NASCUS
National Association of State Credit Union Supervisors

WRITTEN COMMENTS

OF NASCUS PRESIDENT AND CEO LUCY ITO

FOR THE NCUA BOARD BRIEFING

'NCUA'S 2017 – 2018 BUDGET'

Oct. 27, 2016

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On behalf of NASCUS – including its regulator members who represent all states that issue charters for state credit unions, and state-chartered credit unions from around the country – thank you Board Chairman Metsger and Board Member McWatters for conducting today's briefing. Your commitment to transparency is greatly appreciated among our members, and by holding this briefing you have demonstrated that commitment. As Chairman Metsger has stated, the briefing itself offers another level of engagement, providing stakeholders – such as NASCUS – a role in the process.

By way of background, NASCUS is the primary resource and voice of the state governmental agencies that charter, regulate and examine the nation's state-chartered credit unions. NASCUS membership is made up of state-chartered credit unions, state regulators and other supporters of the state credit union system. Our association is the only organization dedicated to the autonomy of state credit union regulatory agencies and the defense and promotion of the state credit union charter – as well as the dual charter system.

The built-in tension of the dual charter system has been critical to the vibrancy and dynamism of today's credit union system, with American consumers benefiting from the innovation that it fosters. NCUA's budget process—in particular, its current overhead transfer rate methodology -- poses a threat to maintaining a robust dual charter system. Our comments are made in the spirit of mutual partnership and commitment to preserving this healthy tension so that American consumers can continue to prosper from the interplay between our state and federal systems.

To that end, NASCUS' comments here are grouped into three broad areas – all related to the subject of NCUA budget transparency, but not necessarily focusing on the budget. The three areas I will address are transparency for the "overhead transfer rate," clearer separation between NCUA's functions of chartering authority and insurer, and the future structure of the NCUA Board, which we believe could have a positive impact on budget deliberations of the agency.

To be clear: NASCUS has consistently held the position that it expresses no opinion about NCUA's overall budget expenditures. NASCUS believes that a regulatory agency is best positioned to know the resources it needs to maintain a safe and sound supervisory program.

However, NASCUS and its members have long held concerns regarding NCUA's management of budget funding sources and of the agency's management of its complex role as both the chartering authority of federal credit unions (FCUs) and as the administrator of the National Credit Union Share Insurance Fund (NCUSIF). Consistent with that approach, we have submitted comments and recommendations over the years to help ensure the funds in the NCUSIF are managed in an equitable manner keeping with the letter, and spirit, of the Federal Credit Union Act (FCUA). Our comments here repeat that approach.

Transparency for the "overhead transfer rate"

A persistent goal of NASCUS and the state system has been greater transparency for the overhead transfer rate (OTR), which determines the funds that are to be transferred from the NCUSIF to the operating fund of the agency to cover "insurance-related costs." To be more specific: For 2016, the OTR is 73.1%. This means that this year, $213 million of NCUA's $291 million approved budget has been funded by the share insurance fund.

Greater transparency, we believe, will be a big step to adopting an OTR that is more equitable to state and federal charters, and easier to understand.

We commend NCUA for demonstrating budgetary discipline by revising its 2017 spending plan downward by $3.8 million. However, while the decrease for the revised 2017 budget is laudable, it fails to reflect any change in the overhead transfer rate. If there are costs savings associated with "safety and soundness," those savings should be echoed in a downward adjustment to the OTR.

It matters where savings are realized because NCUA's current OTR methodology allocates all safety and soundness expenses to the share insurance fund. By the same token, it matters where any future budgetary increases are made. The proposed requested budget for 2018 shows significant increases. At this time, it is not at all clear what impact these cost increases will have on the OTR. We welcome complete transparency and a comprehendible explanation of how NCUA's budget decreases and increases will affect the OTR.

We additionally commend the agency for the Examination Flexibility Initiative, which (among other things) would establish a working group that includes state supervisors to evaluate and recommend further changes to the exam program, and proposes reductions for both 2017 and 2018 in the number of NCUA examiners, which state credit unions and regulators have long observed an excess capacity of in some regions. The EFI has the potential to reduce NCUA's budget, enhance a stronger mutual partnership between NCUA and state regulators -- and rationalize the OTR.

When the NCUA Board brought the OTR forward this spring for formal notice and comment, we greatly appreciated the action, and we again commend the Board for doing so. We availed ourselves of the opportunity by filing a comprehensive comment letter. A broad swath of the credit union system at large also commented on the issue, as represented by several state regulatory authorities, both of the major national trade groups, state associations, other organizations and state credit unions themselves. In fact, those letters shared a common thread: changes must be made to the OTR methodology.

Our letter (and those of the other groups filed) is a matter of public record; we won't repeat all of the details here. However, we do want to reiterate the following, key points from our letter:

- **The OTR is subject to notice and comment under the Administrative Procedure Act (APA)**: NASCUS agrees with Board member McWatters that the OTR is a "legal construct." As noted in the 2015 legal analysis of the OTR commissioned by NASCUS and performed by Schwartz & Ballen LLP, the OTR and the methodology used by the NCUA Board to calculate the rate is a Board statement of general applicability and future effect designed to implement and interpret the FCUA provisions pertaining to the rate. Additionally, we do not believe the OTR qualifies for any of the exemptions from notice and comment rulemaking provided for under the APA. Example: The OTR has had an adverse effect on the competitive position of FISCUs in relation to FCUs in that state-chartered credit unions have absorbed an increased percentage of NCUA expenses following the change in methodology, while FCUs have enjoyed a substantial reduction in their "out of pocket" operating fees. Taking into consideration the OTR's impact on federally insured credit unions (FICUs), the OTR and its methodology should be recognized as a legislative or substantive rule subject to notice and comment to provide FICUs -- both federal and state-charters -- an opportunity to contribute input into a process that fundamentally affects them. Notably, NCUA's sister federal bank regulatory agencies (FDIC, OCC, and the Fed) all publish their proposed assessments in the *Federal Register* for public comment pursuant to the APA.

- **NCUA expenses, under the current methodology, are improperly allocated** to the insurance fund: Doing so inflates the cost of credit union share insurance, threatens the dual chartering system by artificially disadvantaging the state system, and inhibits regulatory and supervisory innovation. Fundamentally, NCUA's current methodology that classifies all safety and soundness as solely an insurance fund concern runs contrary to both the plain language of the FCUA and the history of bank and credit union regulation in the United States.

- **NCUA has an obligation to exercise its safety and soundness responsibilities:** Contrary to the agency's fundamental premise that all safety and soundness is insurance, the FCUA states that "regulators" (as in NCUA as chartering authority) are responsible for safety and soundness to protect the public and the economy. That is why the chartering authority for national banks, the Office of the Comptroller of the Currency (OCC), examines national banks for safety and soundness. And yet, the OCC has no role as insurer of bank deposits. Neither does the Federal Reserve Board (FRB), yet it examines state chartered member banks for safety and soundness.

Overall, our position as outlined in our comment last spring remains the same: that the current allocation of NCUA's operating expenses is inequitable to the state credit union system and incompatible with the wording, and spirit, of the FCUA.

Our comment letter provided four alternatives for NCUA to consider for more equitably recognizing the costs of examination for purposes of computing the OTR:

- **The NCUSIF should treat federal credit unions, and federal credit union examinations, in the exact same manner as it treats federally insured state chartered credit unions and federally insured state chartered credit union examinations.** NCUA should examine all FCUs for compliance and safety and soundness in its capacity as chartering entity. Those exams should be used for NCUSIF purposes. To the extent additional supervision is required, then those additional costs should be borne by the NCUSIF. However, non-NCUSIF sources of funding should support a robust chartering safety and soundness examination program. As previously noted, this approach is consistent with NCUSIF treatment of FISCUs, consistent with the OCC's supervision of its national charters, and consistent with the FRB's supervision of its member banks.
- **Rather than reduce the overhead transfer by the amount of the imputed value of state examination work, the NCUA should refund that money to federally insured state chartered credit unions.** NCUA has the authority to return to FISCUs the value of the state work those FISCUs have funded. Section 1782 of the FCUA specifically authorizes NCUA to distribute funds from the NCUSIF back to credit unions. While the FCUA places limits on the agency's ability to pay distributions from the funds, these limits apply to the statutory mandate to pay distributions if the funds in the NCUSIF exceed the established operating level. Our proposal here is not a dividend distribution subject to those provisions; rather it is in effect an operating expense to the insurance fund, offsetting the cost of work performed by states, funded by FISCUs, and essential to the administration of the fund.
- **Rather than reduce the overhead transfer by the amount of the imputed value of state examination work, the NCUA should pay out those funds for the benefit of the state agencies.** In this case, the NCUA would dedicate an amount equal to the "SSA Imputed Value" for the benefit of the state agencies. Dedicating the amount for the benefit of the state agencies could take the form of increased training and technical assistance for the states, or transfer of the amount to a third party to manage on behalf of all of the states. This approach accomplishes several laudable goals.
- **The NCUA should eschew a formal overhead transfer calculation and establish the overhead transfer rate at 50% of its budget**. There might be merit in returning to a simple OTR of 50 percent of NCUA's annual operating budget. This would be consistent with the OTR for 30 of its 45 years. The advantage of this approach is it balances simplicity with an acknowledgement that a restructuring of the OTR to truly reflect NCUA's Title I prudential supervisory responsibilities could possibly represent a steep

rise in non-NCUSIF funding. Further, by tying the NCUSIF and non-NCUSIF expenses allocations to parity, NCUA can help ensure that some efficiencies of examination flow to the NCUSIF, contrary to the current approach which reverses the flow of efficiencies. Under this approach, NCUA could repurpose its methodology from calculating the OTR to tracking and managing NCUSIF examination hours as an efficiency metric.

Regardless of what approach NCUA ultimately chooses to address the current (and flawed) OTR methodology, as we pointed out in our comment, it is self-evident that Congress never intended the share insurance fund to completely subsidize NCUA's Title I chartering responsibilities. Congress intended the NCUSIF to benefit from NCUA's Title I responsibilities, not the other way around. As we wrote: "Congress chose a specific structure for banking and credit union supervision, and that structure requires federal chartering authorities to supervise their charters for safe and sound operation while creating a redundant function in a deposit insurer to evaluate the safety and soundness of its insured institutions to mitigate risk to the deposit insurance fund."

In short, NCUA's Title I functions precede and are tantamount to NCUA's Title II responsibilities.

In addition: As we wrote in our comment letter this spring, the NCUA Board must not delegate its authority to administer the methodology to calculate the OTR to the staff of the NCUA Office of Examination and Insurance. The Board's delegation of its final approval of the OTR to staff is an abdication of one of the most important functions of the Board: oversight of the agency's and the NCUSIF's budget. Without discussion and oversight of the actual OTR by the NCUA Board, there is no check, nor accountability, for the equitable nature of the transfer. The OTR is important: the credit union system deserves better than the leadership of the NCUSIF delegating away important responsibility of budgetary oversight.

Clearer separation between NCUA's functions of chartering authority and insurer

NASCUS holds that NCUA's role as the chartering authority for federal credit unions and as the administrator of the share insurance fund presents a potential conflict of interest within the agency unless those functions are internally separated. To ensure a safe, sound and equitable dual chartering system, the Title II insurance and Title I supervision functions of the NCUA should be separated within the agency.

NASCUS is not alone in this view; indeed, 25 years ago (in 1991), the then-titled General Accounting Office (GAO, now the "Government Accountability Office") stated "if the NCUSIF remains within the NCUA, we believe a clearer distinction between the chartering, regulatory and supervisory functions and the insurance function needs to be made. Separate positions for a Director of Supervision and a Director of Insurance should be established, each reporting separately to the Board."

We believe that this recommendation is just as needed today -- if not more so -- as it was a quarter century ago.

The context for the GAO report was the Congressional dissatisfaction with another combined chartering and insuring regulator in the thrift industry. Those functions were separated in 1989 because (as GAO wrote): "At the regulatory level, critics have observed a blatant conflict of interest between the FHLBB and the FSLIC. A high priority of the FHLBB was the survival of the thrift industry. A high priority of the FSLIC was the survival of the FSLIC, which often required the speedy closing of ailing thrifts to reduce damages. The fact that Board members of the FHLBB are also required to be directors of FSLIC created a fundamental conflict of interest. FHLBB members, in effect, wore two hats, guardian of the thrift industry as well as guardian of the public trust."

GAO was asked to review NCUA's structure, and recommend internal partitions within the agency. Of interesting note, one of the factors driving concerns about possible internal division of the NCUA was a fear that the Title I supervisor would be slow to act on one of its charters which could hurt the NCUSIF. Of course, if the Title I supervisor has no safety and soundness concerns, as asserted by NCUA, this would never have been a Congressional concern.

There are obviously budget considerations of separating the two functions within the agency. However, doing so would also more clearly delineate the overall budget impact of the agency's administration of the insurance fund and give the entire credit union system a clearer view of where agency resources – which are provided primarily by credit unions – are spent.

For example, credit unions would know exactly what costs are associated with running the chartering and prudential supervisory agency and what costs are associated with administration of the insurance fund. Inefficiencies within the chartering authority would be quickly identified and market discipline would be imposed to control fees.

NASCUS has recommended that the agency create a Division of Insurance whose director reports directly to the Board. Activities related to the insurance function would be placed under this director as well as those activities that are or should be predominately funded by the overhead transfer: examiner training (for both state and federal examiners – and ending the favoritism currently given to federal examiner training), information systems and technology, and more.

Change the structure of the NCUA Board

NASCUS continues to advocate for enhancement of the NCUA Board's deliberative process by increasing its size from three members to five members, with one seat reserved for a person with experience as a state credit union regulator.

Clearly these are changes that are not in the power of the NCUA Board to make, but require acts of Congress. However, we present these recommendations in the context of today's briefing as a way of underscoring the need for bringing more voices and ideas into the deliberative process – including a voice with ideas from the perspective of state regulation – for policy decisions by the Board, including consideration and approval of the NCUA budget.

This suggestion also has context in today's legislative environment, with at least one proposal in Congress (H.R. 5983, The Financial CHOICE Act) calling for a five-member NCUA Board.

Further, this change would increase the Board's collective depth of experience and expertise, and allow for direct communication between Board members (by allowing two Board members to discuss important issues with each other without triggering the Government in Sunshine Act).

However, the benefits of expanding the NCUA Board to five members go beyond increased communication among the principals. Additional Board Members provide additional perspectives. This enhances the deliberative process – as NCUA well knows, since the agency requires all federal credit unions to carry a minimum of five board members to ensure that the decision making at the credit union's board level is robust and informed.

Regulators know that pursuing effective operations can often have an impact on the organization's budget -- and expanding the NCUA Board by two seats is no different. Ultimately it is for the credit union system's stakeholders to determine whether that additional expense is worth the potential for improved deliberation at the NCUA. NASCUS believes it is worth the expense.

In fact, NASCUS has analyzed those costs, and estimated that (based on the approved 2016 NCUA budget of $290.9 million) each additional Board seat would cost approximately $979,000, for a total of just under $2 million – an increase in the agency's budget (for 2016) of just more than two-thirds of 1% (0.67%). This slight increase is clearly not material.

State credit union supervisors and credit unions believe that the benefits of diversifying the Board, obtaining broader views and spreading authority likely outweigh the added cost; in fact, over the longer term, it could even lead to greater budget scrutiny and accountability. In terms of efficiency, as mentioned above, the benefits are clear: with five Board members, two may talk to each other directly without violating sunshine laws, as is the case today.

Conclusion

Our comments here are all offered in a good-faith effort to assist NCUA in improving transparency of the formulation of its budget, and (in specific cases) to ensure equitable treatment of state and federal credit unions for the resources they provide to the agency.

As noted above, the state credit union system recognizes that a regulatory agency is best positioned to know the resources it needs to maintain a safe and sound supervisory program. This view has been developed and tempered within the state system after years of experience of dealing with the oversight and approval of regulatory budgets by state legislatures or executive departments (or both).

In fact, according to the NASCUS 2016 State Profile (compiled this summer), 100% of states must have their budgets approved by either the governor, or the state legislature, or both. More than four in five states responding (87%) must have their budgets approved by either the governor or the state legislature. The remainder of the states reporting must have their budgets approved by both the governor and the legislature, a commission, the head of the individual agency – or (as in Alaska), the legislature appropriates funds and the governor has the ability to make line-item amendments.

NCUA has no such comparable oversight of its budget development. Therefore, it is all the more imperative that the agency provide transparency in its budget process -- including the OTR methodology -- for the entire credit union system. The comments we have made here are designed to enhance and promote that transparency – and this budget briefing is likewise an important step for developing and maintaining constructive dialogue.

Our thanks and commendation, again, for giving NASCUS this opportunity to present its views.