NASCUS

The National Association of State Credit Union Supervisors

November 21, 2023

Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: NASCUS Comments on NCUA Staff Draft Budget Justification 2024 – 2025 (Docket number NCUA–2023–0117).

Dear Ms. Conyers-Ausbrooks:

The National Association of State Credit Union Supervisors (NASCUS)[1], on behalf of its regulator members who represent all state regulatory agencies that administer a state credit union charter, and state-chartered credit unions across the country, provides the following comments on the NCUA staff draft budget for 2024 and 2025.

A regulatory agency is generally in the best position to know the resources it needs to maintain an effective safe and sound supervisory program. With respect to the overall expense of NCUA operations in the coming year, NASCUS would expect that NCUA, like many state agencies, will strive to fully maximize efficiencies consistent with safe and sound supervision and therefore our comments will be limited to broad structural issues.

Our comments that follow address the impact of the NCUA's Risk-Based Examination Scheduling Policy[2], NCUA staff's expense allocations of the cost of its operations, the administration of the National Credit Union Share Insurance Fund (SIF or Fund) and the use of the Overhead Transfer Rate (OTR).

Specifically, NASCUS's comments address:

- Recommendation to Raise the Asset Threshold Requirements for annual Examinations.
- Impact of the State Supervisory Programs on the SIF

[1] NASCUS is the professional association of the nation's forty-six state and territorial credit union regulatory agencies that charter and supervise over 1900 state credit unions. NASCUS membership includes state regulatory agencies, state chartered and federally chartered credit unions, and other important stakeholders in the state system. State-chartered credit unions hold over half of the $2.2 trillion assets in the credit union system and are proud to represent nearly half of the 134 million members. The remaining 5 states lack state-chartered credit unions.

[2] Letter to Credit Union 16-CU-12 / December 2016

- Risk that the OTR Methodology may Inequitably Subsidize FCU Regulatory Oversight at the Expense of the State Systems
- Lack of Independent Review and Transparency of OTR Methodology Primary Inputs
- Counterintuitive Aspects of the OTR Methodology
- Recommendations for Strengthening SIF Governance & OTR Transparency

Raise the Asset Threshold Requirements for annual Examinations.

NASCUS firmly believes the NCUA should consider following other state and federal regulators in raising the asset threshold requirements for annual examinations exemption to $3 billion for qualified institutions to preserve resources, reduce regulatory burden without materially increasing risk to the Share Insurance Fund (SIF) and help mitigate scheduling conflicts with state agencies.

The NCUA outlines in its Risk-Based Examination Scheduling Policy its FCU risk based examination guidelines to allow the extension of the annual examination requirements for credit unions to 18 months if a credit union is less than $1 billion in total assets, maintains a well-rated Management and Composite rating under the Uniform Financial Institutions Rating System (CAMELS), and is not under a Document of Resolution (DOR) related to significant recordkeeping deficiencies or an outstanding formal enforcement action.

For FISCUs the NCUA requires a full scope NCUA examination of any credit union every five years but requires annual examinations if the institution holds total assets greater than $1 billion, represents a CAMELS rating of 3 with assets greater than $250 million or a CAMELS 4 or 5 with assets greater than $50 million.

The FDIC[3] and OCC[4] have similar supervisory cycle requirements; however, the federal banking regulators set the asset threshold for an extension to 18 months examinations at institutions with total assets less than $3 billion.[5]

Many state regulatory agencies also utilize guidelines similar to the federal banking agencies with the $3 billion asset limit. In so doing, the states are able to ensure allocation of resources to institutions whose operational risk presents more pressing need for supervisory attention while relieving supervisory and regulatory burden on institutions evidencing strong performance. It should be noted that the policies of all these agencies do not prohibit full scope examinations on any of the institutions meeting the qualifications for an extension. As such, exams can be conducted at any time as the policies only provide regulatory flexibility to examination staff and represent a maximum requirement of 18-month exams and not a minimum examination timeframe.

[3] 12 CFR 337.12
[4] 12 USC 1820(d)(4) and 12 CFR 4.6
[5] NASCUS appreciates that respective sizes of the FDIC deposit insurance fund and the SIF may lend themselves to proportional comparisons of asset-based examination cycle comparisons. However, we suggest such comparisons can be instructive, but should not be determinative.

The Board should consider elevating the annual examination asset threshold to reflect the practices adopted by its federal and state regulatory peers.

Adoption of a higher exemption threshold would help eliminate potential examination scheduling conflicts between the state and federal policy requirements, provide additional flexibility to the NCUA Regions to allocate their limited resources toward problem institutions, and provide regulatory relief to credit unions while acknowledging the improvements in offsite supervision and examination applications resulting from NCUA's significant investment in technology.

Based on June 30, 2023, 5300 information published by the NCUA this change would potentially allow an extended examination cycle to 275 FICUs including 156 FISCUs, without considering the impact of institutions not qualifying due to outstanding DORs, regulatory actions or low management/composite ratings. These state institutions represent $273.3 billion in total assets with an average size of $1.75 billion and approximate $230.4 billion in total shares and deposits and $210.6 billion of insured shares. We note that with respect to FISCUs, the fact that examinations of credit unions within the asset range in question are comprised of staff from both NCUA and the states itself provides an addition level of risk mitigation as the perspectives of two independent supervisory agencies are evaluating the institutions.

Eliminate Potential Examination Scheduling Conflicts with State Agencies

As noted above, many state agencies have adopted risk-based examination scheduling policies that generally allow the extension of an examination up to 18-months if an institution meets certain qualifications and is less than $3 billion in assets. Given the dollar variation between many state agencies' use of the $3 billion threshold and the NCUA's $1 billion threshold, conflicts can arise relating to the scheduling of joint or concurrent examinations. To work collaboratively, the NCUA's lower threshold typically requires state examination participation exceeding the regulatory standard and prohibiting flexibility to target more problematic or higher risk institutions. This issue impacts potentially 156 FISCUs with total assets between $1 to $3 billion category and, depending on the state, a significant opportunity for scheduling conflict between the NCUA Region and the state agency, and draw of resources.

Provide NCUA Region Flexibility to Allocate Resources to the Most Problematic Institutions

While the narrative above outlines the restrictions NCUA's current policy places additional burden upon state credit union supervisors beyond those in practice by peer state and federal regulators, it is important to note that the current policy also limits flexibility within each of the NCUA Regions. This flexibility is also an important factor in the NCUA's ability to quickly address potential increases in problematic institutions, temporary adverse economic, environmental, cyber/operational disasters, or shortages of qualified staffing. Without an appropriate risk policy, NASCUS is concerned that a lack of scheduling flexibility may result in examinations performed under a stressed environment to be inappropriately rushed to completion and may not meet FFIEC or NCUA examination standards.

Provide Regulatory Relief to Credit Unions While Acknowledging the Significant NCUA Investment in Technology

Providing regulatory relief for well rated, managed and capitalized credit unions to potentially extend their examination cycle not only provides flexibility in regulatory resources targeting higher risk or systemically material institutions, but also provides regulatory relief to institutions that evidence the qualifications that merit consideration of an extension. The significant investments in offsite monitoring and examination technology, as well as the lessons implemented as part of the reaction to the pandemic continue to alter the paradigm related to effective examination techniques. These opportunities, when appropriate and effective, should also provide resource savings to the credit unions involved, allowing the application of credit union resources to better suit the needs of credit union members and other stakeholders.

<u>Impact of the State Supervisory Programs on the SIF</u>

The 46 State and Territorial credit union supervisory agencies are the prudential regulators of approximately 2,000 state-chartered credit unions across the country, representing 68 million members and slightly more than half of the assets in the domestic credit union system. NCUA, and the SIF, benefit tremendously from the supervisory efforts of state regulators. State supervision is primarily funded by state credit unions: not the SIF, nor the NCUA.

Based on NCUA's published December 2022 call report data, state-chartered credit unions reported paying $94 million in state operating fees compared to $109 million in operating fees paid by federal credit unions to NCUA. Those state credit union funds ensured robust, independent oversight throughout the country, funded over 440,000 state examiner hours, and resulted in more than 1,500 state generated reports. Much of this state credit union funded work is safety and soundness supervision that benefits the SIF as NCUA is able to rely on much of this work and save itself the direct costs of onsite examination in many FISCUs. This is precisely what Congress envisioned when it directed the SIF to rely on examinations done by states and NCUA under its Title I authority.

We raise this point because NCUA's budget justification illustrates what it purports to be the relative contributions by state and federal credit unions to fund supervision which fails to represent the impact of the savings afforded the NCUA budget by the application of the aforementioned state related resources. This is most evident when the draft budget notes that state credit unions pay only 30.8 % of NCUA's operating budget with a footnote mildly acknowledging state credit unions pay a supervisory fee to their state regulator. In the narrow context of the direct funding of the NCUA budget this may be true, but it significantly misrepresents the material expenses borne by state credit unions to fund supervision, understates the significant reliance of those programs by the SIF, and presents an incomplete picture of the beneficial impact state supervisory programs have on the SIF.

The OTR is the delicate balance Congress struck in Title II of the FCUA. Congress clearly intended the SIF to pay costs for its administration. However, Congress also clearly intended the SIF administration to be managed economically, relying on work NCUA was doing as the federal chartering authority and saving costs. In essence, relying on the federal regulator just as it does the state regulator.

This is important, because every dollar transferred from the SIF by the Overhead Transfer, is one less dollar available to cover current losses and diminishes the SIFs future earnings potential. At a time when some have suggested the SIF equity ratio needs to be raised, diverting funds out of the SIF could be counterproductive, particularly when credit union income is under pressure.

To be clear, costs associated with administering the SIF should be allocated to the Fund. That is what Congress intended when it established the SIF. Whether driven by supervisory necessity or due diligence, the SIF must directly fund the examination of some federally insured credit unions. But the SIF's reliance on examinations funded directly by credit unions and the minimization of its expenses should also be formally acknowledged, documented and made part of the OTR setting process.

Risk that the OTR Methodology may Inequitably Subsidize FCU Regulatory Oversight at the Expense of the State Systems

It can be easy to underappreciate the impact of the OTR on credit union resources as it does not result in an annual expense item carried by credit unions, but rather in lost opportunity, in both interest income and capital held.

However, the fact that the OTR is not accounted for as a direct charge to credit unions does not mean it does not represent a cost to FICUs to cover the OTR. Loss of earnings on SIF related deposits by credit unions and capital exposure to loss of those deposits represents material impact on an institution's earnings stream and a potential impact on capital.

As implied earlier in our discussion of the impact of the state programs on the SIF, the overhead transfer, if not handled prudently and equitably, has the potential to imbalance the dual charter system by artificially reducing the cost of the federal charter while providing no equal cost benefit to the state charter.

NASCUS is pleased to note a 60-basis point decline in the OTR, and we commend NCUA for this step to return the OTR to a more equitable ratio. The 2024 reduction represents a positive improvement but given the Federal Credit Union Act (FCUA) mandate that the SIF rely on Title I examinations, we believe the OTR should be further reduced, and additional work remains to better calibrate the OTR methodology toward ensuring equitable management of the SIF for all charters.

Lack of Independent Review and Transparency of OTR Methodology Primary Inputs

Total assets and insured shares of state-chartered and federally chartered credit unions are equal, but the number of charters in each category is materially different:

	FCUs	**SICUs**
Insured Shares	50.1%	49.9%
Assets	50.1%	49.9%
Credit Unions	62.1%; 2,848 Units	37.9%; 1,735 Units

Sources: NCUA 2024 Draft Budget Justification and NCUA 2023 Q2 Call Report Data

In its insurance role, NCUA has over 1,000 more FCUs to monitor. Given the equal number of insured shares and assets between federal and state-chartered FICUs, one would expect NCUA's insurance workload to be significantly higher for FCUs than that of SCUs. Further, one would expect the NCUA's chartering related work for FCUs would be significantly higher than that of the state agencies related to FISCUs.

However, as the NCUA does not publish its OTR workload analysis, it is not possible to evaluate the intuitive perception that NCUA physically spends far more of its time on FCUs.

Understanding the primary drivers of the OTR is critical because these drivers reflect NCUA's cost allocations and, more importantly, NCUA's assumptions in completing its workload analysis. 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[6]....The workload estimates are then refined by regional managers and submitted to the NCUA central office for the annual budget proposal." However, NCUA's explanation statements do not provide sufficient detail to enable validation of the assumptions that drive NCUA's workload analysis.

NCUA's cost allocation and OTR calculation processes remain too opaque for proper public evaluation of the allocation of costs to administration of the SIF and to the Title I chartering function. l Greater transparency would enhance stakeholder confidence of an equitable balancing of the interests of the state and federal charter.

Counterintuitive Aspects of the OTR Methodology

NCUA's Conflation of Principle 1 & Principle 2 with Respect to Monitoring Third Party and CUSO Risk

Principles 1 and 2 of the OTR formula read:

1. Time spent examining and supervising federal credit unions is allocated as 50 percent insurance related.
2. All time and costs the NCUA spends supervising or evaluating the risks posed by federally insured, state-chartered credit unions or other entities that the NCUA does not charter or regulate (for example, third-party vendors and Credit Union Service

[6] NCUA Staff Draft: 2024 – 2025 Budget Justification, Page 34, available at https://ncua.gov/files/publications/budget/budget-justification-proposed-2024-2025.pdf

> Organizations (CUSOs)) are allocated as 100 percent insurance related. [NASCUS emphasis.]

The 2023 Overhead Transfer Rate (OTR) Summary[7] reads in footnote 1:

The 50 percent allocation mathematically emulates an examination and supervision program design where NCUA would alternate examinations, and/or conduct joint examinations, between its insurance function and its prudential regulator function if they were separate units within NCUA. It reflects an equal sharing of supervisory responsibilities between NCUA's dual roles as charterer/prudential regulator and insurer given both roles have a vested interest in the safety and soundness of federal credit unions. It is consistent with the alternating examinations FDIC and state regulators conduct for insured state-chartered banks as mandated by Congress. Further, it reflects NCUA is responsible for managing risk to the Share Insurance Fund and therefore should not rely solely on examinations and supervision conducted by the prudential regulator.

This assumes that all time examining FCUs is split 50/50 between the operating fee charged to FCUs and the SIF. However, this assessment presumes that the prudential regulator and the deposit insurer functions necessitate the exact same activity levels to be effective in their respective oversight responsibilities. The appeal of the ease of application of a 50/50 split is understandable and we concede the efficiency of maintaining the blended structure of NCUA's Title I and Title II responsibilities. However, given the plain language of the Federal Credit Union Act and the importance of the dual chartering system, more granular calibrating of Title I and Title II cost allocations is warranted. In fact, Congress directed the SIF to rely on NCUA prudential regulatory exams, thereby reducing operating costs to the SIF in Section 1782(5)(b).

CUSOs are at times also subject to review during the examination of a federally insured credit union.

The OTR methodology captures CUSO-related time within the scope of the examination and supervision of federally insured credit unions under Principle 1 for federal credit unions and Principle 2 for federally insured state-chartered credit unions. The time designated for separate, standalone reviews of CUSOs and third-party vendors is accounted for separately in the NCUA's workload budget and is covered by Principle 2 only. The standalone review of CUSOs and third-party vendors is to identify and address risk to federally insured credit unions.

While NASCUS agrees that appropriate cost allocation is necessary given the lack of separation of NCUA's regulatory and deposit insurance roles, we do not agree that reviews of CUSO's or third-party vendors should be allocated 100% to the SIF. Given that NCUA's supervisory interest in CUSOs and other third-party service providers would include both FISCU and FCU related safety and soundness concerns from a SIF perspective, we would agree that CUSO allocation would be heavily weighted to the SIF. However, to allocate 100%

[7] Available at https://ncua.gov/files/publications/budget/overhead-transfer-rate-summary-2023.pdf

of this work to the SIF is not appropriate. Put simply, to accept that all NCUA CUSO reviews of FCU CUSOs are strictly SIF related and hence 100 percent of CUSO reviews to the SIF is to assert that but for the SIF, NCUA as a chartering authority of FCUs has no interest in its charters' investments into CUSOs and the associated operational and/or transactional risks nor FOM and other compliance risks. As this is an unlikely proposition, we believe a modest percentage of CUSO reviews are properly allocated as Title I expenditures.

Recommendations for Strengthening SIF Governance & OTR Transparency

Properly evaluating NCUA's proposed 2024 budget necessitates more that an understanding of the OTR methodology and mechanics, it necessitates an understanding of the underlying data applied to the methodology. In the shared interest of strengthening SIF governance and enhancing the transparency of NCUA's overall budget process, NASUS makes the following recommendations:

- Provide greater transparency to NCUA's underlying workload analysis in the aggregate. Providing stake holders more information on the aggregate distribution of supervision hours as well as hours allocated among different agency offices would enhance stakeholder understanding of the respective Title I and Title II costs.
- Reconsider the November 19, 2015, NCUA Board decision to delegate calculation and administration of the OTR to a strictly formula administration. Given the potential for misbalancing the dual chartering system, the NCUA Board should evaluate the need for equity-based adjustments.
- Provide the documentation necessary to support all underlying assumptions utilized in the OTR methodology.
- Amend NCUA Principles 1 and 2, as appropriate based on regular review of the supporting analytics, to assure that NCUA's treatment of costs associated with FCU insurance activities and third-party vendor and CUSO risk reviews for FCUs is reasonably applied to the SIF.

Closing Remarks

As already noted, it is difficult to comment on NCUA's budget without addressing the allocation of expenses and spending that is inextricably tied to the OTR. We encourage NCUA to continue to calibrate the OTR methodology to ensure equitable treatment of both FCUs and FISCUs.

The current OTR methodology marks an improvement over the previous iteration. However, more work is needed to ensure the reasonable distribution of expenses between NCUA's Title I and Tittle II authorities in the manner intended by Congress. The Federal Credit Union Act (FCUA) clearly contemplates that the SIF should benefit from the exam work NCUA is doing as the Title I administrator of the federal charter. All of NCUA's various formulas turn this Congressional intent on its head and shift the benefits from the SIF to the NCUA's Title I chartering functions. application of costs to the SIF.

Our comments herein are made in the spirit of State/Federal regulator collaboration and in support of our shared objectives to foster a vibrant dual charter system that increases consumer access to safe and sound cooperative financial institutions. NASCUS commends NCUA for the agency's continued willingness to collaborate with stakeholders to better calibrate the agency's budget and the OTR methodology.

Sincerely,

- signature redacted for electronic publication -

John J. Kolhoff
Senior Vice President,
Policy and Supervision
NASCUS