

Open Board Meeting

November 19, 2015

**Board Member J. Mark McWatters
Statement on Continuing Concerns with NCUA's Budget and Budget Process**

**Transparency of the Operating Budget and Budgetary Process
(The NCUA Should Increase Its Transparency, Not Its Budget)**

In analyzing the 2016 and 2017 operating budgets, I have undertaken to address two fundamental inquiries. First, what actions may the NCUA take to reduce its operating budget and, second, how may the agency make its operating budget and the budgetary process more efficient, effective, transparent, and accountable? I will address each of these questions and recommend specific changes in my comments today.

NCUA Can and Should Reduce Its Operating Budget

It is difficult to accept that the FDIC, which supervised the banking system during the worst financial crisis in seventy-five years, has cut its budget for the last five years while the NCUA, which supervises a healthy credit union system, is compelled to maintain or increase its funding for the ninth straight year.

Contrary to the putative message reflected in the complex array of documents and schedules pending before the Board today, I believe there are meaningful approaches the NCUA may take to reduce the agency's operating budget, including the following ideas.

12- vs 18-Month Examination Cycle/Joint Exam Efficiencies

In my view, it is worthwhile for the agency to consider strengthening our examination process by focusing on outliers and possibly lengthening the examination cycle from 12-months to 18-months for certain "low-risk" credit unions. However, this concept has been all but dismissed by the NCUA.¹

Regrettably, the NCUA seems to have forgotten that it is not 2008, but, 2015 and that the credit union community—in the NCUA's own assessment—is strong and resilient. That the top-tier of credit unions require examination every 12-months at enormous cost to the community is worthy of challenge and rigorous debate. That the agency would back-burner this approach without discussion among the Board offices also evidences the lack of transparency within the agency.

Although it is entirely possible that after full consideration by all Board offices the agency would elect to continue the current examination cycle (perhaps, with my

¹ The NCUA currently has the statutory authority to adopt a longer examination cycle for lower risk credit unions, an approach the agency has employed in the past. The Small Bank Exam Cycle Reform Act of 2015 (H.R. 1553) would permit lower risk banks to adopt an 18-month examination cycle.

support), the failure to engage in a dialogue within the agency and with the credit union community offers yet additional evidence of the need for formal budget hearings on the record.

I want to remain clear that my support for the proposed 18-month examination cycle for “low-risk” credit unions is not a foregone conclusion. The devil is in the details, and my response will depend upon how one defines “low risk.” There is little doubt that some may advocate for a more generous definition than I could support as a safety and soundness regulator.² That is their job and I have my job, yet as I have stated many times over the past year, reasonable minds may differ.³

My point, however, is more subtle—the idea that a group of well-managed, fiscally sound credit unions could operate without an undue safety and soundness risk if examined every 18-months (or 15-months)⁴ is not, per se, without merit. The proposal deserves a thoughtful cost-benefit analysis by the NCUA and is precisely the type of reflection the credit union community deserves from us. If successful in implementing an extended examination cycle, the agency could materially decrease its operating budget. Further, by shifting examination teams away from low risk to higher risk credit unions, the NCUA could more appropriately target its resources to those areas—such as fraudulent behavior and the failure of internal control systems—that potentially threaten the safety and soundness of the National Credit Union Share Insurance Fund.

Some may argue that the NCUA is not prepared to undertake either the analysis or implementation of an 18-month examination cycle due to the agency’s commitment to the implementation of newly finalized and pending regulations. If not now, then when? Since the Risk-Based Net Worth rule does not become effective until 2019, will the agency wait until 2020 or 2021 to begin analyzing the appropriateness of adopting an 18-month examination cycle for low risk credit unions? Since the pending Member Business Lending rule, the proposed field-of-membership rule, and the contemplated Supplemental Capital rule all qualify as regulatory relief, does the agency need to shelf one form of regulatory relief—the 18-month examination cycle—due to the implementation of other forms of regulatory relief? In my view, the agency should promptly begin studying the efficacy of an 18-month examination cycle and immediately implement the rule upon adoption by the Board.

² Some may argue that a “low risk” credit union should have a CAMEL 1 rating, a well capitalized leverage (net worth) ratio, and a well capitalized risk-based net worth ratio. Others may argue for a more relaxed or rigorous standard. The NCUA should thoughtfully analyze this issue and propose a definition of “low risk credit union” that is based upon a transparent methodology.

³ The proponents of an extended examination cycle no doubt expect give-and-take regarding the development of these metrics with the ultimate goal of reducing the NCUA's operating budget, decreasing management distraction from a relentless 12-month examination cycle of low risk credit unions, while protecting the safety and soundness of the share insurance fund.

⁴ The NCUA examination teams may receive supplemental information electronically regarding specific credit unions between formal on-site examinations and analyze the data off-site.

Along these lines, the NCUA should endeavor to adopt a more collaborative approach with the State Supervisory Authorities (SSA) so as to respect and protect the dual charter credit union system that has proved so resilient and beneficial to the community. Surely, the NCUA and the SSAs could develop enhanced economies of scale in their independent examination functions so as to heighten their efficiency and effectiveness. Is it not possible for the NCUA and the SSAs to share the examination function instead of needlessly duplicating efforts and distracting credit unions from better serving their members?

Anachronistic rules, such as the NCUA’s mandate to examine every credit union with greater than \$250 million in assets—both state and federal charters—every 12 months, should give way to data driven, sophisticated approaches that more appropriately coordinate the examination process with the SSAs, so as to protect the safety and soundness of the Share Insurance Fund without rigid adherence to unwieldy, inefficient models that generally necessitate year-by-year increases in the operating budget.

If the NCUA was serious about materially decreasing its operating budget, the Board would immediately begin analyzing the feasibility of adopting an 18-month examination cycle for a well-articulated subset of low risk credit unions and developing a more collaborative approach with the SSAs to the examination process.⁵ Posting documents on a website and reassigning an employee here and there will not accomplish much more than to serve as window dressing.

Revisit “Complexity” As It Relates to the Operating Budget

Regrettably, credit unions are disappearing at the rate of approximately one per business day,⁶ and we should acknowledge that the community is steadily consolidating into a fewer number of larger credit unions. We should remain mindful, however, that asset size alone does not necessarily correlate with or cause complexity. The NCUA has justified past budget increases based upon the flawed logic that a mere increase in the asset size of a credit union causes an increase in the complexity of the credit union and, hence, the need for more costly and burdensome examinations. However, the examination of one \$500 million credit union should generally command less NCUA resources than the examination of two \$250 million credit unions with similar asset and liability structures, and the merger of those two smaller credit unions should free-up NCUA resources and result in a decrease in the agency’s operating budget.

The NCUA examines credit unions, and not assets, and as the number of exams decreases, the agency should benefit from proportionally less work. That the NCUA is

⁵ The agency’s reluctance to proceed with either of these sensible measures reflects a strong desire to maintain the status quo. The rollout of a new website and the disclosure of a few more documents – that should have been disclosed many years ago – accomplishes little in the way of true budgetary reform and transparency.

⁶ According to the NCUA 2014 Annual Report (<http://www.ncua.gov/Legal/Documents/Reports/AR2014.pdf>, page 148) the credit union community has lost roughly 265 (2012-2013), 275 (2011-2012), and 245 (2010-2011) federally insured credit unions. There are approximately 251 business days in a calendar year.

increasing exam teams and the length of examinations appears counterintuitive to the savings that should follow the economies of scale evidenced in larger credit unions and the continuing consolidation within the community.

Employ Actual Zero-Based Budgeting, Which Should Result in a “Peace Dividend”

Although the NCUA professes to employ zero-based budgeting, I continue to have doubts. Instead of budgeting to justify each expenditure, I remain concerned that the agency appears to spread a set of ever increasing fixed costs over a decreasing workload as the number of credit unions shrink. In other words, budgeting consists of allocating X employees at \$Y cost over the examination of Z credit unions. If Z decreases, yet \$Y increases (or remains substantially unchanged), both the duration of, and the number of examiners assigned to, each examination must—by definition—increase. In my experience, that’s the antithesis of zero-based budgeting.⁷

True zero-based budgeting would correlate to the number of credit unions, the enhanced sophistication of larger credit unions, the decrease in fraud as credit unions increase in size and adopt more targeted internal control systems, macroeconomic considerations (recessions and expansions), technological changes, and the like. Instead, the NCUA budget keeps on steadily growing (or not materially decreasing) year-in-and year-out.

Moreover, the dramatic increase in the regulatory burden placed on credit unions over the past few years should have yielded a “peace dividend” permitting the NCUA to stand-down some of its forces.⁸

Any Agency Office That Received An Increase in the Last Budget of More Than 3 Percent Should Receive Additional Scrutiny

We should ensure the NCUA’s budgetary process takes into full account how budget expenditures over recent cycles have been affected and subject budget requests to additional review that come from offices that were allocated material increases of more than 3 percent, even those that were prior to the last cycle.⁹ The rigor of such analysis may help department heads more directly focus on more creative ways to manage their budgets.

Meaningful Regulatory Relief for Credit Unions Will Result in Cost Savings for the NCUA

As I believe the credit union community is well aware, I am a strong proponent of

⁷ I have traveled throughout the country and credit union directors and officers have repeatedly and vigorously confirmed my analysis.

⁸ Do more heavily regulated credit unions really require longer examinations, staffed with more examiners?

⁹ For example, the 2015 budget contained increases for a number of agency departments – the Office of National Examination and Supervision, the Office of Examination and Insurance, and the Office of Consumer Protection all received 9 percent increases, the Office of the Chief Economist (12 percent), the Office of General Counsel (8 percent), the Office of Continuity and Security Management (58 percent), the Office of Public and Congressional Affairs (15 percent), and the Office of the Executive Director (5 percent).

regulatory reform for credit unions. I understand that today credit unions have little choice but to operate under too many rules and regulations that are designed to remove risk, not necessarily enable credit unions to manage it. Modeling our regulatory approach to allow more flexibility for well-managed credit unions would help them and their communities to thrive.

The added benefit of true regulatory relief for credit unions is that it would result in less time spent examining credit unions and, hence, reduce the operating budgets of the NCUA and the SSAs. In 2016, the NCUA should work with the credit union community to identify specific, unwarranted regulatory burdens that can be reduced or eliminated, thereby allowing well-managed credit unions to focus on their members and the NCUA to focus on problem cases.¹⁰

NCUA's Budget Process Must Be Corrected to Provide True Transparency and Accountability

The use of non-transparent zero-based budgeting is not the only flaw in the NCUA's budgetary process. I remain concerned that while the agency touts its budget transparency, the process for allocating resources remains opaque. When I dissented from the adoption of the 2015 operating budget last November I encountered strong pushback from the agency. I was told that the NCUA was the most transparent financial institutions regulator. Since then, the NCUA has indicated it has become even more transparent and taken some actions to address many of the issues I raised last November.¹¹

¹⁰Advocating for a reduction in regulatory burdens does not alter the conclusion that the current level of credit union regulation should result in less exam time or that reducing regulations for well-run credit unions should not per se create the need for additional supervisory scrutiny. Simply put, regulations targeted to specific risks to the NCUSIF should reduce the examination burden as should the removal of non-targeted, scattershot regulations.

¹¹ In my November 2014 dissent to the adoption of the 2015 operating budget I noted the following regarding the transparency of the NCUA's operating budget; see, <http://www.ncua.gov/newsroom/Pages/speeches/2014/november/SP20141121McWatters2015BudgetStatement.aspx>, page 1:

Over the past year I have argued for budget hearings enhanced budgetary transparency.

That said, the Board should further enhance the transparency of the budgetary process and NCUA's operations by disclosing or undertaking each of the following:

- 1 Additional detail regarding each of the following expenditures: Employee Pay and Benefits, Travel, Rent/Communications/Utilities, Administrative, and Contracted Services;
- 2 A detailed analysis of how NCUA may reduce the expenditures noted in item 1 above;
- 3 The submission of the methodology employed by NCUA in calculating the OTR for public comment, and a detailed description of the methodology adopted by NCUA following a thoughtful analysis of the comments received;
- 4 A detailed analysis of expenditures among NCUA, the National Credit Union Share Insurance Fund, the Temporary Corporate Credit Union Stabilization Fund, and the Central Liquidity Facility;
- 5 A detailed analysis of why NCUA's budget has increased by over 50 percent in the past five years, as well as a year-by-year analysis of all such increases;
- 6 A detailed analysis of all cost savings programs implemented by NCUA over the past five years;
- 7 A detailed analysis of all expenditures incurred by NCUA to support the Financial Stability

Although the NCUA has made some gestures toward transparency of the operating budget and budgetary process over the past year at my behest, much work remains.

Functional transparency consists of more than dumping thousands of pages of documents on a redesigned website, leaving members of the credit union community with the challenge of “figuring out” what it all means. The agency needs to relate in a more fluid and cogent manner how these documents influence the structure and development of the operating budget and the agency’s expenditure priorities. Transparency requires an analysis of documents, spreadsheets, and other materials in plain language that communicate the agency’s intentions with razor sharp accuracy. The quality and clarity of the NCUA’s disclosure and accompanying analysis matter far more to the credit union community than the mere quantity of the disclosure.

A year ago, the concept of budgetary transparency at the NCUA was an oxymoron. Why this approach continued for so many years, I cannot say. While I certainly welcome the beginnings of transparency at the NCUA, it is time for the agency to embrace another level of regulatory openness and accountability that extends beyond the mere posting of documents on its website. My recommendations to bring light into the agency’s process include the following.

Hold Public Budget Hearings

I am quite concerned that the NCUA Board has not held public hearings on the 2016 and 2017 operating budgets and the budgetary process.¹² As a Board, we should remain mindful that we are spending the scarce resources of federal and state chartered credit unions and of their members. Any allocation of these funds should follow only after thoughtful reflection as to the necessity of the expenditures and whether the costs have been undertaken in the most efficient, effective, transparent, and fully accountable manner. Further, the Board’s job, in my view, is not merely to follow a template set by other financial regulators, but to lead and to set a progressive standard of transparency and accountability for all such regulators to consider.

The refusal of the NCUA Board majority to hold a public hearing on the operating budget and the budgetary process constitutes a breach of transparency as those who

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- Oversight Council (FSOC);
 - 8 A detailed analysis of all expenditures incurred by NCUA in implementing the Sensitive Compartmented Information Facility (SCIF);
 - 9 A detailed analysis of all expenditures that NCUA anticipates to incur with respect to the proposed risk based net worth rule, as well as all other proposed rules;
 - 10 A formal cost-benefit analysis with respect to each rule or regulation proposed by NCUA, as well as a detailed description of the methodology employed by NCUA in conducting such analysis; and
 - 11 A detailed reconciliation of how NCUA plans to allocate budget expenditures to achieve its strategic goals.

¹² My request that the NCUA conduct formal budget hearing is not novel in the least. The agency has held such hearings in the past where members of the credit union community and public were permitted to address the Board on the record.

fund the budget are forbidden to comment and present their analysis of the budget to the Board on the record. Posting documents on the NCUA website without guidance and a formal mechanism to challenge the inadequacy or relevance of the disclosure does not constitute transparency. Disclosure requires context and context requires a feedback mechanism where members of the credit union community and public may question and challenge the substance and form of the disclosure.

For example, approximately 55 percent of the NCUA’s operating budget consists of the salary, benefits, and travel expenses attributable to employees of the Regions and AMAC, and approximately 82 percent of the operating budget consists of the salary, benefits, and travel expenses of the entire agency. I believe these figures can be decreased and any reasonable suggestion regarding how to better manage these costs merits thoughtful reflection. However, while examinations are a prime activity for this agency, total examination costs are not readily determined without a careful and time consuming study of the agency’s budgetary documents. Credit unions deserve to know more through a public hearing on how we manage and determine costs for these areas and all other agency activities.

Last year, I strongly encouraged the NCUA Board to deliver the next proposed budget and calculation of the OTR to the credit union community and general public at least two weeks *prior* to a formal budget hearing.¹³ Regrettably, this did not happen and we are here today to consider budgets for two years without comment, criticism, or analysis from the credit union community.¹⁴

It is important to note that the recent “forum” held at the NCUA’s offices in Alexandria did not suffice as a “budget hearing” as it is impossible to elicit feedback on the agency’s budget and budgetary process without providing the commenters with a copy of the budget prior to receiving their comments. While the forum was not unhelpful, I prefer to interact with members of the credit union community in their environment and away from the intrigue of Alexandria.

As I have traveled throughout the country over the past year, I have held dozens of town hall meetings where I have welcomed questions and criticisms from the community regarding our regulations, examination procedures, budgetary process, and general

¹³ At that hearing the NCUA staff would formally present the proposed budget and OTR to the public in a detailed, understandable and transparent manner supported by written analysis posted on the NCUA website. The agency would also afford the public the opportunity to submit written comments regarding the proposed budget and OTR and to make presentations to the Board in an open meeting. At the November 2014 Board meeting the Chair stated that a budget hearing would result in “regulatory capture,” that is, members of the credit union community and general public would somehow corrupt or compromise the Board if they addressed the Board in a public meeting on the record. That assertion made little sense to me as members of the credit union community comment on the budget and budgetary process to individual Board members in private settings without issue of “regulatory capture.” How could a public discussion on the record for all to see corrupt or compromise the Board?

¹⁴ I encouraged the Board not to act on the proposed budget or OTR until after reflecting upon and giving due consideration to the comments received. In my view, this approach, while somewhat cumbersome, would have materially enhanced the transparency, accountability, and inclusiveness of the budget and budgetary process.

operations, among other areas. It is not possible for me to discharge my responsibilities without engaging in such exchanges as a matter of course on a regular and periodic basis. I prefer lively exchanges—even though they are occasionally uncomfortable—where people speak frankly, off-script, and convey to me the real-world consequences of our regulatory and administrative actions.

Nonetheless, as an optimist and in anticipation of the next budgetary cycle, I invite interested parties to communicate their issues and concerns directly to my office. I welcome, without limitation, your specific, detailed comments regarding the agenda and mechanics of a public hearing on the budget, the overall transparency of the budget and budgetary process, the methodology employed in calculating the OTR, the definition of “low risk credit union” for purposes of implementing an 18-month examination cycle, how the NCUA may better collaborate with the SSAs, and how the NCUA may more effectively address losses to the Share Insurance Fund arising from fraudulent activity and the failure of internal control systems. I very much appreciate your assistance in this endeavor.¹⁵

Change the Approach to Setting the Overhead Transfer Rate

Regarding the OTR, I reiterate that the NCUA should draft and submit a formal OTR rule for a 90-day public comment period in accordance with the Administrative Procedure Act (APA).¹⁶ In that document, the agency should unpack the OTR methodology with cross-references to all sources employed in the process.¹⁷

There is little doubt that the determination of the OTR is of material consequence to both federal and state-chartered credit unions and it is surprising that the NCUA has drafted and implemented the rule based upon advice from two accounting firms, yet

¹⁵ As I noted in my statement on the operating budget last year, the NCUA again appears overly concerned with head count or, in government-speak, with the number of FTEs. This is myopic. If the NCUA truly needs to retain the services of additional professional staff so as to discharge its mandate to protect the safety and soundness of the NCUSIF, the agency should do so without needless hand wringing. The NCUA, however, should clearly articulate to the credit union community – to those who pay the bills – why current staffing needs are inadequate, why additional expertise is truly needed as opposed to merely desirable, the most efficient and effective approach to obtaining the necessary professional competence, and the full-cost of retaining the required employees and independent contractors. The NCUA should make every effort to minimize these costs, as well as the costs associated with all employees and contractors, and should vet all retention decisions in a transparent and fully accountable manner.

In addition, some have argued that the NCUA should not invest credit union funded resources in seemingly non-core functions such as the Office of Small Credit Union Initiatives, as assisted by the Office of the Chief Economist, and the Office of Consumer Protection. To me, assisting the underserved in obtaining financial services at an affordable price is an absolutely critical mission of the credit union community. Given the overarching significance of the mandate to serve credit union members of modest means, I welcome and support the NCUA's work in this area.

¹⁶ The National Association of State Credit Union Supervisors (NASCUS) recently received a legal opinion from a third-party law firm concluding that the determination of the OTR is subject to a notice and comment requirement under the APA. See http://www.nascus.org/press_release/2015-pressreleases/06.23.15%20Legal%20analysis%20on%20OTR.php. The NCUA's Office of General Counsel disagrees and argues that the OTR does not qualify as a “rule” under the APA.

¹⁷ I also think additional consideration needs to be given to how funds from mid-year budget reductions are allocated and whether they should be used, at least in part, to address OTR issues directly, rather than routinely applied to reduce operating fees to benefit just one group of credit unions.

without comment from the credit union community.¹⁸ While I have maintained a CPA license since 1979 and hold the accounting profession in the utmost esteem, it is important to note that accounting firms generally do not render legal advice, provide legal services, or otherwise operate as law firms in the United States. The determination of the OTR methodology is essentially a legal construct and requires the sophisticated analysis of statutes, regulations, and case law, which lies beyond the operational mandate of accounting firms, even highly regarded, top-tier firms.

Further, the NCUA is a federal regulator and should develop and implement policies in an impartial manner, yet the inexorable increase in the OTR over the past several years generally favors federally chartered credit unions. This creates the appearance of a conflict of interest between a federal regulator and federally chartered credit unions to the particular detriment of state-chartered credit unions.¹⁹

As the number of federally chartered credit unions has decreased it appears that the NCUA has redeployed its examination resources to state examinations thereby increasing the insurance related hours and, as such, the OTR. This result necessarily follows if there is an increasing examination force shift toward more active state charter insurance examinations. Thus, as the operating budget steadily increases (or remains substantially unchanged) year-in and year-out or the number of federal charters diminish relative to state charters, the OTR continues its climb as well.²⁰

While, in my view, credit unions are best served by having a regulator that understands the not-for-profit, cooperative business model, the justification for a separate federal credit union regulator becomes less apparent as the agency shifts to more of an insurer and less of a regulator. This distinction becomes even more pronounced as the regulations promulgated by the NCUA closely parallel those of the FDIC and are less tailored to the specific risks presented by the credit union community to the Share Insurance Fund. If the NCUA simply acts as an insurer with a panoply of FDIC-centric regulations, some may begin to question its reason for being.²¹

¹⁸ In effect, the OTR is really nothing more than whatever the NCUA says it is. Such an approach reminds me of Lewis Carroll's Humpty Dumpty who famously remarked, "When I use a word, it means just what I choose it to mean - nothing more, nothing less."

¹⁹ The OTR accounting presents the agency as principally an insurer and less of a regulator or chartering body. This may not bode well for the agency as some may question why we need two federal deposit insurers.

²⁰ To my knowledge, this reallocation of resources has occurred under the radar and the NCUA has yet to articulate its justification for substantially accelerating its participation in state charter insurance examinations. Causality does not necessarily exist between an increasing gross asset size and the complexity of a credit union. As I have previously stated, the adoption of an 18-month examination cycle for low risk credit unions and heightened collaboration between the NCUA and the SSAs would result in a material decrease in the NCUA operating budget and the ill effects of an increasing OTR.

²¹ It is worth noting that an interesting intersection between the OTR and the NCUA's lack of transparency arose when the agency attempted to redact certain critical language directed towards the agency in the January 20, 2011, PricewaterhouseCoopers (PwC) report on the OTR methodology commissioned by the agency. Specifically, PwC – the agency's handpicked expert on the OTR – admonished the agency regarding its lack of transparency by concluding:

"Based on PwC's review, the OTR Methodology was considered lacking in terms of the extent to which the classification of NCUA's activities between insurance and regulatory (upon which the methodology is fundamentally dependent) represents a consensual view on such classifications in the industry. Further, there

In order to negate the appearance of a conflict of interest, follow the letter and spirit of the APA, respect the dual charter system, and add a strong element of much needed transparency, I encourage the NCUA to submit, without hesitation, the OTR as a proposed rule for public comment under the APA.²²

In addition, I am deeply troubled that the NCUA Board will today consider the delegation of the OTR to the NCUA staff instead of leaving that determination to the Board. Such a delegation will make the determination of the OTR less transparent and more steeped in mystery than it is today. The timing of the delegation is particularly awkward given the NCUA's lack of transparency in redacting certain critical language directed towards the agency in the January 20, 2011, PricewaterhouseCoopers (PwC) report on the OTR methodology commissioned by the agency.²³

Further, the delegation compounds the legal problems the NCUA's treatment of the OTR has created by ignoring its responsibilities under the APA.²⁴ From my expedited analysis, the Federal Credit Union Act does not specifically address the issue of whether the NCUA may delegate the setting of the OTR to the NCUA staff. How the agency calculates the OTR, however, is inseparably linked to what it must decide when setting the OTR. As a result, the most reasonable reading of the Federal Credit Union Act is that the NCUA Board should oversee the methodology and its application to the OTR and not delegate the function of overseeing the selection and use of the methodology for setting the OTR to the NCUA staff. This conclusion is strengthened by consideration of the APA in light of the impact and nature of the OTR.²⁵

was found to be dissatisfaction within the industry with respect to NCUA's efforts to communicate and explain the OTR Methodology in adequate detail.

It is recommended that NCUA should consider providing more visibility on how it characterizes its activities to the different industry groups and credit unions and possibly solicit their feedback with regards to the reasonableness and accuracy of the classification. NCUA should also consider steps aimed at making the methodology itself more transparent, along with all of the assumptions and steps that are utilized. Possible ways of achieving this include more frequent interactions with the stakeholders through different channels (e.g. meeting, publications, etc.).²¹

See, Overhead Transfer Rate Review,
<http://www.ncua.gov/about/Documents/Budget/Misc%20Documents/2011PwCOTRReview.pdf>,

That the NCUA redacted these remarks and did not seek to follow the sensible guidance of PwC does not reflect well for an agency that presents itself as the paragon of transparency.

²² At its current rate of increase it seems possible that the OTR will reach a tipping point where virtually all of the NCUA's operating budget will originate from the NCUSIF. Some may argue that the agency could then "subcontract" part of its safety and soundness function to the SSAs and remit payment from the NCUSIF (pursuant to section 1781(b)(2) of the FCUA) for services rendered by the SSAs.

²³ See footnote 21.

²⁴ I am also troubled by the approach the agency is apparently advancing to solicit comments on the OTR. According to the Board Action Memorandum on Delegating Operating Fees, the Board would seek input from the credit union community on the OTR in January, two months after the OTR is set, and then in conjunction with the agency's strategic plan, which would involve a three-year cycle. Seeking comments is not without cost and it must be undertaken in an effective and meaningful way that serves a useful purpose. This approach for engaging with the credit union community on the OTR is less than transparent and I urge the board to instead develop the OTR under the APA, as it legally should.

²⁵ Summary Analysis

The OTR methodology is not a “plug and play” formula but, instead, relies upon judgment and perspective as to the component parts of the methodology that should reside with the Board in a public meeting. I cannot help but conclude that the true reason for the delegation resides in the desire of the existing Board majority to lock-in the OTR today through the transfer of authority to the NCUA staff so as to avoid the “awkwardness” of a 2 to 1 vote on the OTR or the “uncertainty” that may arise in the event a future NCUA board consists of only two members.

In addition, I should note that these same comments apply to the Board majority’s delegation of the “operating fee” to the NCUA staff.

Do Not Employ a Two-Year Budget Process

I have repeatedly questioned why the NCUA seems compelled to adopt a biennial operating budget. The putative reason, as I understand the rationale, is to offer the credit union community—those who actually fund the operating budget—with enhanced transparency.

I question this motive. How can less opportunity to review even basic agency budget information offer more transparency? If two-year operating budgets are the talisman of transparency, then why hasn’t NCUA offered two-year operating budgets over the past several years? Was it somehow appropriate to offer less budgetary transparency during the financial crisis?

The agency will more effectively and efficiently provide the community with

- NCUA relies on 12 USC 1783(a) to take funds from the NCUSIF to pay for its operations that are related to supervision of federally insured credit unions.
- 1783. National Credit Union Share Insurance Fund
Creation; use of fund

“There is hereby created in the Treasury of the United States a National Credit Union Share Insurance Fund which shall be used by the Board as a revolving fund for carrying out the purposes of this subchapter. Money in the fund shall be available upon requisition by the Board *and for such administrative and other expenses incurred in carrying out the purposes of this subchapter as it may determine to be proper.*”
(emphasis added)

- The FCUA does not address how the Board should determine which expenses that may be paid for by the NCUSIF.
- However, it does clearly state the Board is to determine those costs.
- It is undeniable that the manner in which NCUA chooses to select expenses that may be included as supervision costs is a prime component in the OTR process that drives the Board’s actual decision regarding what the OTR should be.
- As the NASCUS analysis regarding the application of the APA supports, the OTR has significant economic impacts for credit unions and NCUA and thus, is a substantive, policy matter that should be processed by the agency under the APA.
- The methodology for determining insurance-related costs is central to the OTR decision and highly significant to the outcome of which costs will be covered, how much the agency’s budget can be, and how much credit unions must fund in any budget cycle.
- As a result, the OTR methodology itself should be subject to notice and comment, along with the determination of the level of the OTR.
- Moreover, the methodology in determining the costs that are covered by the OTR should be reviewed and determined by the NCUA Board.

heightened transparency and accountability by offering a traditional one-year operating budget, along with four additional years of detailed and thoroughly vetted budget projections. Simply put, a two-year budgetary process offers the credit union community with less transparency by jamming two budget cycles into one. In a two-year budget, the agency is forced to rely upon crystal ball logic and the uncertainty inherent in any such analysis. The second year budget in a two-year cycle is really nothing more than a “best guess” projection of what may come to pass and, as such, the Board should not adopt such financial and accounting speculation as a formal budget.

As noted with respect to the delegation of the OTR to the NCUA staff, I fear the more accurate justification for this sudden embrace of a biennial operating budget may be for the existing Board majority to lock-in a two-year budget today so as to avoid the “awkwardness” of a 2 to 1 vote on the 2017 budget or the “uncertainty” that may arise in the event a future NCUA Board consists of only two members.

Like the delegation of the OTR, such an approach represents dreadful governance as it precludes the then existing Board offices from negotiating and reaching an accord on the 2017 operating budget after giving due consideration to the facts and circumstances presented to the agency at that time. It is entirely inappropriate for the existing Board majority to tie the hands of a future Board and any attempt to do so under the guise of enhanced transparency will achieve exactly the opposite result in both form and substance.

If the current Board majority was truly interested in transparency and accountability, they would hold public hearings on the budget and permit members of the credit union community to address the Board on the record.

Transparency, Redux, and Conclusion

Before concluding, there are a few more transparency-related areas worthy of note. In my view, the NCUA should:

- Disclose all legal fees and the basis for the determination of such payments related to the corporate system stabilization litigation and settlements,
- Reconsider the need for rule-required stress tests and, at a minimum, the Blackrock methodology employed in all such tests,
- Disclose all credit union losses greater than \$5 million (instead of the current level of greater than \$25 million),
- Revise the appeals process so as to enhance due process, and limit ex parte

determinations,²⁶

- Consider whether there is merit in disclosing CAMEL ratings with an 18-month or longer lag,
- Consider providing better and more timely information to credit unions on what issues are resulting in Letters of Understanding and Agreement and consent decrees, and
- Disclose the agency's legal opinion regarding its authority under the CUSO rule.

Having expressed my views regarding the 2016 and 2017 budgets, I cannot in good conscience vote to approve them.²⁷

The NCUA can and should reduce the operating budget and improve its budget process in line with its status as a federal agency that happens to receive most of its funds from credit unions. Until the transparency of the funding process is materially enhanced and the credit union community and general public are afforded sufficient opportunity to comment on the proposed budget and the OTR prior to action by the Board, I cannot support the agency's misguided efforts to fund our operations.

Thank you.

²⁶ See "CUs Deserve a Better Appeals Process: McWatters," *Credit Union Journal*, at <http://www.cujournal.com/news/opinions/cus-deserve-a-better-appeals-process-mcwatters-1025208-1.html>.

²⁷ My comments regarding the 2016 and 2017 budgets and the budgetary process arise from the issues outlined in these remarks and not from any concerns with the Chief Financial Officer or his staff. My dissent to the adoption of the 2015 budget was also policy driven as outlined in my written statement, at <http://www.ncua.gov/newsroom/Pages/speeches/2014/november/SP20141121McWatters2015BudgetStatement.aspx>.