The National Voice of the State Credit Union System

PREPARED REMARKS OF

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2021 BUDGET BRIEFING OF THE NCUA BOARD

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NASCUS, its regulator members who represent all state agencies that issue a state credit union charter, and state-chartered credit unions across the country thank you, Chairman Hood and Board Member Harper, for conducting today's budget briefing. NASCUS applauds the NCUA Board for continuing to hold these public meetings which reflect your commitment to transparency, accountability, and giving stakeholders a role in NCUA's budgeting process.

At its core, NASCUS is the professional organization for state credit union regulators and the national voice of the state credit union system ensuring a robust dual charter credit union framework. Our membership is comprised of state regulators and other credit union system stakeholders that believe in fostering a dynamic, innovative dual charter system that assures safe and sound credit unions that can compete and grow in today's marketplace while protecting their members from consumer financial abuse. NASCUS is the only organization dedicated to the defense and promotion of the state credit union charter and the autonomy of state credit union regulatory agencies.

NASCUS and its members continue to monitor NCUA's management of budget funding sources and NCUA's execution of its complex role as both the chartering authority for federal credit unions (FCUs) and as the insurer of both state chartered and federally chartered credit unions through administration of the National Credit Union Share Insurance Fund (NCUSIF). The overhead transfer rate (OTR)—which determines how much of NCUA's operating expenses are covered by the NCUSIF—is inextricably tied to NCUA's implementation of its budget.

As we have stated previously, NASCUS has historically held the position that a regulatory agency is in the best position to know the resources it needs to maintain a safe and sound supervisory program. Accordingly, we do not typically reflect on specific budgetary elements; however, we are happy to share SSA budgetary practices and we, certainly have a few observations to make with respect to NCUA's budget justification for 2021-22 mostly with respect to OTR. I wish to address five issues today:

(1) Significance of the OTR especially in the current economic context
(2) Imbalance and potential inequity resulting from OTR implementation
(3) Validation & reconciliation of allocation assumptions vs. actual time allocations.
(4) Revisiting the cost allocation of NCUA's supervision of CUSOs and third parties.
(5) Treatment of capital expenditures and miscellaneous revenue

Significance of the OTR Especially in the Current Economic Context

The OTR methodology and the allocation of NCUA's expenses takes on particular importance against the backdrop of the ongoing pandemic in the United States and resulting economic dislocation. The incontrovertible truth is that every dollar transferred from the NCUSIF to fund NCUA expenses is one dollar less that is available to cover losses in the system and subsequently a dollar that may need to be replenished in the NCUSIF by the charging of a premium. Furthermore, the allocation of NCUA's operating expenses and the corresponding effect on FCUs' chartering fees has the potential to imbalance the dual chartering system by disadvantaging the state system in an inequitable manner.

Most of us expect the lagging economic impacts of the COVID-19 pandemic to surface. In full force in 2021. An NCUA operating budget of $316 million and an operating budget plus capital budget of $334 million and a 1% increase in the OTR means that there will be more than $3 million less in the NCUSIF to cover credit union losses.

Imbalance and Potential Inequity Resulting from OTR Implementation

In a departure from earlier historical practice, for over 20 years, a majority of NCUA's annual budget has been paid by the OTR, reaching a high of nearly 75% of NCUA's 2016 budget. This is significant because FISCUs shoulder an inordinate cost of supervising the safety and soundness of the credit union system. By sheer number of individual credit unions, FISCUs make up only 37% of the total number of FICUs. However, since FISCUs make up 50% of all insured shares, the cost of the OTR is borne equally from the funds of both FISCUs and FCUs, even though there are more FCUs whose examination costs are being charged to the NCUSIF. Put another way, FISCUs pay 50% of the NCUSIF's costs but represent only 37% of NCUA's insurance-related work.

Some stakeholders will argue that FCUs pay an aggregate greater amount of NCUA's overall budget when the total expense to FCUs of the operating fee and OTR are aggregated. But this ignores the fact that the NCUSIF is *not* expending resources to conduct examinations on a majority of FISCUs because NCUA relies on the exam work conducted by state agencies work—exam work which is paid for entirely by FISCUs.

NASCUS recently canvassed 9 states representing 20% of state agencies about their expenditures on state credit union supervision during the 2019-2020 fiscal year:

Expenditure by 9 of 45 State Supervisory Authorities on SCU Examinations & State Examiner Training	
Pennsylvania Oregon Kentucky Texas Michigan Iowa Georgia Connecticut Washington	493 examinations >6,793 hours of non-NCUSIF-funded training 2019-20 Expenditure by 9 States Alone: **= $25.2 million**

Those 9 states, alone, conducted 493 examinations and funded nearly 6,800 hours of state-financed training for state examiners. These states expended $25.2 million for examination and supervision of credit unions in their states and a similar story can be told in the remaining 36 state regulatory agencies. Extrapolating, state agencies collectively expended $100-$125 million entirely covered by fees paid by state-chartered credit unions.

FISCUs pay the full cost of their state examinations plus—through the OTR—100% of NCUSIF insurance reviews of FISCUs, 50% of FCU examination costs, 100% of CUSO and vendor supervision and other costs. Hence, the OTR is borne by FISCUs in the form of a lost NCUSIF dividend opportunity or as additional NCUSIF premium costs as may be the case in 2021. FCUs incur a lesser burden even though they also contribute to the OTR because, by contrast, the OTR carries an inverse benefit for FCUs: the larger the OTR, the more modest the FCU operating fee. This inequitable effect between state and federal credit unions is one reason why the OTR methodology is so important to the state system.

When the current methodology was introduced in 2017, NASCUS acknowledged it was an improvement over the then existing methodology, albeit an imperfect improvement. In particular, while we noted that the allocation of 50% of FCU examination time as insurance-related was a sensible compromise, we also observed that a more accurate approach would be for NCUA to examine FCUs pursuant to Title I of the Federal Credit Union Act and for the NCUSIF to review those Title I examinations in the same manner as NCUA does for state FISCU examinations. To be candid, as more NCUA annual budget expenditure categories are allocated to the NCUSIF, the 2017 compromise becomes less tenable for the state system.

Validation & Reconciliation of Allocation Assumptions vs. Actual Allocations

During last year's budget briefing, as NCUA entered its third year of implementing the 2017 OTR methodology, NASCUS shared two realizations and attendant requests. The first realization was that it would be helpful and constructive to publish NCUA's annual OTR summary in conjunction with NCUA's annual budget justification document. We asked that the NCUA Board consider issuing the two documents in tandem to possibly make it easier to understand what precisely makes the OTR go up or down. Secondly, it had become clear to us that we are not able to understand how federal examiner hours are calculated and to what extent state examiner hours are calculated and valuated.

NASCUS continues to find it impossible to figure out why the OTR goes up in one year or goes down in another. For 2021, the budget justification explains, "The primary driver of the increase in the estimated 2021 OTR is the increase in examination and supervision time for federally insured state-chartered credit unions." The justification continues, "The increase in budgeted time for FISCU examination and supervision for 2021 is due to program obligations associated with examination and scope requirements." These statements do not provide sufficient detail to be able to validate the assumptions that flow into the OTR allocation formulas. For example, NCUA explains that its OTR "analysis starts with a field-level review of every federally insured credit union to estimate the number of workload hours needed for the current year.…The workload estimates are then refined by regional managers and submitted to the NCUA central office for the annual budget proposal." A step that may be missing is SSA validation of NCUA's workload estimates. Furthermore, in the event that the time allocations used for calculating the OTR are either over-or under-estimated, it would desirable that NCUA is held accountable to reconcile the budgeted time allocations with actual, on-the-ground time allocations. Concerningly, the budget justification adds, "The OTR methodology accounts for the costs of the NCUA, not the costs of the state regulators. Therefore, there are no calculations made for state examiner hours." It would seem that such calculations of state time or costs would validate or invalidate the assumptions going into NCUA workload estimates and pave the way for reconciling any inaccurate assumptions and creating a higher accountability standard both of which would contribute to the credibility of the OTR year-in and year-out.

To be sure, NASCUS and state regulators recognize the mutual value of state and federal collaboration. Over the years, NCUA has proven to be a critical and reliable backstop when state agencies experience occasional local dislocations. And the reverse is also true—SSAs have been dependable partners for NCUA.

As we expressed a year ago, in the interest of both transparency and federal-state interdependency, NASCUS welcomes the opportunity to review with NCUA its workload estimation methodology and valuation process of federal examiner and state examiner hours. NASCUS is prepared to cooperate with NCUA on the valuation method so that NASCUS and other stakeholders can better appreciate the circumstances that contribute to driving the OTR up in some years and down in others. It is reasonable that in some years NCUA would spend relatively more time on state-chartered credit unions' supervision or assessment of risk and in other years spend less. It would be helpful to easily understand the swings in either direction. Open sharing and mutual appreciation can only foster greater federal-state trust and collaboration.

Re-Visiting the Cost Allocation of NCUA's Supervision of CUSOs & Third Parties

Under Principle 2 of the current OTR methodology, all the time and costs NCUA spends supervising or evaluating the risks posed by FISCUs or other entities NCUA does not charter or regulate are allocated as 100% of insurance related. We agree that NCUA oversight of FISCUs is 100% insurance related, but question whether other entities are justifiably allocated as 100%.

NASCUS does not believe that allocating NCUA work related to "stand-alone reviews of CUSOs and other third-party vendors" as solely related to the NCUSIF is consistent with the principles of the OTR methodology or with the practical reality of a chartering authority. As we noted in 2017, while it is true that NCUA does not charter or supervise CUSOs or vendors, NCUA, as the chartering authority of FCUs, has an obligation to ensure that FCU CUSOs and other third parties are operating safely and in compliance with applicable rules and regulations. For example, chartering rules limit the services that an FCU's CUSO may provide and to whom it may provide them. NCUA must ensure FCU CUSO mortgage loan originator registration in compliance with the SAFE Act. These are but a few examples, but they illustrate that NCUA has regulatory and supervisory concerns with CUSOs and other third-party vendors that are not primarily safety and soundness issues and of de minimis concern to the NCUSIF.

Just as state credit union regulators, and the Office of the Comptroller of the Currency (none of which administer a deposit or share insurance fund) have robust safety and soundness and third party vendor authority, NCUA as the chartering authority of federal credit unions would consider review of third parties, as necessary, as inherently related to their examination process even in the absence of the NCUSIF.

The allocation of third-party regulatory and supervisory work takes on an enhanced importance given NCUA's interest in obtaining direct supervisory authority over such entities. Should NCUA obtain that regulatory and supervisory authority (which NASCUS supports), ensuring equitable allocation of associated expenses will be essential.

It would follow that *some* of NCUA's workload hours in CUSOs and third parties reflect NCUA's safety and soundness responsibility as charterer/prudential regulator of federal credit unions. Additionally, NCUA's chartering rules limit the services that a federal credit union's CUSO may provide and to whom it may provide them. These are not material safety and soundness issues; they are compliance issues. As NCUA further explores third party vendor authority, we remind NCUA that we do not agree that 100% of the time and costs associated with NCUA's supervision of CUSOs and third parties is insurance-related. We recommend that NCUA allocate at least 25% of its CUSO and third party workload hours to its Title I function.

Treatment of Capital Expenditures and Miscellaneous Revenue

NCUA proposes including the budget for capital projects within the annual budget subject to the OTR. NCUA believes apportioning a proportionate share of the capital budget to the NCUSIF is consistent with the 2017 OTR methodology and represents a more equitable treatment of capital expenditures with respect to the OTR and FCU operating fees.

NASCUS agrees to the extent that the NCUSIF should bear the capital budget costs of its operations. However, while the allocation of the capital budget pursuant to the four principles might be convenient, it may not be equitable as the percentages are currently defined for the methodology. In its budget justification, NCUA states that "By applying the four principles in a manner that incorporates all Operating and Capital Budget activities, the OTR for 2021 is estimated to be 62.3 percent, the same result as applying the four principles to the Operating Budget alone." This strikes us as a circular statement rather than a convincing explanation for why the same allocation should apply to the capital budget as applies to the operating budget.

As a side note, footnote 30 of the budget justification explains that "Some costs are directly charged to the Share Insurance Fund when appropriate to do so. For example, costs for training and equipment provided to State Supervisory Authorities are directly charged to the Share Insurance Fund." While MERIT training for SSAs will surely be a significant cost in 2021, the NCUSIF will end its computer lease program in 2021, and states have long begun the process of acquiring their own computers at state expense.

Since states and state credit unions alone will bear the capital cost of computers and computer software going forward, it would seem that the NCUSIF should carry a much smaller percentage of NCUA's computer, software and other capital charges than NCUA allocates to its role as the FCU chartering authority.

Summary Recommendations

	Activity Allocated as Insurance Related	**Current**	**Suggested**
1	NCUA time spent examining & supervising federal credit unions	50%	37%
2	All time and costs the NCUA spends supervising or evaluating the risks posed by **(a)** federally insured state-chartered credit unions or **(b)** other entities that the NCUA does not charter or regulate (e.g., third party vendors & CUSOs).	100%	100% for (a) 50-75% for (b)
3	Time & costs related to the NCUA's role as charterer and enforcer of consumer protection and other non-insurance based laws governing the operation of federal credit unions (e.g., field of membership requirements).	0%	0%
4	Time and costs related to NCUA's role in administering federal share insurance and the Share Insurance Fund.	100%	100%
5	Capital Budget Expenses	= OTR	<25%

Additional Recommendations	
A	SSA Validation of NCUA Workload Estimates
B	Reconciliation of Allocation Assumptions & Actual Time Allocations

Closing Thoughts

Public budget briefings are very much appreciated. Now that a number have been held in consecutive years, it is fair to ask what recommendations have been heeded from one year's briefing to the next year's budget. While I believe that NCUA is genuine in gathering perspectives to improve its budgeting process, I cannot say that I can identify the suggestions that have been taken up over the last few years. NASCUS is partly to blame in not reaching out to NCUA staff early enough in the next budget cycle to influence significant change. We endeavor to work with NCUA sooner rather than later the next time around.

Let me take this opportunity to repeat NASCUS' appreciation for the yeoman's work that NCUA completed in 2017 to develop a much more sustainable and equitable approach to implementing the overhead transfer rate.

NASCUS credits the NCUA Board, NCUA staff, and state supervisory agencies for the collaborative relationship that NCUA, state regulators, and NASCUS enjoy. We acknowledge both of you for treating state regulators and NASCUS as partners with shared objectives and we thank each of you for recognizing the value that a robust dual charter framework brings to state and federal credit unions alike.

In closing, we echo our previous thanks to Chairman Hood for committing to and signing the 2019 NASCUS-NCUA Document of Cooperation in August of last year. And, we thank Board Member Harper for his insatiable interest in how state agencies approach various consumer finance matters and credit union supervisory challenges. Through your actions, both of you recognize the distinct roles that state regulators and NCUA have in supervising credit unions while also embracing the cooperation that is critical to ensuring safety and soundness and fostering an environment of innovation and shared success. I applaud both of you for your personal commitments to diversity, equity, and inclusion as well as your personal dedication to assuring and broadening consumer access to credit unions in this unprecedented time of consumer uncertainty.