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OVERHEAD TRANSFER:

THE AUTHORITY OF THE

NATIONAL CREDIT UNION ADMINISTRATION

TO ALLOCATE COSTS TO THE

NATIONAL CREDIT UNION SHARE INSURANCE FUND

Study commissioned by
National Association of
State Credit Union
Supervisors

Study prepared by
CUNA Legal Department

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Preface

Since the 1970's when the National Credit Union Administration (NCUA) Board began funding a portion the agency's expenses from the earnings of the National Credit Union Share Insurance Fund (NCUSIF) through a mechanism known as the overhead transfer, questions about the Board's authority to do so have never been definitively researched.

The decision by the NCUA Board on October 19, 2000 to raise the overhead transfer rate from 50 percent to 66.72 percent prompted opinion makers to ask how consistent NCUA's cost allocation decisions were with the Federal Credit Union Act (FCUA).

In reaction to the outpouring of concern expressed by state regulators, credit union associations, state and federal credit union leaders, the Board of The National Association Of State Credit Union Supervisors (NASCUS) directed management to commission a study of the NCUA's legal authority to pass its expenses on to the insurance fund.

The NASCUS Board went beyond just commissioning a legal study, though. They directed NASCUS Management to commission an absolutely unbiased and objective study.

In response to the NASCUS Board's overriding goal, NASCUS Management commissioned the Credit Union National Association's (CUNA) legal staff to research the legal foundations of the overhead transfer policy. With CUNA's membership including both federally and state chartered credit unions, its legal department brought objectivity to the design and conduct of the study that NASCUS could not have realized by relying on other legal resources.

The study, rooted in fact, speaks to the authority the Federal Credit Union Act grants NCUA and the authority it withholds. It compares the justifications for the policy against the provisions of the Act and tests the policy against the obligation the Act imposes on the NCUA to serve federally and state chartered credit unions in an equitable way.

As you read the study, several salient points surface. Noteworthy:

- The Federal Credit Union Act provides meaningful limitations on the ability of the NCUA Board to transfer expenses of the agency to the National Credit Union Share Insurance Fund (NCUSIF). There are specific provisions within the Act that limit the agency's authority. The NCUA does not have *carte blanche* authority to pass expenses on to the NCUSIF.

- Congress directed NCUA to balance the interests of state and federal credit unions. The Act directs the agency to accomplish this, in part, by containing costs through reliance on activities normally undertaken by the NCUA or the state regulators in the performance of their supervisory duties.

- Title I of the FCUA requires the NCUA to prepare an examination on each Federal Credit Union. Title II of the FCUA requires the NCUA to fashion its Title I examination reports in a manner usable by the NCUSIF. It also obligated the NCUA to rely on the examination reports prepared by state credit union regulators in the same manner it must rely on NCUA Title I examination reports. The NCUA does not have the authority to ignore the language of Title I which requires the NCUA to complete examination reports or of Title II which requires the NCUA to make its Title I reports usable to fulfill its Title II responsibilities.

- Title I obligates the agency to rely on operating fees to underwrite the costs of its supervisory activities for federal credit unions. It was never envisioned that redundant costs would be allocated to the NCUSIF.

- The term "safety and soundness" and "insurance-related" actions are not synonymous. The NCUA clouds the overhead transfer rate issue when it attempts to equate these terms.

- The NCUA's decision to rely on an internal staff study to justify the increases in the rate approved in October 2000 was questionable and raises concern that the decision was ill advised.

- The process under which the NCUA Board determines the rate raises separate legal issues. Given the directives of the FCUA and the economic impact of the Board's decision, the determination of the overhead transfer rate is a policy matter that should be subject to notice and comment under the Administrative Procedure Act (APA).

- Because the NCUA is directed to rely on examinations under Title I and those required by state regulators alike, it is reasonable to assume that the NCUSIF should reimburse state regulators to the same extent it reimburses the NCUA.

The authors of the study conclude that there have been lapses of fiscal and regulatory discipline that have allowed the federal agency to batten on unexamined authority. No matter the choice of charter, credit unions must have an insurance provider in whose conduct and fairness they can have confidence.

Doug Duerr
NASCUS President & CEO

EXECUTIVE SUMMARY

Long-standing and legitimate questions have, until now, gone largely unanswered regarding the basis and extent of the National Credit Union Administration Board's authority to apportion expenses to the National Credit Union Share Insurance Fund (NCUSIF). Since the late 1970's, the Board has allocated a portion of its operating expenses to the earnings on the NCUSIF through a mechanism known as the overhead transfer rate. The agency also funds its operations through fee assessments to federal credit unions, investment income, and to a lesser extent through the sale of agency publications.

The decision of the NCUA Board on October 19, 2000 to raise the overhead transfer rate from 50% to 66.72% heightened suspicions that the agency's actions regarding cost allocations are not consistent with the Federal Credit Union Act.

The implications are far reaching. Foremost, as reported in *NewsWatch*, October 23, 2000, with the last overhead transfer rate increase, the proportion of total agency costs borne by federal credit unions decreased by $10.1 million and the proportion borne by state credit unions increased by that exact amount.

Beyond that, though, if the agency continues to enlarge the proportion of "insurance-related" costs it allocates to the NCUSIF, serious concerns may be raised as to the need for a separate agency to supervise federal credit unions.

Such concerns are further compounded by the fact that economic consequences for credit unions result from the Board's overhead transfer rate decisions.
By raising the rate, the agency was able to reduce the operating fee scale for federal credit unions. Understandably, this was a welcome development in the federal credit union community, but others charged that the agency improperly subsidizes its federal regulatory activities with NCUSIF earnings.

Also, the amount of funds available for a dividend to federally insured credit unions is clearly affected by the overhead transfer. The Act requires that after certain conditions are met, a dividend must be paid to federally insured credit unions on the 1% deposit they must maintain with the NCUSIF. However, the amount of NCUSIF expenses, such as covering costs for NCUA regulation, will reduce the amount of funds available for a dividend. Thus, when the overhead transfer is increased, the funds available for dividends to credit unions are reduced. In short, the use of the current overhead transfer rate mechanism has resulted in consequences for the credit union system that are unfortunate and unintended by the Act.

This report squarely addresses the legal parameters attendant to the NCUA Board's authority to reach into the resources of the NCUSIF to fund a substantial portion of its expenses. It is clear that NCUA relies on but one provision of the

Act to justify its decision concerning the overhead transfer rate. Yet, as this review discusses, there are a number of provisions in Title I and Title II, which must guide the agency in setting the overhead transfer rate.

The Act provides meaningful limitations on the ability of the NCUA Board to transfer expenses of the agency to the NCUSIF. Several provisions in the Act speak to the manner in which the agency is authorized to fund its expenses, and taken together, these terms and conditions present a paradigm for the agency to follow that carefully circumscribes its ability to allocate costs. This includes the ability of the agency to label its activities as "insurance-related," in order to attribute such costs to the NCUSIF.

As the regulator of federal credit unions and the administrator of the NCUSIF, the NCUA Board presides over a structure that is unique within the federal financial institution supervisory system. NCUA has a safety and soundness function relating to federal credit unions that is not, strictly speaking, driven solely by Congress' intent to safeguard the NCUSIF. Yet the current, significant allocation of costs through the overhead transfer rate helps to reinforce a misconception that agency actions are driven solely by the requirement to protect the NCUSIF.

As the Act indicates, it is Congress' intent that NCUA balance the interests of state and federal credit unions when it performs its concurrent roles. In allocating costs through an overhead transfer, the agency must not ignore Congress' directive for fairness and equity for both types of credit union charters it insures. The Act directs the agency to accomplish this, in part, by containing costs through reliance on examination reports that are required under Title I and by the state regulators, thus minimizing the need for an overhead transfer rate. Because NCUA is directed to rely on examinations under Title I and those required by state regulators alike, it is reasonable to assume that the NCUSIF would be authorized to reimburse state regulators, as it does NCUA.

The process under which the NCUA Board determines the overhead transfer rate raises separate legal issues. Relying on an internal agency study which does not clearly delineate activities that are "insurance-related" for purposes of cost allocations, the Board did not obtain comments from credit unions or other interested parties prior to raising the rate over 32 basis points -- a substantial increase. Given the directives of the Federal Credit Union Act and the impact of the Board's decision, NCUA would be well-advised to engage in a rulemaking, notice and comment process under the Administrative Procedure Act (APA). A recent Supreme Court decision (*U.S. v. Mead Corp.*) supports the view that absent such a distinct rulemaking process, the agency's decisions on the overhead transfer rate may not be entitled to deference if challenged in court.

The authority of the NCUA Board to establish the overhead transfer rate has important limitations and must be exercised only in a manner that is consistent with the Federal Credit Union Act and the APA. Only then will credit unions be assured that the agency is exercising its dual roles of NCUSIF administrator and federal credit union regulator as Congress intended.

I. Introduction -- The Legal Authority of the NCUA Board to Set the Overhead Transfer Rate Involves Many Key Issues

While the National Credit Union Administration's Annual Report for the Year 2000[1] labels the overhead transfer a mere "accounting procedure," in actuality it is an important substantive matter. Through the use of the overhead transfer rate, NCUA allocates costs, such as expenses incurred by examiners and central office staff, that it determines are related to the safety and soundness of the National Credit Union Share Insurance Fund.[2]

A. Description of the Current Overhead Transfer Rate System

To fund its operations, NCUA divides its operating expenses between the agency and the NCUSIF. Basically, NCUA draws upon annual federal credit union operating fees, investment income on excess cash, miscellaneous income primarily from the sale of agency publications, as well as a transfer of certain expenses to the NCUSIF that are determined by the agency to be "insurance-related." Expenses allocated to the NCUSIF are underwritten by earnings on the NCUSIF, which is comprised of deposits from state and federal credit unions.[3]

In the late 1970's, NCUA set the transfer rate at 33%; that is, one-third of the agency's expenses were defrayed by the NCUSIF. In 1985, the agency

[1] "Entering the 21st Century," National Credit Union Administration Year 2000 Annual Report, p. 31.
[2] *Id.*
[3] *Id.*

increased the rate to 50%, so that half of the agency's costs associated with regulating and supervising federal credit unions were borne by the NCUSIF. In 1997, the agency agreed to retain the 50% rate until the Year 2000, based on an internal staff report that disclosed how examiners and central office staff indicated they divided their time between insurance- and regulatory-related activities. In October 2000, relying on an updated internal study, the NCUA board concluded that a change in the transfer rate was overdue and voted to move the rate to 66.72%, the largest rate increase to date. Thus, over two-thirds of the agency's regulatory expenses are now paid for by the NCUSIF.[4]

An independent study, conducted by Deloitte & Touche, the agency's outside auditing firm, was requested by the NCUA Board when it approved the increased rate. That study is expected prior to the agency's reconsideration of the overhead transfer rate in the Fall of 2001.

Concerns about the agency's determination of the overhead transfer rate call into question the strength of the dual chartering system; the agency's relationship with state regulators and state chartered federally insured credit unions; the extent to which the agency must adhere to reasonable principles of equity in reaching decisions that produce different outcomes for state-chartered federally insured credit unions and federal credit unions; the process under which it

[4] *See* NCUA Board Action Bulletin, Oct. 19, 2000, "Report on the Overhead Transfer Rate for Fiscal Year 2001".

selects the overhead transfer rate; and the authority of the agency to allocate costs to the National Credit Union Share Insurance Fund. This report focuses on this latter, legal issue, although a limited discussion of those other matters which are inextricably connected helps to illuminate the importance of a clear understanding of the statutory restraints on NCUA's authority.

B. Thorough Analysis of NCUA's Authority Regarding the Overhead Transfer Rate Is Imperative

Even though the agency has employed the overhead transfer to help fund its operations for over twenty years, the legal basis for such action has only been superficially articulated, and thus, perennial concerns about NCUA's statutory authority have not been satisfactorily addressed.

The third-party study requested by the NCUA Board in October 2000 when it approved the largest increase ever in the overhead transfer rate is underway. It is unclear to what extent, if at all, that study will examine relevant legal directives, as this report is designed to do.

Because an adequate explanation from the agency demonstrating Congress' intent that agency costs be allocated to the NCUSIF has not been forthcoming, a number of credit union officials are understandably deeply concerned and dubious of the legal underpinnings of NCUA's actions. This uncertainty undermines NCUA as a supervisory agency and perpetuates the lingering debate over the legitimacy of the overhead transfer.

C. Salient Issues Which Have Not Been Sufficiently Addressed By NCUA in the Context of the Overhead Transfer Rate

This report concentrates on several essential questions that have been largely ignored in the debate and deliberations regarding the overhead transfer. These fundamental issues are:

- What is NCUA's legal authority to utilize NCUSIF funds to support agency activities? In other words, in what manner does the Federal Credit Union Act contemplate NCUA's use of the overhead transfer to attribute its costs to the NCUSIF?
- Is that power unlimited, as some have suggested?
- Does the FCU Act compel equity for state and federal credit unions when the agency performs its concurrent roles of federal regulator and NCUSIF Administrator?
- Does the Administrative Procedure Act apply to the overhead transfer rate?
- Is the current overhead arrangement consistent with the requirements of the Federal Credit Union Act and the Administrative Procedure Act?

1. Important terms have not been clarified

Critical to the development of a meaningful dialogue on the issue of the overhead transfer rate is the use of terminology that is consistently understood by those involved in the discourse. Indeed, as addressed subsequently in this report, NCUA has been roundly criticized for allocating the agency's "insurance-related costs" to the NCUSIF, without clearly delineating what that term encompasses -- or more to the point, what it does not include.

A brief discussion of three terms is essential to a thoughtful consideration of NCUA's authority regarding the overhead transfer rate. These terms are: "safety and soundness"; "insurance-related" activities; and "regulatory related" activities.

Safety and soundness is a broad term that is not defined in the Act or other banking statutes. What the Act does make clear through requirements such as prompt corrective action, limits on credit unions powers, credit union organization and management requirements, field of membership restrictions, financial condition reporting requirements and other provisions is that credit unions are expected to operate in a manner that protects their members' funds and the integrity of their operations, and does not jeopardize the NCUSIF. Also, the Act leaves no doubt that the NCUA Board has a crucial role to play in administering and safeguarding the NCUSIF.

Safety and soundness requirements for federal credit unions were first confined to Title I of the Act. Also under Title I, the NCUA is given the authority to regulate federal credit unions and to assess an operating fee to fund the agency's regulatory and supervisory activities for such credit unions. This includes safety and soundness examinations, which were required prior to the addition of Title II in the Act. Title II establishes the NCUSIF and designates NCUA as its administrator, among other provisions.

Through provisions such as the requirement that federal credit unions be supervised by the NCUA Board and be subject to its examination, Title I makes it clear that NCUA has an important safety and soundness function for federal credit unions in order to protect these credit unions and their members' shares. The agency's safety and soundness role under Title I was not designed to protect the NCUSIF, which had not come into existence until thirty-six years after the FCU Act was enacted in 1934.

When Congress adopted Title II in 1970 establishing the NCUSIF and NCUA's function as the NCUSIF administrator, it did not repeal the provisions of Title I addressing NCUA's supervisory role over federal credit unions. Thus, NCUA has a safety and soundness function relating to federal credit unions that is not, strictly speaking, driven solely by Congress' intent to safeguard the NCUSIF. In short, the term "safety and soundness" regulation is not synonymous with "insurance-related" regulation, and NCUA clouds the overhead transfer rate issue when it attempts to equate these terms.

The term "insurance-related" activities has been used by NCUA , without defining it, to refer to the supervision of credit union operations that expose credit unions and the NCUSIF to risk.[5] It includes the implementation of requirements such as prompt corrective action, which under Title II applies to all federally insured credit unions.

Title II also addresses examination standards and other provisions for all federally insured credit unions. Nowhere in the Act does Congress indicate that NCUA's function to protect the NCUSIF under Title II is more significant than its regulatory role to supervise federal credit unions under Title I.

Because it is clear from the Act that the NCUA's supervisory role for federal credit unions is not solely predicated on the need to protect the NCUSIF,[6] the term, "insurance-related" in the context of the overhead transfer rate may be more properly used to denote Title II activities, such as net worth standards. It should not be used as a catch-all nomenclature basket into which NCUA can toss the majority of its activities in order to have the NCUSIF fund them.

A phrase that is defined in NCUA's report issued October 2000 to support an increase in the overhead transfer rate is "regulatory-related" activities.[7] NCUA states that this term refers to “regulations that apply only to federally chartered credit unions – not those applying to all federally insured credit unions.” This

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[5] *See,* NCUA Board Action Bulletin, Oct. 19, 2001 “Report on the Overhead Transfer Rate for Fiscal Year 2001,” p. 5.
[6] Title I of the Federal Credit Union Act, which predated Title II by 36 years, was not deleted when Congress adopted the later title in 1970, establishing the National Credit Union Share Insurance Fund. Title I establishes a supervisory role for NCUA regarding federal credit unions that is not expressly overridden in Title II. (12 USC 1755, 1756, 1757, and 1766.)
[7] “Report on the Overhead Transfer Rate for Fiscal Year 2001,” at p 5.

description is imprecise, as the agency is required to regulate all federally insured credit unions under rules such as Truth-in-Savings and prompt corrective action.

Consistent with Congress' directives in Title I regarding NCUA's role as the primary regulator of federal credit unions, NCUA should define "regulatory-related" expenses as those costs it incurs to supervise federal credit unions, including implementation of provisions relating to their activities and examinations found in Title I.[8]

II. The Federal Credit Union Act Establishes a Paradigm Regarding the Overhead Transfer Rate

The Federal Credit Union Act establishes a template for the agency to follow in executing its concurrent duties as the federal credit union regulator and the administrator of the NCUSIF. The agency ignores the intent of Congress when it dismisses the directives of the Act.

A. Title I Provisions Limit NCUA's Overhead Transfer Rate Authority

Title I of the Act includes several relevant provisions that address the scope of NCUA's authority to transfer costs to the NCUSIF.

[8] 12 USC 1751, 1756, 1757, 1766.

Title I provides that federal credit unions must be under the supervision of the NCUA Board, make financial reports as required by NCUA, and be subject to examination by the Board.[9]

To fund those supervisory activities, 12 USC 1755 provides that each federal credit union must pay an annual operating fee. More specifically, 12 USC 1755(d) provides:

> All operating fees…may be expended by the Board to defray the expenses incurred in carrying out the provisions of this Act, including the examination and supervision of Federal Credit Unions.

This language could not be clearer. The agency is authorized to utilize operating fees from federal credit unions for its expenses in supervising federal credit unions.[10]

Other provisions of Title I address the funding of NCUA's activities and further reinforce the use of operating fees to defray agency supervisory costs on behalf of federal credit unions. For example, subsection 12 USC 1766(j)((3) provides, “The salaries and expenses of the Board and employees…shall be paid from

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9 12 USC 1756

10 This provision uses the word “Act” instead of Title I and could be interpreted as allowing NCUA to transfer funds from operating fees to defray costs for the NCUSIF – just the opposite of the mechanism currently employed. This may be a novel view as there is no indication that NCUA has contemplated using this approach. However, this statutory provision indicates that NCUA has authority to fund actions under Title II, administration of the NCUSIF, including those that affect state chartered credit unions, by allocating such costs to operating fees collected under Title I.

fees and assessments (including income earned on insurance deposits) levied on insured credit union under this Act."

This provision deserves careful scrutiny. While directing the NCUA Board to use operating fees and assessments to pay for agency costs, it also opens the door for NCUA to allocate some costs to the NCUSIF.

By stating that salaries and expenses must be paid for from fees and assessments, including the earnings on the NCUSIF, it is clear that such earnings may be used only to supplement what is collected from operating fees. According to *Webster's Dictionary*, to "include" means "to place, list or rate as a part or component of a whole or of a larger group, class or aggregate; to take in, enfold or comprise as a discrete or subordinate part or item of a larger aggregate group or principle."[11] Thus, something that is "included" is not distinct, but is added on to a larger, existing group.

Congress could have stated that salaries and expenses should be borne exclusively or significantly through the earnings on the NCUSIF, but it did not. Rather, it established a system under which earnings on the NCUSIF could be included or added to operating fees to cover agency costs. The terminology in

[11] *Webster's New International Dictionary*, 3d ed., s.v., "include."

this provision not only seems to preclude the use of earnings on the NCUSIF to defray all the agency's costs, but also raises doubt as to whether NCUA is authorized to shift a lesser but still significant part of its costs to the NCUSIF. This language is important in light of the informal suggestions some staff at the agency have offered that all of the agency's costs could be allocated to the NCUSIF.

Title I clearly indicates that the agency must use operating fees to underwrite the costs of its supervisory activities for federal credit unions.[12] Some costs may be allocated to the NCUSIF, but NCUA does not have *carte blanche* to ignore the language of Title I and attribute a major part of the agency's costs to the NCUSIF.

B. Provisions Regarding NCUSIF Authority and Funding in Title II Also Restrict NCUA's OTR Powers

Several provisions in Title II relate to the overhead transfer rate and must be taken into consideration in reviewing the scope of NCUA's authority over this matter.

[12] 12 USC 1756(b).

Under 12 USC 1781(a), the NCUA Board is designated as the insurer of credit union member accounts. Title II enumerates a host of activities the NCUA Board as the administrator of the NCUSIF must undertake. It directs that credit unions must pay for their insurance through a 1% deposit and through insurance premiums, as necessary.

Title II gives the Board the authority to use “Money in the fund… for such administrative and other expenses incurred in carrying out the purposes of this title as it may determine to be proper.” [13] This lone provision is the only authority NCUA consistently cites for its decisions to effect or raise the overhead transfer rate.

A superficial, isolated reading of this one provision seems to support NCUA’s sweeping interpretation that it has authority to allocate costs liberally to the NCUSIF. However, it is significant that the language limits NCUA’s cost allocations to expenses incurred only under Title II, that is those that are directly related to protecting the NCUSIF. Because Title I already required supervision of federal credit unions, it is reasonable to conclude that agency costs allocated to protect the NCUSIF necessarily must be minimal and only in addition to costs allocated to operating fees.

[13] 12 USC 1783(a).

Under Title II, NCUA is directed to use examinations from Title I and those conducted by state regulators "to the maximum extent feasible." Congress felt this directive is so critical that it also mandates that the NCUA Board use reports required under Title I for insurance purposes as well as reports submitted to state regulators by state credit unions again, to the "maximum extent feasible."[14]

This language has a direct bearing on the overhead transfer rate issue. Congress intended that NCUA economize to the extent practicable and that as the insurer, NCUA should rely on examination reports required under Title I and by the state regulators.[15] The Board, as the NCUSIF Administrator, is to look to both sources, as relevant, for safety and soundness information. Because NCUA is directed to rely on examinations under Title I and those required by state regulators alike, it is unreasonable to conclude that NCUA has unfettered discretion to charge costs to the NCUSIF. A further reasonable assumption is that NCUSIF would be authorized to reimburse state regulators, as it does NCUA, in order to preserve the symmetry created by the Act's directive that NCUA rely on exam reports under Title I and those required by state regulators.

In any event, there is no reasonable reading of the FCU Act that preordains a resource allocation system that only addresses the use of information and

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[14] 12 USC 1781(a)(1), 12 USC 1782(a)(5).
[15] H. Rep. No. 91-1457, 91st Congress, 2d Session (October 5, 1970), at 4169, 4170.

activities regarding federal credit unions when the Act so clearly obliges the NCUSIF to rely on state regulatory information and examinations as well.

One other provision in Title II raises serious concerns about NCUA's overhead transfer rate mechanism. Under 12 USC 1782(c)(1)(B)(iv) deposit funds (the 1% insurance deposit)

> may be used by the fund if necessary to meet its expenses in which case the amount so used shall be expensed and shall be replenished by insured credit unions in accordance with procedures established by the Board.

This language is problematic when viewed as complementing NCUA's interpretation regarding the overhead transfer rate. If the agency's overhead transfer rate authority continues unchecked, this provision could be used to require credit unions to replenish their 1% if NCUA ever needed funds in excess of the earnings on the NCUSIF. In other words, this provision, when viewed in light of NCUA's overhead transfer rate interpretation, would allow NCUA to reach deeply into the pockets of the NCUSIF to defray agency costs.

While this scenario is unlikely given the agency's historic treatment of the NCUSIF, it does raise troubling possibilities. Such an interpretation would lead to a direct conflict with Title I limits on the agency's ability to allocate expenses to the earnings on the NCUSIF only.

Yet another provision in Title II that must be underscored in assessing the agency's role as the administrator of the Fund's Section 211 of the FCU Act. Labeled by Congress as the "Nondiscriminatory provision," this section leaves no doubt that NCUA must fairly balance the interests of state and federal credit unions in decisions relating to the Fund, including its implementation of the overhead transfer rate.[16]

III. NCUA Must Evaluate All Relevant Provisions of the FCU Act in Determining the Permissibility of the Overhead Transfer Rate

This analysis addresses several key provisions in the Act that affect the agency's overhead transfer rate decision. Yet, the agency has chosen to ignore all but one. Not surprisingly, NCUA focuses on the single provision that allows the agency to use NCUSIF funds to defray "administrative and other expenses incurred in carrying out the purposes of this title as it may determine proper..." [17]

On its face, this language is quite permissive, and it would be very enticing for any agency to focus myopically only on such a provision.

Yet the Federal Credit Union Act compels the agency to read on. By taking a broader view of the Act, as surely Congress intended (otherwise certain provisions as discussed above would be rendered meaningless), it is apparent that Congress directed NCUA to balance the interests of state and federal credit

[16] 12 USC 1790.

unions. It directs the agency to accomplish this in part by containing costs through reliance on examination reports that are required under Title I and by state regulators, thus minimizing the need for an overhead transfer rate. NCUA's increased cost allocation for state credit unions flies in the face of this clear signal from Congress that NCUA is subordinate to state supervisors when state chartered credit unions are involved.

The Act's intent to provide an equilibrium between state and federal credit union interests is also apparent in the requirement that NCUA use operating fees to fund agency supervisory costs for federal credit unions, while allowing it to allocate some costs to the NCUSIF to supplement those fees. These directives necessarily curtail the agency's authority to allocate expenses to the NCUSIF.

In light of these interconnected provisions, in Title I and Title II, it is inescapable that NCUA's' authority to allocate costs to the NCUSIF has real limits that are intended to strengthen dual chartering and reinforce reasonable notions of equity between state and federal credit unions.

IV. The Applicability of the Administrative Procedure Act Raises Concerns

This report primarily addresses concerns regarding the application of the Federal Credit Union Act to the agency's decisions regarding the overhead transfer rate.

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[17] 12 USC 1783(a).

However, because of the inadequacies in the agency's process for determining the overhead transfer rate, questions about the applicability of the Administrative Procedure Act will inevitably arise as part of the debate.

NCUA has not taken the position that the APA requires a rulemaking process under which there is adequate notice and comment for credit unions and other interested parties for the agency to establish the overhead transfer rate. In fact, it is unclear to those outside the agency exactly how the Board arrives at its determinations regarding the overhead transfer rate. (The Board seemed to recognize this sentiment when it called for an independent study in October 2000.)

Under Section 553 of the APA, which addresses standards for a rulemaking procedure, substantial exemptions from the rulemaking requirements are provided. For example, matters that relate to agency management or personnel are not subject to required rulemaking. Interpretive rules, general statements of policy, or rules of agency organization or practice are not subject to published notice in the *Federal Register*. [18]

Further, the APA provides that when the agency for good cause finds that notice and comment are impracticable, unnecessary or contrary to the public interest, public notice may be avoided. [19] It would be reasonable for the agency to refrain

[18] 5 USC 553(b)(A).
[19] 5 USC 553(b)(B).

from applying any of these exemption categories to the overhead transfer rate process. The overhead transfer rate issue involves substantive concerns, such as the scope of NCUA's authority, credit union property rights, the effect of the overhead transfer rate on the Congressionally-mandated dividend, and the impact of NCUA's decisions on state regulators. Substantive matters should not automatically be exempted from the rulemaking process, as the agency has done. While agencies have latitude in applying the APA, generally only rules without substantial impact, such as statements of clarification, are exempt from notice and comment procedures.[20] It should also be noted that some agencies, as a matter of good public policy, consistent with the purposes of the APA, have waived the exemptions and voluntarily complied with the notice and comment provision of the APA.[21]

The APA, which seeks to balance the need for an agency to have flexibility to perform its functions with the rights of due process for aggrieved parties, also provides that any "person" must be given the "right to petition for issuance, amendment or repeal of a rule."[22]

[20] *See* generally 5 USCS 553 (2001), LEXSTAT; *U.S. v. Hallmark Constr. Co*. (1998, ND Ill) 14 F Supp 2d 1069, 29 ELR 20168, judgment entered (1998, ND Ill) 30 F Supp 2d 1033.
[21] 41 ALR Fed 926 at 5.
[22] 5 USC 553(e).

Even if an agency does not initiate a rulemaking process, the APA provides that a decision of an agency on a substantive matter, such as the overhead transfer rate, may be afforded judicial review. "A person suffering a legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof." [23]

Further under the APA, in reviewing the agency's policy, the court may compel action or set aside decisions which it finds are arbitrary, capricious, contrary to any constitutional right or privilege, in excess of statutory jurisdiction, were promulgated without observance or procedure required by law or unwarranted by the facts.[24]

Whether an agency's interpretations of statutory provisions must be given deference by a court during judicial review is generally reviewed under standards articulated by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*., 467 US 837 (1984) and its progeny. *Chevron* stands for the principle that agency determinations regarding statutes which they are charged to implement are entitled to deference from the court if they are reasonable.

[23] 5 USC 702.
[24] 5 USC 706.

A. *U.S. v. Mead Corp*. Has Important Implications for Overhead Transfer Rate

In June 2001, the Supreme Court issued an opinion in *United States v. Mead Corp*. that raises serious questions about deference under *Chevron* for agencies when a rulemaking procedure is not involved, as in the case with the overhead transfer rate.[25] The implications of the case were best articulated by Justice Antonin Scalia who summarized the holding of *Mead*:

> Only when agencies act through 'adjudication, notice and comment rulemaking, or some other [procedure] indicati[ng] comparable congressional intent [whatever that means]' is *Chevron* deference applicable. (Brackets added by Justice Scalia)[26]

While thus confining the applicability of *Chevron,* the majority opinion did indicate some deference may nonetheless be afforded an agency under a 1944 Supreme Court opinion, *Skidmore v. Swift & Co.,* 323 U.S. 134.

Under that opinion, the measure of deference to an agency administering its own statute “var[ies] with circumstances, including "the degree of the agency's care,

[25] United States v. Mead Corp. 121 S. Ct. 2164 (2001).5
[26] *id* at 2171.

its consistency, formality and relative expertness, and the persuasiveness of the agency's position."[27]

As summarized by Justice Scalia, "The Court has largely replaced *Chevron* with that test most beloved by a court unwilling to be held to rules (and most feared by litigants who want to know what to expect): th' ol' 'totality of the circumstances' test."[28]

As *Mead* indicates, the more careful the process, the more deference an agency is likely to receive if challenged in court. Conversely, the more ad hoc the process, the less deference an agency is likely to be afforded.

Thus, there are legitimate concerns under the APA regarding the processing of the overhead transfer rate decisions. As the decision in *Mead* indicates, the more carefully an agency follows a rulemaking procedure under the APA, the more deference it is likely to be afforded if challenged. Given the concerns raised about NCUA's approach to determining the overhead transfer rate, the agency's process and decision-making may not withstand judicial scrutiny.

[27] *Id.* at 2172.
[28] I*d.* at 2173.

V. Historical Perspective on the Overhead Transfer Rate Reveal a Flawed Process

NCUA's use of the overhead transfer rate to fund agency activities has disregarded relevant provisions of the Federal Credit Union Act. As a result, the use of the overhead transfer rate mechanism has resulted in consequences for the credit union system that are unfortunate and unintended by the Act.

A. Development of NCUA's Reliance on the Overhead Transfer

As reported by the General Accounting Office (GAO), in the early 1970's NCUA began transferring expenses related to the examination of federal credit unions to the NCUSIF.[29] The rationale for this procedure is that with the inauguration of federal share insurance and NCUA's new role as insurer in 1970, the agency's safety and soundness examinations of federal credit unions not only continued to protect members' shares and credit unions' operations, but also protected the NCUSIF. If NCUA were only the insurer and not also the regulator of federal credit unions, it would undoubtedly have to undertake such examinations for itself or arrange with a third party for such service. Under the overhead transfer, NCUA simply pays itself as the regulator of Federal credit unions for costs the NCUSIF would have otherwise incurred to safeguard the NCUSIF.

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[29] *See,* NCUA Board Transcript of Oct. 19, 2001.

As the GAO pointed out, agency supervisory costs that benefit both the operating fund and the NCUSIF "must be allocated to both the funds." GAO also noted that the "basis for the allocation was the actual examiner time spent on supervision activity."[30]

1. The Overhead Transfer Rate Impacts the NCUSIF Dividend

NCUA's current approach to the overhead transfer rate results in at least one very significant adverse consequence for the entire credit union system. That is, as the amount of the transfer of agency expenses to the NCUSIF increases, the amount of funds available for a dividend to all federally insured credit unions decreases. When GAO recognized NCUA's use of the overhead transfer rate in 1973, the current system for rebating dividends to federally insured credit unions was not in the Act.[31]

Under the Act, each federally insured credit union is required to deposit and maintain with the NCUSIF an amount equal to 1% of its insured shares, adjusted annually. The NCUA Board is required to provide a pro rata distribution to each federally insured credit union if at the end of a calendar year any loans to the federal government have been repaid; the NCUSIF's equity ratio exceeds the normal operating level (currently at 1.3% of insured shares) and the NCUSIF's

[30] Comptroller General of the United States, "Examination of Financial Statements of the National Credit Union Administration for the Fiscal Year Ended June 30, 1973…"

[31] The amendment regarding dividend distributions was added in 1984 under PL 98-369. This language was again amended under PL 105-210; 12 USC 1782 (c)(3).

available assets ratio exceeds 1% of insured shares.[32] This means that when the assets of the NCUSIF exceed the levels prescribed by the Act, a dividend must be paid. However, expenses and insurance losses impact the amount of the NCUSIF's assets. Thus, the amount of NCUSIF expenses, such as covering costs for NCUA regulation, will reduce the amount of funds available for a dividend.

2. Agency Relied on Flawed Study to Determine Overhead Transfer Rate

The Board's decision to rely on an internal staff study to justify the increase in the overhead transfer rate approved October 2000 was questionable and raises concerns that the decision was an arbitrary misuse of its authority.

NCUA's study surveyed principal examiners, regional staff and central office staff in an effort to ascertain how the work time of agency staff is allocated between "insurance-related" and "regulatory-related" activities.[33] More specifically, the agency surveyed individuals from these groups to determine: the percentage of federal credit union exam time devoted to completing various examination components; the percentage of time devoted to insurance or regulatory related activities that employees perform while carrying out their responsibilities; and the time that central office managers estimate their staffs collectively devote to regulatory and insurance-related issues.

[32] 12 USC 1782(c)(3).

Credit unions have raised a number of questions relating to the agency's methodology in conducting the study, which include:

- NCUA's definition of "regulatory related" is incorrect as there are regulations that NCUA is required to implement for state chartered credit unions, such as Truth-in-Savings and member business loans restrictions. This calls into question NCUA's division between regulatory related activities, that are not allocated to the NCUSIF, and "insurance-related" costs that are.

- NCUA's study does not include the definition of "insurance-related" activity so it is impossible to know how this term is defined and whether it accurately depicts insurance-related activities. Again, such imprecision undermines the agency's process and reinforces the concern that NCUA acted arbitrarily.

- NCUA lists a number of changes that result in increased insurance related activities, such as prompt corrective action. The study indicates that PCA will increase the focus on safety and soundness issues. However, under the new flexible examination policy adopted by NCUA in July, NCUA will spend less time on healthy credit unions, which comprise the vast majority of credit unions.

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[33] "Report of the Overhead Transfer Rate from Fiscal Year 2001," at 5.

- NCUA asserts that the high volume of field of membership expansions, merger and conversion requests as a result of passage of the Credit Union Membership Access Act will increase the agency's focus on insurance related activities. NCUA provides no data, historical or otherwise, to support this argument that these activities, which are regulatory-related, will result in increased insurance-related activities.

- NCUA cites its small credit union programs as another change that increases insurance-related activities. The small credit union program should be focused on federal credit unions only and would appear to be primarily regulatory-related. NCUA has provided no data to demonstrate how the small credit union program increases insurance-related costs.

- NCUA contends that trends within the credit union system will necessitate greater insurance-related activities on its part. Again, there is no quantifiable analysis that supports NCUA's claims that the growth in the number of large and complex credit unions will increase insurance-related activities and by how much. The agency does not mention that the number of credit unions continues to decline, as does the amount of assets in problem credit unions.

- NCUA relied on a small number of responses to develop its findings and conclusions. The survey uses responses from 61 principal examiners, 54 non-examiner regional employees and 41 responses from central office employees. When NCUA initiated the study in 1984 and through 1994, the agency typically received between 1,000 and 1,200 responses on which it based the study.

- The study did not sample all examiners, but only those with at least five years' experience. While stating that new examiners may not fully understand the distinction between regulatory and insurance-related activities, the study does not adequately explain why the agency chose the 5-years' benchmark, as opposed to six or four.

- Regional examiner staff indicated they spent less time on insurance related activities than their managers reported examiner staff spent on such activities. NCUA used the higher figures reported by managers.

- NCUA asked regional staff to divide their time between regulatory, insurance and other duties. NCUA's study "adjusts" those responses to attribute roughly two-thirds of the time reported for "other duties" to insurance-related activities.

- NCUA uses the figure of 1,047.07 full time equivalents in allocating time to insurance activities to determine the OTR. The agency decreased its FTEs by over 20 positions at the December NCUA Board meeting.

B. Bifurcated Role of the National Credit Union Administration Impacts the Overhead Transfer Rate

The Federal Credit Union Act envisions two primary and concurrent missions for the NCUA Board, the supervision of federal credit unions and the administration of the NCUSIF.[34] Each of these roles is addressed in a separate title of the Act, indicating the relative importance of these individual functions.

The allocation of costs through the overhead transfer rate helps to reinforce a misconception that agency actions are driven solely by the requirement to protect the NCUSIF. This legal fiction will inevitably lead to the conclusion, unfounded in the Act, that most of the agency's costs should be defrayed by the NCUSIF.

As discussed above, the extent to which the agency may use NCUSIF funds to cover a significant portion of its safety and soundness expenses is not as clear as the agency contends. (In fact, NCUA's utilization of any NCUSIF funds was not apparent to the agency until the idea was suggested by the GAO.)

An integral element of NCUA's responsibilities as the administrator of the NCUSIF is to respect state regulators and state chartered credit unions.[35] The current overhead transfer rate mechanism undermines the agency's responsibility to deal equitably with state and federal credit unions, as well as to

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[34] 12 USC 1756; 12 USC 1781 et seq.
[35] 12 USC 1781(b)(1)(I); 12 USC 1782(a)(5).

act with due deference toward the state regulators on matters that impact the institutions they are charged with regulating.

While the Act establishes simultaneous and equally prominent roles for the agency, it is not a foregone legal conclusion that these functions will result in a conflict of interest in handling matters such as the funding of the agency's activities.[36] It is the agency's interpretation-- that the overhead transfer rate should be used to underwrite a significant portion of the agency's budget -- that creates needless tension within the credit union system.

1. NCUA's Role as Supervisor of Federal Credit Unions Was Not Subsumed by Its Administration of the NCUSIF

Title I of the Act establishes a chartering mechanism for federal credit unions and addresses their powers. This title delineates the duties NCUA must perform as the supervisor of federal credit unions. In addition, it establishes an operating fee system under which federal credit unions are assessed an annual fee to fund the agency's supervisory costs. The most reasonable interpretation of these provisions is that Congress intended such fees to be used to fund examination and supervision costs of Federal credit unions, with some additional funding, if necessary, from the NCUSIF.

If the agency continues to increase the proportion of "insurance-related" costs it allocates to the NCUSIF, serious concerns may be raised as to the need for a

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[36] As this report emphasizes, the FCU Act seeks to strike a balance in the agency's execution of its concurrent duties as federal regulator and insurance administrator.

separate agency to supervise federal credit unions. In other words, could the regulation and supervision of federal credit unions be handled solely by the NCUSIF? This surely is not a result that would benefit federal credit unions, as agency decisions would undoubtedly be driven by their impact on the NCUSIF, rather than what is advantageous for federal credit unions and their members.

2. Relationship with State Chartered Credit Unions and State Regulators Must Be Equitable

One of the concerns regarding the overhead transfer rate is that the NCUSIF reimburses NCUA for "insurance-related" costs but does not underwrite such costs for the states, which perform similar functions. While the Act does not require such reimbursement, the fact that NCUA does not provide funds to the states for corresponding activities sets up a system that virtually guarantees inequities. This is understandably exacerbated when NCUA lowers the operating fee for federal credit unions in the process.

One of the reasons the agency may be reluctant to reimburse state regulators, beside the budgetary impact already addressed, it is apparent that the NCUSIF plans to spend more time focusing on state chartered federally insured credit unions, thus reducing the amount of funds it might otherwise have available for reimbursement. (There may be state-level legal considerations that limit this option as well, which are beyond the scope of this report.)

The agency's "Report on the Overhead Transfer Rate for FY 2001" states, "Emerging trends also offer insights as to how NCUA's work responsibilities will continue to change."[37] The report lists several items including the fact that "During the past three years, the proportion of insured shares in Federally Insured State Chartered Credit Unions increased materially while the proportion of NCUA's supervision of FISCUs, in terms of contact hours, remain relatively unchanged."

The fact is that with the last overhead transfer rate increase, the proportion of total agency costs borne by federal credit unions decreased by $10.1 million and the proportion borne by state credit unions increased by that exact amount. Apparently, the agency envisions an expanded role for itself in supervising state credit unions. This was corroborated by NCUA's Director of Examination and Insurance David Marquis on October 19, 2000 when in explaining the increase to the NCUA Board he stated, "Oversight of the risk in FISCUs will inevitably need to increase to ensure that NCUA meets its fiduciary responsibility of protecting the NCUSIF."[38]

The Federal Credit Union Act, the Document of Cooperation between NASCUS and NCUA, and publications of NCUA such as its Examiners' Guide, as well as directives of the current Administration under President Bush, necessitate that

[37] "Report on the Overhead Transfer Rate for Fiscal Year 2001" at 5.
[38] NCUA Board Transcript of Oct. 19, 2000.

NCUA not only take into account the impact of its actions on state chartered credit unions and their regulators, but that it cooperate with state regulators to the greatest extent possible when executing its roles as administrator of the NCUSIF. For example the FCU Act provides, “To the maximum extent feasible, the Board shall use for insurance purposes reports submitted to State regulatory agencies by State-chartered credit unions.”[39]

Another key provision is Section 211 of the FCU Act, which reinforces Congress' purpose that NCUA not “discriminate in any manner against state chartered credit unions….”[40] This concept is further reinforced by the Document of Cooperation -- which binds not only the states which agree to its provisions, but NCUA as well. It states, “It is recognized and agreed that the regulation and examination of state chartered credit unions properly belong to and is the primary responsibility of the states.”[41]

The overhead transfer rate mechanism as currently implemented by NCUA contravenes the clear admonition of the Act and other key documents to which NCUA is a party. These documents direct the agency to respect the state regulators and balance the interests of state and federal credit unions in the performance of its concurrent roles as a federal credit union supervisor and as the NCUSIF administrator.

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[39] 12 USC 1782(5).
[40] 12 USC 1790.
[41]NASCUS/NCUA Document of Cooperation .

VI. Conclusion -- NCUA's Authority Concerning The Overhead Transfer Rate Is Carefully Circumscribed

At the outset, this report outlined several legal questions regarding the overhead transfer rate, which relate to the scope of NCUA's authority to transfer costs to the NCUSIF and consistently increase the rate.

As this analysis demonstrates, although NCUA does have authority to allocate to the NCUSIF its expenses related to the supervision of federal credit unions, that authority is not boundless, as the agency seems to believe. That authority is limited by Congress' directive to balance the interests of state and federal credit unions and to respect the role state authorities play in regulating state chartered credit unions.

It is clear that NCUA relies on but one provision of the Act to justify its decision concerning the overhead transfer rate. Yet, as this review reveals, there are a number of provisions in Title I and Title II which must guide the agency in setting the overhead transfer rate.

Read together, these provisions present a more comprehensive picture of what Congress intended than does the selective focus on one broad provision. The most reasonable interpretation of these provisions is that the Act contemplates agency cost allocations that rely primarily on operating fees for Title I expenses, although such fees may be supplemented with an expense allocation to the

NCUSIF. However, the Act does not envision a blank check for NCUA, under which any and all costs may be attributed to the NCUSIF as "insurance-related."

In addition to directives in the Act, the application of the Administrative Procedure Act raises serious concerns about the process the agency uses to determine the overhead transfer rate. Further, under a recent Supreme Court decision, it is not clear that NCUA's decisions and decision making process would be afforded deference if challenged in court.

The overhead transfer rate has an undeniable impact on the insurance dividend required by Congress when certain conditions are met. Costs allocated to the NCUSIF do decrease the availability of funds for a dividend and significant increases in that allocation translate into appreciable decreases in the dividend. This result is detrimental to all federally insured credit unions.

In conclusion, the Act establishes meaningful boundaries around NCUA's authority to allocate agency expenses to the NCUSIF -- limitations that the agency is ignoring. In order for NCUA's actions regarding the overhead transfer to be consistent with its authority under the FCU Act as well as the APA, the agency should reconsider its interpretations regarding the overhead transfer rate and develop a new policy that embodies equity for all parties, while acknowledging the critical legal limitations on its power to determine the overhead transfer.

The lawyers who researched and authored the study.

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During the Carter Administration, Eric worked at the U.S. Department of Justice. He began as an assistant to the head of the Legislative Affairs Office, and moved up to become Special Assistant to the Attorney General. In 1995-86, Eric -served as Legislative Director for Senator Arlen Specter (R-PA). In private practice, Eric specialized in bank and thrift regulation and legislation. Eric received his undergraduate degree from Princeton University, and his J.D. from Harvard Law School. He is a member of the District of Columbia Bar, and the bars of the U.S. District Court, U.S. Court of Appeals, and the U.S. Supreme Court

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