NASCUS

• 1655 North Fort Myer Drive, Suite 650, Arlington, Virginia 22209 • P: (703) 528-8351 • www.nascus.org •

WRITTEN COMMENTS

OF

NASCUS PRESIDENT & CEO LUCY ITO

FOR

THE NCUA BOARD 2018-2019 BUDGET BRIEFING

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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—thank you, Chairman McWatters and Board Member Metsger for conducting today's briefing. NASCUS applauds you both for resurrecting the NCUA budget briefing practice last year and continuing it this year. Your actions reflect your commitment to transparency, accountability, and giving stakeholders a role in NCUA's budgeting 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. Our membership is comprised of state regulators, state-chartered credit unions, and system organizations that support a robust dual charter system. NASCUS is the only organization dedicated to the defense and promotion of the state credit union charter and the autonomy of the state credit union regulatory agencies.

NASCUS' comments today are related to the subject of NCUA budget accountability and transparency. As we have stated previously, NASCUS has historically held the positon that a regulatory agency is best positioned to know the resources it needs to maintain a safe and sound supervisory program. Accordingly, while we do not reflect on specific budgetary elements, we do have a couple of general observations to share with respect to NCUA's budget justification for 2018-19.

Beyond NCUA's budget justification, NASCUS and its members have long-held concerns regarding NCUA's management of budget funding sources and NCUA's management of its complex role as both the chartering authority for federal credit unions (FCUs) and as the administrator of the National Credit Union Insurance Fund (NCUSIF). The overhead transfer rate—which determines how much of NCUA's operating expenses are covered by the NCUSIF—is inextricably tied to NCUA's implementation of its budget.

Accordingly, my remarks today will address:

(1) Budget Consistency with Anticipated Credit Union System Consolidation
(2) NCUA's Fiduciary Responsibility to Protect the NCUSIF
(3) Refinements to NCUA's Proposed OTR Methodology

Budget Consistency with Anticipated Credit Union System Consolidation

NASCUS applauds NCUA's recent announcement of plans to restructure the agency so as to reduce unnecessary duplicative resources. NASCUS further commends the agency for its commitment to work with state regulators to reduce the "footprint" of NCUA and the burden of supervision and examination on credit unions through the extension of the examination cycle for well-managed, low-risk credit unions, greater reliance on state regulators, and greater reliance on emerging virtual examination technology.

Accordingly, NASCUS was somewhat surprised to observe that the proposed NCUA 2018 Operating Fund Budget is increasing by $6.1 million to $298.2 million or 2.1 percent more than the restated 2017 Board Approved Budget of $292.1 million. Similarly, the proposed 2019 Operating Fund budget is estimated to increase to $302.8. These increases are counter-intuitive given the anticipated staff reductions and the planned consolidation of two regional offices by January 2019. NASCUS understands that NCUA faces contracted rent expenses and plans to invest in a research and development function.

Still, NASCUS encourages NCUA to consider further efficiencies in staff, management, and budget—consistent with anticipated credit union system consolidation.

In this context, we note that NCUA and FDIC currently share $1 billion as the asset threshold for well-managed and low-risk credit unions and banks to be eligible for an extended exam cycle. FDIC earlier this year publicly announced its support for raising the asset threshold for well-managed and low-risk banks from $1 billion to $2 billion which would require a statutory change. In any event, NASCUS encourages NCUA work with state regulators to periodically review the asset threshold for well-managed and low-risk credit unions so long as safety and soundness are not compromised. Periodic review of the threshold by NCUA and state regulators should guard against credit unions facing excess supervisory burden compared to their community bank peers.

NCUA Board's Fiduciary Responsibility to Protect NCUSIF

Before sharing our thoughts on refinements that NCUA can make to its proposed OTR methodology, we wish to take a moment to reflect on the NCUA Board's solemn fiduciary responsibility to protect the NCUSIF.

NASCUS takes this opportunity to commend the NCUA Board for its recent decision to close the Temporary Corporate Credit Union Stabilization Fund (TCCUSIF) and transfer the funds to the NCUSIF. This prudent decision promises to buttress the NCUSIF equity ratio and better protect both the fund and its insured credit unions. In addition to merging the TCCUSIF into the NCUSIF, NASCUS also supports the temporary increase of equity ratio's normal operating level to 1.39%. NCUA Chairman McWatters and Board Member Metsger have both well-articulated NCUA's objective rationale for setting the equity ratio at 1.39% at this time to cover possible risks. NASCUS supports the temporary increase to 1.39% especially in light of additional possible risks including losses related to taxi medallion loans and the recent series of natural disasters caused by hurricanes and fires. NASCUS welcomes NCUA commitment to review the NOL annually.

We commend the NCUA board for seriously considering the ramifications of the past overhead transfer rate which has had serious implications for all federal-insured credit unions—both state-charted and federal-chartered. The higher the OTR, the less dollars available to contribute to the NCUSIF's equity ratio. The effect of the proposed methodology, had it been applied to 2017, would have reduced the amount of funds transferred from the NCUSIF to cover NCUA's operating costs. That is, in reconsidering the OTR methodology, the NCUA Board is, in effect, fulfilling its responsibility to be a good steward of the NCUSIF and its the equity level. This benefits all insured credit unions.

Refinements to the NCUA's Proposed OTR Methodology

NASCUS and its members have long held concerns regarding the OTR methodology and NCUA'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).

The proposed OTR methodology is an indication that NCUA gave serious consideration to the forty (40) "Round 1" comments submitted in response to the initial request for comments published in 2016. That NCUA received so many comments on such a complex and technical issue is testament to how important the OTR is to the credit union system in general and state system in particular. After all, NCUA is well aware of the credit union system's desire for regulatory relief, yet the agency received only 28 comment letters in response to four separate notices for comment related to the Economic Growth and Regulaory Paperwork Reduction Act (EGRPRA) process—or an average of 7 comments per EGRPRA notice. By comparison, during "Round 2" of the OTR notice and comment process, NCUA received a total of 26 submissions, reflecting considerable stakeholder interest in OTR.

Of the 26 comments submitted, 19 comments largely supported the proposed OTR methodology with some added refinements while 7 comments do not support the proposal.

NCUA's Safety & Soundness Responsibility as the Chartering Authority for FCUs

The primary source of contention for the state system with the prior OTR methodology was that it failed to recognize (and account for) NCUA's safety and soundness responsibility as the FCU chartering authority. The prevailing assumption under the prior methodology was that all safety and soundness related costs were *exclusively* "insurance-related." That assumption was inconsistent with the FCUA, the NCUA's own regulatory history, and with the regulatory practice of the other federal financial regulators.

NCUA acknowledges in this proposal, other bank regulators that are not deposit insurers view their primary examination responsibilities to be that of safety and soundness. In fact, the GAO also shares this common understanding of the responsibility of the chartering authority.

the NCUA is to be credited for acknowledging in the current proposal that it also has safety and soundness responsibilities for FCUs in its role as the prudential regulator. This is a major step forward in establishing an equitable and workable methodology.

That recognition is also central to the shift to a "principles-based" approach that allocates the NCUA's examination time and costs evenly between its chartering and insurance-related responsibilities. The adoption of a principles-based approach will help reduce the complexity of the OTR methodology and the 50 percent rule makes intuitive sense because it is modeled after and reflects the likely allocation using alternating examination schedule.

- NASCUS accepts the adoption of this principles-based approach and the allocation of the examination time and costs of FCUs as 50 percent chartering and 50 percent NCUSIF-related as a workable approximation for OTR purposes.

Accepting as a working rule that 50 percent of the costs of FCU examinations is insurance-related <u>*is a compromise*</u> by the state system. The most accurate calculation of costs would be for the NCUSIF to accept Title I exams in their entirety for a majority of FCUs. The NCUSIF should cover only the resources needed to review those exams or conduct its own insurance reviews for due diligence or material risk - just as it does with respect to FISCUs. This explains why the NCUA's budgeted workload hours for FISCUs is substantially lower than the workload hours attributable to FCUs. Nevertheless, the adoption of a principles-based rule that allocates 50 percent of the FCU examination time and cost to the NCUSIF is a significant improvement.

- We urge NCUA to hold fast to the proposal's acceptance of NCUA's Title I responsibilities. Backsliding from this position would undermine the principles-based approach espoused by the Board and render the remainder of the proposal unacceptable.

The Principles-Based Approach

The new proposal is predicated on four underlying principles.

<u>Principle (1)</u> is that 50% of NCUA's time spent examining federal credit unions is allocated as Title I chartering.

- NASCUS supports this new classification; however, we note that a case could easily be made that a 50% allocation to Title I is too modest. For the sake of simplicity we can accept the 50% allocation.

Principle (2) is that all time and costs NCUA spends supervising or evaluating the risks posed by FISCUs or other entities NCUA does not charter or regulate is allocated as 100% insurance related. NCUA gives as examples of non-regulated entities CUSOs and third party service providers. While it is true that NCUA does not charter nor supervise those entities, NCUA has taken steps to assert supervisory authority over such entities out of concern for the safety and soundness of its federal charters as well as the FISCUs it insures. It would follow that *some* of NCUA's workload hours in CUSOs and third parties reflect NCUA's safety and soundness responsibility as charterer/prudential regulator. Additionally, NCUA's chartering rules limit the services that an FCU's CUSO may provide and to whom it may provide them. These are not materially safety and soundness issues, they are compliance issues.

- We agree that NCUA oversight of FISCUs is 100% insurance related.

- However, we do not agree that 100% of the time and costs associated with NCUA's supervision of CUSOs and third parties is insurance-related. We recommend that NCUA allocate 25% of its CUSO and third party workload hours to Title I.

Principle (3) is that the time and costs related to NCUA's role as charterer and enforcer of consumer protection and other noninsurance based laws governing credit unions are allocated as 100% Title I.

- We agree.

Principle (4) is that NCUA's hours administering the NCUSIF is 100% insurance related.

- We agree.

Other Cost Allocations

NCUA's proposal allocates 13% of the office of Consumer Financial Protection and Access (OCFPA) to the NCUSIF. However, NCUA has recently proposed a reorganization that would change this office and its mission and create a new program office.

- We request clarification on how changes to the OCFPA and the creation of the Office of Credit Union Resources and Expansion would affect the proposed methodology.

The proposed changes make significant improvements in the allocation of costs, but further refinements can and should be made. For example, the costs for "all other offices" still represent approximately one-third of NCUA's total operating budget - this includes the Board, the Executive Director, the General Counsel, the Chief Financial

Officer, the Chief Information Officer, the Chief Economist, the Human Resources, the Office of Examination and Insurance, the Inspector General, the Office of Minority and Women Inclusion, the Public and Congressional Affairs Office, and the Office of Continuity and Security Management.

The current proposal uses a weighted-average of other cost centers to designate 60% of the costs as insurance-related. This is an improvement over the prior methodology which allocated approximately 90% of the costs as insurance-related, but the notice fails to justify the proposed allocation. Indeed, the notice acknowledged that "improvements can be made in allocation methods involving non-field offices." Just because NCUA is willing to shift 50% of its examination costs of FCUs to the NCUSIF, it does not follow that 50% of everything else it does with FCUs is insurance related for purposes of calculating the expense allocation for each program office.

NCUA's Human Resources (HR) office is but one example. Were NCUA to be formally divided into its NCUSIF and chartering functions, the NCUSIF would need far **fewer** examiners for performance of its insurance functions because rather than performing 50% of FCU examinations, it would be accepting Title I examinations for review and only examining troubled institutions or sampling healthy institutions for due diligence. NCUA as chartering authority on the other hand would need to increase its funding to support a majority of its current existing examination force. Therefore, to suggest that a majority of the HR function is NCUSIF is a flawed premise. Likewise, we believe that at a minimum, the NCUA board's expenses be allocated as only 50% NCUSIF related.

- We recommend that NCUA use a 50% allocation for its HR and board functions.
- We are willing to accept the 60% allocation for the other program offices *as a compromise* designed to balance the OTR. NCUA should revisit these initial allocations in the future.

Imputed Value of State Regulator Work

NCUA's proposal would eliminate calculating and crediting the imputed value of state regulator work and the related cost savings. For this year the imputed value of state regulator work is $50.8 million. This is value paid for by FISCUs that accrues to the benefit of all insured credit unions by reducing the workload, and expenses, of the NCUSIF. Backing the imputed value out of the total OTR under the existing methodology was an understandable—if imperfect—means for the NCUSIF to recognize those costs borne directly by the state system. Within the context of this proposed OTR methodology, eliminating the imputed value seems consistent with the underlying principles of the new formula.

- However, should NCUA decide to *not* finalize the proposed methodology changes, the imputed value should be returned to the state system. The most workable way to return the imputed value to the state system is not by backing it out of the OTR, but rather by paying the imputed value back to the state system.

NASCUS is willing to discuss alternative means of recognizing the imputed the value should NCUA decline to move forward with the new methodology.

Future Notice and Comment for the OTR Methodology

The notice reiterates NCUA's position that the OTR methodology is not subject to notice and comment rulemaking requirements under the Administrative Procedure Act. We continue to believe that NCUA's position is wrong, as a matter of law, on this issue.

Nevertheless, NASCUS commends the NCUA for committing to: (1) seek comment through the Federal Register on the OTR methodology every three years; (2) to hold annual public board meetings on the OTR and to post all related materials on the NCUA website; and (3) for all future rulemakings to identify and seek comment on whether the proposed regulation is being issued pursuant to NCUA's regulatory authority or its role as the administrator of the NCUSIF.

These are important procedural safeguards that help ensure transparent and accountable processes, will result in increased stakeholder input and, ultimately, better informed decision making by the agency.

NCUA is required to provide an opportunity for notice and comment for its rulemakings unless otherwise exempted. Because the OTR methodology is an NCUA Board statement of general applicability and future effect designed to implement and interpret FCUA it clearly falls within the scope of the APA. The NCUA Board, itself, characterized the OTR as a rule and procedure at the very Board meeting where this proposal was approved for publication.

As currently proposed, NCUA would seek comment at least every three years and whenever the methodology changed. Public comment should also be sought any time the OTR changes by more than 2% points in any given year. This recommendation accounts for the fact that the new methodology as proposed may not in fact be the methodology going forward. Under the old methodology where controversial categorization of rules as insurance or chartering can dramatically swing the OTR, it is prudent for NCUA to seek stakeholder input to ensure equitable allocation of agency expenses.

- We recommend that public comment on the OTR is sought at least every three years, whenever the methodology is changed, and any time the OTR changes by more than 2% (in either direction) in any given year.

The OTR Methodology's Inverse Impact on FCU Operating Fee

We recognize that there is an inverse relationship between the OTR and the FCU operating fee and understand that if the OTR is adjusted to become more equitable NCUA might have to increase its operating fee accordingly. But increasing the FCU operating fee is not NCUA's only option. Increases in the operating fees paid by FCUs could be tempered by reductions in NCUA's overall budget. In fact, in June of this year NCUA announced a 2% overall budget savings equaling over $5 million.

While the OTR has risen steadily in the past years, the opposite inverse reaction has been occurring. Over the past decade, the FCU operating fees decreased by nearly 30%.

History of NCUA FCU Operating Fee (2009 – 2016)

	OTR		Δ FCU Operating Fees	
2009	53.8%	↑	-6.77%	↓
2010	57.2%	↑	-1.58%	↓
2011	58.9%	↑	-2.86%	↓
2012	59.3%	↑	-0.90%	↓
2013	59.1%	=	+0.24%	"↑"
2014	69.2%	↑	-18.4%	↓
2015	71.8%	↑	-0.90%	↓
2016	73.1%	↑	-0.47%	↓

While the FCU operating fee increased by approximately 24% in 2017 and would have increased another approximately 24% under the proposed principles-based OTR methodology, the estimated 48% swing is offset by the resulting reduction in the OTR and the principles-based proposal correctly acknowledges that NCUA does have safety and soundness responsibilities as the prudential regulator and chartering agency for federal credit unions.

We commend the NCUA board for seriously considering the ramifications of the existing overhead transfer rate which has had significant implications for all federally-insured credit unions—both state-charted and federal-chartered. The higher the OTR, the less dollars are available to contribute to the NCUSIF's equity ratio. The NCUA has a solemn fiduciary responsibility to protect the equity of the NCUSIF including the equity ratio. The effect of the proposed methodology, had it been applied to 2017, would have reduced the amount of funds transferred from the NCUSIF to cover NCUA's operating costs. That is, in reconsidering the OTR methodology, the NCUA Board is, in effect, partly fulfilling its stewardship of the NCUSIF. This benefits all insured credit unions.

In Conclusion

We thank NCUA for the opportunity to comment on its 2018-2019 budget including specific refinements to NCUA's proposed methodology for revising the Overhead Transfer Rate. The proposed revisions to the methodology evidence a commitment within NCUA to develop an equitable and understandable basis for allocating the combined expenses of the agency's dual mission.

NASCUS, state regulators, and the state credit union system remain committed as well to forging a balanced partnership with NCUA that contributes to a vibrant dual charter credit union system well into the future.