Overhead Transfer Rate Methodology Request for Comment
Staff Prepared Comments - NCUA Board Presentation
June 23, 2017

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Good morning Acting Chairman McWatters and Board Member Metzger. Loss Risk Analysis Officer Russell Moore, Attorney Kevin Tuininga, and I are here to request that the Board approve publishing in the *Federal Register* for public comment a proposed change to the methodology for determining the overhead transfer rate, or OTR.

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First, I'd like to provide a brief background of what has led to this proposal. To achieve its statutory mission, the agency incurs various expenses, including those involved in examining and supervising federally insured credit unions. The Board adopts an Operating Budget each year to fund the vast majority of the costs of operating the agency. NCUA uses two primary sources to fund the Operating Budget: (1) requisitions from the Share Insurance Fund; and (2) Operating Fees charged to federal credit unions. Requisitions from the Share Insurance Fund are determined by the Overhead Transfer Rate (OTR) methodology.

NCUA has used various methods for determining the OTR since it was first established in 1972. The current methodology was developed and adopted in 2003 and has remained largely unchanged since. The current methodology is very comprehensive, defines essentially all safety and soundness related activities as insurance-related, and takes into consideration the value of the insurance-related work performed by state supervisory authorities by correspondingly reducing the OTR. The current approach is therefore very complex. It historically has not been well understood and remained the subject of criticism from some stakeholders.

In an effort to improve transparency and provide for more stakeholder involvement, in January 2016 NCUA published in the Federal Register a Request for Comment detailing the OTR methodology and requesting stakeholder input on it. While NCUA received only forty comment letters, they covered a broad range of issues that necessitated significant research to provide a thorough and thoughtful response. Based on the comments and NCUA’s internal assessment of ways to improve the OTR methodology, staff recommends the Board consider changes to the OTR methodology. This new Request for Comment explains and solicits comments on the proposed changes to the OTR methodology, as well as provides responses to comments received as a result of the January 2016 request for comment. We will now summarize the comments we received from the January 2016 request.

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As previously noted, NCUA received forty comment letters containing a wide variety of comments. Staff grouped related comments into eight categories. I will briefly highlight and discuss the most significant issues raised.

First, a variety of commenters questioned various aspects of NCUA's legal authority regarding the OTR. Some commenters stated the Board has no authority to assign operating costs to the Share Insurance Fund while others contended it can only allocate expenses related to resolving problem credit unions. NCUA's opinion has not changed; the Board has clear authority to charge relevant expenses, including operating costs, to the Share Insurance Fund and broad discretion for how it determines this allocation. The Act authorizes two primary sources to fund the Operating Budget: (1) Requisitions from the Share Insurance Fund ''for such administrative and other expenses incurred in carrying out the purposes of Title II of the Act as the Board may determine to be proper''; and (2) ''fees and assessments (including income earned on insurance deposits) levied on insured credit unions under the Act."

So, expenses funded from the Share Insurance Fund must carry out the purposes of Title II of the Act, which relate to share insurance regardless of charter. The costs NCUA incurs in safeguarding the Share Insurance Fund relate to the risks in federal credit unions and federally insured state-chartered credit unions. The Act provides the Board with a number of specific authorities that relate to costs NCUA incurs in carrying out its obligations under Title II. For instance, Title II of the Act authorizes the Board to appoint examiners and examine any insured credit union whenever it determines an exam is necessary. Title II also authorizes the Board to implement regulations applicable to all insured credit unions to address risk to the Share Insurance Fund. The cost of the agency activities associated with exercising these and other accompanying authorities can properly be considered costs of carrying out Title II of the Act.

The next area of comment I'll discuss is use of a formula for the OTR. Most commenters favored a formula driven approach but felt the current formula was too complicated. As previously noted, the proposed changes to the OTR simplify the methodology but still incorporate use of a formula to help ensure it is fair and equitable. This also avoids the temptation to pick a figure for the OTR without a reasoned basis to demonstrate this level of agency operating costs are properly allocated to Title II activities.

Various commenters also disagreed with assigning safety and soundness activities as insurance-related. NCUA recognizes there are various ways to view this issue and we will we cover this when we discuss the proposed changes to the OTR methodology.

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Some commenters believe the current OTR methodology disadvantages federally insured state-chartered credit unions, resulting in them paying higher operating fees to their state regulators. The independent review of the OTR by PriceWatehhouseCoopers determined there was no basis to conclude that the method favors or disadvantages any one type of credit union. The chart on this slide illustrates the operating fee for both federal credit unions and federally insured state-chartered credit unions as a percent of average assets. As the chart shows, overall federal credit union operating fees have been proportionally higher than federally insured state-chartered credit union operating fees, even as the OTR has increased in recent years.

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The primary goal of the proposed changes to the OTR methodology is to reduce its complexity while ensuring it remains fair and equitable. The proposed changes would also reduce the agency resources needed to administer the OTR. The proposed new methodology also incorporates a key assumption change – that is the recognition that safety and soundness is not the sole domain of the insurer.

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As reflected on slide 6, the proposed new methodology incorporates four key principles in allocating agency operating costs. Principle 1 address the time and costs of examining and supervising federal credit unions. Time spent on these activities is allocated as 50 percent insurance related. This emulates an examination and insurance program where NCUA would alternate examinations and/or conduct joint examinations as if its insurance function and its prudential regulator function were separate units within NCUA. It also supports the assumption that safety and soundness is not the sole domain of the insurer. This approach is consistent with how the FDIC and state regulators conduct alternating examinations of state-chartered banks as mandated by Congress. It also reflects that NCUA's insurance role should not solely rely on examinations and supervision conducted by the prudential regulator.

Principle 2 addresses the time and costs of supervising federally insured state-charted credit unions or other entities not chartered by NCUA. These activities are allocated as 100 percent insurance related as NCUA's only role for these institutions is as insurer.

Principle 3 addresses the time and costs related to NCUA's role as charterer and enforcer of consumer protection rules. These activities are allocated as 0 percent insurance related.

Principle 4 relates to the time and costs of NCUA's role in administering federal share insurance and the Share Insurance Fund, such as credit union liquidations, insurance payouts, and answering consumer inquiries about share insurance coverage. These activities are allocated as 100 percent insurance related.

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As you'll see when we walk through the new calculation, the proposed new methodology reduces the number of steps in the calculation from eight to three. This includes: eliminating the four step calculation of the State Supervisory Authority (SSA) Imputed Value; reducing the number of categories in Steps 1 and 2 from fifteen to five and eight to six respectively; and decreasing the number of necessary data points by about 80 percent. The proposed methodology also eliminates the annual Examination Time Survey. Since the proposed methodology assumes NCUA shares the examination and supervision of federal credit unions equally, the Examination Time Survey is not necessary. Additionally, NCUA will no longer need to review and update the regulatory mapping every year. We will now walk through the proposed new calculation.

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Slide 8 shows the first Step in calculating the OTR. We are using 2017 data for illustrative and comparison purposes. This step assigns the workload program hours for examination and supervision of credit unions and other entities conducted by NCUA's field staff. The corresponding allocation principle is noted for each workload program category. The result from Step 1 is that 61% of NCUA's field program is insurance-related.

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Step 2 is how the agency's operating budget is then allocated. The allocation factors for the cost of the Regions and ONES are based on the result from Step 1. The central offices with roles distinct enough to have their own factors, that is the Asset Management & Assistance Center, the Office of Consumer Protection and Financial Access, and the Office of Small Credit Union Initiatives, are determined separately and applied here. The details of how these office allocation factors are arrived at are included in the Request for Comment. The dollar-weighted factor for the four primary mission functions is arrived at in the subtotal and then applied to the remainder of the central offices – which design or oversee the examination and supervision program, or support the agency's overall operations. Step 2 results in an allocation of $179.0 million of NCUA's $298.2 million 2017 budget as insurance related.

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Step 3 is relatively simple. The OTR is expressed as a percentage of the agency operating budget paid for by the Share Insurance Fund. Thus, this step merely divides the dollar amount of insurance-related costs calculated in Step 2 by the total amount of NCUA's Operating Budget. Thus, the proposed methodology if applied to the 2017 data would result in an OTR of 60.0 percent.

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Slide 11 compares the results of the 2017 OTR calculation based on the current methodology with the results of the proposed methodology. As you can see the OTR declines from 67.7 percent to 60.0 percent. The costs allocated to the federal credit union operating fee would increase by $22.8 million – a 24% percent increase.

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It's important to remember that federal credit unions also shoulder the implicit costs of Share Insurance Fund requisitions. Slide 12 illustrates the cost distribution of NCUA's Operating Budget between federal credit unions and federally insured state-chartered credit unions. Under the proposed methodology, federal credit unions would cover 71 percent of NCUA's Operating Budget compared to 67 percent under the current methodology.

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At this time we request the NCUA Board approve publishing in the Federal Register the Request for Comment on the proposed change to the OTR methodology with a 60 day comment period. It is our goal to present a final proposal for the OTR methodology to the Board at its November 2017 meeting.

We would be happy to answer any questions you have at this time.