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Contents

EXECUTIVE SUMMARY

NASCUS believes NCUA should create a "Director of Insurance" coequal to the Executive Director, General Counsel and Inspector General and reporting directly to the NCUA Board. Duties directly related to the administration of the NCUSIF should be moved into an office reporting to the Director of Insurance. These duties would include:

- **Reviewing examinations performed by state and federal examiners on their respective credit unions**
- **Performing examinations on state and federal credit unions whose financial condition raise a concern with the NCUSIF**
- **Overseeing the liquidation and/or merger of troubled credit unions**
- **Developing examination platforms**
- **Providing training to state and federal examiners**

The separation of NCUA's insurance and chartering authorities should take place at the Regional Office. Until recently, the NCUA web site listed "insurance" functions at the Regional Office to include:

- **All chartering and FOM issues**
- **Federal credit union name changes**
- **Federal credit union bylaw changes**
- **Low income designations**
- **Federal credit union member complaints**

All of the above are the responsibility of the Chartering Authority, not the Insurer. By classifying the above as insurance functions, the NCUA is subsidizing the federal charter at the expense of state-chartered credit unions.

In essence, NCUA is hampered by two related conflicts of interest that arise because the insurance [Insurer] and chartering, regulatory and supervisory [Chartering Authority] functions are commingled at NCUA and indistinguishable for all practical purposes. There should be greater checks and balances between the NCUSIF and the supervision of federal credit unions. This structure gives rise to:

1. a competitive conflict of interest and

2. a supervisory conflict of interest.

The competitive conflict of interest provides NCUA, in the words of economist Lawrence White, "the ability to favor federal credit unions at the expense of [federally insured state-chartered credit unions]." This in turn impairs the natural competition between regulators that creates a healthy and innovative environment for their institutions. This result is manifested in the subsidization of federal credit unions by way of the OTR and corresponding reductions in federal examination fees. The NCUA acknowledged as much in its 1984 Annual Report. White described the NCUA's conflict of interest as a "*persistent problem*."

The supervisory conflict of interest was the primary source of concern in 1991 when the General Accounting Office (GAO) recommended in its report on credit unions that "a clearer distinction between the chartering, regulatory and supervisory functions and the ***insurance function*** [emphasis added] 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." GAO was concerned that NCUA could benefit federal credit unions at the expense of the NCUSIF, stating in that same report that the current conflict of interest at the Agency could allow for trade offs in favor of "weakened supervision over timely insurance action." Congress was concerned with this type of organizational structure when it chose to reorganize the Federal Home Loan Bank Board (FHLBB) by separating the FHLBB from the Federal Savings and Loan Insurance Corporation (FSLIC) in 1989.

Finally, in addition to inhibiting regulatory competition and raising supervisory concerns, the NCUA's conflict of interest has resulted in an OTR methodology that violates reasonable interpretation as well as the spirit of the Federal Credit Union Act (FCUA). A study commissioned by NASCUS, and performed by the CUNA Legal Department determined that "NCUA's role as Supervisor of federal credit unions was not subsumed by its administration of the NCUSIF."[1]

Currently, NCUA Region II operates from the NCUA's main office in Alexandria, Virginia. Within the main office, Region II is prominently segregated from the remainder of the NCUA Central Office staff. NASCUS presumes this is a result of a desire on the part of NCUA to emphasize that the staff of Region II are performing different functions than the rest of the Central Office. This concept is on point for the NCUA's separation of Insurance and Chartering Authority functions.

NASCUS' proposal to reorganize the NCUA, separating the insurance functions from the chartering functions is modeled on the State Regulator/NCUSIF structure. It would restore regulatory competition to the benefit of both regulatory agencies and their credit unions. It would result in fiscal accountability for the NCUA both toward its federal credit unions and the NCUSIF. It would restore public and Congressional confidence in the NCUA's ability to carry out its dual missions effectively.

1 "Overhead Transfer" CUNA Legal Department (October 2, 2001) p. 15.

It would cure the NCUA's violation of the FCUA and it is not without precedent within the Agency.

Remedying those conflicts would create a healthier federal agency, provide greater protection to the credit union deposits held by the NCUSIF, and create greater accountability within the NCUA. Restoring a true competitive environment between regulatory systems would benefit all credit unions. Reducing the expenses of the NCUSIF would arguably increase dividends paid back to credit unions. From a regulatory standpoint, reorganizing the NCUA is not only logical, it is consistent with minimal standards required of the financial institutions they and the states regulate.

Introduction

Background

The Dual Chartering System

The credit union system is predicated upon the only "meaningful dual chartering system" in the country today.[2] That system is comprised of approximately 4,000 state credit unions, chartered and supervised by 48 state and territorial regulatory agencies and approximately 6,000 federal credit unions chartered and supervised by the National Credit Union Administration (NCUA). The dual chartering system thrives on the ability of those credit unions to choose a state or federal charter, and in some cases, federal or alternative insurance. In order to attract credit unions to their charter, regulatory agencies engage in a healthy "regulatory competition" that often fosters innovation in regulation, efficiency in examination, and market discipline in controlling cost of supervision. This regulatory competition is the healthy consequence of the credit union dual chartering system.[3]

The NCUA also administers the National Credit Union Share Insurance Fund (NCUSIF or the Fund) which provides federal insurance for shares and deposits at state and federal credit unions. The NCUSIF also plays an important role within the dual chartering system by serving as a "charter neutral" check on state and federal supervisory actions by proscribing the activities of federally insured credit unions that pose an unacceptable risk to the insurance fund.

At times in the past, there has also been a meaningful dual chartering check on the NCUSIF in the form of various state and private insurance or guarantee systems for credit union shares.[4] However, as discussed below, the elimination of most of these share insurance alternatives has minimized the checks and balances to the NCUSIF actions.

Use of the National Credit Union Share Insurance Fund

The NCUSIF was created by an Act of Congress in 1970 to provide federal insurance protection for the shares in federal and state-chartered credit unions. The NCUSIF is entirely funded by deposits made by those credit unions.

2 See NCUA Annual Report, remarks of NCUA General Counsel Wendell Sebastian, p. 18 (1984).

3 See Caught in a Regulatory Vise: The Peculiar Problem Faced by Federally Insured State-Chartered Credit Unions, Lawrence J. White, p. 7, (2001).

4 See NCUA Annual Report, p. 18, (1984).

The funds on deposit in the NCUSIF are to be used by the NCUA as the Administrator of the Fund, for three distinct purposes:

1. For payment of insurance under Section 207 (coverage of insured shares in a failed credit union);
2. For expenditures made under Section 208 (assistance in connection with the liquidation or threatened liquidation of an insured credit union); and
3. For such administrative and other expenses incurred in carrying out the purposes of Title II of the Federal Credit Union Act. [see 12 U.S.C. § 203.]

In addition, the NCUSIF pays back dividends to the credit unions whose deposits with NCUSIF constitute the Fund.

Through a mechanism known as "the overhead transfer rate" (OTR) the NCUA has allocated a portion of the earnings of the NCUSIF to pay its operating expenses. Over a period of time, the rate of this overhead transfer has increased from zero in 1970, when Congress enacted Title II of the Federal Credit Union Act, to 33% in the late 1970s, to 50% in 1985, and then to 66.72% in October 2000. The rate was subsequently reduced to 62% in November 2001 and is the rate used for NCUA fiscal years 2002 and 2003. What this means is that the NCUA has determined, for fiscal 2002 and 2003, the earnings of the Fund will be used to pay 62% of the NCUA's total operating expenses of carrying out both of its missions.

The NCUA's Current Structure May Create Conflicts of Interest

There are potential conflicts of interest inherent in the current structure of the NCUA. The conflicts exist between NCUA's two fundamental missions: 1) as the chartering, regulatory and supervisory authority for federal credit unions [Chartering Authority] (under Title I of the FCUA) and 2) as the insuring authority of the shares and deposits at federally-insured credit unions [Insurer](Title II of the FCUA).

Because of its structure, the NCUA in its role as insurer is presented with and makes choices that benefit federally chartered credit unions at the expense of state-chartered credit unions. Currently, the insurance and chartering, regulatory and supervisory functions are commingled at NCUA and often indistinguishable for all practical purposes. There should be a check and balance between the NCUSIF and the supervision of federal credit unions.

These potential conflicts of interest may manifest themselves in policy choices that disadvantage state credit unions and weakens both the dual chartering system and the administration of the NCUSIF, causing us grave concern.

The potential conflicts of interest:

1. Subvert the competitive process of the dual chartering system;
2. Taint the methodology for determining the overhead transfer rate and result in a violation of the FCUA;
3. Deprive the NCUSIF of a true quality control methodology; and
4. Often deprive federal credit unions of innovative regulation.

The conflicts within the NCUA also necessarily taint information flowing to the NCUA Board (the Board). This information impedes the Board in evaluating the success of NCUA in accomplishing either of its missions.

We believe the potential conflicts of interest are a serious issue that should be addressed and mitigated by the NCUA. Failure to mitigate the conflict may impact NCUA's credibility and reputation among credit unions, Congress and the public.

State Regulators Propose Remedies

Over the years, NASCUS has shared its concerns with NCUA arising from the NCUA's conflicts of interest. State regulators have proposed various solutions (state representation on NCUA Board, creation of a separate Board for the NCUSIF, clear segregation of NCUA's distinct missions) to remedy the flaws inherent in the NCUA's conflict. While varied, those proposals all speak to the need for a clear definition within the NCUA of its distinct missions and a reduction of the conflict of interest between NCUA as administrator of the NCUSIF and NCUA as supervisory authority for federal credit unions.

NASCUS Chairwoman Jerrie Lattimore (NC) and NCUA Board Member JoAnn Johnson have discussed the NASCUS recommendation that NCUA more clearly define its roles and reorganize to reduce the inherent conflict of interest.

The NASCUS Proposal

In this proposal, NASCUS will review the flaws in the NCUA's current organizational structure and examine the ramifications of those flaws for the dual chartering system. NASCUS will outline its vision for reorganizing the NCUA then apply its proposal to those problems identified in this analysis. Finally, NASCUS will address NCUA's implementation of the proposal.

Note: In the following sections, where NCUA job titles descriptions and functions are cited, the source of this material is NCUA's website. For further details, please refer to http://www.ncua.gov.

The Flawed Structure of NCUA's Current Organization

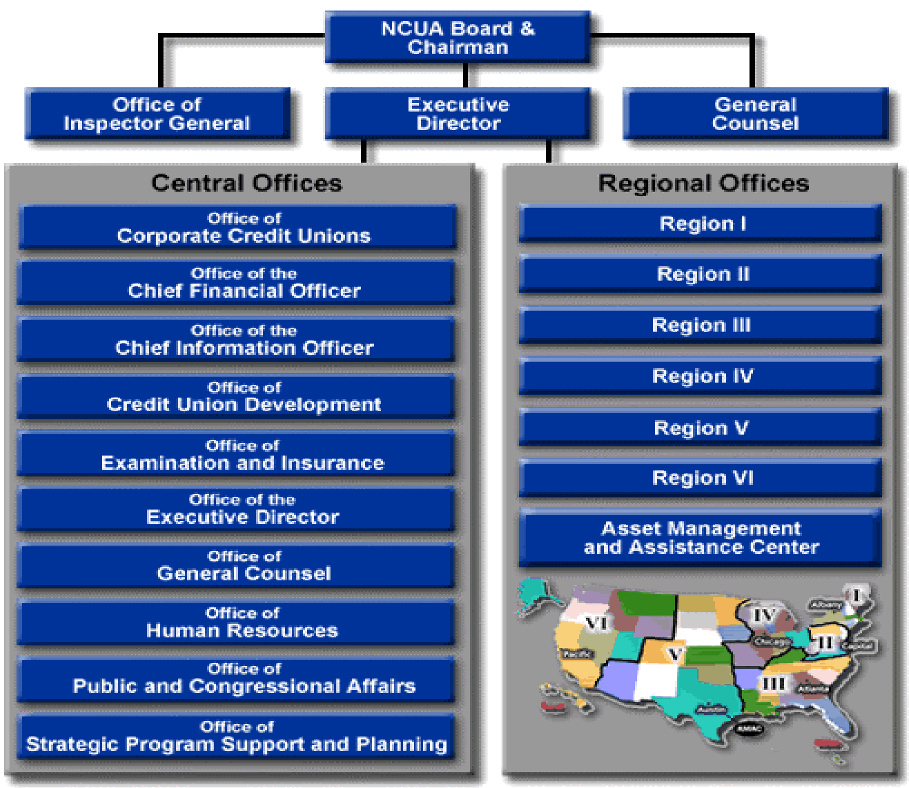

Figure 1: Current NCUA Organization

Under the construction shown in Figure **1** the NCUA personnel responsible for administering the insurance fund are the same people responsible for chartering federal credit unions, examining federal credit unions, regulating federal credit unions and promoting the federal charter.

Conflicts of Interest

The problem for the credit union system is that the NCUA bears responsibility for the federal charter as well as responsibility for the NCUSIF. This position gives the NCUA, in the words of economist Lawrence J. White, "the ability to favor federal credit unions at the expense of [federally insured state-chartered credit unions]." Professor White goes on to say "since NCUA is in competition with the states, its position as NCUSIF administrator places it in a conflict of interest."[5]

NCUA's competitive conflict is just one of two broad conflicts of interest within the Agency. NCUA also faces a conflict of interest between its duty to the NCUSIF and its role as chartering and supervisory authority for federal credit unions. One need look no further than the now rejected organization of the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) to appreciate the potential risk posed by this conflict.

Case Study: FIRREA

From the 1930's to 1989, both the chartering and supervisory responsibility for the thrift industry and administration of the thrift insurance fund (FSLIC) resided under the FHLBB. This organizational structure mirrored the current NCUA structure.

This structure had no shortage of critics:

At the regulatory level, critics have observed a blatant ***conflict of interest*** *between the FHLBB and the FSLIC.* [emphasis added] *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.***[emphasis added][6]

In 1989, Congress acted to end this conflict of interest, separating the insurance administration functions and the regulatory supervision for the thrift industry.[7]

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[5] See Caught in a Regulatory Vise: The Peculiar Problem Faced by Federally Insured State-Chartered Credit Unions, Lawrence J. White, p. 20, (2001).
[6] See Congress, regulators, RAP, and the savings and loan debacle, (regulatory accounting principles), Ahmad W. Salam, The CPA Journal on Line, (January 1994).
[7] In 1989 Congress enacted The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) which eliminated both FHLBB and FSLIC.

Why did Congress choose not to address the conflict of interest at the NCUA at the same time?

At the time of FIRREA, the credit union industry looked very different than it does today. Ten share insurers diluted the implications of NCUA's competitive conflict of interest over the entire industry in 1991. A diversity of share insurers meant that regulatory competition existed side by side with insurance competition. The availability of charter and insurance choice served to mitigate the existing conflict of interest within the NCUA by providing both state and federal credit unions with the ability to "vote with their feet" by converting charter and insurance coverage. Therefore, while at the time of FIRREA, the credit union system had some built in checks and balances, the FHLBB and FSLIC did not.

Another reason may be that Congress wanted to gather more information about the credit union system before moving to remedy NCUA's second conflict of interest. FIRREA directed the General Accounting Office (GAO) to study the credit union industry, probably because, while the existence of other insurers mitigated the NCUA's competitive conflict of interest, the other conflict, that between charterer and insurer, still existed.

The General Accounting Office (GAO)

In 1991, GAO published a study on credit unions and the NCUA. The study, mandated by FIRREA, was to determine if NCUSIF should be split out from NCUA's chartering functions in conformity to the FIRREA reorganization of the savings association industry.[8] GAO found that there was not a need to create a separate agency to administer the NCUSIF as long as certain corrective measures in NCUA's organization were undertaken.

Primarily, a separation of the personnel responsible for supervision and insurance was recommended by GAO to elevate any "discussions of trade offs, for example in favor of weakened supervision over timely insurance action, to the Board level."[9] Furthermore, GAO recommended that the NCUA Board be expanded to include regulators from other federal financial agencies. Presumably, these additional Board members would not share the core Board member concerns with the federal charter and would therefore provide for independent NCUSIF objectivity.

For over a decade, concern has existed regarding NCUA's inherent conflicts of interest (regulatory and safety and soundness). Today, the credit union movement's checks and balances have diminished, and the NCUA's conflict of interest endures unfettered. This conflict poses serious challenges for the credit union system.

[8] Credit Unions: Reforms for Ensuring Future Soundness; General Accounting Office Report to Congress, July 1991, p.188.
[9] Credit Unions: Reforms for Ensuring Future Soundness; General Accounting Office Report to Congress, July 1991, p.194.

Consequences Resulting from the NCUA's Conflicts of Interest

As identified above in the introduction, there are several consequences resulting from the NCUA's conflict of interest.

- **There is no genuine regulatory competition.**
- **The methodology for determining the overhead transfer rate is flawed.**
- **The safety and soundness of the NCUSIF may be jeopardized by a lack of independent/objective review of federal examinations.**
- **Federal credit unions are deprived of innovative regulation.**
- **All information from within the agency flowing to the NCUA Board originates in offices with potential conflicts of interest and therefore may be "tainted."**

Finally, the mere perception of a conflict of interest, for any regulatory agency is a serious flaw that in and of itself must be addressed.

- **There is no genuine regulatory competition.**

Understanding the concept of dual chartering is essential for understanding the inherent competitive conflict of interest within the NCUA. The credit union system is one that is based on the principle that different and distinct chartering authorities are in healthy competition. This concept, applicable to any dual chartering system, is so fundamental, it prompted this statement from the Federal Reserve Bank of Cleveland in 2000:

Economists generally consider competition an effective discipline for both private firms and public agencies. In the area of bank regulation, competition between the three federal regulatory agencies and between federal and state regulators has been said to confer two important benefits: ***Regulatory competition checks overzealous regulators by mitigating their tendency to stifle innovation and restrict new entrants. Moreover, competition encourages regulatory agencies to innovate, thus increasing their effectiveness and lightening the burden of regulation costs borne by their clients.*** [emphasis added][10]

The overhead transfer rate is a clear example of how the NCUA's conflict of interest has prevented genuine regulatory competition. One of the surest benchmarks for competing regulatory agencies is comparing the fees they charge the institutions they examine.

Federal credit union examination fees are lowered as more cost is passed through to the NCUSIF and state-chartered credit unions. On the state side, regulatory agencies must assess their credit unions the true cost of examination and supervision.

[10] Excerpted from Two Deposit Insurance Funds Are Not Necessarily Better than One, James B. Thompson, Federal Reserve Bank of Cleveland, October 15, 2000.

State regulatory agencies, forced to assess credit unions the true cost of their supervision, must strive for regulatory and supervisory efficiency. Because the NCUA does not pass the true cost of examination on to their federal credit unions, the federal charter represents a less expensive option for credit unions in an artificial manner.

Another example of the breakdown of regulatory competition is the increasing homogenization of state and federal credit unions resulting from NCUA regulation that is categorized as insurance regulation. By shifting its regulatory authority predominately to insurance regulation, the NCUA has limited the ability of state regulators to promulgate innovative regulations and dampened competition between regulators and the state and federal charters.[11]

- **The methodology for determining the overhead transfer rate is flawed.**

It violates the spirit of the FCUA and discourages budget discipline on NCUA's part.

The inherent conflict of interest within the NCUA has tainted the overhead transfer methodology. The ease with which NCUA characterizes all safety and soundness work as insurance related and subsidizes supervision of federal credit unions with the NCUSIF clearly demonstrates the need for a division of responsibility within the agency. Throughout its organization, the NCUA charges the NCUSIF for work which a true insurer would not subsidize.

Until recently, the NCUA characterized the mission of the ***Insurance Division*** at the Regional level as follows:

The Division of Insurance is responsible for all **chartering and field of membership (FOM)** issues for Region II federal credit unions, member complaints regarding federal credit unions, as well as insurance issues regarding federally insured state-chartered credit unions (FISCUs). Division of Insurance personnel consists of the Director, Analysts, Technicians, and the Economic Development Specialist. Contact the Division of Insurance if you have any questions regarding the following topics:

1. **Bylaws**
2. Charter Conversions (State to Federal and Federal to State)
3. Field of Membership (FOM)
4. Insurance Conversions
5. **Low Income Designations**

[11] Since January 2002, of 18 proposed and final rules considered by the NCUA Board, 11 rules were insurance regulation and 7 were federal credit union rules.

6. Federal Credit Union Election Procedures
7. Federal Credit Union Charter Applications
8. Federal Credit Union Community Charter
9. Expansions/Conversions
10. Insurance Applications (new Federally Insured State Credit Unions)
    Involuntary Liquidations
11. Mergers
12. National Credit Union Share Insurance Fund (NCUSIF) Coverage
13. Federal Credit Union Start-up packages
14. Federal Credit Union Name Changes
15. Federal Credit Union Member **Complaints**
16. **Small Credit Union Program**

Many of the functions described above should be performed by the Chartering Authority at the Regional level.12 We believe the Insurance Division should concentrate solely on reviewing the examinations submitted by state and federal examiners, overseeing the management of problem credit unions and the merger or liquidation of federally insured credit unions. These functions are directly related to the safety and soundness of the Fund.

Furthermore, as discussed above, the NCUA ***should be just as concerned with safety and soundness*** as a Chartering Authority as it is as an Insurer.[13] It appears as though, under NCUA's current structure and overhead transfer methodology, almost all of the NCUA's safety and soundness work is charged to the Fund. This creates an inappropriate subsidization of the federal credit union program. Unless NCUA segregates the employees performing safety and soundness reviews for the Fund and those performing safety and soundness reviews for the federal credit unions as required by Title I, there can be no accurate accounting of the true costs of either program.

From the initial Congressional authorization for federal credit unions in 1934, to the inception of the NCUA and NCUSIF in 1970, federal credit unions were chartered, examined and supervised by federal agencies without the additional oversight of an insurer:

- The Farm Credit Administration (1934-1942)

[12] Bylaw issues, FOM, Low Income Designation, Charter Applications, Election Procedures, Community Charter Expansions, Credit Union Name Changes, Member Complaints, Small Credit Union Program are all examples of duties properly performed by the Chartering Authority.
[13] See *The Distinct Safety and Soundness Concerns*. Pages 20-22.

- The Federal Deposit Insurance Corporation (1942-1948)
- The Federal Security Administration (1948-1952)
- The Department of Health, Education and Welfare (1952-1970).

For 36 years, these agencies were primarily responsible for the safety and soundness of federal credit unions.

Surely, when Congress created the National Credit Union Administration in 1970, Congress was interested in no small way in the safety and soundness of federal credit unions. After all, at the time, federal credit unions remained the only uninsured, federally-chartered depository institution. And yet, Congress declined to include the amendments creating the NCUSIF in the final bill. The NCUA was created alone to charter/supervise/examine federal credit unions, to ensure safety and soundness. The NCUSIF was created independently later that year.

Title I of the FCUA requires the NCUA Board to examine and supervise federal credit unions, funded by federal credit unions' operating fees. Federal Credit Union Act: Section 106. Other federal and state chartering agencies today – the OCC and the OTS and all the state agencies that charter banks, thrifts and credit unions, without an insurance function – are very interested in the safety and soundness of the institutions they regulate. In fact, is that not the *raison d'etre* of their regulation?

Is it not indisputable that the Board's examination and supervision of federal credit unions under Title I should be concerned with safety and soundness? And yet the NCUA's current methodology to determine the overhead transfer rate seems based on a presumption that the NCUA, in its role as charterer of federal credit unions, does not involve itself with the safety and soundness of these credit unions, and that safety and soundness is solely an insurance [NCUSIF] function.

Title II of the FCUA provides that credit unions applying for NCUSIF insurance must agree:

1. To pay the reasonable cost of such examinations as the Board may deem necessary in connection with determining the eligibility of the applicant for insurance: ***Provided*****, That examinations required under title I of this Act shall be so conducted that the information derived therefrom may be utilized for share insurance purpose**s, and examinations conducted by State regulatory authorities shall be utilized by the Board for such purposes to the maximum extent feasible;

2. To permit and pay the reasonable cost of such examinations as in the judgment of the Board may from time to time be necessary for the protection of the fund and of other insured credit unions; …

> -Section 201(b)(1), (2). See also NCUA forms 9500 and 9600, the Application And Agreement For Insurance Of Accounts required from federal and state credit unions, respectively, that apply for NCUSIF insurance. [Emphasis supplied]

Clearly, under (1) above, Congress intended that the NCUA Board should rely on the on-going exam/supervision program of the Board under Title I to carry out its insurance function in regard to federal credit unions. Section 201(b)(1); Section 202(a)(5). Similarly, the Board must rely on state exams and reports in regard to state credit unions. Section 201(b)(1); Section 202(a)(5).

Although the initial part of (1) above before the "Provided" clause addresses insurance eligibility exams, NASCUS believes that Congress intended the "Provided" clause to be much broader in scope. Congress intended this clause to apply to insurance eligibility exams *and future exams* conducted by the Board under Title I (and by the states) after applicants were approved for insurance. *Why?*

- In most instances, as appropriate, the Board does not rely on an existing examination as the eligibility examination. In the case of de novo federal credit unions, there is no existing examination. In the case where a state has performed a charter eligibility examination for a de novo state charter, the state examination may not focus on the same matters. Even with an existing credit union applying for insurance, it is likely that any existing examination has become stale through the passage of time or was not focused on eligibility matters.

  If the "Provided" clause required reliance on Title I exams and state examinations for eligibility purposes only, it would render this wording largely ineffective. To give this wording real effect, it should be read to apply to the on going examination programs of both the Board (under Title I) and the states.

- The wording in subsection (2) is different from (1) – reinforcing our interpretation that it applies only to examinations "as in the judgment of the Board may from time to time be necessary" under the Board's Title II discretionary examination authority.

Title I requires federal credit unions to pay an "operating fee" to the NCUA. These operating fees are deposited with the U.S. Treasurer, and may be spent by the Board on expenses incurred in carrying out the FCUA, including the examination and supervision of federal credit unions. <u>Section 105(a), (d)</u>.

Under Title II, insured federal and state credit unions pay deposits and premium charges that fund the NCUSIF revolving fund. <u>Section 203(a)</u>. The Board may use the NCUSIF fund to pay, among other things, such administrative and other expenses incurred in carrying out the purposes of this title as it may determine to be proper. <u>Section 203(a)</u>.

The Board's reliance on this wording for authority to make "overhead transfers," as they have come to be known, is misplaced. As used in 203(a), "this title" refers to Title II. As noted above, the Board's required examination/supervision of federal credit unions is under Title I.

Consequently, Title II limits the authority for overhead transfers to sums needed to reimburse the Board for other insurance examination and supervision work in regard to insured credit unions, not for the on going examination and supervision of federal credit unions required by Title I.

In regard to the overhead transfer for the current fiscal year, the NCUA conducted an internal study to determine the percentage of staff (and Board?) time devoted to "insurance-related" matters. Apparently the study indicated that over 62% of the NCUA's time was spent on insurance matters. Accordingly, the Board authorized an overhead transfer from the NCUSIF fund to pay over 62% of the NCUA's total operating expenses. Following this action, the Board decided to reduce the operating fee to federal credit unions by, on average, more than 20%.

As noted above, the Board's methodology for determining the overhead transfer rate is clearly inconsistent with the statutory scheme set forth in Title I and II of the FCUA. The effect of this unlawful methodology is significant:

- State credit unions are forced to subsidize NCUA examination and supervision of federal credit unions from the NCUSIF
- The cost of federal deposit insurance is artificially inflated for all credit unions
- Because of the unlawful overhead transfer, state credit unions are paying more than their share of the cost of the NCUSIF
- Federal credit unions are not paying their way – they are not paying the true cost of NCUA regulation mandated by Title I
- Because the NCUSIF is so flush with cash, the Board has a deep pocket to pay for its expenses – making it difficult to engage in a reasoned debate about the appropriate level of NCUA examination and supervision of federal and state credit unions
- The Board is able to mix its chartering and insuring authorities without any clear understanding of the differences between the two.

Essentially, the Board's methodology is backwards – just the opposite of the statutory mandate. The Board should first determine the amount of time spent on federal credit union exam/supervision, including regular safety and soundness exams, and charge the federal credit unions the appropriate amount in the form of an operating fee to cover these costs. Remaining insurance costs of the Board could then be covered through an overhead transfer. The only way to cure this backward approach would be to separate the functions within the NCUA.

In 2001, CUNA's Legal Department published an excellent review of the OTR and the FCUA. They concluded that NCUA's shifting of almost all cost of examination to the NCUSIF violates the letter and the spirit of the FCUA.

1. The safety and soundness of the NCUSIF may be jeopardized by the lack of an independent/objective review of federal credit union examinations.

The present structure does not provide a check and balance system for quality control of federal credit union examinations. State credit union examinations are performed by one agency (state regulator) and reviewed by another (NCUA). Federal credit union examinations are performed and reviewed by the same division within the same agency (NCUA). This is equivalent to not separating the risk taking, the risk monitoring, and risk management functions in a business entity. Regulators would consider such a structure a fundamental internal control weakness, which would be recognized as such, and the business entity would be required to change the arrangement and eliminate the internal control weakness. This was the main point in GAO's recommendation that the chartering and insurance functions be separated and that the NCUA Board be expanded.

Furthermore, the Fund's administrator should be concerned with minimizing operating expenses. However, NCUA's conflict of interest subordinates concern with Fund expenses to the NCUA's funding its overall budget. Without a co-equal branch of the NCUA to challenge cost allocation, NCUA has no incentive to demonstrate efficiency or fiscal discipline in its supervision of federal credit unions because those operations may be subsidized by the Fund. As a result, funds are unnecessarily bled from the NCUSIF.

2. Federal credit unions are deprived of innovative regulation.

The present structure of the NCUA deprives both federal credit unions and the NCUSIF of a true advocate.[14] As discussed below in the review of the state model, federally insured state-chartered credit unions benefit from having an advocate in their regulator when it comes to issues concerning insurance regulations. Furthermore, the need to pass true costs along to state-chartered credit unions provides an incentive for the state regulator to perform its duties effectively and efficiently. Federal credit unions receive neither benefit. No voice challenges assumptions made by the Insurance Fund regarding acceptable risk when it comes to federal credit unions.[15]

[14] By "advocate" we mean a supervisory body that weighs risk versus the promotion of a healthy competitive environment.

[15] Inherent in this discussion is the concept of 'acceptable risk." All financial institutions inherently are at risk. The job of regulation is to set parameters for acceptable risk.

The lack of a supervisory body that seeks to both balance risk, and promote the success of its regulated institutions has weakened the dual chartering system and retarded federal credit union innovation. While NCUA has promulgated recent progressive regulations such as the proposed member business lending rule, final foreign branching rule and final federal field of membership regulations, the fact remains that almost all major credit union innovation has occurred at the state level. Issuance of share drafts, member business lending, CUSO investments, mortgage lending, issuance of credit cards and expanding opportunities for credit union membership were all approved at the state level before being adopted by the federal regulator. This innovation occurred in part because state regulators assessed risk differently than the insurer. The fact that all of these innovations have been adopted by the federal regulator seems to validate the state assessment.

In October of 2003, the NCUA amended its member business loan rule. The excellent amendments promise to provide much needed relief to federally insured credit unions engaged in member business lending. Interestingly, many of the new provisions are "borrowed" from state member business lending rules. When NCUA allowed states to promulgate state specific rules, the innovative benefit of dual chartering immediately took affect.

By separating the insurer from the chartering entity, NCUA will create an advocate for the federal system that may take the lead in negotiating risk parameters with the insurer.

The NCUSIF too is deprived of a true advocate. Without a separate manager, there is no voice that seeks to minimize the expenses charged to the Fund. An increasing overhead transfer rate indicates that while the ***number of insured institutions*** has decreased, the cost of insuring them has steadily increased.

3. Information from within the Agency flowing to the NCUA Board originates in offices with inherent conflicts of interest and is therefore tainted.

The NCUA's current structure also inhibits the Board's ability to evaluate the effectiveness and efficiency of its operations. The conflict of interest within the organization almost certainly assures that criticisms or information critical of either the Fund's risk analysis or the quality and efficiency of the regulator go unreported to the Board. Simultaneously performing the roles of FCU regulator and NCUSIF administrator requires the NCUA Board to act based on information from staff with inherently conflicting motivations (keeping FCU fees low versus keeping insurance costs low). The absence of direct costing for credit union deposit insurance (a system where the majority of costs are directly attributable to particular functions with a relatively small amount of common overhead cost allocated across functions) exacerbates this inherent conflict.

4. NCUA's credibility

Finally, we believe the potential conflict of interest is a serious issue that should be addressed and mitigated by the NCUA. Failure to mitigate the conflict may significantly impact NCUA's credibility and reputation among credit unions, Congress and the public.

Among credit unions, NCUA should be concerned with the growing perception that dividends due credit unions from the Fund are being improperly diverted to subsidize federal credit union regulation. NCUA should be concerned that Congress may become troubled by the potential conflict of interest within the NCUA. Possible Congressional cures for this conflict could present the NCUA some unfavorable scenarios such as complete removal of the insurance function.

NASCUS does not support such a solution. We believe the credit union system can and should mange its own insurance fund. However, we recognize that the ongoing potential for a conflict of interest within the NCUA must be remedied.

The public must believe the NCUA is operating in the best interest of the NCUSIF and holding itself to the same standards as the institutions it is regulating. From an accounting control standard, the NCUA's current overhead structure in relation to the overhead transfer would be unacceptable in any credit union and NCUA itself has taken steps to eliminate even ***perceived*** conflicts of interest in the credit union environment where that conflict might have an anti-competitive effect. See NCUA Rules and Regulations Part 711, Management Official Interlocks. [16]

The States as a Model: How the System was Meant to Work

Cooperation between the Insurer and the Chartering Authority

Under the state model, credit unions are supervised by a chartering, supervisory and regulatory authority (Chartering Authority/Supervisory Authority or SA). The cost of those programs is passed back to the credit unions. The SA examines the credit unions for safety and soundness and regulatory and statutory compliance. In addition, programs to assist credit unions are often administered by the SA, supported by the fees levied on credit unions.

[16] Part 711.1(b) reads: "The purpose of the Interlocks Act and this part is to foster competition by generally prohibiting a management official from serving two non-affiliated depository organizations in situations where the management interlock likely would have an anti-competitive effect."

The examinations of those credit unions are submitted to the insurer for review. The insurer reviews those exams and in most cases those exams, performed by the SA, serve as the Insurer's annual examination of the credit union. In some cases, the Insurer will conduct joint exams with the SA to validate the examination process as part of its due diligence. In other cases, the SA's exam has revealed troubling trends in a particular institution, and the Insurer conducts joint supervision of that institution. Therefore, while the Insurer does conduct joint examinations of some credit unions, predominantly, the responsibility for examination and supervision lies with the SA. The Insurer and the SAs developed an examination platform that is used by both the SA examiners and the Insurer's examiners, which allows the examinations performed by the SA to be integrated into the Insurer's annual reviews of its insured credit unions.[17]

In addition to sharing the exam platform, the Insurer provides training and other examination support to the SA in exchange for the submission of the SA examination for the Insurer's review.

The Benefits of Distinguishing between Insurer and Chartering Authority

The review of the state examinations by the Insurer validates the Insurer's reliance on the state examination program and adds a layer of protection to the Fund on the state side. Shortcomings in examinations are easily identified and addressed. Because there is a separation between insurer and supervisory examination, there is no incentive to delay action on unsatisfactory exams.

Furthermore, because there exists a clear separation between the Insurer and the SA, credit unions know exactly what costs are associated with running the supervisory agency and what costs are associated with administration of the Fund. Inefficiencies within the SA are quickly identified and market discipline is imposed upon the supervisory authority to control fees.

[17] 47 of 48 SAs use the "ARIES" exam platform. Utah uses the FDIC platform.

Purpose of Reorganization

NASCUS proposes the NCUA reorganize internally to achieve the following:

1. Reflect its two distinct missions;
2. Reduce conflict of interest in performing those missions;
3. Create accountability in use of funds from the NCUSIF; and
4. Create a healthier regulatory agency.

NCUA, ***with its existing Board structure***, could achieve this reorganization by creating a Director of Insurance reporting directly to the Board and supervising NCUA's insurance responsibilities both at the Central Office and at the Regional level. Staff responsible for insurance functions would be separated from staff performing NCUA's Title I examination and supervision functions.

The NCUA's Dual Mission

In order to properly frame the following discussion, an important distinction must be drawn between the two missions of the NCUA. In 1991, GAO characterized the NCUA's mission as two pronged: chartering, regulatory ***and supervisory functions*** and the insurance function.[18] This is an accurate assessment.

Title I: Chartering, Regulatory and Supervisory Functions (Chartering Authority)

In this capacity, NCUA acts exactly as a state credit union regulatory agency. In previous communications, we have referred to this as NCUA's Title I authority. This mission comprises all of the expectations of Congress in 1934 when the Federal Credit Union Act was passed.

Under the first component of this mission is the NCUA's chartering responsibility. Clearly, NCUA is responsible for establishing the parameters within which federal credit unions are chartered. Bylaw requirements, Board qualifications, fields of membership, and other incorporating principles fall within this category.

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[18] "If the NCUSIF remains within the NCUA, we believe a clearer distinction between the chartering, regulatory and supervisory functions ***and the insurance function*** [emphasis added] needs to be made."
- *Credit Unions: Reforms for Ensuring Future Soundness*; General Accounting Office Report to Congress, July 1991, p.194.

The second component, regulatory, encompasses those powers and activities federal credit unions need to fulfill their mission that are derived by the regulatory process.

The third component is supervisory. This encompasses the examination of federal credit unions by the NCUA. These examinations must fulfill two functions: to ensure that federal credit unions are in compliance with regulatory and statutory mandates ***and*** to ensure they are being operated in a ***safe and sound manner***. It is this component, the supervisory examination for safety and soundness, where distinctions must be drawn. Before we address those distinctions, it is useful to review the second component of NCUA's mission.

Title II: Insurance Functions

In this capacity, NCUA administers the credit union share insurance fund. Under Title II, NCUA should review the examinations of federally insured credit unions performed by state agencies and by the NCUA's federal examiners. The exams are reviewed to determine if any credit union poses an unacceptable risk to the NCUSIF. Under Title II, NCUA may conduct additional joint examinations of federal and state credit unions to more fully ascertain any liability to the Fund as a form of validation of the supervisory examinations being performed by state and federal examiners. Furthermore, under Title II, the NCUA develops exam platforms, manages the technical needs of credit union examiners and provides training to ensure examiners are using the exam platform properly.

As the Insurer, NCUA does exercise "supervisory" authority over ***state and federal*** credit unions. However, this insurance supervisory authority is exercised in cooperation with an insured credit union's primary chartering and supervisory authority.

The Distinct Safety and Soundness Concerns

NCUA's dual mission encompass two distinct safety and soundness concerns. While a superficial analysis of these two functions may find some overlap, a more detailed analysis of the core motivations of those responsibilities reveals the fundamental distinction between those two missions.

Supervisory or Chartering Authority Safety and Soundness

Simply put, the NCUA's ***supervisory*** safety and soundness concern is identical to that of a state regulatory agency: to ensure that their credit unions are operated in a safe and sound manner to protect ***the member's deposits***.

For 36 years, these agencies were primarily responsible for the safety and soundness of federal credit unions.

Insurance Safety and Soundness

Under NCUA's ***insurance*** mission, it is concerned with safety and soundness to ensure that the ***insurance fund does not incur liabilities and to the extent that the fund must pay out to cover losses, it is adequately capitalized.***

The NCUA Board

In its 1991 Study, GAO recommended the NCUA Board be expanded.[19] This is not necessarily the solution for the problem of ensuring objectivity in the governance of the Insurance Fund. With a reorganization of the NCUA, the Board is capable of supervising both the NCUA's insurance responsibilities and its chartering, regulatory and supervisory functions. The challenge before the Board is therefore not in the Board's structure, but rather in the Agency structure below the Board level.

The imbedded conflict of interest and lack of financial accountability within the NCUA's current structure necessarily taint the information flowing to the Board and impede the Board's decision making process. By reorganizing the NCUA along functional mission lines as proposed below, the Board will remedy the tainted information stream.

Recommendation: Agency Organizational Structure

In order to execute faithfully the responsibilities dictated by Congress in 1934 and again in 1970, we recommend the NCUA reorganize to more clearly define its two missions.

1. We suggest that NCUA create a Division of Insurance whose director reports directly to the Board. Activities related to the Fund should be placed under this director as well as those activities that are or should be predominately funded by the overhead transfer: examiner training, information systems and technology (IS&T), the asset management center and the insurance mission staff of the regional offices.

2. We also recommend moving the Office of General Counsel from under the Executive Director and placing it under the General Counsel as an independent office.

[19] *Credit Unions: Reforms for Ensuring Future Soundness*; General Accounting Office Report to Congress, July 1991, p.192.

3. Furthermore, to the extent feasible, we would urge NCUA to create a physical distinction between their two missions. Within the Central Office, the proposed Division of Insurance should be segregated from the rest of the NCUA. We believe physically segregating the NCUA's office will serve several important functions:

    a) Help staff focus on their respective missions;
    b) Create appropriate separation for accounting and internal control purposes;
    c) Address GAO's conflict of interest concerns; and
    d) Create a healthy competitive tension between NCUA's dual mission.

The Precedent of Region II

There is contemporary precedent for physically segregating the NCUA's insurance functions and staff from the NCUA's chartering, regulatory and supervisory functions and staff. Currently NCUA's Region II office is located within the NCUA's headquarters building in Alexandria, Virginia. However, all of Region II's functions and staff are clearly delineated from the rest of the NCUA's "Central Office" staff. Region II is located in a section of the headquarters that is separated and distinct from the rest of the operations. An office within an office, a visitor must pass through glass doors clearly marking they have entered a segregated area dedicated solely to Region II staff and operations. *Why?*

We believe Region II is thus segregated because while the region shares offices with the Central Office, the region's responsibility is to fulfill a distinct mission: the servicing and supervising credit unions in regions and administering the Fund's activities in the region.

As a result of the segregation, both NCUA as an agency and the credit unions in Region II benefit. Credit unions receive oversight, both supervisory and insurance related, that is focused on their issues. NCUA can more clearly account for the costs associated with Region II's program as a result of their physical segregation.

NCUA Reorganizational Structure[20]

Under NASCUS' proposed reorganization of the NCUA, four equal divisions would report directly to the Board.

Office of the Inspector General (OIG)

No Change. NCUA's OIG "carries out its principal mission through audits, investigations, and other inquiries, and makes reports to the NCUA Board, agency management, and Congress. The IG also reviews proposed and

[20] See Appendix I for *Proposed NCUA Organizational Chart.*

existing laws, regulations, and internal instructions concerning NCUA and makes appropriate recommendations to enhance economy, efficiency, and internal controls. The IG is prohibited from performing any agency program function, other than the OIG, in order to maintain independence."

General Counsel (GC)

Consolidate Office of General Counsel under General Counsel. The NCUA's GC "provides legal advice to the Board and other NCUA offices, administers the Agency's rule making policies, and represents the agency in litigation proceedings." Currently, the GC reports directly to the Board, however the Office of General Counsel reports to the Executive Director.

NASCUS believes the OGC should be moved out from under the Agency support offices that report to the Executive Director. Under our proposed reorganization, all of the NCUA's administration of the NCUSIF would be segregated into a division reporting directly to the Board. Because the Insurance Division will need to use the Office of General Counsel for drafting proposed insurance rules, interpreting insurance rules, and because it seems natural that the Board would rely on the GC's office to help settle internal disputes over what would be properly the Executive Director's Title I authority and the Insurance Director's Title II insurance authority, the Office of General Counsel should be independent of both the Executive and Insurance Directors.[21]

Executive Director (ED)

With some insurance functions broken out, the ED remains largely in charge of the majority of NCUA's daily operations. Under our proposed reorganization, the ED would continue to oversee the daily operations of all of NCUA's chartering, regulatory and supervisory functions.

Another change under the ED would separate the Office of Human Resources. While the office would continue to perform a majority of its duties in the same manner, we have split out training and examiner development. NASCUS believes that because training is provided for state examiners as well, these duties are more properly coordinated by the new Office of Insurance and charged directly to the Fund. Furthermore, oversight of examiner training by the Division of Insurance would serve as an additional validation of the state and federal examination programs.

For much the same reason, we have also moved IS&T into the new Office of Insurance.

[21] Clearly, the NCUA will apportion the GC's "insurance" related costs back to the Fund directly or back to the Insurance Division and then the Fund. NASCUS discusses accounting issues associated with the reorganization in detail below.

There are several offices currently "under" the ED that perform functions that would support the new Office of Insurance. Each is addressed below, but in general those offices remain under their current organizational structure. The offices will continue to report to the ED, however, percentages of their operating expenses may be charged back to the Office of Insurance to defray costs of supporting the insurance functions.[22]

Office of the Chief Financial Officer

NASCUS anticipates some costs allocated to Office of Insurance.

Office of the Chief Information Officer (OCIO)

OCIO is responsible for managing all aspects of the Agency's automated information resources. This includes:

- Collecting, validating, and securely storing Agency electronic information.
- Providing the appropriate tools and techniques for accessing, processing, and using this information.
- Developing, implementing, and maintaining all standard Agency information systems.
- Developing, implementing, and maintaining the required computer hardware, software, and data communications infrastructure.
- Fulfilling outside requests for releasable Agency computerized information.
- Ensuring all related material security and integrity risks are recognized and controlled.

Office of Credit Union Development

The Office of Credit Union Development fosters business development of credit unions by providing the guidance and education needed for the delivery of financial services, facilitates the expansion of credit union services through the chartering of new credit unions and field of membership expansions, coordinates efforts -- with third-party organizations -- to improve the viability and successful operation of credit unions.

Office Of Public and Congressional Affairs (PACA)

PACA provides information to the public, credit unions, Congress, the media, and NCUA employees about NCUA and its functions, Board actions, and other matters.

[22] Budgeting and accounting for these "split duty" offices are also discussed below. See *Costs of Reorganization* below.

PACA keeps the NCUA Board and staff informed about pending national legislation and serves as a liaison with members of Congress and congressional committee staff members.

NASCUS anticipates some costs associated with PACA's performance of its duties will be allocated to the Office of Insurance for payment with funds from the NCUSIF.

Other

The Regional Offices and the corporate credit union office presented a difficult question in creating a new organizational chart. The Regional Offices must support both the supervisory Title I operations as well as the Title II insurance operations and the corporate credit union office retains authority over state chartered corporate credit unions. Because of the complexity of these two offices, they are given separate treatment below.

Director of Insurance

New Division. The centerpiece of the NASCUS' proposed reorganization is the creation of the Office of Insurance. A Director of Insurance, co-equal with the General Counsel, the Executive Director, and the Inspector General, and reporting directly to the Board would head a division that would administer the Fund and NCUA's Title II functions. The Director of Insurance would be primarily responsible for reviewing the examination reports of state agencies and the NCUA's Office of Supervision and Examination. The Director would also oversee the promulgation of insurance rules, the continued development of the examination platforms, oversee the examiner training program, the IS&T functions and the Asset Management and Assistance Center.

All of these functions are directly related to the NCUA's Insurance responsibilities.

Regional Offices

Restructuring chain of authority. Ideally, NASCUS would physically separate the Regional Offices in order to prevent a co-mingling of duties between Chartering Authority and Insurer. However, NASCUS acknowledges that such a plan might be more difficult at the Regional level than in the Central Office. Therefore, while leaving the physical structure of the Regional Offices in place, NASCUS recommends more clearly defining the dual mission nature of each of the regions, and a separation of staff functions.

Clearly, reorganizing the missions of the divisions at the Regional level will necessitate staff reorganization. NASCUS envisions that the Regional Offices would retain their single Regional Director (RD) structure. However, while the RD is currently responsible directly to the ED, under the new organizational scheme, the RD would be equally responsible to the ED and the Insurance Director.

This dual responsibility will ensure that insurance issues impacting the Fund, state and federal examination quality as an example, are translated unfiltered to the executive decision-makers for the Fund. It would also serve to ensure that staff is dedicated to either chartering or insurance review work.

In addition to the RD, staff reorganizations would be necessary at the examiner and supervisory examiner levels. Because the Insurance Division is primarily reviewing exams, and conducting joint exams with the state and federal supervisory examiners on troubled institutions and for validation, there would need to be insurance examiners in each Regional Office.

Office of Corporate Credit Unions (OCCU)

The OCCU has greater regulatory authority over state-chartered corporate credit unions than NCUA has in general over state-chartered natural person credit unions that are federally insured. However, chartering, examination and general supervision of federal credit unions is NCUA's Title I authority and subject to review by the ED. OCCU's oversight of state-chartered credit unions is insurance related and expenses allocated to the NCUSIF.

Staffing within the OCCU would mirror that of the Regional Offices discussed above. Dedicated insurance examiners should review the examinations of all corporate credit unions. The review of examination reports (on the federal side) by the same entity responsible for the examination itself creates a conflict of interest that poses an unnecessary risk to the NCUSIF. NCUA's repeated assertions that corporate credit unions pose a unique risk to the Fund seem to convincingly support NASCUS' concern that examinations performed on federal corporate credit unions be validated to the same extent as state-chartered corporate credit union examinations.

Benefits of the NASCUS Proposal

NASCUS' proposal for reorganizing the NCUA benefits all federally insured credit unions by creating a more direct accounting of ***their*** funds on deposit with the Insurer as well as benefits federal credit unions by creating market discipline within their supervisory agency. Furthermore, a separation of duties would create a quality control review over federal examinations.[23] Specifically, the NASCUS proposal remedies each of the flaws in the NCUA's current structure addressed above.

- **Eliminates the potential conflict of interest between NCUA's obligations as the chartering, regulatory and supervisory authority for federal credit unions and its responsibility as the administrator of the Insurance Fund for all federally insured credit unions**

By creating separate regulatory, chartering and supervisory functions and insurance functions, the NCUA will eliminate its inherent conflict of interest: two Divisions, one solely focused on creating a healthy environment for federal credits and one solely dedicated to ensuring that both state and federal examinations are being conducted in a manner that accurately evaluates the condition of the institutions. Flaws in the federal examination process can be identified and remedied just as they would be in state examinations. This would create a healthier agency, further reduce risk to the Fund, remove any appearance of inappropriate funding and elevate the Agency to the standard of internal control demanded of the institutions it regulates.

Separating the chartering and insurance functions, and creating a quality control check for federal credit union examination, similar to those that exist for state credit union examination, is significant. Federal credit unions make up the majority of federally insured credit unions. Independent review of those credit unions' examinations would add a layer of protection to the Fund.

- **Facilitates accurate accounting of true costs of operating the Insurance Fund.**

Reorganizing the NCUA would create accountability. As mandated by Congress, the cost of the examination of federal credit unions would be passed back to those credit unions and the true costs of operating the Insurance Fund would be charged to the Fund.

[23] See *State as a Model*. Page 21.

Presumably, the Director of Insurance would serve as an auditor of the overhead transfer, calculating the Insurance Division's true use of the "pooled" NCUA resources discussed above. The expenses of running the Insurance Division would be clear and therefore more easily allocated.

With more accurate accounting of true costs, the NCUA could replace the current overhead transfer methodology with a much more straightforward accounting practice. As the current methodology has been criticized variously as flawed, inaccurate, in violation of the Administrative Procedure Act, and contrary to Congressional mandate, it would seem a more straightforward accounting would benefit the Agency also from a public policy perspective.

- **Creates for federal credit unions a strong advocate for innovative approaches to their regulation, and for the Insurance Fund an advocate for ensuring cost-effective management of credit union assets on deposit.**

As the supervisory, chartering and regulatory authority for federal credit unions, NCUA should seek to provide their credit unions a competitive environment that provides the opportunity for viability and success. This includes seeking to charter federal credit unions, removing regulatory roadblocks to safe innovation and streamlining the examination process to balance safety and soundness with efficiency.

As the administrator of the Fund, NCUA should seek to minimize the Fund's operating expenses and should review examinations of federally insured institutions as a form of due diligence that its reliance on state and federal regulators is well founded. By separating its functions, NCUA would create co-equal independent departments dedicated to both of those missions. That would bring ***greater*** safety to the Fund. Efficiency for both the Fund and NCUA's Title I examination processes would be created and federal credit unions could be assured that their chartering issues are of primary concern to a dedicated portion of the Agency. At the same time federally insured institutions would be reassured that their funds on deposit are not being exploited.

- **Cures the tainted information stream reaching the NCUA Board.**

  A significant portion of this proposal has addressed the conflict of interest presented by the current NCUA structure. The end result of this conflict is that the NCUA Board cannot rely on shortcomings within the Agency to be brought to its attention expeditiously. Information to the Board is tainted by the conflict, quality control is lacking, accountability is defused so as to be practically non-existent. By creating co-equal Division heads reporting to the Board, the NASCUS proposal remedies the Board's tainted information stream.

Implementing the NASCUS Proposal

Costs of Reorganization and the Future NCUA Budget

NASCUS recognizes that the proposed reorganization raises critical cost issues. For purposesof discussion in this forum, the "costs" associated with reorganization have been categorized as:

- ***Cost of reorganizing;***
- ***Impact on annual budget; and***
- ***Accounting: allocation of costs.***

Cost of Reorganizing;

There will be costs associated with reorganizing the NCUA: including those associated with new staffing, recruiting, hiring, and training of new examiners and support staff. There will be costs associated with segregating the Division of Insurance from other NCUA staff and other costs as NCUA restructures.

In the long term, these initial reorganization costs will be a small price for the benefit of NCUA's drawing clear distinctions between its two missions.

Impact on the Annual Budget

NASCUS believes that after the reorganization the annual cost to the Fund will ***decrease***. There may or may not be increased staffing needs, however, NASCUS believes that by segregating its functions, NCUA will create budget accountability that will work to control annual costs.[24]

As discussed above, NASCUS believes that currently many functions that are purely supervisory in nature are being funded by the NCUSIF. While the proposed reorganization will undoubtedly create some redundancy, the operating expenses of the NCUSIF should decrease. While this may result in a corollary rise in federal credit union operating fees, those fees will undeniably be a true reflection of the cost of operating a regulatory agency. Because market forces (the ability of credit union to convert charter) will be amplified by more accurate accounting, both state and federal agencies will have powerful incentives to operate more efficiently and effectively: providing benefits to both credit union systems.

Even if the envisioned accounting improvements do not result in a lower operating budget, there are other benefits.

[24] See *Benefits of NASCUS Proposal*. Page 30.

Currently, debate on examination fees and the overhead transfer are meaningless. The lack of transparency allows costs to shift quietly between supervision and insurance. By separating the missions of NCUA, even if the costs to the Fund increase along with federal examination fees, federally insured credit unions are assured that their deposits with the NCUSIF are being properly used and judiciously guarded. Federal credit unions gain a true accounting for their regulator's budget. The resulting "sunshine" can only help the credit union movement prepare for tomorrow.

Accounting: Allocation of Costs

By reorganizing, the NCUA will create a much clearer accounting of costs between its supervisory and insurance functions. However, many of the NCUA's departments will continue to support both missions. In those cases, NASCUS anticipates the NCUA will be able to determine how much should be charged back to the Insurance Division for payment by the Fund.

What is important is that the NCUA's budget reflects true costs: true costs for chartering and supervising federal credit unions and true costs for administering the insurance fund. While it is true that NCUA will continue to make "value" judgments on what percentage of some of the dual support offices, such as PACA, should be allocated to supervision and insurance, there are two significant changes.

First and foremost, the creation of the Insurance Director will presumably create a guardian for the Fund with a vested interest in ensuring the most accurate expense allocation to the NCUSIF. Secondly, the vast majority of the current debate over the allocation of expenses revolves around examination expenses. Under the NASCUS proposal, those expenses are clearly allocated between two distinct operations.

With a more accurate accounting of the expenses of chartering and supervising federal credit unions and administering the NCUSIF, the NCUA will be forced to develop spending discipline.

Implementation

NASCUS would expect that NCUA could define the parameters of the reorganization and then move to implement the structure over several years. NASCUS and state regulatory agencies are prepared to work with NCUA throughout the reorganization process.

Conclusion

In 1970, Congress envisioned a federal agency with two related but distinct missions: the chartering, supervision and regulation of federal credit unions (Chartering Authority), and the administration of a national credit union share insurance fund (Insurance Authority).

As early as 1991, GAO made several recommendations to address what they saw as problematic conflicts of interest within the Agency, and Congress acted in 1989 to eliminate a parallel conflict of interest at the FHLBB. Many state regulators, members of the state credit union system and certainly NASCUS have for several years urged the NCUA to address the potential conflicts of interest that hinder regulatory competition and Hamper everyone's ability to truly analyze the NCUA's operational efficiency from a budget perspective. In 1984, NCUA itself discussed the need for the credit union system to monitor "what [the NCUA] is doing with [their] money." Economist Lawrence White described the NCUA's conflict of interest as a "persistent problem."

Remedying those conflicts would create a healthier federal agency, provide greater protection to the credit union deposits held by the NCUSIF, and create greater accountability within the NCUA. Restoring a true competitive environment between regulatory systems would benefit all credit unions. Reducing the expenses of the NCUSIF would arguably increase dividends paid back to credit unions. From a regulatory standpoint, reorganizing the NCUA is not only logical, it is consistent with minimal standards required of the financial institutions we regulate.

Why reorganize the NCUA? Given the inherent conflicts of interest within the Agency, and the consequences those conflicts present to the credit union movement, the answer seems clear. Why not reorganize the NCUA? Given the benefits to the NCUA itself, those credit unions it charters, those credit unions it regulates, and to the states in partnership with the Agency, there appears to be no convincing answer.

NASCUS acknowledges that there are several models that might address the concerns raised in this study. Even within this proposal, there can be fair debate as to several offices proper placement within the organizational chart included in **Appendix I**.

However, the cornerstone of this proposal, and any model, is the absolute necessity of separating the NCUA's supervisory, chartering and regulatory functions from its insurance review responsibility. It is here that the flaw is most pronounced. Any practical discussion of remedying the NCUA's organization must begin here. GAO knew as much in 1991, and that fact is no less true today.

Appendix I: NCUA Organizational Chart