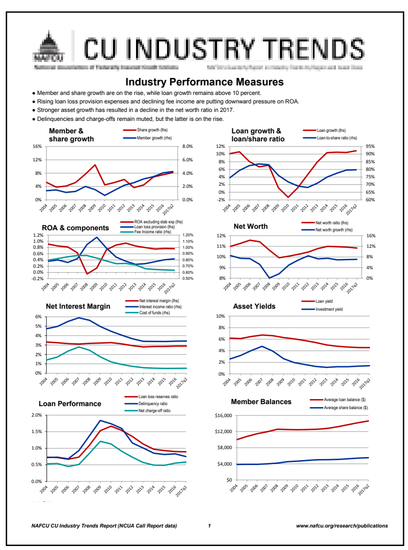
NAFCU Report on Credit Unions

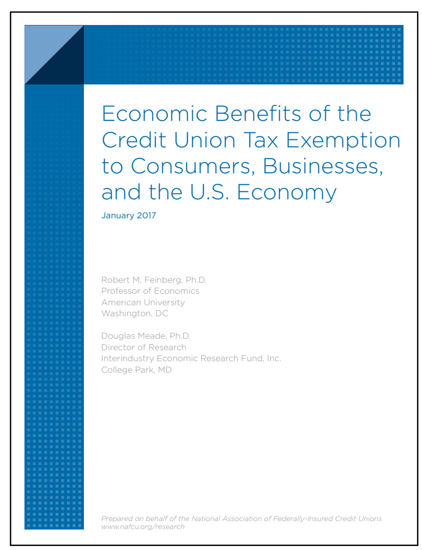
NAFCU's Federal Reserve Meeting Survey is an annual assessment of NAFCU members covering topics we discuss in the annual NAFCU Report on Credit Unions. Survey data for the current report was collected in August 2017.

Economic Benefits of the Credit Union Tax Exemption to Consumers, Businesses, and the U.S. Economy

NAFCU commissioned a special study to examine what would happen to the U.S. economy if the presence of credit unions was reduced significantly as a result of eliminating the credit union federal tax exemption. The 2017 study quantifies the benefits to all consumers – both credit union members and bank customers – of having a strong credit union presence in financial markets. The study shows that reducing the number of credit unions would weaken competition for consumer financial services and lead to higher interest rates on consumer loans and lower interest rates on retail deposits. The study also estimates the broader economic impact of these lost consumer benefits.







KEY FINDINGS

Credit union trends

- Overall industry growth is strong, despite the fact that not-for-profit credit unions are small, highly regulated and typically operate with much smaller margins than their for-profit counterparts.
- Credit unions are healthy and well-capitalized, and the industry is continuing to strengthen following the financial crisis.
- Credit unions are good actors that did not cause the financial crisis; nevertheless, smaller credit unions in particular continue to struggle under immense regulatory burden. Industry consolidation has accelerated in recent years, with the number of credit unions declining at a pace of nearly one per day.

Credit union service to members and use of Federal Reserve services

- Investing in technology is a priority for credit unions, as evidenced by the growth in the number of institutions offering remote deposit capture, mobile payments, and other electronic services.
- Credit unions are expanding their internet banking and mobile banking offerings. Credit unions also plan to invest heavily in mobile banking, online banking platforms and in ways to optimize customer development over the next three years.
- The Federal Reserve remains a critical source of transaction services for the industry.

Legislative issues facing credit unions

- Credit unions provide over $16 billion annually in benefits to the economy, and preserving the credit union tax exemption remains NAFCU's top legislative priority.
- Several basic tenets of a healthy and appropriate regulatory environment are necessary for credit unions to thrive: a regulatory framework that allows credit unions to grow; tailored regulation and relief from growing regulatory burdens; a fair playing field; transparency and independent oversight; and an independent NCUA as the primary regulator for credit unions.
- Particularly in light of the massive Equifax data breach, credit unions face growing concerns over data and cybersecurity. Uniform national data security standards are now more important than ever.

Regulatory issues facing credit unions

- Modernized field of membership rules, including a strong federal charter and the ability to serve underserved areas, are crucial to the future welfare of the credit union industry.
- Credit unions continue to labor under the immense cumulative regulatory burden in the post Dodd-Frank era. Compliance challenges are exacerbated by the CFPB's seeming lack of understanding of the operational difficulties associated with implementing its complex rules.
- NAFCU continues to work to ensure that any new payments system will be cost-effective, operationally effective and scalable for credit unions of all sizes.

Emerging challenges

- In the face of rapid evolution in the financial marketplace, credit unions are under significant pressure to keep pace with sweeping technological change by increasing expenditures in information technology.
- Regulatory burden continues to be a drag on credit unions, while non-traditional financial service providers that are directly competing with credit unions are largely unencumbered by existing rules.
- Continued outreach to millennials and young adults is key to credit union strategic growth.

CREDIT UNION TRENDS

Role in the Economy

Credit unions are small organizations making a large impact in the communities they serve. Despite the fact that credit union resources pale in comparison to those of other financial institutions (Table 1), they are in many respects more highly regulated. Field of membership constraints, restricted access to capital, interest rate caps, and limitations on their authority to make loans to businesses are some of the significant regulations unique to credit unions.

The business model for a typical credit union stands in stark contrast to that of other depository institutions. As member-owned, not-for-profit cooperatives, credit unions are committed to returning operating surpluses to their members via more favorable interest rates, lower fees, and dividends. As a result, credit unions typically operate with much smaller margins than other financial institutions.

Despite the fact that they are small and highly regulated, industry growth is gaining traction. Loan growth has topped 10 percent annually since 2014. Credit unions have a sizable and growing market share for vehicle loans (29.1 percent), mortgage loans (7.9 percent), and revolving loans (5.4 percent). Despite regulatory limitations on their ability to make business loans, credit unions provided a critical source of credit for the nation's small businesses during the Great Recession, and they continue to do so today (Chart 1).

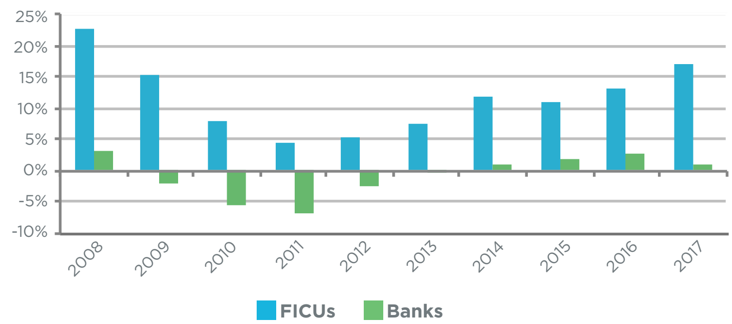
Credit unions provide value to the economy that goes far beyond their small stature. The presence of credit unions leads to greater competition among financial institutions, which ultimately results in better interest rates for both credit union members and bank customers (Chart 2). A recent study[1] estimates the value of credit unions to consumers at $16 billion per year. The resulting increase in economic activity accounts for 90,000 jobs annually.

Table 1 | Average by Institution Type

	All Banks	Community Banks	Credit Unions
Assets ($bn)	$2.96	$0.41	$0.24
Shares/ Deposits ($bn)	$2.27	$0.34	$0.20
ROA	1.13%	1.04%	0.75%
Employees	361	80	52

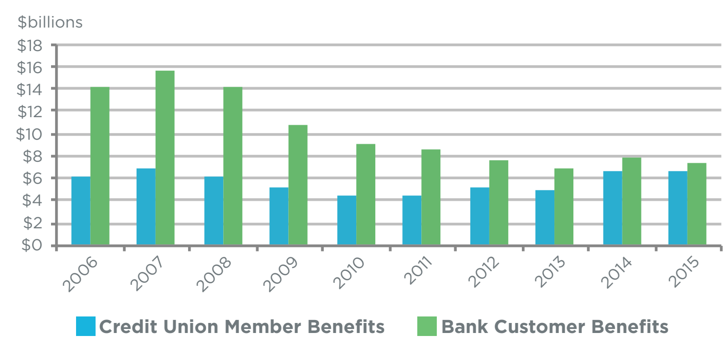
Source: FDIC, NCUA

Chart 1 | Small Business Loan Growth



Note: All figures show year-over-year growth as of the second quarter. All FICU member business loans treated as small business loans. Source: NCUA, FDIC

Chart 2 | Annual Consumer Benefits Due to Presence of Credit Unions



[1] Feinberg, Robert and Douglas Meade, *Economic Benefits of the Credit Union Tax Exemption to Consumers, Businesses, and the U.S. Economy*, 2017.

General Financial Conditions

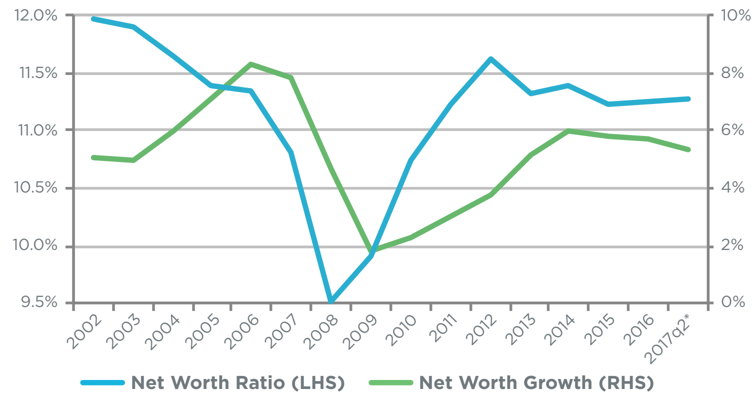
Credit unions are conservatively run, well-capitalized institutions, which helps to explain their relatively quick recovery from the financial crisis. After dropping during the crisis, FICUs' net worth ratio has since recovered (Chart 3). As of June 2017, year-over-year growth in net worth (7.1 percent) was slightly below asset growth (7.7 percent). Since the onset of the Great Recession, credit unions have experienced a lower failure rate than banks. From 2008 through 2016, there were 520 bank failures compared to only 174 credit union failures.[2] As of June 2017, NCUA reported that there were 210 problem credit unions with a CAMEL rating of 4 or 5. These credit unions constitute 0.9 percent of industry shares, which is down from a peak of 5.7 percent in 2009 and in line with the pre-recession figure.

The industry experienced a spike in share growth during the financial crisis (Chart 4), but it moderated in subsequent years. Over the past several years, however, share growth has been on the rise and now exceeds its long-run average in non-recession years of roughly 6 percent. Year-over-year growth in credit union membership was 4.2 percent in June 2017, which is its highest level in nearly 30 years.

The extended period of low interest rates has resulted in a shift in liabilities as members have opted out of share certificates and into core deposits (share drafts, regular shares and money market shares). From December 2007 to June 2017, the ratio of core deposits to total shares and deposits increased from 55.5 percent to 73.6 percent. This has resulted in a lower cost of funds for credit unions, but that trend could reverse as interest rates normalize.

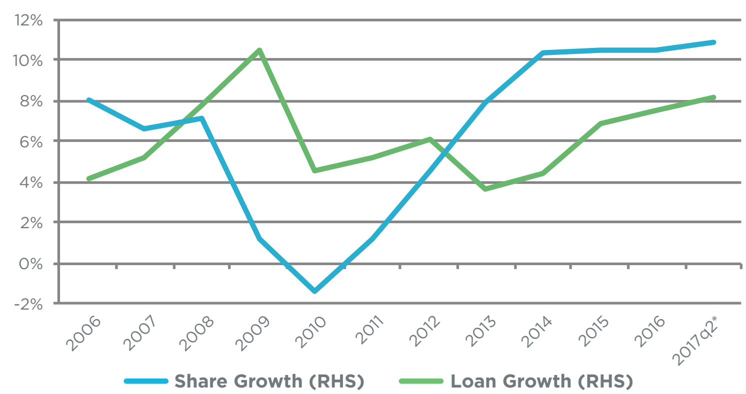
Credit unions are a critical source of credit for households, and their market share for first mortgage, vehicle, and revolving loans has increased significantly since 2007 (Chart 5). Loan balances overall continue to surge, increasing 10.9 percent year over year as of June 2017. Vehicle loan balances grew by 13.6 percent during that time and accounted for 42 percent of overall loan growth.

Chart 3 | FICU Net Worth Ratio



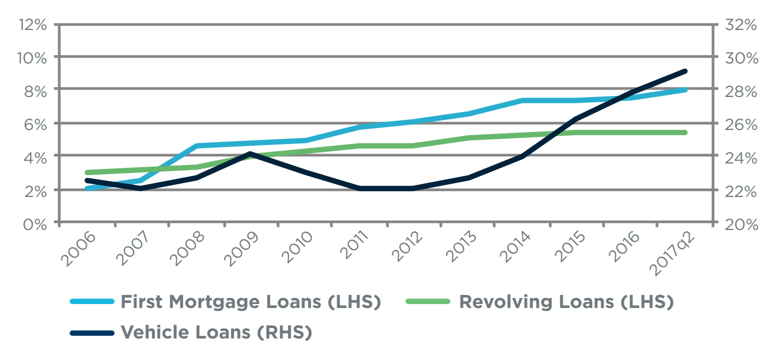
*Growth rates are year over year Source: NCUA

Chart 4 | FICU Loan and Share Growth



*Growth rates are year over year Source: NCUA

Chart 5 | FICU Market Share



First mortgage loan figures reflect loan originations, revolving and vehicle loan figures show loans outstanding
Sources: NCUA, Mortgage Bankers Association, Federal Reserve

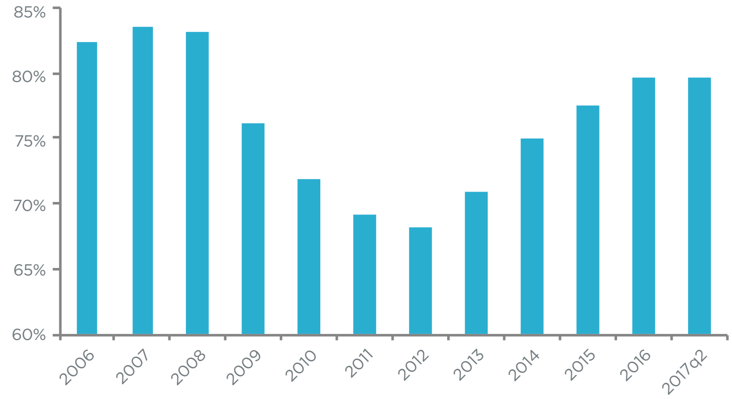
[2] As of December 2007, there were 8,534 banks in existence and 8,101 credit unions.

As a result of weak loan growth and a surge in share growth during the recession, the industry's loan-to-share ratio dropped by over 150 basis points from 2007 to 2012 (Chart 6). Since declining to 68 percent in 2012, however, the ratio has climbed to 80 percent. Nevertheless, there exists surplus balance sheet liquidity when compared to pre-crisis levels.

FICUs' June 2017 annualized ROA (0.75 percent) was unchanged from a year prior (Chart 7). In general, ROA has recovered since the recession as asset quality and provision for loan loss expense have returned to pre-crisis levels, but declining fee income in recent years presents a challenge for the industry as it seeks to maintain a viable operating margin. The decline in interchange fees has already affected credit unions' non-interest earnings (see *Interchange Fees*, page 21), and potential regulation on overdraft fees (see *Overdraft*, page 31) threatens to place greater stress on credit union margins.

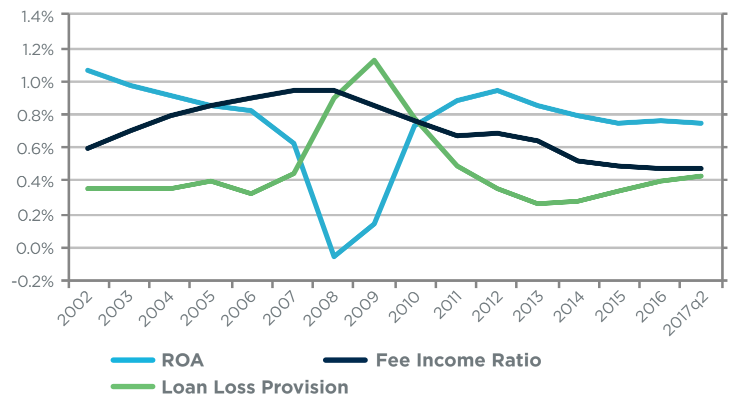
Credit unions did not participate in the type of lending activities that precipitated the financial crisis, and yet, FICUs did experience some deterioration in their loan performance as a result of the economic turmoil. However, loan performance has improved since 2009 and returned to pre-crisis levels. The delinquency ratio for the credit union industry as of June 2017 was 0.75 percent, which is unchanged from a year earlier. This compares to a delinquency ratio of 1.23 percent for all banks and 0.94 percent for community banks (Chart 8). The net charge-off ratio for credit unions is 0.57 percent, which is six basis points higher than a year ago.

Chart 6 | FICU Loan-to-Share Ratio



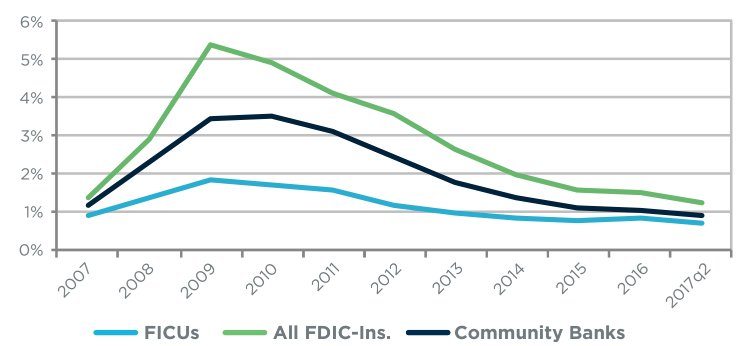
Source: NCUA

Chart 7 | ROA



Source: NCUA

Chart 8 | Delinquency Ratios*



**FICU loans considered delinquent after 60 days, FDIC loans considered delinquent after 90 days*
Source: NCUA, FDIC

Industry Consolidation

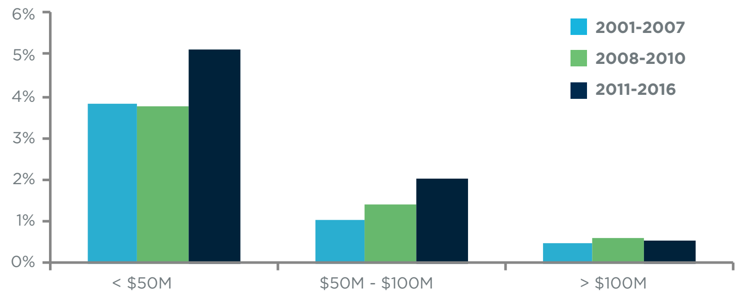
While credit unions on the whole are performing well, small credit unions continue to struggle. As a result, industry consolidation has accelerated in recent years. The number of credit unions continues to decline at a pace of nearly one per day.

A review of merger trends since 2001 shows that small credit unions are far more likely to merge than larger credit unions (Chart 9). Since that time, four to five percent of credit unions with less than $50 million in assets merge out of existence each year, on average. Mergers of credit unions with over $100 million in assets are relatively rare by comparison.

From 2008 through 2010, the combination of weak economic conditions and NCUA premium assessments related to both the National Credit Union Share Insurance Fund (NCUSIF) and failures within the corporate credit union system depressed industry net worth and earnings. Merger activity rose modestly across the industry. However, small credit unions have experienced much higher rates of consolidation in the years since, and that trend shows no signs of slowing down or reversing. In NAFCU's 2017 Federal Reserve Survey, respondents indicated that the minimum asset size required to compete in the current environment is $250 million. Survey respondents from credit unions below that level were more likely to say that they anticipated being merged into another credit union over the next three years (Chart 10).

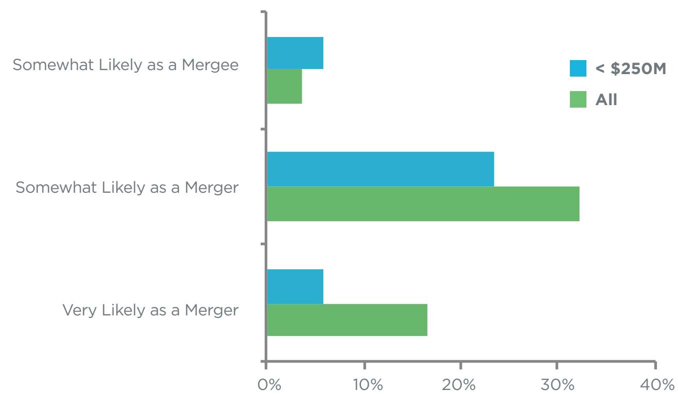
The low-interest rate environment is often cited as a factor in the struggles of small credit unions. However, according to NAFCU's survey the share of respondents citing net interest margin as a key strategic challenge was not significantly different for small credit unions as compared to larger ones (Chart 11). Far more disparity was evident in the area of regulatory compliance, where 76 percent of small credit unions considered it to be a key strategic challenge, compared to 61 percent of overall respondents. Regulatory compliance was the top strategic concern among credit unions with under $250 million in assets in NAFCU's survey.

Chart 9 | Average Annual Merger Rate by Asset Class



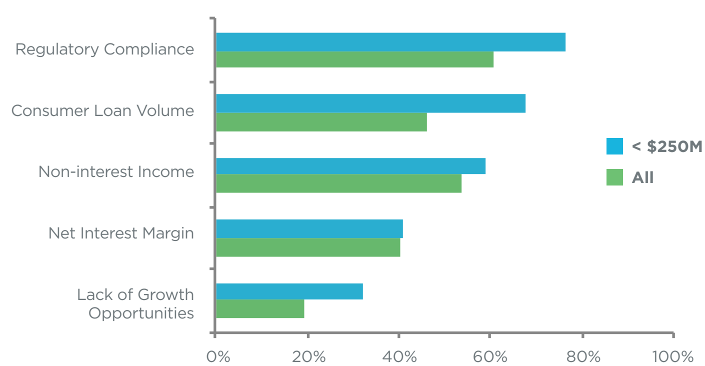
Source: NCUA

Chart 10 | Likelihood of Involvement in a Merger in the Next Three Years



Source: NAFCU 2017 Federal Reserve Meeting Survey

Chart 11 | Strategic Challenges Rated as "Significant" Over the Next Three Years



Source: NAFCU 2017 Federal Reserve Meeting Survey, selected responses

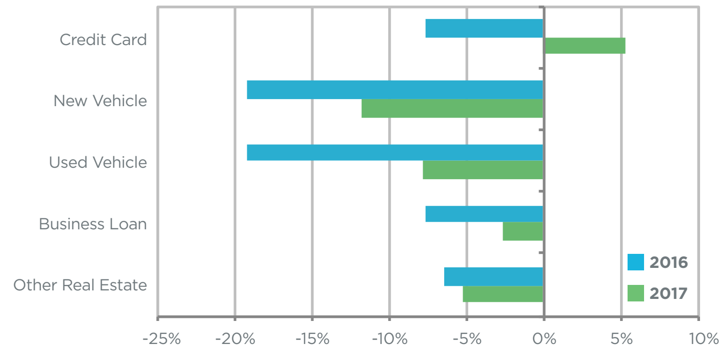
Lending Standards & Conditions

NAFCU's annual *Federal Reserve Survey* includes questions on lending standards, and a comparison between 2016 and 2017 shows that standards have been eased for most types of non-mortgage loans, but tightened for most types of mortgage loans (Charts 12a and 12b). For credit cards, a net majority of respondents indicated that they had tightened loan standards in 2017 as compared to the year prior. For vehicle, business, and other real estate loans, standards eased in 2017, but less so than the year prior.

For mortgage loans, lending standards were tightened for all types other than GSE-eligible loans. In 2016 the only category where respondents noted a tightening of standards was for non-QM jumbo loans.

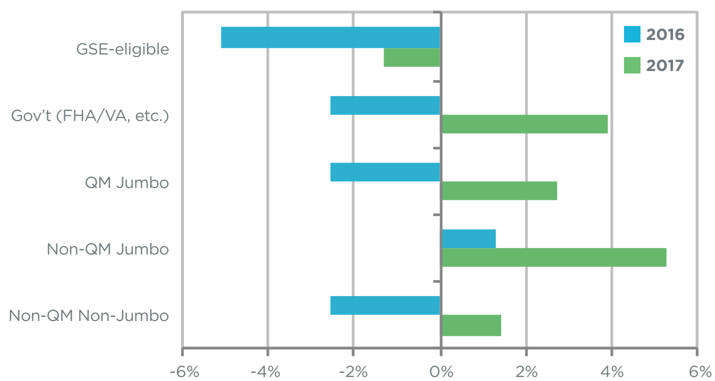
Credit union loan growth has been strong by historical standards in recent years, and survey respondents indicated broad-based increases in loan demand over the past year. The strongest increases were in new and used vehicle loan demand (Chart 13). Other lending categories with significant net increases in demand were credit card, business, and other real estate. While more than 20 percent of respondents reported increased demand for GSE-eligible residential mortgages, 16 percent reported that demand had weakened, which was the highest of any loan category.

Chart 12a | Net % of Respondents Tightening Loan Standards (Last 12 Months)



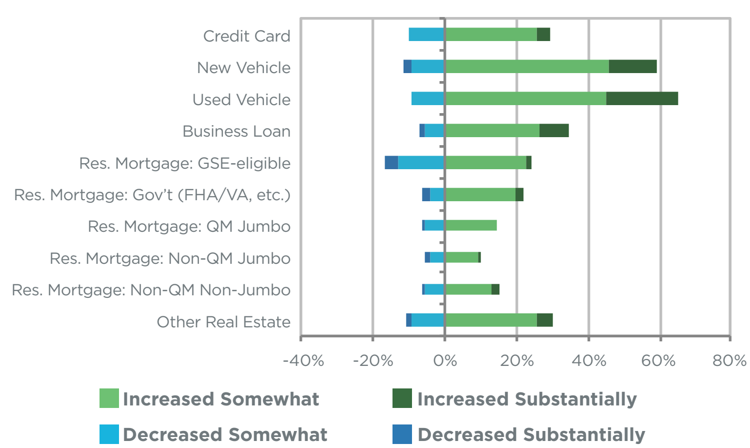
Negative figure indicates standards were eased, on net
Source: NAFCU 2017 Federal Reserve Meeting Survey

Chart 12b | Net % of Respondents Tightening Residual Mortgage Loan Standards (Last 12 Months)



Negative figure indicates standards were eased, on net
Source: NAFCU 2017 Federal Reserve Meeting Survey

Chart 13 | Change in Loan Demand (Last 12 Months)

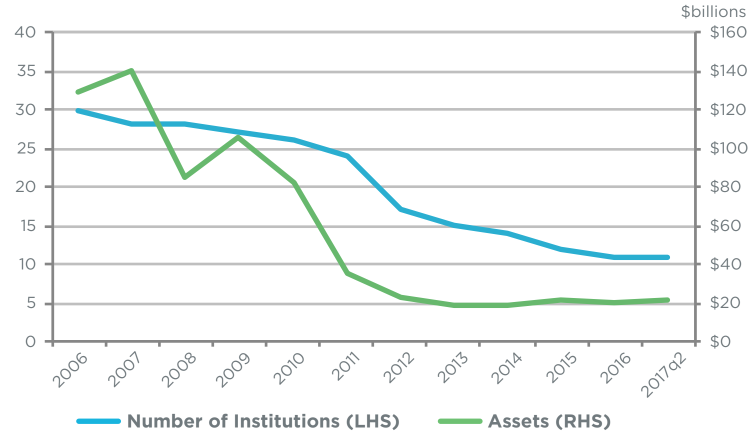


Source: NAFCU 2017 Federal Reserve Meeting Survey

Liquidity

Prior to the recession, credit unions relied heavily on corporate credit unions for their short-term liquidity needs. However, several corporate credit unions failed in the wake of the financial crisis. A regulatory overhaul and intense consolidation has reshaped the corporate credit union system, although some stability has returned in recent years (Chart 14).

Chart 14 | Corporate Credit Unions



Source: NCUA

The corporate credit union failures during the Great Recession impacted the NCUA's Central Liquidity Facility (CLF). When U.S. Central Bridge Corporate Credit Union shut its doors in October 2012, the CLF's borrowing authority was reduced by 96 percent, from $46 billion to just $2 billion. As of June 2017, the CLF's statutory borrowing authority was $6.6 billion, which is up from $6.1 billion in June 2016.

In October 2013, NCUA passed a rule requiring credit unions with over $250 million in assets to establish a contingent liquidity funding source through either the Federal Reserve Discount Window or the CLF. Based on NAFCU's 2017 *Federal Reserve Survey* results, credit union respondents with over $250 million have tended to utilize the Discount Window more heavily than smaller credit unions (Table 2). Federal Home Loan Banks (FHLBs), which NCUA did not include as an approved provider of contingency funding in their rule, are also an important source of liquidity for credit unions. This is especially true for those with over $250 million. Credit union respondents under the $250 million threshold continue to utilize corporate credit unions more heavily.

Table 2 | Credit Union Liquidity Sources

	Increased available lines of credit in past 12 months	Accessed lines of credit in past 12 months	Tested access in backup liquidity plan in past 12 months	Intend to gain access to funds in next 12 months
FRB Discount Window				
<$250 million CUs	12.0%	0%	8.0%	8.0%
>$250 million CUs	19.1%	8.5%	68.1%	8.5%
Central Liquidity Facility				
<$250 million CUs	0%	0%	4.0%	0%
>$250 million CUs	0%	2.1%	2.1%	4.3%
FHLBs				
<$250 million CUs	16.0%	4.0%	32.0%	4.0%
>$250 million CUs	38.3%	40.4%	55.3%	10.6%
Corporate CUs				
<$250 million CUs	4.0%	12.0%	64.0%	8.0%
>$250 million CUs	6.4%	10.6%	36.2%	2.1%
Banks				
<$250 million CUs	4.0%	4.0%	12.0%	0%
>$250 million CUs	2.1%	0%	8.5%	2.1%

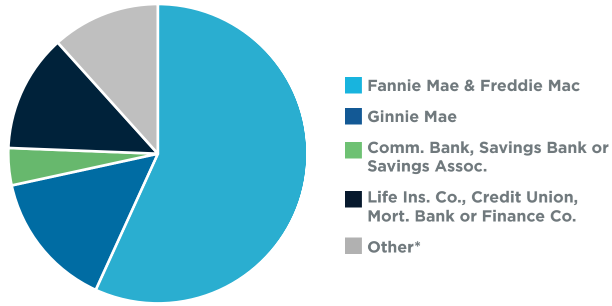
Source: NAFCU 2017 Federal Reserve Survey

Secondary Mortgage Market

The secondary mortgage market is vital to many small financial institutions with mortgage loan portfolios, both as a source of liquidity and as a tool to manage interest rate and concentration risks. Through June 2017 credit unions sold 34 percent of first mortgage loans originated in the calendar year. This is down from 2016 when 40 percent of first mortgage originations were sold. Credit unions that participated in NAFCU's 2017 *Federal Reserve Meeting Survey* indicated that, on average, 72 percent of their outstanding first mortgage loans qualify to be sold on the secondary market (up from 57 percent in the 2016 survey).

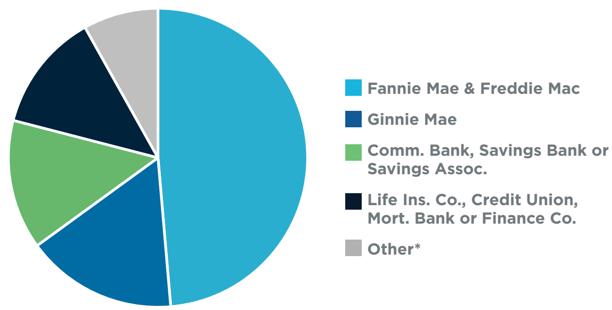
Based on data released under the Home Mortgage Disclosure Act (HMDA), credit unions tend to utilize Fannie Mae and Freddie Mac more heavily relative to banks and thrifts (Charts 15 and 16). Among respondents to this year's survey, 24 percent sell mortgages to Fannie Mae, 12 percent sell to Freddie Mac, and another 11 percent sell to both. Among alternatives for placing mortgage loans, the most popular were mortgage wholesalers (32 percent), FHLBs (26 percent), and credit union service organizations, or CUSOs (24 percent).

Chart 15 | Credit Union Mortgage Sales by Purchaser Type



"Other" includes private securitization, affiliate institution or other type of purchaser
Source: 2016 HMDA data

Chart 16 | Bank & Thrift Mortgage Sales by Purchaser Type



"Other" includes private securitization, affiliate institution or other type of purchaser
Source: 2016 HMDA data

CREDIT UNION SERVICE TO MEMBERS AND USE OF FEDERAL RESERVE SERVICES

Credit unions carry on their commitment to offering superior products and services to their members. Investing in technology is a priority for credit unions. This is evident in the growth in the number of institutions offering remote deposit capture, mobile payments, and other financial products.

Electronic Financial Services

According to NCUA call report data, Account Balance Inquiry is the most common online service offered by FICUs, with 79 percent reporting that they currently offer this service (Table 1). This is up from last year's 78.2 percent. The electronic services that saw the largest increase in usage were Remote Deposit Capture (37.3 percent, up from 30.5 percent last year) and Mobile Payments (24.7 percent, up from 20.3 percent).

More credit unions are offering mobile banking to members (57.1 percent, up from 52.3 percent last year, Table 2). The shares of credit unions that offer ATM and internet banking services also increased from 74.1 percent to 74.7 percent and from 76.5 percent to 77.4 percent, respectively.

NAFCU's 2017 *Federal Reserve Meeting Survey* found that 93.8 percent of respondents expect information technology to be a main driver for spending increases over the next three years. When asked to identify specific IT-related projects, more than half of the respondents envisioned their credit unions investing in mobile banking, online banking platform and in ways to optimize customer development over the next three years (Chart 1).

Table 1 | Financial Services Offered Electronically by Federally-Insured Credit Unions

Online Service Offered	Provided in 2016	Provided in 2017
Account Balance Inquiry	78.2%	79.0%
View Account History	77.0%	78.0%
Loan Payments	71.2%	72.4%
e-Statements	68.8%	70.9%
Bill Payment	63.0%	64.3%
Remote Deposit Capture	30.5%	37.3%
Mobile Payments	20.3%	24.7%
Electronic Signature Services	17.6%	21.8%

Source: NCUA June 2016 & 2017 Call Reports

Chart 1 | Anticipated IT-Related Investments Over Next Three Years

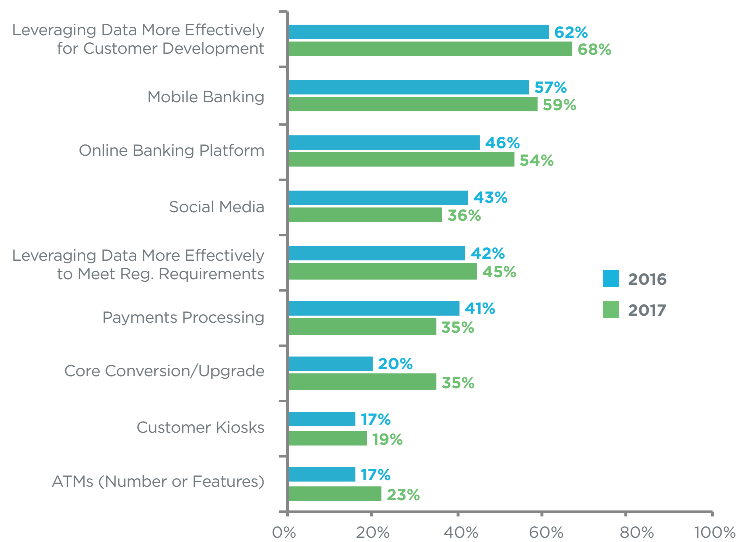


Table 2 | How Do Your Members Access/Perform Electronic Financial Services?

Electronic Service	Percentage of # of Institutions		Percentage of Assets	
	2016	2017	2016	2017
Audio Response/Phone-Based	59.4%	59.5%	96.3%	96.1%
Automatic Teller Machine (ATM)	74.1%	74.7%	98.9%	98.9%
Home Banking via Internet Website	76.5%	77.4%	99.4%	99.4%
Kiosk	6.3%	6.5%	35.4%	36.0%
Mobile Banking	52.3%	57.1%	95.5%	96.7%
Other	4.9%	5.0%	5.9%	6.7%

Source: NCUA June 2016 & 2017 Call Reports

Federal Reserve Services

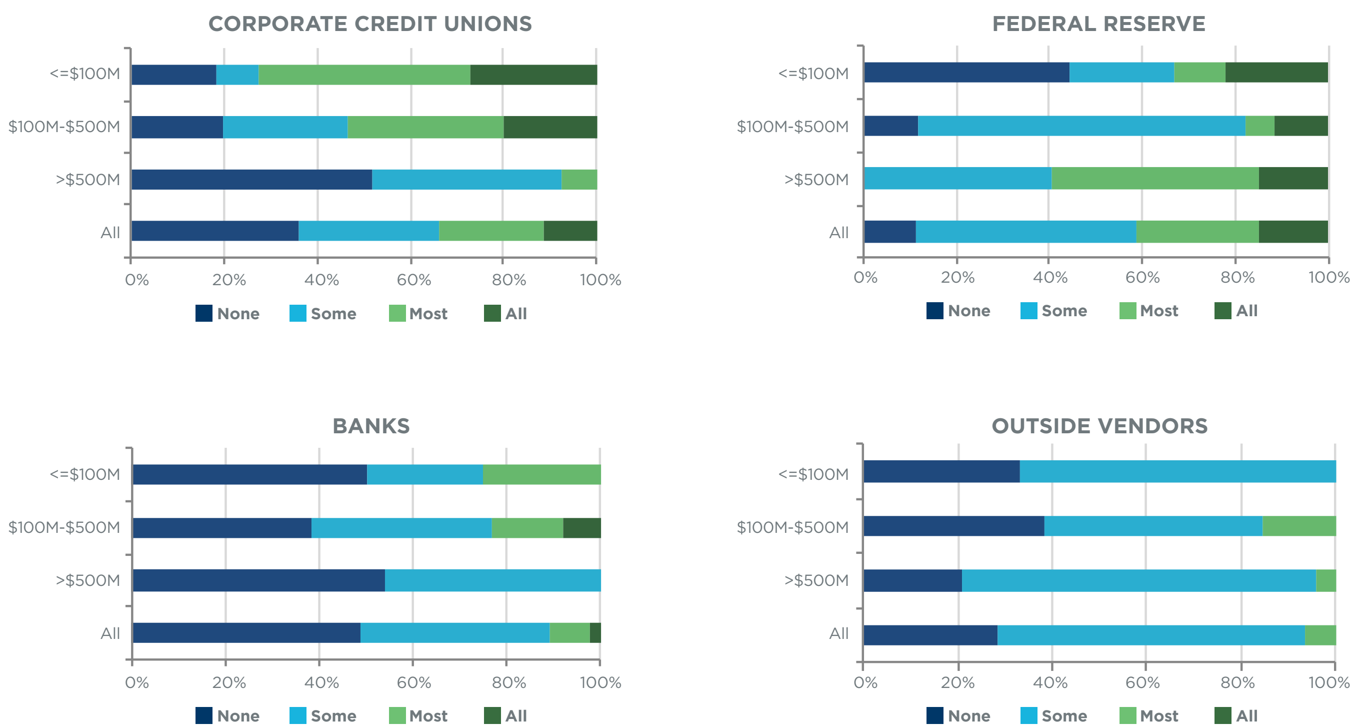
In NAFCU's 2017 *Federal Reserve Meeting Survey*, participants were asked to indicate their use of intermediaries for transaction services (Table 3). The share of respondents that use the Federal Reserve increased from 83.3 in 2016 percent to 88.7 percent in 2017. Meanwhile, the share of respondents that use corporate credit unions decreased slightly from 66 percent to 64.2 percent.

Table 3 | Which Intermediaries Does Your Credit Union Use for Transaction Services?

	Corporate Credit Unions		Banks		Federal Reserve		Outside Vendors	
	2016	2017	2016	2017	2016	2017	2016	2017
None	34.0%	35.8%	52.0%	48.9%	16.7%	11.3%	38.0%	28.3%
Some	34.0%	30.2%	42.0%	40.4%	40.7%	47.2%	48.0%	65.2%
Most	22.6%	22.6%	4%	8.5%	29.6%	26.4%	14.0%	6.5%
All	9.4%	11.3%	2.0%	2.1%	13.0%	15.1%	0.0%	0.0%

Source: NAFCU 2016 & 2017 Federal Reserve Meeting Surveys

Chart 2 | Use of Intermediaries by Asset Class



Responses by asset class suggest that credit unions under $500 million rely more heavily on corporate credit unions for their transaction services than larger credit unions (Chart 2). Credit unions over $100 million in asset size are much more likely to utilize the Federal Reserve for at least some of their transaction services. Meanwhile, respondent usage of outside vendors was mostly uniform across asset classes.

Table 4 | Which Intermediaries Does Your Credit Union Use for Transaction Services?

Federal Reserve Service	2017 Respondent Usage				Average Rating: 1 to 5 (5=excellent)	
	Total	Declining	Same	Increasing	2016	2017
FedLine Advantage	78.0%	0.0%	56.0%	22.0%	3.7	3.8
Fedwire Funds Service	77.6%	0.0%	53.1%	24.5%	3.7	3.7
ACH Originations	75.0%	1.9%	28.8%	44.2%	3.6	3.6
Fed Discount Window	70.8%	0.0%	60.4%	10.4%	3.6	3.5
ACH Receipts	70.6%	0.0%	31.4%	39.2%	3.7	3.6
Coin and Currency Orders	70.4%	5.6%	53.7%	11.1%	3.7	3.5
Customer Help Services	68.8%	4.2%	56.3%	8.3%	3.7	3.6
FedLine Web Services	68.8%	0.0%	56.3%	12.5%	3.6	3.6
Account Services	68.0%	2.0%	56.0%	10.0%	3.6	3.6
Check 21 Enabled Service	64.2%	5.7%	43.4%	15.1%	3.7	3.6
Coin and Currency Deposit	64.2%	3.8%	49.1%	11.3%	3.6	3.5
Educational Seminars	61.2%	2.0%	51.0%	8.2%	3.5	3.5
Paper Check Clearing	56.6%	22.6%	28.3%	5.7%	3.6	3.6
FedImage Services	54.0%	0.0%	40.0%	14.0%	3.5	3.5
FedLine Command	53.2%	0.0%	36.2%	17.0%	3.5	3.5
FedMail	50.0%	2.1%	41.7%	6.3%	3.4	3.5
FedLine Direct	48.0%	0.0%	40.0%	8.0%	3.5	3.4
FedPayments Reporter Service	43.8%	0.0%	25.0%	18.8%	3.3	3.4
Fedwire Securities Service	43.8%	4.2%	31.3%	8.3%	3.2	3.5
ACH Risk Management Services	42.9%	2.0%	28.6%	12.2%	3.5	3.3
Foreign Check Services	41.2%	3.9%	29.4%	7.8%	3.4	3.4
National Settlement Service	39.6%	0.0%	33.3%	6.3%	3.3	3.7
Presentment Point Services	37.3%	2.0%	33.3%	2.0%	3.7	3.3
FedGlobal ACH Payments	34.0%	0.0%	25.5%	8.5%	3.3	3.3
FedTransaction Analyzer Service	33.3%	0.0%	27.1%	6.3%	3.4	3.2
FedComplete Package	28.3%	0.0%	21.7%	6.5%	3.5	3.5

Source: NAFCU 2016 & 2017 Federal Reserve Meeting Surveys

NAFCU's 2017 *Federal Reserve Meeting Survey* asked participants about their usage rates of Federal Reserve services with respect to last year and to rate the service provided (Table 4). The most widely-used Federal Reserve service was Fedline Advantage (78.0 percent), followed by Fedwire Funds Service (77.6 percent), Automated Clearing House (ACH) Originations (75.0 percent), Fed Discount Window (70.8 percent) and ACH Receipts (70.6 percent). The least-used services were FedComplete Package (28.3 percent), FedTransaction Analyzer Service (33.3 percent) and FedGlobal ACH Payments (34.0 percent).

The services in which the greatest number of respondents noted a decline in usage were Paper Check Clearing (22.6 percent) and Check 21 Enabled Service (5.7 percent). The services with the largest increases in usage were ACH Originations (44.2 percent), ACH Receipts (39.2 percent) and Fedwire Funds Service (24.5 percent). Of the 26 services in the survey, 24 showed a positive net usage change from a year ago. Presentment Point Services showed no net usage change, while Paper Check Clearing had a net decline in usage among respondents.

Participants were asked to rate the Federal Reserve services on a scale of one to five with five indicating an "excellent" rating (Table 4). Credit unions participating in the survey were generally pleased with the quality of Federal Reserve services, and ratings were little changed overall from a year ago. All 26 of the services included in the survey received an average rating above three, or "average." The Federal Reserve services with the highest ratings were FedLine Advantage (3.8 rating), Fedwire Funds Service (3.7 rating) and National Settlement Service (3.7 rating). FedTransaction Analyzer Service received the lowest rating (3.2 rating).

Ten of the services received a lower average rating than in 2016, while five received a higher rating (Chart 3). The services that saw the largest decline in their average ratings were Presentment Point Services (-0.4), Coin and Currency Orders (-0.2), FedTransaction Analyzer Service (-0.2) and ACH Risk Management Services (-0.2). The services that saw the largest rating improvements were National Settlement Service (+0.4) and Fedwire Securities Service (+0.3).

Survey participants were also asked to review the overall competitiveness of Federal Reserve services. A large majority (69.8 percent) felt that the Federal Reserve services were either "competitively" or "very competitively" priced (Chart 4). This is a slight decrease from 2016, when 70.2 percent rated Federal Reserve service pricing as either "competitive" or "very competitive." Less than 2 percent of the participants rated the Federal Reserve services as "not competitively" priced. The specific service identified as "most competitively-priced" was ACH Transaction, while the service viewed as "least-competitively priced" was the Fed Discount Window.

Chart 3 | Change in Rating of Federal Reserve Services: 2016 to 2017

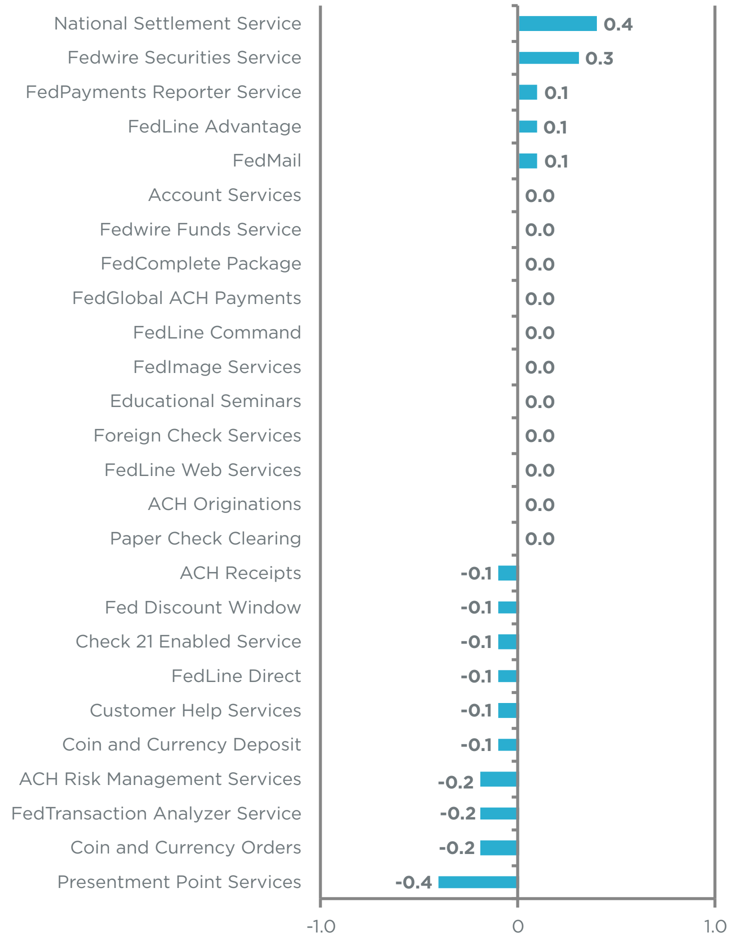
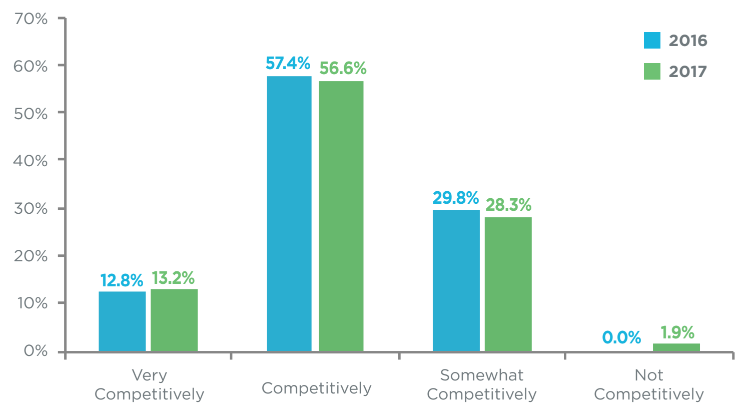


Chart 4 | Overall Competitiveness of Federal Reserve Service Pricing



LEGISLATIVE ISSUES FACING CREDIT UNIONS

Preserving the Credit Union Tax Exemption

The Federal Credit Union Act grants credit unions a tax exemption because "credit unions are mutual or cooperative organizations operated entirely by and for their members." Credit unions are eligible for tax-exempt status because they operate on a not-for-profit basis, are organized without capital stock, and for mutual purposes. These defining characteristics of a credit union, no matter what the size, persist today as they did in 1934 when the Federal Credit Union Act was first enacted.

NAFCU President and CEO Dan Berger discussed tax reform and the importance of credit union regulatory relief during a Fox Business television segment in August.

Credit unions still pay many taxes and fees, among them payroll and property taxes. Moreover, share dividends paid to credit union members are taxed at the membership level. Unlike banks, credit unions are restricted in where they can invest their members' deposits and are subject to stringent capital requirements. While a bank has stockholders, a credit union's owners are its members and each member has one vote, regardless of the amount on deposit.

Preservation of the credit union tax exemption continues to be NAFCU's top legislative priority. While no member of Congress has proposed eliminating the exemption, NAFCU remains vigilant as Congress eyes comprehensive tax reform in 2017. A NAFCU study on the benefit of the tax exemption, released in January of 2017, found that the presence of credit unions provided an average of $16 billion annually in benefits to consumers, businesses and the U.S. economy. Removing the credit union tax exemption would result in the loss of 900,000 jobs and cost the federal government $38 billion in lost income tax revenue over the next 10 years. Over time, possible consequences to credit unions and their members include a loss of the self-help, volunteer identity, higher rates and fees, increased industry risk impacting the safety and soundness of the credit union industry, and erosion of the volunteer base. NAFCU remains vigilant in educating lawmakers about the value of the credit union tax exemption and ensuring larger tax reform efforts do not alter credit unions' tax-exempt status.

Regulatory Relief

Broad-based regulatory relief continues to be a top priority for NAFCU and its member credit unions. Credit unions continue to face a staggering wave of compliance burden in today's regulatory environment. Lawmakers across the political spectrum recognize that credit unions did not engage in the risky behaviors that led to the financial crisis, yet credit unions continue to face a litany of new regulations aimed at those institutions that did. The compliance burden is not attributable to any single regulation from any single agency, but rather, the cumulative layers of duplicative, conflicting and onerous regulations that overall create an overwhelming burden for credit unions. This onslaught of regulation is becoming more than many credit unions can bear, resulting in further consolidation among credit unions. Over 1,700 credit unions have disappeared since the passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) in 2010—at a rate of approximately one credit union loss per day—and over 95% of those were small institutions with under $100 million in assets. Many smaller institutions simply cannot keep up with the new regulatory tide. Meanwhile, surviving credit unions must divert resources in order to meet all of the compliance requirements.

Asked to rate the magnitude of the anticipated challenges facing credit unions over the next three years, approximately 62 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated meeting

NAFCU witness Steve Grooms, president and CEO of 1st Liberty Federal Credit Union of Great Falls, Mont., testifying before the Senate Banking Committee in June on meaningful regulatory relief for the credit union industry.

regulatory compliance requirements represented a "significant" challenge to credit unions. Ballooning compliance costs are also a major challenge. The vast majority of respondents (70 percent) cited the current regulatory environment as an area they expect to drive significant spending increases over the next three years.

A healthy and appropriate environment is crucial for credit unions to thrive. History can attest that a robust and thriving credit union industry benefits our nation's economy, as credit unions often fill a need for consumers and small businesses in the financial services marketplace not otherwise met by other institutions.

NAFCU supports several basic tenets of a healthy and appropriate regulatory environment:

- A regulatory environment that allows credit unions to grow.
- Appropriate, tailored regulation for credit unions and relief from growing regulatory burdens.
- A fair playing field.
- Transparency and independent oversight.
- A strong, independent NCUA as the primary regulator for credit unions.

Regulatory relief for community focused financial institutions has been under consideration in the 115th Congress. In June 2017, the House of Representatives passed H.R. 10, the *Financial CHOICE Act of 2017*. The CHOICE Act includes reforms to the Consumer Financial Protection Bureau, an off-ramp for risk-based capital requirements, and numerous NAFCU-supported regulatory relief provisions already marked-up and passed by the House Financial Services Committee. The bill also contains numerous other NAFCU-sought measures, including requiring regulatory agencies to improve their cost-benefit analyses and better tailor regulations to the size and scope of the regulated institutions. It would also preserve the NCUA Board's current three-member structure and mandate agency budget transparency. The measure now awaits consideration by the Senate.

In addition, H.R. 2133, the *CLEARR Act of 2017* contains key elements of regulatory relief for credit unions, including increasing the "small servicer" exemption thresholds; waiving escrow mandates for certain loans; repealing small business data collection requirements; raising the Dodd-Frank Act's current $10 billion asset-level exemption to $50 billion; and providing a qualified mortgage safe harbor for portfolio loans.

NAFCU continues to work to ensure that the best interests of credit unions are preserved as these regulatory relief measures move through the legislative process.

Data and Cybersecurity

Data security and cybersecurity are important issues for credit unions, especially with the continued growth of online commerce and banking. Some institutions have found themselves victims of denial of service attacks and data breaches, in addition to other cybercrimes that threaten to compromise the financial information of a member. As an industry, credit unions and other financial institutions must increase their collaboration and work together to combat these crimes. NAFCU's June 2017 *Economic & CU Monitor* member survey found that approximately 92 percent of respondents' costs related to data and cybersecurity have increased over the past three years. Asked to rate the magnitude of the anticipated challenges facing credit unions over the next three years, 69 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated maintaining a secure electronic environment represented a "significant" challenge to credit unions.

Chevron Federal Credit Union President and CEO Jim Mooney emphasized the importance of a national data security standard during his testimony on behalf of NAFCU before the House Small Business Committee in March.

A primary concern of credit unions and their members continues to be ensuring that our nation's retailers have data security standards to protect consumers' sensitive financial information. Data and cybersecurity breaches are a serious problem for both consumers and businesses, and stronger safeguards for consumers are necessary. Traditionally, consumers have trusted that entities collecting their financial information will take necessary steps to protect them from risk. Unfortunately, in the wake of numerous significant retailer breaches in recent years, consumers are losing that trust. While both merchants and credit unions are targets of cyberattacks and data thieves, only credit unions and other financial institutions have been subject to standards on data security since the passage of the Gramm-Leach-Bliley Act. Retailers and many other entities that handle sensitive personal financial data are not subject to these same standards. Credit unions bear a significant burden as they must absorb fraud-related losses, and often suffer steep losses in reestablishing member safety after a data breach occurs.

A June 2017 survey of NAFCU members found that the estimated costs associated with merchant data breaches in 2016 were $362,000 on average. Credit unions, while rarely being the source of data breaches, were notified an average of 189 times in 2016 about possible breaches to members' financial data. Aside from the tremendous direct costs to credit unions from merchant breaches (for example, investigation and monitoring costs, card reissuance, fraud losses, and insurance expenses), credit unions bore significant intangible costs or impacts from merchant data breaches in the past year, including increased customer service activity (83 percent) and damage to the credit union's reputation (56 percent). As owners of not-for profit cooperatives, credit union members are ultimately impacted by these costs.

With the recent massive data breach at Equifax, Congressional attention is again turning to this important issue. NAFCU continues to advance the call for uniform national data security standards for all parties handling sensitive consumer financial information. At a minimum, NAFCU would like to see that any comprehensive data security bill include: the payment of associated costs by breached entities; national standards for safekeeping of information; data security policy disclosures; timely and public disclosure of breached entities; enforcement of prohibition on data retention; notification of the account servicer; and the burden shifted to the breached entity.

NAFCU has called on Congressional leaders to introduce legislation similar to the *Data Security Act of 2015* to create a national standard of data protection that applies to all entities in the payments chain. Further, the public sector should play a larger role in information sharing so that "known" threats are shared and can be guarded against. NAFCU supports efforts to create a new cybersecurity framework that encourages or even mandates a greater level of collaboration, not only between financial institutions, but also between the public-private sectors, in addition to protecting our nation's cyber infrastructure.

Interchange Fees

In 2017, NAFCU has continued to push for repeal of the Dodd-Frank Act's amendment on interchange fees (Durbin amendment). NAFCU is also opposed to any efforts to expand interchange price caps to credit products.

NAFCU's 2017 *Federal Reserve Meeting Survey* found that, overall, 54 percent of credit unions have seen per-transaction interchange rates decrease since the Durbin amendment went into effect in October 2011. The impact of this change is notable in light of the fact that nearly three-quarters of respondents indicated that their current budget for data security represents a larger share of the credit union's overall budget, compared to its pre-Durbin budget. Only 1.4 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* said a one-cent adjustment for certain issuers is sufficient to defray these growing costs. NAFCU continues to advocate on behalf of our members to raise the cap on debit interchange fees.

The Electronic Payments Coalition, of which NAFCU is a member, has launched a campaign based on the results of a recent study proving that retailers paid much less in interchange fees while passing no savings on to consumers. Data shows that the retail industry has already seen $825 million in savings since the federal regulation on debit cards went into effect. NAFCU will continue to work on behalf of our members to preserve a reasonable return for credit unions from interchange fee income.

NAFCU witness Sonya McDonald, executive vice president and chief lending officer at Randolph-Brooks Federal Credit Union, told the House Small Business subcommittee that the arbitrary cap on credit union member business lending must be lifted so credit unions can better serve community small businesses during her testimony in March.

Member Business Lending

NAFCU has long advocated for member business lending (MBL) reform, both through legislation and through regulatory relief from NCUA. The agency's revised MBL rule, backed by NAFCU and effective January 2017, removed many of the prescriptive underwriting and personal guarantee requirements, thereby eliminating the overly burdensome waiver process. NAFCU has continued to vocally support NCUA and the legality of its MBL rule in the face of legal challenges against the rule. NAFCU is also working with Congress to advance legislation to provide relief from the arbitrary statutory MBL cap.

When Congress passed the Credit Union Membership Access Act (CUMAA),P.L.105-219, in 1998, it put in place unnecessary restrictions on the ability of credit unions to offer business loans to their members. CUMAA codified the definition of a member business loan (MBL) and limited a credit union's MBLs to the lesser of either 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets and set the threshold for a member business loan at $50,000 and above.

As the country continues to recover from the financial crisis, credit unions have the capital to help America's small businesses thrive. However, due to the outdated and arbitrary MBL cap, their ability to create jobs and help stimulate the economy by providing credit to small businesses is hampered. Removing or modifying the credit union MBL cap would help provide economic stimulus without using taxpayer funds.

In the 115th Congress, NAFCU has continued to pursue support and passage of legislation to increase or remove the arbitrary MBL cap currently imposed on credit unions. In January 2017, the *Credit Union Residential Loan Parity Act*, H.R. 389, was reintroduced in the House. The bill would exempt loans for non-owner-occupied, one- to four-unit dwellings from credit unions' statutory MBL cap, making it possible for credit unions to lend more to small businesses without running up against the current cap. In April 2017, similar legislation introduced in the Senate would also exclude loans for the purchase of one-to-four unit, non-owner-occupied buildings from the statutory cap. NAFCU has a strong history of supporting credit union member business lending and is committed to pursuing all legislative avenues to move this issue forward, including seeking alternative solutions to easing restrictions on credit union business lending. For example, as an alternative to lifting the arbitrary MBL cap, NAFCU would support legislative efforts to raise the minimum loan amount that would count against the MBL cap.

In February of 2016, the NCUA Board unanimously approved changes to their MBL rules to eliminate the unnecessarily burdensome process that was in place for approving loans. The final rule allows credit unions to implement a principle-based risk management policy related to their commercial and business lending activities. It is important to recognize that NCUA's MBL rule provides some regulatory relief, but does not alter the statutory cap on credit union member business lending established in the Federal Credit Union Act nor circumvent congressional intent. The statutory cap imposes an aggregate limit on an insured credit union's outstanding MBLs and the regulation does alter that limit. Credit unions need Congress to provide that relief. Additionally, this final rule does not change the requirement that credit unions have strong commercial lending underwriting standards.

In September 2016, the Independent Community Bankers of America (ICBA) filed a lawsuit against NCUA challenging the agency's final rule. ICBA's complaint alleges that NCUA violated the Administrative Procedure Act by carving out new commercial lending exemptions not expressly authorized by the Federal Credit Union Act. In January 2017, the United States District Court for the Eastern District of Virginia dismissed the lawsuit on procedural grounds, noting that the suit was untimely and ICBA lacked standing because it could not show an impending harm to its members due to the final rule. Aside from those procedural defects, the Court opined that the MBL rule would still pass muster under federal law.

NAFCU continues to support the rule, which eases regulatory burdens so credit unions can better serve the needs of their small-business members.

Capital Reform

NAFCU continues to push for a fair capital system for all federally-insured credit unions that both provides for true risk-based capital and access to supplemental capital. In October 2015, the NCUA Board approved a final risk-based capital (RBC) rule, which will take effect January 1, 2019. NAFCU consistently opposed this rulemaking and urged its withdrawal. While significant concerns remain, the final rule is an improvement over the first RBC proposal issued in 2014. The final rule recalibrates many risk weights to better align with banks' requirements, removes interest-rate risk from the calculation of the risk-based capital ratio, and extends the implementation date.

However, to create a true and fair risk-based capital system for credit unions, NAFCU fundamentally believes that legislative reforms are necessary. NAFCU has outlined a legislative solution that will institute fundamental changes to the credit union regulatory capital requirements. The plan, as it relates to capital reform:

- Directs the NCUA to, along with industry representatives, conduct a study on prompt corrective action (PCA) and recommend changes;
- Modernizes capital standards to allow supplemental capital, and directs the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks; and
- Establishes special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

In addition to a legislative solution to risk-based capital, NAFCU is also seeking access to supplemental capital for credit unions. Currently, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth (such as share growth) can dilute a credit union's regulatory capital ratio and trigger non-discretionary supervisory actions under PCA rules.

Allowing all credit unions access to supplemental capital, in addition to retained earning sources, will help ensure healthy credit unions can achieve manageable asset growth and continue to serve their member-owners efficiently.

Since at least 2016, NCUA has been considering potential supplemental capital solutions and in February 2017, the agency sought public comment on an Advanced Notice of Proposed Rulemaking (ANPR) on alternative forms of capital, including both secondary capital and supplemental capital. NAFCU is generally supportive of these regulatory efforts to allow credit unions alternative forms of capital, so long as they do not conflict with the mutual, cooperative structure of credit unions.

On February 28, 2017, Reps. Peter King (R-NY) and Brad Sherman (D-CA) reintroduced, for the 115th Congress, the *Capital Access for Small Businesses and Jobs Act*, H.R. 1244, that would allow federal credit unions to receive payments on uninsured, non-share capital accounts, provided certain criteria are met, most particularly that of maintaining a credit union's mutuality. NAFCU continues to advocate for capital reform for credit unions. Ultimately, NAFCU believes legislative action is necessary to bring about comprehensive capital reform for credit unions such as allowing credit unions to have access to supplemental capital sources, and making the statutory changes necessary to design a true risk-based capital system for credit unions.

Housing Finance Reform

Effective housing finance reform that preserves a government guarantee, maintains unfettered access to the secondary market and ensures fair pricing for credit unions based on loan quality, not volume, remains a top legislative issue for NAFCU as lawmakers continue deliberations on the disposition of the Government-Sponsored Enterprises (GSEs), including Fannie Mae and Freddie Mac.

The GSEs enable credit unions to obtain the necessary liquidity to provide new mortgages for their member-owners by utilizing the secondary market. In addition, the Federal Home Loan Banks (FHLBs) allow credit unions to meet their liquidity needs through timely loans. The availability of these stable and reliable sources of funding has facilitated credit unions' ability to offer new mortgage loans and related credit to their members, many of whom have been denied access to homeownership by other lenders. The GSEs and FHLBs have long served as valuable partners in credit unions' efforts to meet their members' mortgage needs. This continues to be true in the current economic environment.

In the over eight years since the federal government took Fannie Mae and Freddie Mac under conservatorship, the GSEs and the secondary mortgage market have continued to be a key topic of congressional debate. More recently, several lawmakers and agency heads have indicated that housing finance reform will be a major agenda item under their leadership. NAFCU is committed to educating Congress and the Administration about the positive impact the secondary market has had for the credit union community and the role credit unions play in ensuring the safety and soundness of America's housing market. In any housing finance reform efforts, NAFCU will push for equal access to the secondary market for credit unions and fair pricing based on loan quality as opposed to volume.

REGULATORY ISSUES FACING CREDIT UNIONS

Credit unions are laboring under significant regulatory burden and growing compliance costs. Regulatory burden is the top challenge facing credit unions today. Reducing burdensome and unnecessary regulatory compliance costs is the only way for credit unions to thrive and continue to provide their member-owners with basic financial services and the exemplary member service they need and deserve. Indeed, 84 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated that "a healthy, appropriate regulatory environment" is critical to their credit union's continued growth and success.

Compliance costs in the aftermath of the economic crisis have skyrocketed. NAFCU's 2017 *Federal Reserve Meeting Survey* found that the number of full-time equivalent (FTE) staff members devoted to "total compliance activities" has increased 114 percent since 2010, and 87 percent of respondents expect it will be necessary to increase the number of compliance FTEs even more. Meanwhile, compliance expenses have increased 289 percent since 2010. The impact of this growing compliance burden cannot be overstated. Since the second quarter of 2010, over 23 percent of the credit union industry has been lost. While there has been a historical consolidation trend in the industry, this trend has accelerated since the passage of the Dodd-Frank Act. Many institutions simply cannot keep up with the new regulatory tide. While smaller credit unions continue to disappear due to the growing burden, all credit unions are finding the current regulatory environment challenging. Credit unions did not contribute to the financial crisis yet are still subject to increasing regulatory requirements mandated under the Dodd-Frank Act.

While credit unions continue to look for ways to provide forward-thinking products and services to better serve their members, regulatory overreach continuously thwarts that innovation. Ultimately, regulators must work to strike a balance between industry safety and market growth.

Federal Reserve

Payments

NAFCU and its members continue to be engaged in the Federal Reserve's evolving payments initiative and Roadmap for the U.S. Payments System. NAFCU is a member of the Federal Reserve's two payments task forces: the Faster Payments Task Force and the Secure Payments Task Force. NAFCU's goal is to ensure that any new payment system can be cost-effective, operationally effective, and scalable for credit unions of all sizes.

NAFCU appreciates the Federal Reserve's efforts in gathering industry stakeholders' input on potential payment solutions that could benefit both financial services providers and their customers by increasing the speed and security of sending and receiving money. NAFCU and our members appreciate the Federal Reserve's recognition of the industry-wide movement toward the adoption of faster payment technologies with its approval of enhancements to its same-day automated clearing house (ACH) service. However, NAFCU continues to believe that it is best for the industry to lead the way to innovate and improve the U.S. payment systems rather than for the Federal Reserve to attempt its own reforms that risk resulting in unintended consequences.

Last year, the National Automated Clearinghouse Association (NACHA) adopted a rule mandating that all receiving financial institutions provide same-day processing of ACH transactions. The originating depository financial institution is required to compensate the receiving institution 5.2 cents per transaction in order to offset the costs of implementation and ongoing administration. However, about 65 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated the fee is either "somewhat" or "significantly" lower than the amount needed to offset their true costs.

With respect to the Secure Payments Task Force's draft payment use-cases descriptions, including the draft Card Signature Payment Use Case, NAFCU is concerned that without thorough vetting, a Federal Reserve Task Force report could complicate messaging on a number of issues related to PIN, interchange, and EMV if not properly scoped. NAFCU believes it is imperative that the Secure Payments Task Force remain neutral regarding the value of any particular authentication method, in order to avoid unintentionally opening a policy debate about authentication methods. In general, NAFCU believes that federal regulators should refrain from endorsing any single authentication method.

NAFCU looks forward to working with the Federal Reserve and other industry stakeholders in the future to ensure a payments model that is more efficient, secure, and cost sensitive for its members.

Debit Card Interchange Fees

NAFCU continues to believe that the current cap on interchange fees remains too low. Although a low fee cap does not directly influence fees charged by smaller issuers, market forces have driven down the fees financial institutions of all sizes can charge. Further, the impact of this low fee cap is substantially greater for credit unions compared to other institutions because, unlike other financial institutions, credit unions cannot raise capital simply by going to the open market. The only capital credit unions can raise comes from their members in the form of retained earnings. Based on a May 2017 survey of NAFCU members, 50 percent of credit unions indicated that their current per-transaction debit interchange rates are "significantly" or "somewhat" lower than pre-Durbin rates for signature transactions. Meanwhile, about 55 percent of respondents said that their current per-transaction debit interchange rates for debit and PIN transactions are "significantly" or "somewhat" lower than pre-Durbin rates.

In an era of continuous data breaches and cybersecurity concerns, fraud monitoring costs are the highest yet. A large majority (75%) of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated that their current data security budget, comparatively to pre-Durbin, represents a larger share of the credit union's overall budget. While the Federal Reserve's final rule implementing the debit interchange cap includes a one-cent adjustment for issuers who meet certain data security requirements, one cent is simply not enough. Less than 2 percent of respondents to NAFCU's survey indicated the one cent per debit transaction is sufficient to mitigate inflating data security costs. NAFCU believes that additional adjustments are necessary to capture all of the costs associated with fraud protection.

Regulation D

The outdated restriction on "convenience transfers" under Regulation D presents an ongoing concern for NAFCU and its members. The current law is burdensome, confusing, and prevents credit union members from enjoying unfettered access to their funds. Consumers are often unable to understand and remember the arbitrary limits on the number and types of transfers the regulations permit them to make from their savings account. The regulation is antiquated given our technological society and, consequently, the transfer restrictions are incongruent with modern realities. Consumers would benefit from a modification to the regulation that reflects their contemporary needs and the current financial services environment.

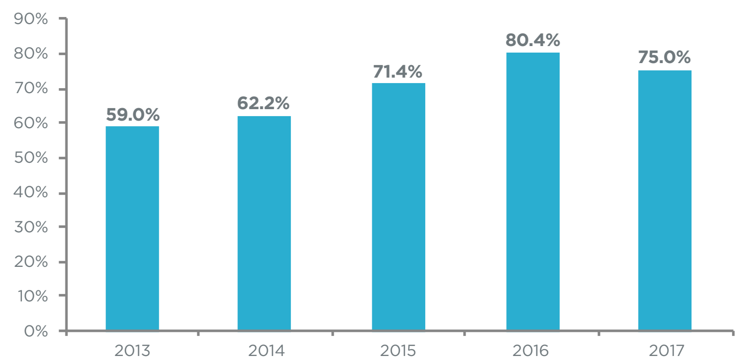
Modern consumers expect to have the ability to transfer their funds with ease to and from particular accounts, and the regulation's six-transfer limitation from savings accounts creates an undue burden for both consumers and financial institutions. Roughly 80 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* did not believe it is necessary to limit the number of monthly transfers on accounts that fall under Regulation D. About a quarter of all respondents indicated they treat all accounts as transaction accounts for reserving purposes, largely to simplify compliance with the burdensome six-transfer limitation. NAFCU believes that the Federal Reserve should update and increase this six-transfer limitation, while maintaining the distinction between savings and transaction accounts.

Regulation CC

In general, NAFCU encourages the Federal Reserve Board to closely evaluate and modernize the language of Regulation CC in order to bring it in line with the rest of the Board's current regulatory framework and applicable requirements under the Dodd-Frank Act and other legislation. The outdated terminology and requirements still found in Regulation CC are both confusing and misleading for financial institutions and pose serious compliance and safety and soundness concerns.

NAFCU believes that the regulation's timeframe for making personal checks available should be increased from two business days to three business days. In addition, NAFCU urges the Federal Reserve to allow a credit union greater ability to hold a cashier's check or money order, rather than requiring next day availability. The current requirement creates undue risk for both the credit union and the credit union member because the rule does not allow sufficient time to determine if a check could be counterfeit or there are insufficient funds. Three-quarters of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* reported seeing an increase in check fraud in recent years due to restrictions on hold times (Chart 1).

Chart 1 | Credit Unions Experiencing an Increase in Check Fraud in Recent Years Due to Reg CC



Source: NAFCU Federal Reserve Meeting Surveys

Additionally, NAFCU does not support eliminating provisions regarding case-by-case holds. Many credit unions employ such holds to protect against bounced checks and, although the absence of non-local checks makes the extended hold period less useful, it is still a worthwhile instrument compared to a complete lack of protection for many credit unions. Further, NAFCU does not support eliminating entirely the notice in lieu of return. Although there are fewer instances where such notice is necessary as processing systems become more digitized, there remain situations where the notice serves as the best method available to a credit union returning a check and the additional flexibility thus provides an important and continuing benefit.

NAFCU is generally supportive of the Board's recently proposed presumption of alteration under Regulation CC, as it will provide certainty and predictability in the check collection process. Check collection today is predominantly electronic, and the instances where an original paper check is available for inspection in the event of a dispute are rare. Adoption of an evidentiary presumption of alteration in Regulation CC could be beneficial where there is disagreement as to whether the dollar amount or the payee on a substitute check or electronic check has been altered or forged, and the original paper check is unavailable for inspection. NAFCU anticipates that a regulatory presumption will help resolve conflicting court opinions which address whether a fraudulent substitute or electronic check should be treated as altered or forged when the original check cannot be presented as evidence.

Consumer Financial Protection Bureau

The CFPB has rulemaking authority for all credit unions, regardless of size, and has examination and enforcement authority over credit unions with more than $10 billion in assets. In the wake of Dodd-Frank, NAFCU was the only credit union trade association to oppose the creation of the CFPB. NAFCU remains opposed to the CFPB's authority over credit unions, given that credit unions were not responsible for the financial crisis and, despite that, credit unions are more highly regulated than any other financial depository institution. The CFPB should be cognizant of NCUA's role as primary regulator for credit unions and recognize the positive role that credit unions serve in the financial services industry. In doing so, they should be aware of not only the detrimental impact their rules can have, but also focus on the unique benefits that credit unions consistently provide to consumers.

NAFCU has consistently taken the position that CFPB's oversight over credit unions is unwarranted and we will continue to urge the CFPB to make better, more effective decisions in how it exercises its authority, including exempting credit unions from its regulations under Section 1022 of the Dodd-Frank Act.

Reforming the CFPB has always been a top priority for NAFCU advocacy. Litigation calling into question the constitutionality of a single CFPB director could open the door to legislative reforms to the CFPB, including improvements to its leadership structure and subjecting it to the appropriations process.

In June 2017, the Department of the Treasury released its report, "*A Financial System That Creates Economic Opportunities: Banks and Credit Unions*," detailing numerous proposals aimed at helping the financial services industry to better serve its members and communities. Among these proposals were several changes to the CFPB, including clearer rulemaking or guidance on unfair, deceptive, or abusive acts and practices (UDAAP) and governance reform, including the possibility of changing the sole director to a bipartisan commission.

Also in June, the House of Representatives passed *Financial CHOICE Act*, which, among many other provisions, includes several substantive changes to the CFPB. In addition to this legislation, there are a number of other bills to help improve the CFPB from a credit union perspective.

The CFPB is currently working on a number of regulatory issues of particular interest to the credit union industry. The following is a summary of some of the more important issues raised by the CFPB's rules.

Unfair, Deceptive, or Abusive Acts and Practices

Since the enactment of the Dodd-Frank Act, and particularly in recent years, NAFCU has worked to seek clear, transparent guidance from the CFPB on its expectations for credit unions under the law. Of special concern are those areas of the law, such as a call for a focus on unfair, deceptive, or abusive acts and practices (UDAAP), that provide few or no specific directives for implementation and for which neither the CFPB nor NCUA has provided any specific guidance. Meanwhile, the CFPB continues to regulate through enforcement action in this area. NAFCU believes that additional Dodd-Frank guidance—articulating clear supervisory expectations—is necessary to ensure credit unions have the information they need to ensure their operations are safe, sound, and reflective of the spirit and letter of the law governing them.

Qualified Mortgages

The CFPB has issued a final rule that imposes requirements on credit unions to assess and verify a borrower's ability to repay a mortgage loan before extending the loan. In that same rule, the CFPB defined "qualified mortgage" and extended legal protections to mortgages that meet the definition. The rule extends a "safe harbor" legal protection to prime loans that meet the qualified mortgage definition, while a rebuttable presumption of compliance would apply to non-prime loans.

Many of NAFCU's members have decided to extend only mortgages that meet the definition of safe harbor "qualified mortgage" as they are concerned that they will not be able to sell non-qualified mortgages and are worried about the legal and regulatory risks associated with extending non-qualified mortgages. When asked about their credit union's approach to non-qualified mortgages, 40 percent of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* indicated they have ceased to originate non-qualified mortgages. Another 17 percent of respondents stated they have reduced originations of non-qualified mortgages. Due to the hesitance of lenders to extend non-qualified mortgages, NAFCU is concerned that many otherwise qualified borrowers will not be able to obtain mortgages.

NAFCU believes the definition of qualified mortgage must be revised in a number of ways to reduce the enormous negative impact the rule will undoubtedly have on credit unions and their members. Our primary concerns include the debt-to-income (DTI) threshold (43% of the total loan) and the inclusion of affiliate fees in the calculation of points and fees. The DTI threshold excludes many otherwise creditworthy borrowers from the market, while the inclusion of affiliate fees hinders the ability of credit unions to find cost savings for their members. The CFPB proposed a cure for unintentional points and fees overages. While NAFCU supported such a cure, a legislative change is still necessary to clarify points and fees calculations.

Mortgage Servicing

The CFPB's mortgage servicing rule has unnecessarily complicated mortgage servicing, greatly increased costs of servicing and jeopardized credit unions' established practices that center on relationships with members. NAFCU's concerns with the rule include the cost and burden related to the host of new or greatly revised periodic statement, policies, procedures and notices it requires, as well as the timing and inflexible procedural requirements related to how a credit union must deal with delinquent borrowers and take loss mitigation actions. Although the rule does exempt credit unions that service 5,000 or fewer mortgages, along with affiliates, from some of the requirements, mortgage servicing costs have nevertheless greatly increased for all credit unions.

Reputation Risk

The CFPB continues to encourage consumers to utilize its Consumer Complaint Database. The CFPB created the publicly available database in early 2012 to disclose credit card complaints received from consumers. The database has since been expanded to include complaints that the CFPB receives on most financial products, such as mortgages, bank accounts and services, private student loans, other consumer loans, credit reporting, money transfers and debt collection. The database is public and available on the CFPB's website. The disclosures are made for institutions under the CFPB's supervisory authority. As of the start of this year, the CFPB had reportedly handled approximately 1,080,700 consumer complaints through the public Consumer Complaint Database.

In 2015, the CFPB issued its Final Policy Statement announcing that consumers would have the ability to include narratives when filing a complaint on the CFPB's database. Only those narratives from consumers who opt-in and give their consent to use their narratives are published. The CFPB assures that all narratives are scrubbed of information that would make the consumer identifiable. Financial institutions, including credit unions, are then able to submit a narrative response for inclusion in the consumer complaint database.

NAFCU believes that the CFPB Consumer Complaint Database presents a very specific reputational risk concern for financial institutions. These complaints follow a pattern of unverified information that is given credibility by the mere fact that the CFPB is posting it on their website. There is no mechanism to ensure the complaints are fully vetted. Consequently, narrative data accompanying unverified complaints filed against each institution could be misleading and could create reputational risks that cannot be easily mitigated. Credit unions have unique relationships with their members and NAFCU supports resolution and investigation of valid and verified member complaints by the credit unions, but the reputation risk brought on by unverified complaints is significant.

Remittances

In 2012, the CFPB issued a final rule on remittance transfers to individuals and businesses in foreign countries, and amended the rule several times before the October 28, 2013, effective date. Section 1022(d) of the Dodd-Frank

Act requires the CFPB to engage in an assessment of any significant rule no later than five years after the rule's effective date, and to publish a report of the assessment. The CFPB conducted that assessment earlier this year.

NAFCU members consistently voice concerns regarding the effects of the remittance rule. The rule has resulted in increased confusion and costs to consumers. NAFCU's May 2017 *Economic & CU Monitor* member survey found that more than 11 percent of those that offered remittance services before the rule was promulgated have now stopped offering that service to members and even more were considering dropping the service. The compliance burden is simply too high. Between the countless disclosure requirements and additional fees, many credit unions have come to realize they cannot justify continuing to offer remittance services. With fewer credit unions now providing these services, consumers' options are severely limited.

Of those credit unions that do still offer remittance services, many have expressed frustration that their members are deeply dissatisfied with the remittance process, particularly the disclosure requirements. On a fundamental level, consumers do not use the disclosures and are confused as to why they must receive them. The disclosures also extend the time required for the entire remittance process, affecting both the credit union and the consumer.

Overall, the remittance rule has not promoted access to the market, has created inefficiencies, and has caused significant market disruption. Further, the remittance rule has failed in bringing about greater transparency and predictability of market prices. NAFCU believes the CFPB should more closely evaluate the real-world impact of the rule and consider excluding credit unions from its onerous requirements.

Home Mortgage Disclosure Act Requirements

In August 2017, the CFPB issued a final rule amending a 2015 rule that made several substantive changes to Regulation C's reporting requirements under the Home Mortgage Disclosure Act (HMDA). The amendments included in the 2015 HMDA rule take effect on January 1, 2018, January 1, 2019 and January 1, 2020.

The 2015 HMDA rule, among other things, expanded the data financial institutions are required to collect and report under Regulation C. Some of the expanded data collection and reporting is mandated by Dodd-Frank, which amended HMDA to require collection of certain new data points. However, the CFPB also appears to have taken this opportunity to collect significantly more data than Dodd-Frank expressly requires. In addition to expanded data collection, the final rule changed the scope of Regulation C's coverage to include most closed-end loans, open-end lines of credit and reverse mortgages secured by dwellings. Under this expansion, reporting is required on all HELOCs.

NAFCU believes that the Bureau should limit the changes to the HMDA dataset to those specifically mandated by Dodd-Frank. While credit unions support HMDA requirements that further the goal of ensuring fair lending and anti-discriminatory practices, NAFCU is concerned that some of the additional reporting requirements do not achieve these goals and only serve to impose significant additional compliance and reporting burdens.

Prepaid Accounts

In November 2016, the CFPB issued a final rule regarding prepaid accounts. The nearly 1700-page rule mandates comprehensive consumer protections for prepaid accounts under Regulation E and Regulation Z. The final rule modifies Regulation E to create tailored provisions governing disclosures, limited liability and error resolution, and periodic statements, and adds new requirements regarding the posting of account agreements. Additionally, the final rule regulates overdraft credit features offered in conjunction with prepaid accounts.

NAFCU has consistently supported providing consumers with helpful information about the products and services they use. Prepaid accounts offered by credit unions are among the most transparent and understandable products available in the financial marketplace. Yet the rule's array of pre-acquisition disclosures, which incorporate multiple fee schedules and specific methods for determining reportable fees, will require credit unions to thoroughly review prepaid account agreements and engage in extensive coordination with program managers for white label products. Many underserved consumers depend on prepaid accounts to avoid the higher costs associated with traditional products or financial services. A highly regulated prepaid account environment could adversely affect these financially vulnerable consumers by forcing credit unions to discontinue prepaid products.

Earlier this year, the CFPB proposed amendments to the prepaid accounts rule that would provide some relief, particularly in the context of drawing reasonable limits on the applicability of Regulation E's error resolution provisions to unverified prepaid accounts. Nevertheless, NAFCU believes the CFPB should rescind the rule entirely to avoid the risk of disrupted service or loss of access to affordable prepaid products. Alternatively, the CFPB should exempt credit unions from the rule. The transition to new disclosures, new systems, and potentially new service agreements will result in significant costs and reduce availability of prepaid products. At a minimum, NAFCU is advocating that the CFPB delay implementation of the rule for one year, until April 1, 2019. Amendments to error resolution rules, modifications to the content and packaging of Regulation E disclosures, and the proposed written authorization requirement for linking credit features are all changes that will necessitate additional implementation time for credit unions. Given that the rule already imposes significant new burdens for credit unions, at a minimum, an adjustment to the effective date is necessary to avoid disruption of member access to prepaid account services.

Overdraft

For the past several years, the CFPB has consistently placed overdraft on its rulemaking agenda. However, the timeframe for the release of a proposal continues to be delayed due to the Bureau's tenuous statutory authority in this area coupled with consumers' continued support of overdraft programs. In addition, the Dodd-Frank Act requires the CFPB to convene a Small Business Review Panel to solicit input from small entities before introducing any formal proposed rule. In the meantime, the CFPB has released two studies of overdraft markets and conducted several high profile information collections. All of these efforts indicate the Bureau is continuing to progress toward a rulemaking on overdraft.

Credit unions are focused on providing value to their members by offering responsible overdraft protection. According to NAFCU's 2017 *Federal Reserve Meeting Survey*, nearly 55 percent of credit union members opted in to overdraft protection. In addition, a 2015 survey of our members found that every respondent offered an alternative to overdraft or courtesy pay programs, with overdraft lines of credit and linked savings or money market accounts being the most popular (84.4% each). Additionally, 97% of respondents reverse overdraft charges on a case-by-case basis. NAFCU will work to ensure that the substance of any rule does not curtail credit unions' overdraft programs.

Payday Lending

In October 2017, the CFPB issued a final rule to impose sweeping and complex new requirements on payday, vehicle title, and similar loans. The final rule serves as a comprehensive overhaul of the short-term, small-dollar lending space, potentially reaching a number of other products not traditionally associated with "payday lending." For covered loans, the rule requires the lender to undertake enhanced ability-to-repay requirements and limit the number of allowable subsequent loans. In contrast to the proposed rule, the final rule does not impose additional limitations on a federal credit union's ability to offer Payday Alternative Loans (PAL loans) under NCUA's rule, such as restricting the use of the statutory lien authorized by the Federal Credit Union Act.

Several provisions in the proposed rule would have encroached upon NCUA's authority and could have impaired prudential regulations related to safety and soundness. NAFCU will continue to advocate for a credit union exemption from the entirety of the rule.

The Bureau's final rule likely will not impact most credit unions' small dollar loan products. For those credit unions that will be impacted, simple changes should be sufficient to avoid the rule's coverage. Since the CFPB published the outline in 2015, NAFCU repeatedly met and worked with Bureau staff, explaining how the proposed coverage of credit union products would significantly limit the availability of small dollar credit. Thankfully, the final rule provided a blanket exemption for credit unions loans made under, and consistent with, NCUA's PAL loan regulation. Additionally, the Bureau produced enough carve-outs and exemptions for most non-PAL credit union products so they can continue serving their members.

Nevertheless, NAFCU has reservations about whether the final rule will truly curtail the predatory practices of bad actors in the payday loan market. In addition, NAFCU is concerned that the rule could curtail future innovation by credit unions as they develop products that address the needs of their members.

National Credit Union Administration

Field of Membership

Strengthening the credit union dual chartering system is imperative to the future strength and well-being of the industry. The credit union dual chartering system functions best when the state and federal credit union charters keep pace with one another. In recent years, however, several states have been much more progressive in modernizing their field of membership rules to recognize today's dynamic marketplace. As a result, the industry has seen multiple credit unions convert to state charters over the past year because of their inability to grow under the federal charter.

NAFCU continues to hear from our members that NCUA's field of membership (FOM) rules and regulations have unnecessarily inhibited their ability to grow and serve their communities. Moving forward, the federal charter must keep pace with changes in state laws, technology, and the financial services industry. While legislation is necessary to relax aspects of the Federal Credit Union Act's limitations on chartering, the credit union industry as a whole will benefit from the continued modernization of NCUA's chartering and FOM procedures, as well as removing all non-statutory constraints on FOM chartering and expansion. Greater outreach to underserved areas is of particular importance.

In October 2016, in the most comprehensive FOM reform initiative seen by the industry in over a decade, NCUA finalized amendments to the FOM rule and issued additional changes in a second proposal. On December 7, 2016, the American Bankers Association filed a lawsuit challenging NCUA's final rule. NAFCU strongly believes the FOM amendments are well within the agency's legal authority and is in keeping with the Federal Credit Union Act. The case is set to be heard before the United States District Court for the District of Columbia in late 2017. NAFCU has long advocated for the changes in both the finalized and proposed rule. FOM reform will help federal credit unions reach potential members who want and need affordable financial services as well as provide much needed regulatory relief by streamlining the FOM process for community, multiple common bond and TIP charters alike. This important relief measure is crucial to the future welfare of the credit union industry and NAFCU will continue to support and defend the rule.

Voluntary Mergers of Federally-Insured Credit Unions

Recently, NCUA issued a proposed rule to establish new disclosure and notice requirements for voluntary mergers of federally-insured credit unions. Among other things, the proposed rule would require merging credit unions to disclose all merger-related financial arrangements for certain covered persons and establish procedures to allow for reasonable member-to-member communication in advance of a proposed merger.

NAFCU supports a transparent and open voluntary merger process that allows credit union members to understand the benefits and costs associated with consolidation. Mergers are carefully planned transactions that must reconcile the preferences of membership with changes that are necessary to support continued, high quality service. A successful merger depends upon meticulous assessment of the compatibility of the merging and continuing credit unions, which may take years to accomplish. The length of the merger process necessitates a commitment of significant resources, a fact that typically compels diligence and tempered expectations from both credit unions.

NCUA's existing regulatory framework for mergers has fostered a consolidation process that places the needs of members first. As a result of successful voluntary mergers, members often gain access to more convenient locations and more accessible technology, as well as better rates and fees. Solid partnerships also give the combined credit unions an improved cost structure and new platforms to welcome new members to the credit union. In short, a successful merger is one where the combined members and employees are better off. NCUA's existing merger regulations provide the flexibility to identify a range of different merger processes that may be optimal in different circumstances. Credit unions must be able to select a merger process that best suits the unique facts and circumstances supporting strategic consolidation for the benefit of members and competitive viability. In contrast, the more prescriptive merger process proposed by NCUA demands protracted review of non-material information; thus, the proposal would offset the economic benefits that accrue from careful planning and timely execution of the merger transaction.

While NAFCU strongly values transparent and robust discussion regarding mergers, the proposed rule would add significant and unnecessary new burdens to the voluntary merger process. NAFCU is urging NCUA to withdraw the proposal and instead use its discretionary authority to address the narrow circumstances where enhanced transparency and communication in the merger process might be necessary.

Risk-Based Capital

In October 2015, the NCUA Board finalized a rule regarding risk-based capital (RBC) for credit unions. The rule made a number of changes to NCUA's capital adequacy rules. Most notably the final rule established a new method for computing NCUA's risk-based requirement that would include a risk-based capital (RBC) ratio measure for federally-insured natural person credit unions with over $100 million in assets. NAFCU remains concerned with the impact that RBC will have on the credit union industry. NAFCU worked to mitigate the negative impacts of the rule and, as a result, the final rule recalibrated many risk weights to better align with banks' requirements, removed interest-rate risk from the calculation of the risk-based capital ratio, and extended the implementation date. NAFCU continues to advocate for the NCUA Board to revisit and reconsider its approach to RBC.

NAFCU supports an RBC system for credit unions that would reflect lower capital requirements for lower-risk credit unions and higher capital requirements for higher-risk credit unions. However, we continue to believe that Congress needs to make statutory changes to the Federal Credit Union Act in order to achieve a fair system. Such a system should move away from the static net-worth ratio to a system where NCUA joins the other banking regulators in having greater flexibility in establishing capital standards for institutions. NAFCU also believes that capital reform must include access to supplemental capital for all credit unions.

NAFCU has outlined a legislative solution that will institute fundamental changes to the credit union regulatory capital requirements. The plan directs the NCUA to conduct a study on PCA and recommend changes; modernizes capital standards to allow supplemental capital and directs NCUA to design a risk-based capital regime that accounts for material risks; and establishes special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

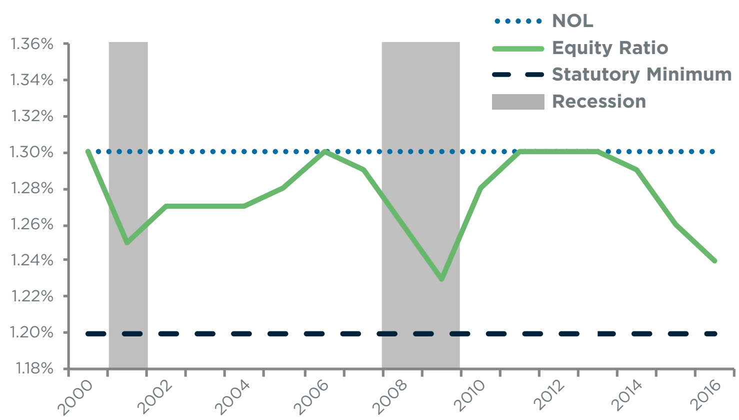
Closure of the Temporary Corporate Credit Union Stabilization Fund

In 2009, the Helping Families Save Their Homes Act of 2009 amended the Federal Credit Union Act to provide NCUA with authorities to mitigate costs associated with stabilizing the corporate credit union system, so those costs would not have to be borne by the National Credit Union Share Insurance Fund (NCUSIF). Acting under its new authority granted by Congress, in June 2009, the NCUA Board implemented the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to cover the costs of the Corporate System Resolution Program, approved in September 2010 as a comprehensive strategy to address the failure of five corporate credit unions due to investment losses. Initially, the Stabilization Fund was set to expire after seven years. However, NCUA and the Department of the Treasury agreed in September 2010 to extend the life of the Stabilization Fund until June 30, 2021.

Late last year, NCUA announced that a NCUSIF premium charge of 3 to 6 basis points for all federally-insured credit unions could be necessary in 2017 due to a continuing downward trend of the NCUSIF equity ratio. The NCUSIF equity ratio is used as a general measure of the health of the share insurance fund. As of December 2016 the equity ratio was 1.24 percent (Chart 2). NCUA does not anticipate that the equity ratio will fall below the statutory minimum of 1.2 percent in 2017. However, as a potential solution to the declining equity ratio, in July 2017, NCUA issued a proposal to close the Stabilization Fund and raise the NCUSIF normal operating level (NOL). Under the proposal, the assets and liabilities of the Stabilization Fund would be distributed to the NCUSIF, which would improve the fund's equity ratio.

In September 2017, the NCUA Board unanimously approved the proposal to close the Stabilization Fund and raise the NCUSIF NOL by nine basis points to an all-time high of 1.39, purportedly to offset the perceived risk from the assumption of the Stabilization Fund's liabilities, as well as to provide additional protection in the event of a recession. After closure, the NCUSIF will assume the liabilities of the Stabilization Fund. Closing the Stabilization Fund and transferring its assets to the NCUSIF will increase the equity ratio to approximately 1.45 to 1.47 percent. When the equity ratio exceeds the NOL, along with other statutory requirements, the Federal Credit Union Act requires the NCUSIF to make a pro rata distribution to credit unions based on the equity ratio's excess over the NOL.

Chart 2 | NCUSIF Year-End Equity Ratio*



**After premium or dividend*
Source: NCUA

Thus, NCUA anticipates a $600 million to $800 million distribution from the NCUSIF to credit unions in early 2018, but the distribution will be about 60 percent lower than if the NOL was left unchanged at 1.30.

To date, credit unions have paid $4.8 billion in stabilization assessments and $5.6 billion in depleted capital into the Stabilization Fund. NAFCU has historically worked to ensure a strong share insurance fund, but NCUA has failed to adequately justify an unprecedented nine basis-point increase to the NOL when the current 1.3 percent has proven more than sufficient, even during the financial downturn and despite the pressures of corporate stabilization.

NAFCU believes credit unions should receive all of their money back, not just a small portion. Under NCUA's action, credit unions will only receive about 15 percent of the $4.8 billion they have paid in stabilization assessments since 2010. NCUA will retain almost $1 billion of the funds anticipated to be available through the merger of the funds. Further, in addition to the fact that there is no compelling need to increase the NOL, NCUA has failed to provide any meaningful assurance that the increase to 1.39 will be unwound in future years, suggesting only periodic reviews at undefined intervals. Finally, even if there were no merger of the funds, NCUA will not have to charge an NCUSIF premium this year. A premium charge is only statutorily required if the equity ratio falls below 1.2 percent; even NCUA's own base-case models do not project such a decline to occur for years to come. NAFCU continues to strongly advocate for additional future rebates for credit unions.

Department of Defense

Military Lending Act

In July 2015, the Department of Defense (DoD) released a final rule amending regulations under the Military Lending Act (MLA). The MLA provides enhanced protections for members of the armed services and their dependents in consumer credit transactions and establishes a Military Annual Percentage Rate (MAPR) cap of 36 percent. The 2015 rule vastly expanded the number and types of products that are subject to the MLA. Credit unions that were not previously covered worked vigorously to develop rigorous MLA compliance policies and procedures before the majority of the changes were implemented beginning October 3, 2016. Protecting members of the military and their families from predatory actors by fulfilling the purpose of the MLA is of the utmost importance to NAFCU's member credit unions. However, the complexities of the MLA rule are staggering and significantly impact credit unions. Credit unions are different than most other types of financial institutions. As member-owned, not-for-profit cooperatives, credit unions have a duty to provide members with financial products and services that are designed to help members reach their individual financial goals. The relationship between a credit union and its member is based on disclosure, fairness, and responsible practices and, in particular, credit unions have a strong track record of working with active duty members of the armed forces and their families to escape predatory practices that prompted Congress' passage of the MLA.

NAFCU and its members have repeatedly voiced concerns regarding unclear regulatory language in the MLA rule and urged DoD to remedy the numerous ambiguities and uncertainties in the rule. In August 2016, the DoD issued guidance interpreting its MLA rule. However, while NAFCU continues to support the objectives of the MLA, the DoD's interpretive guidance fell far short of addressing the extensive list of ambiguities within the language of the rule. In fact, the interpretive guidance raised some additional questions and concerns among NAFCU's members.

With an eye toward the October 3, 2017 compliance deadline for the credit card components of the MLA rule, NAFCU has continued to advocate for additional clarification from DoD throughout 2017.

Federal Communications Commission

Telephone Consumer Protection Act

In July 2015, the Federal Communications Commission (FCC) issued a Declaratory Ruling and Order to clarify its interpretations of the Telephone Consumer Protection Act (TCPA). Among other things, the order provides limited robocall exemptions under the TCPA for financial institutions making free autodialed calls to consumers. Unfortunately, the FCC's Order will make it more difficult for credit unions and other financial institutions to contact their members about identity theft or data breaches. NAFCU is concerned that the order could lead credit unions to cease important communications with members about their accounts over fear of inadvertently violating the rule. NAFCU believes that the FCC should provide more flexibility to the prescriptive requirements for financial institutions using this exemption, especially because this exemption meant to apply in exigent circumstances to protect consumers.

In addition, NAFCU is concerned about the FCC's expansive treatment of the term "automatic telephone dialing system" (auto-dialers). The FCC's order defines auto-dialers to include broadly any equipment even if it lacks the "present ability" to dial randomly or sequentially but can be modified to provide those capabilities. This interpretation is troublesome since it remains unclear what type of technology is actually covered. NAFCU believes the vague standard for what qualifies as an auto-dialer will further inhibit credit union communications to members. Furthermore, NAFCU has significant concerns about the FCC's antiquated regulations that create distinctions between mobile and residential phones. As cell phones replace traditional home phone landlines for an increasing number of consumers, the regulations may have the unintended consequence of reducing consumers' access to vital information about their financial accounts. NAFCU believes that the FCC must remove the distinction between residential and mobile phone lines as it applies to making automated informational calls to consumers about their existing accounts.

The FCC's order also creates an overly vague standard for revoking previous consent and prohibits a financial institution from controlling how the consumer may revoke consent in a reasonable manner. Thus, the order creates a system where the question of whether a consumer's revocation is reasonable becomes a subjective issue, opening up financial institutions to insurmountable liability.

Finally, the order does not provide enough flexibility with regard to the portability of wireless numbers from one consumer to another. Instead, it places a strict burden on credit unions when a consumer's phone number is reassigned. Credit unions could make one call to a reassigned number and have no reason to believe that consent is no longer valid, yet incur substantial liability even when acting in good faith.

In October 2015, NAFCU joined a lawsuit filed by the U.S. Chamber of Commerce seeking a review of the FCC order. NAFCU will continue to urge the FCC to reconsider its order relative to credit unions.

EMERGING CHALLENGES

An Evolving Financial Marketplace

The financial services marketplace is undergoing a rapid evolution driven by sweeping advances in technology and social media. Greater access to the internet and the pervasive use of mobile devices has altered consumer preferences and expectations for financial services. Now highly interconnected and tech-savvy, modern consumers want instantly accessible information and look for new, innovative, and convenient delivery channels for completing financial transactions. Hoping to capitalize on a market experiencing brisk technological change, innovators in financial technology (fintech) are entering the financial services market at a growing pace. Offering advanced technologies in marketplace lending, mobile payments, digital wealth management, distributed ledger technology such as blockchain technology, and more, these non-depository actors and startups are threatening to disrupt the traditional financial services market.

According to NAFCU's February 2017 *Economic & CU Monitor* survey, three-quarters of respondents are "very" or "somewhat" concerned about the rise of fintech in the financial marketplace. The vast majority of credit unions indicate that fintech companies could be "significantly" disruptive to the current market, particularly because of changes in consumer preferences that favor fast, innovative and accessible technologies. For example, credit unions have raised concerns about the overall market shift away from traditional brick-and-mortar services. Credit unions have also observed a greater willingness of younger consumers, especially millennials, to try new technologies from unconventional service providers. The overwhelming majority of our survey respondents identified credit or digital payments as the fintech market segments with the potential to be the most directly competitive to credit union services. At least 20 percent of respondents indicated they have already lost members or market share to fintech companies, mostly in the lending arena. Advantaged by a lower cost structure, greater efficiency and less regulation, fintech companies pose an emerging competitive threat to credit unions.

An Unlevel Playing Field

Credit unions are facing mounting pressures to keep pace with fintech innovators that are offering products and services that directly compete with credit unions, yet have the advantage of being largely unfettered by existing federal financial regulations. Credit unions, already overburdened in the current regulatory environment, are competing against fintech on an unlevel playing field.

Credit unions are more highly regulated than any other financial depository institution. Aside from strict field of membership and capital restrictions that do not apply to other charters and business models, credit unions are also subject to the numerous consumer protection provisions in the Federal Credit Union Act, including the usury ceiling, the prohibition on prepayment penalties, and the member business lending cap. The regulatory burden on credit unions is overwhelming. Comparatively, fintech providers are operating in a regulatory vacuum.

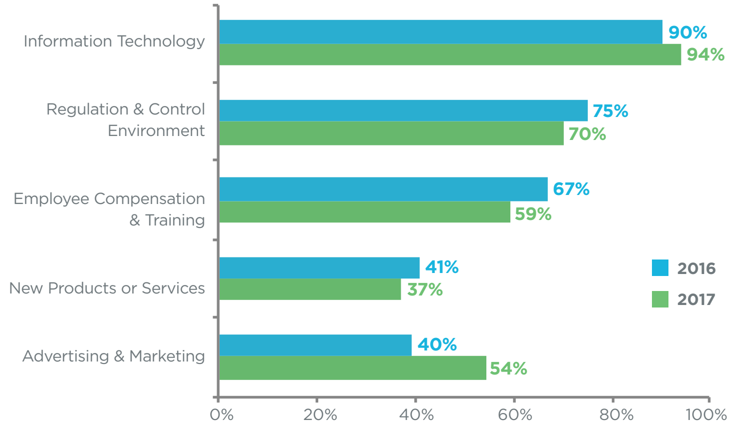
The lack of regulatory oversight over fintech is of significant concern to credit unions. Over 90 percent of those surveyed in NAFCU's February 2017 *Economic & CU Monitor* survey support federal regulation of fintech companies, with two-thirds of respondents in favor of applying to fintech the same regulatory standards that currently govern traditional financial institutions. Respondents to our survey, in equal proportion, identified consumer protection requirements, capital and liquidity requirements, and cybersecurity and data security standards as the key areas in which regulatory oversight of fintech is needed. Given the current regulatory dichotomy, most credit unions surveyed do not believe they are operating on a level playing field with fintech.

The rise of fintech providers underscores the need for Congress and regulators to modernize existing laws and regulations to address emerging technologies and new innovations. Financial regulators must require fintech companies to meet basic and fundamental consumer protections such as the Truth in Lending Act, Bank Secrecy Act and Anti-Money Laundering (BSA/AML) requirements, safe and sound loan underwriting standards, applicable state usury laws, fair lending laws, privacy protections, and others, to ensure fair and effective oversight of financial technology.

Keeping Pace with Technological Change

In a market experiencing rapid technological change, credit unions must meet their members' evolving needs by seeking new ways to innovate and grow and by making greater investments in technology. In response to changing member demands, credit unions have extended their offerings of electronic services in recent years (see *Electronic Financial Services*, page 15). Nearly 94% of respondents to NAFCU's 2017 *Federal Reserve Meeting Survey* cited information technology as the area they expect to drive spending increases the most over the next three years (Chart 1). In fact, respondents cited information technology as the top spending increase expected for the near-term, reflecting credit unions' commitment to offering leading-edge financial products to their members. When asked which areas credit unions anticipate the most need for future investment, half of all respondents to our February 2017 survey cited technological innovation and new digital services as being a key forthcoming investment, indicating that credit unions are striving to be forward-thinking in their service offerings. Nevertheless, given their budget limitations as well as the strains of compliance costs, credit unions may find it difficult to keep pace with competitors who have more resources or fewer regulatory constraints.

Chart 1 | Expected Drivers of Spending Increases Over the Next Three Years



Source: NAFCU 2016 & 2017 Federal Reserve Surveys

Along with the growing pressure to continually innovate and evolve, credit unions continue to face serious and costly threats to data security. Many credit unions have implemented sophisticated and effective data security and cybersecurity safeguards, but despite those efforts, attackers adapt to constantly evolving technology and find new ways to penetrate systems. Data security has become a constant concern of credit unions and their members as major data breaches now seem to occur with an alarming degree of regularity. American consumers' sensitive financial and personally identifiable information will only be as safe as the weakest link in the security chain. Credit unions and other financial institutions have been subject to federal standards on data security since the passage of the Gramm-Leach-Bliley Act, but fintech providers and other entities that handle sensitive personal financial data are not subject to the same standards. Although increasingly engaged in many similar activities, fintech companies are subject to significantly less stringent regulatory requirements relative to data security than are credit unions and banks. All entities that handle consumer information should be required to comply with comprehensive federal data protection standards.

Growing into the Future

Looking forward, continued outreach to millennials and young adults will be crucial to credit union strategic growth. As we all move toward a highly globalized and more integrated future, credit unions must not only be prepared to compete with fintech innovators to address the changing technological needs of its membership, but to attract a younger demographic. Helping young people understand fundamental credit union concepts such as not-for-profit status, volunteerism, and member governance will be vital to recruiting and retaining them as members into the future. As a generation with an open-minded, socially conscious worldview, today's youth face unique problems and challenges. Credit unions can find success in reaching out to millennials by exploring the shared commonalities between credit unions' central values and those of our rising generation. Credit unions — always true to their member-owned, cooperative spirit — are well positioned to offer innovative financial solutions to our youngest Americans and to develop durable relationships that will last a lifetime.

NOTES

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The National Association of Federally-Insured Credit Unions is a strong, independent, direct membership association committed to advancing the credit union community through its relentless focus on membership value in representing, assisting, educating, and informing its member credit unions and their key audiences.

NAFCU

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