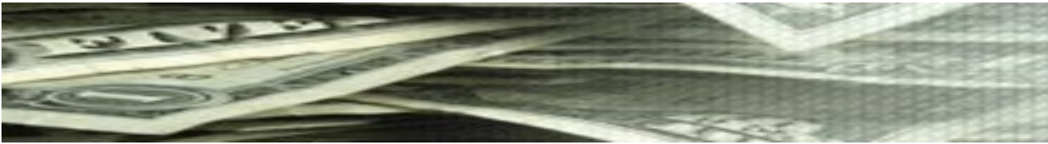

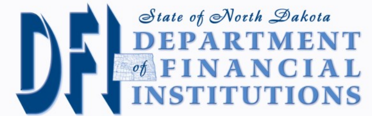

A MESSAGE FROM COMMISSIONER ENTRINGER

OTR – What is it and why you should care?

The Overhead Transfer Rate or "OTR" is the percentage of annual expenses that the NCUA Board uses to determine how much money the NCUA will take from the National Credit Union Share Insurance Fund ("NCUSIF") to cover the annual expenses for NCUA. To understand the OTR, the National Association of State Credit Union Supervisors ("NASCUS") produced a very short video explaining how the OTR works; the video can be seen by clicking on the following link: https://vimeo.com/134151034. In short, the amount of money NCUA has allocated from the contributions of Federally Insured State Chartered Credit Unions (FISCUs) to the NCUSIF, for the purpose of covering its operating expenses, has increased nearly $27,000,000 since 2013.In contrast, the operating fees of Federal Credit Unions (FCUs) have declined by over $14,000,000 during the same period, which has reduced FCU out-of-pocket expenses. When taken together, these actions create a competitive disadvantage for FISCUs relative to FCUs as FISCUs are forced to subsidize the examination of FCUs. NASCUS commissioned a study of the OTR from the Washington D.C. law firm Schwartz & Ballen LLP; this legal analysis concluded that the OTR is a rule subject to the Administrative Procedure Act ("APA") and should be published for notice and comment. (The legal analysis can be found at http://nascus.org/OTRresources/Report%20For%20Public%20Distribution%20061705.pdf)

Upon reviewing the above referenced legal analysis, NCUA's General Counsel issued a letter on July 30th, outlining his opposition to the conclusion that the OTR is a rule and subject to the APA. In spite of this fact, Chairman Matz has "committed to asking [the NCUA] Board to vote to publish the methodology in the *Federal Register* for public comments next January, at the same time [their] new Strategic Plan will be published." I would urge you to watch for this notice and take the opportunity to comment to the NCUA Board.

In a response to the NCUA General Counsel's July 30, 2015 letter referenced above, Lucy Ito, President & CEO of NASCUS states:

> "To be clear, the OTR is no mere budgetary issue involving an agency's internal allocation of funds granted by Congress. The OTR is a cost allocation mechanism that takes credit union money from the insurance fund - money that could be available to cover losses, or to generate earnings to accelerate repayment of Treasury borrowings and hasten a return to dividends for credit unions. Furthermore, that NCUA is using those funds to fully subsidize the safety and soundness examination of federal credit unions rather than charging those examination costs in the form of an operating fee means state chartered credit unions are subsidizing the federal system. These are very real, and very significant issues, deserving of a thorough legal and policy explanation from NCUA."

If you want to read more about the OTR issue, please visit the NASCUS webpage dedicated to this issue at: http://nascus.org/OTRresources/.

Thanks for taking your valuable time to review this information.

Finally, the Department is hosting an Executive Leadership of Cybersecurity Seminar on May 11, 2016 in Bismarck at the Ramkota Inn. The seminar is presented in conjunction with the Conference of State Bank Supervisors with the goal to heighten awareness among CEOs that the management of an institutions cybersecurity risk is an executive level issue that requires CEO involvement. The seminar is not a technical program but is designed for CEOs, senior executives and board members. Registration information will be forthcoming in February.

Wishing you a very healthy, happy and prosperous 2016!

MOST FREQUENTLY CITED UNDERWRITING WEAKNESSES

1. We have noted agricultural or commercial risk ratings that do not pass the reason test. Risk ratings usually start out as a matrix driven numbering system; however, they need to be reviewed to ensure they accurately reflect risk. If a borrower has a history of not being able to make their payments or you have had to substantially modify loans in an effort to keep the borrower current, the credit is possibly a substandard credit. Without a doubt, the credit should not be rated as having low or even average risk. We have noted instances where a borrower has a strong net worth and collateral position, but simply has been unable to make their payments due to excess debt, and restructures have not resolved the underlying weakness. Make sure to avoid the "equity blind" trap or to become too comfortable with the collateral position. Classify credits on the risk you will not be paid from your primary source of repayment, operational cash flow.
2. Support your risk ratings in the credit presentations/loan narratives. Credit committees should see the reasoning behind the number, not just the number. Some of you have already seen a Supplementary Facts document developed by several NCUA examiners. This document is essentially a best practices, and if followed, makes the loan officer show that he/she truly understands the risk with the credit. If you would like a copy of this document, please send us an email and we will send it your way.
3. Make sure your risk ratings are used in developing your watch list/loan classification list. If the risk rating indicates a substandard classification, make sure it is on the loan classification list. If a triggering event such as loan delinquency results in a classification, ensure the risk rating is reviewed and updated. Risk ratings are to be the starting point for loan classification and loan impairment testing. Make sure the risk rating system is used correctly. If you want to brush up on the process, in Letters to Credit Unions 10-CU-02, NCUA cites the OCC Credit Risk Handbook as a reference. The OCC did a very good job of explaining the concept and the handbook can be found at:
   http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/rcr.pdf
4. Obtain an independent review for your agricultural and commercial loans. Mistakes can be made. With this in mind, what process do you and the board have to ensure loans are being underwritten in conformance with policy and industry best practices? Hiring a third party or firm to periodically review a sample of loans and review your underwriting process will help you to identify weaknesses before they result in loss. When negotiating the engagement for these services, make sure it includes a validation of the risk ratings, a review of large and complex accounts, and a review of polices and procedures. This should give you and the board a base comfort level with the process.
5. Compliance remains a challenge for many credit unions. Develop an independent review process over the compliance function. Compliance is a very complex area of regulation, and many changes have been made recently. We have noted a number of violations over the past year. Make sure you have a process to keep staff up to date, and a review process to verify that things are done correctly.
6. Appraisal processes continue to be a source of weakness. Document your independent review of the appraisals and internally generated evaluations. Make sure it was ordered by an independent person. NCUA's Letter to Credit Unions 10-CU-23 which cites FFIEC Guidance does a good job explaining this concept.
   http://www.ncua.gov/Resources/Documents/LCU2010-23Encl.pdf

Facts & Figures

As of December 4, 2015:

- Average Adversely Classified Loans to Equity Ratio: 19.45%
- Average Adversely Classified Loans to Loans Ratio: 3.44%
- Average Adversely Classified Loans to Assets Ratio: 2.36%
- Third Quarter 2015 Average Allowance for Loan and Lease Loss to Loans Ratio: 1.34%
- Third Quarter 2015 Average Delinquency Ratio: 1.11%

Average are of the 21 North Dakota state-charted credit unions.

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