

non-payroll funds identified as those contained in the expense categories of travel, rent, communications and utilities, administrative, and contracted services.

MR. DOLLAR: We have a motion. Is there a second?

MRS. JOHNSON: I'll second.

MR. DOLLAR: We have a motion and a second. All those in favor indicate by saying "aye."

MS. MATZ: Aye.

MRS. JOHNSON: Aye.

MR. DOLLAR: Aye. Opposed, nay?

The ayes have it. The motion carries unanimously.

Thank you very much, Dennis. We'll see you again in just a few moments.

Next on our agenda is a discussion of and a recommendation regarding the overhead transfer rate. Staff presenting will be J. Leonard Skiles, our Executive Director, David Marquis, our Director, and Larry Fazio, the Director of the Division of Risk Management, both within our Office of Examination and Insurance.

Good morning, Len, David, and Larry. Welcome.

MR. SKILES: Good morning, Mr. Chairman, Vice Chair Johnson, and Board Member Matz. I want to offer for consideration yet another change. This is the method to calculate the overhead transfer rate.

What we're going to do today is, I'm going to provide some introductory material, after which Dave and Larry will actually walk us through some of the actual numbers in terms of how we arrived at the overhead transfer percentage. Based on current policy and procedures, the Board must again determine an appropriate overhead transfer rate for 2004. Further, the cycle for reconsideration must also be established. As set forth in the Board Action Memorandum, staff is recommending a revision to the current method of determining the overhead transfer rate. If adopted, the overhead transfer for 2004 would be 59.8 percent, a significantly lower rate than the survey range of approximately 68 to 76 percent utilizing the current procedure.

Additionally, staff is recommending that the overhead transfer rate be determined on an annual basis, as opposed to the three-year cycle. As we discuss the proposal, the rationale for these recommendations will become more evident.

We're concluding, as you know, the third year of the overhead transfer rate cycle. In 2001 the Board established an overhead transfer rate of 66.7 percent; however, after considerable review of survey data and discussion and input from industry leaders, the overhead transfer rate was reduced in 2002 to 62 percent for the remaining two years of the cycle.

The Board also directed an independent review of the process used to determine the overhead transfer rate. That review was

conducted, as you know, by Deloitte & Touche and resulted in a number of recommendations to improve the survey process.

All of the recommendations recommended by Deloitte & Touche were adopted in this latest survey, which concluded in June of this year. The survey actually ran from June 2002 to June 2003, and they are included in the recommended improvements.

Internally, however, we continued to review the possibility of a different method to calculate the overhead transfer rate. For nearly a year now, after receiving Board approval to proceed, we have been actively considering an alternate approach to determine the overhead transfer rate.

In early April an internal working group was established to examine every feasible method to calculate the overhead transfer rate and provided me the results of that study. I would like to thank the members of that working group because, obviously, they tested every feasible alternative that we were talking about earlier, ran the numbers, and tried to test every little aspect of it to see whether it would work: Larry Fazio, sitting at the table with me, and Brenda Martelle, both of whom are from E&I; Mike McNeill from OCFO; and Steve Sherrod and Dan Gordon, from the Office of Strategic Program Support and Planning. As I'm sure you recognize, it was a lot of hard work in trying to arrive at a new method to look at the overhead transfer rate, and their work is deeply appreciated.

From an objective standpoint what we did is this. We provided guidance to this working group. The first thing we wanted to do was to address the issue of transparency. In other words, what could be done to further demonstrate that the overhead transfer rate is based on solid data that is statistically sound?

The second was to determine if we could reasonably input the value of the work performed by state regulators in assisting NCUA in its statutory responsibility relative to safety and soundness, that is, the insurance-related issues.

Third, we wanted to provide a proven mechanism to determine the level of insurance-related work. We believe that the current survey with the enhancements incorporated after the Deloitte & Touche study was sound, but we wanted to again validate that process.

Fourth, we wanted to ensure that the mutual nature of the National Credit Union Share Insurance Fund, as it related to the overhead transfer rate, was carried over. In other words, the distribution of costs should be, to the extent possible, equitable and reflect the distribution of insured shares.

Fifth, we wanted to develop a process that allowed industry leaders with available data to determine the overhead transfer rate.

Now, it is our judgment that we met these objectives. In the process of testing the validity of the overhead transfer rate

formula, that is, the variables and the math behind the concept, staff met with the representatives of CUNA, NAFCU, and NASCUS. This proposal, as well as the methodology of the proposal, was thoroughly briefed. Additionally, a number of follow-up conferences were held with representatives of our stakeholders.

As a result of the briefing and the follow-up conferences, we concluded that the initial assessment was correct; that is, the proposed method to calculate the overhead transfer rate represents an improvement over the current overhead transfer rate process, which relies primarily on the examiner survey, and the new formula represents a more equitable assessment of insurance-related expenses for all federally insured credit unions.

Importantly, several suggestions were made, which we did incorporate in the final proposal and actually caused an adjustment downward of the overhead transfer rate from the rate that we initially briefed when we started this process.

Yes, I would have to say that there remain philosophical differences of opinion on the overhead transfer rate itself and what constitutes insurance-related work within the overhead transfer rate. But it is submitted that this new method thus addresses the important issues that have been raised in the past relative to the value of work performed by state regulators on behalf of the National Credit Union Share Insurance Fund. This refined overhead transfer rate recommendation solidly incorporates

the value of the work performed by state regulators on behalf of the share insurance fund without which the formula would be deficient.

Now, at first glance, the proposed overhead transfer rate formula appears complex. In reality, however, the concept is relatively simple. That may be hard for you to see at this point, but after you've done this a number of times, it does become simpler. But the concept really is simple.

It follows the model of the objectives that we set out to address. The key points to understand are these. First, the budget adopted by the Board is a critical element of the formula.

An important distinction, though, is that the budget is not built on the overhead transfer rate. Rather, the overhead transfer rate is determined after the Board adopts the budget. That has been the case in the past and is the case today even though the budget is a variable in the new formula to determine the overhead transfer rate.

The process seems seamless today, but there is no reliance on the overhead transfer rate in developing the budget. As we have repeated and demonstrated many times, they are separate actions. Our budget is requirement-driven; that is, budget resources are allocated based on actual need.

Second, the distribution of insured shares between federal and state credit unions is essential to an equitable distribution of the expenses to be paid by the overhead transfer rate.

Third, the examiner survey has been retained. It is the essential tool to determine insurance-related work in the field. The actual survey and the guidance provided to examiners are attached to the BAM to provide greater transparency in this particular area because we have so many questions about what we are looking at to determine what is insurance-related versus regulatory-related work.

Fourth, and very importantly, this formula imputes the value of the work performed by state regulators on behalf of the National Credit Union Share Insurance Fund. In other words, this imputed value becomes a credit in determining the overhead transfer rate.

Fifth, I believe that when you review this formula, there's not only greater transparency in the overhead transfer rate calculation, but also the process employed by NCUA to develop the various line items in the field budget. Virtually anyone should be able to determine the overhead transfer rate using obtainable data.

After reviewing these materials, you should have a clear understanding of how we determine resource needs in the field. In fact, when I was briefing [others on] this on a previous number of

occasions, one of the things I kept pointing out is, if you understand how we do this overhead transfer rate, or if you review how we do the overhead transfer rate, you are going to see very clearly how we determine our resource needs in terms of the normal budget. So we have completely opened up this process to all those who are interested in looking at it, and it gives an accurate and clear picture of how we do our budget relative to the resource needs.

The improved examiner survey and the overhead transfer rate formula will be fully explained, as I said earlier, in a moment by Dave and Larry; however, before handing off to them, I want to address this imputed value variable.

The imputed state regulatory value of the work performed by the state regulators is the incremental cost to the National Credit Union Share Insurance Fund of doing the work that the SSAs provide. In other words, the imputed value is what it would cost NCUA to do all the insurance-related work without assistance from the state regulators. That additional value figure is identified in the BAM as \$18.7 million for 2004. Determining the imputed value is the most complex step, but once it has been explained, as Dave and Larry will do momentarily, the whole process begins to jell.

I have found that after briefing on this a number of times, it is helpful to consider these key points when looking at the

actual numbers. The first is, the survey results are applied resulting in a determination of the insurance versus the regulatory work. That's the improved survey that we have from Deloitte & Touche.

These results are then applied to the budget so we determine what's insurance-related or regulatory-related, and we apply it to the budget. These steps are relatively simple, actually, but they are very important to the process.

The second thing is that once the various costs are determined, it becomes necessary to calculate the imputed value of the share insurance work performed by the state regulators. The imputed value portion of the formula involves several different calculations as follows.

The first is that it's necessary to determine the total share insurance-related work that exists in state charters, a relatively easy process. This results in an hours number, which is netted out based on what is already included in the overall budget and includes consideration of the deferred examination. So the important thing here is that when we calculate this, we are treating the state-related work the same that we do our work.

You then calculate how many field and support staff are needed to accomplish the work. To do this, we again apply NCUA resource requirements. Finally, the cost associated with the

additional staff is based on NCUA's actual FTE cost and that is determined.

Now, once these steps are completed you now have the imputed value of the work performed by state regulators. And the imputed value becomes a credit to the overall costs that must be proportionately allocated to state charters.

This brings me to why are we proposing this change. After all, we are comfortable with the current process. Further, it's been validated as a sound method.

Well, simply, this new approach is more equitable, and it treats all federally-insured credit unions the same relative to the overhead transfer rate, and it addresses concerns related to the current proposal.

We essentially had two alternatives as we approached 2004 in the overhead transfer rate. The first was, proceed with the procedure that we had in place, that is, the one driven primarily by the examiner survey. That would have resulted in a range of 68 to 76 percent and, as you know, that could continue to decline, as a result of the risk-focused examination.

The new proposal, which calculates the overhead transfer rate at 59.8 percent, actually tempers the examiner's survey by factoring in the other variables that I mentioned, the budget, the insured shares distribution, and the imputed value of the insurance-related work performed by the state regulators.

So, to summarize this portion briefly, this recommended method to calculate the overhead transfer rate emphasizes a number of things. One, it's a set formula. Anyone can see it, look at it, evaluate it. You can determine the overhead transfer rate annually very easily.

It utilizes and improves the survey and process that we have in place, and it factors in the value of the insurance work performed by state regulators, a key and central ingredient.

It has refined assumptions for the work load programs in terms of all the offices. It does utilize the budget, and it takes into consideration the insured's share of distribution.

Now, with that as somewhat of background information, I'm going to pass to Dave to begin the maybe more complicated process.

MR. MARQUIS: Thank you, Len. What I'd like to do is, I have two slides to present and then four worksheets and we'll call that the simple math, I guess. First, on the revised examiner time survey, because this drives a lot of our decisions on the drivers, if you remember in September 2001 we commissioned Deloitte & Touche to take a look at our survey and make recommendations on how we could improve it, and make it a little easier for our examiners to complete it.

At the time, we were doing a survey every time the overhead transfer rate needed to be evaluated by going back to our examiners at a point in time and asking them to go back and look

at 100 or 200 exam reports and try to remember what was insurance and what was regulatory. Deloitte & Touche suggested that we do this on a flow basis, which we have set up to do, and do it with a statistical sample of senior examiners who knew basically, or had some experience with, the exam program over the years.

We have done that and we now complete the survey on a flow basis. We do it with an SC group, and we also train them in the process in the beginning and along the way, by having some sessions along the way and making sure that they fully understand.

Deloitte & Touche also suggested we provide a little more guidance in terms of what's insurance and what's regulatory by way of some examples in our instruction to examiners before they fill out the survey, which we have also enhanced and done since that report came out.

The end result of all of this is the survey results. Now keep in mind that since that time, we have also adopted things like risk-focused exams and things of that nature, which change the exam program in process. The results of the time survey now reflect that the exam portion of the survey results in a 71 percent exam time devoted to insurance.

There's a range depending on the exam that the examiner does. Some come in less and some come in more, and the accumulation of that is the average of 71 percent. The supervision time is

74 percent devoted towards insurance-related activities when we do supervision in follow-up context.

On the next slide is the four-step process we'll call the mathematics of this. First, before I get into that, let me go through these four steps. We're going to take the results of the survey and other allocation factors, which I'll show you in a second, and we're going to apply it to a work program.

The work program is something we've done for 20 years or more. In other words, Dennis does the financial budget, but every year we go through the exercise of determining how much resources we need to do our exam and supervision programs, and making sure it's fairly and equitably distributed amongst the regions. That results, by the way, in a regulatory portion of what we'll call our core programs.

In the second step, we'll apply this allocation factor to the financial budget, and we'll break down Dennis' budget and apply those factors to it to arrive at a cost of the Share Insurance Fund. From there, we will calculate an NCUSIF cost. We'll call it the imputed cost to the insurance fund. I call it the fair value. It's not all direct costs that we actually pay out because of what Mr. Skiles talked about in terms of trying to calculate the value that's provided by the SSAs when they do exams that we use on our behalf.

He mentioned the number in terms of the dollar amount we arrived at. Larry will actually show you after I'm finished how we arrived at that number, as well. We then in step four, and this becomes a four-step process, allocate the NCUSIF cost in a four-step process to arrive at the overhead transfer rate.

Let's go to step one. I'm going to have to help out here with a pointer so let me direct you over here, and I'm going to turn over here, too. This is our workload budget. This is the budget we've done every year.

If our survey shows 71 percent insurance for exams and 74 percent for supervision is insurance, the reverse of that is 29 percent is regulatory on the exams and 26 percent is regulatory for supervision. This workload for federal exams and supervision makes up about 72 percent of our core program. That is determined every year by the examiners through a bottoms-up approach, determining how many hours they need for every unit that we examine.

That is tested by E&I through a process called the matrix, where we look back at how much the average time was between asset size and CAMEL code, to determine how much time we need, and then we determine if the supervision is appropriately applied and fairly distributed amongst the regions to give them equal access to the resolved problem credit unions.

So that determines how much time, the weighted average, if you will, for exam and supervision. So we weight those according to the survey. The other sectors, some of them are done in proportion to the survey. Any time you see like the 29 percent, it's because we've determined that that is proportional to the results of the survey.

The time collecting 5300 reports, in our opinion, results basically in support of the needs for the examiner in doing that proportion of the exam between insurance and regulatory.

The other two parts, for instance, on the state part, if you notice, we give a value of zero because there's no reason for us to do state exam work except for insurance-related work. The number of \$65,000 is relatively consistent in what we've used over the years plus or minus depending on the economics of any geographic area. So that's roughly 10.8 percent of our budget for core programs going into next year.

We then go down to the specialized programs here, and we tried to break out some specialty areas that we think need to be highlighted differently than the survey. For example, fair lending has nothing to do with insurance. It's all regulatory, so we give it a classification of 100 percent regulatory.

On the contrast, the flip side of that, I'm going to go down to this line here, the RCMS, which is our capital market specialist, all of their time is done for the benefit of the Share

Insurance Fund and looking at the risk to the Share Insurance Fund on a forward-looking basis and so forth and so on.

As you look at the rest of it, you will see small credit union programs that are 85 percent regulatory, agriculture is all insurance, and the chartering, of course, is all 100 percent regulatory, as well.

The bottom line of the weighted average of all of those numbers is 643,000 core hours and specialty hours, and the result of that is a 25 percent regulatory portion of it.

If we go to the next slide, we'll apply it now to the dollar budget. The dollar budget that Dennis presented was \$149.9 million. All we have to do is plug that into the bottom and break out the portions. As you will see in the yellow portions here, we applied the standard survey results to these portions.

All the regional costs we apply, the survey results of 25 percent regulatory, and the rest, of course, would be insurance, to the budget. The only part we break out separately in the region is the one further above, which is the insurance activity of the region and the insurance department, field of membership and the like, and we assign a value of 87 percent regulatory because there's not a lot of share insurance work done there except as it relates to that department's looking at

insurance coverage issues and merger issues that we do on behalf of the Share Insurance Fund.

By the way, I'm not going to go through every single line here, but this will be posted to the public for review, so they can actually go through the details later if they want to.

AMAC by contrast, compared to the insurance, is 100 percent insurance, so it's zero percent regulatory. We gave some adjustment to specialty offices. Most of the offices come close to what the survey results are, but we had to make some adjustments.

I'll give you one, for example, Dennis' shop, the Office of the Chief Information Officer. We gave a 20 percent regulatory instead of 25 percent because there is a piece and component in their office, for instance, that doesn't mirror necessarily what we do in support of the field, because they have a whole section that's just devoted to the Share Insurance Fund. That's all they do is the Share Insurance Fund, that particular department.

And if we go all the way to the bottom, the other biggest portion of this budget is the all other and that would include things like the Office of E&I, the Office of General Counsel, the NCUA Board, and we basically mirror what the results of the survey results are, because most of that of what we do is done in support of all those other functions, which is the exam and supervision programs.

That comes out to a total NCUA budget allocation for regulatory of \$39.6 million out of the total of \$149 million. Then if we go to the next slide, we get a little more complicated in math.

We now try to arrive at and calculate the fair value of the NCUSIF costs. So we take in line 1, Dennis' budget of \$149.9 million; deduct the regulatory costs that I just showed you in step 1 of \$39.6 million. We add back in the SSA imputed value, and you'll have to hold that for a second in terms of how we arrived at that, that Len talked about.

We compute a value of \$18.7 million, if we had to do all of that work ourselves. Then we put in an add-on of \$2.1 million, that's a direct charge to the insurance fund that we do for things like buying computers for the states and doing some training for the states. The end result of that is, we compute a fair market value or fair value imputed cost to the NCUSIF OF \$131.1 million.

In step 4, which, by the way, is a four-step process, we now take the \$131 million and allocate it amongst the resources of how the assets are divided between federal and state [chartered credit unions]. We have to back into this a little bit, but if you look at today, state assets represent 45 percent of the assets. Hence, \$59 million of the NCUSIF imputed cost is representative of what belongs to the state. In step 2, we take that cost and deduct the \$18.7 million to arrive at a net cost for FISCUs of \$40.3 million.

We then take the \$40.3 million and what we are doing is trying to solve for what is the total dollar cost for the overhead transfer. What we are doing here, is we're taking the \$40.3 million, dividing it by a proportional share of FISCO assets of 45, and basically, what this is saying is use math in the opposite direction: $89.6 \text{ times } 45 \text{ percent equals } 40.3$, which is the cost we came up with here for the state exam portion of the cost of running NCUSIF.

Then it's final step, just take the dollar amount of the overhead transfer that we arrived at in step 3, divided by Dennis' financial budget to arrive at the overhead transfer rate of 59.8 percent. That's the math for doing the overhead transfer and arriving at that.

Now, Larry will spend a few minutes and explain how we actually compute the imputed value of the SSAs.

MR. FAZIO: Thank you, Dave. Thank you, Len. Computing the value of the work the state regulators do on behalf of the Share Insurance Fund is a three-step process. To compute that value we first need to construct an examination and a supervision program for all state-chartered credit unions.

We would construct such a program based, at least for the purposes of this formula, on the way that NCUA supervises the risk that federal credit unions pose. Mainly how we do that is through the risk focus examination and the risk-based scheduling programs.

By doing it this way, it also has the advantage of providing equity when we go to allocate costs between federal credit unions and federally-insured state credit unions because they are calculated based on the same parameters.

Then once we have determined the workload hours associated with this risk management program, we then calculate the staff that would be needed to complete this work using the existing staffing patterns within NCUA, again providing for equity. Finally, the level of staffing allows us to calculate the costs of such a program, again using NCUA's actual cost, again providing for equity.

If we go to step 1, to calculate the growth level of workload that all of the work in state-chartered credit unions, all of the exam work, we first looked at the average exam time by asset size and CAMEL rating for federal credit unions. This is what we actually spent examining federal credit unions in 2002.

Then, we look at the number of state-chartered credit unions that fall into those categories, again by asset and CAMEL, and then if we go to table 3, table 3 is simply multiplying the respective cells from tables 1 and 2 to arrive at the total hours and then we add that all up.

So we come to a total growth exam hours of 288,645 that it would take to do examinations of state-chartered credit unions. But keep in mind, and we'll go down further to some other

mathematics we need to go through, that 288,645 hours represents total exam hours, which includes the regulatory portion and since in state-chartered credit unions our only interest would be in doing the insurance-related work, we need to make an adjustment for that.

Here we make that adjustment by using the same examiner time survey results that we applied earlier in the formula, again providing for equity between the two charter types. It gives us the net hours of 204,938.

Then we go through a series of calculations to factor in the risk-based scheduling program that federal credit unions are also running. We would apply that same program to the healthy, well-run state-chartered credit unions and we arrive at a total federally insured, state-chartered credit union hours with the risk-based scheduling program of 175,732.

We have one final series of adjustments to make in terms of the workload hours. At this point, we were talking about primarily exam hours. We do do some insurance related examination work in state chartered credit unions. That was when Dave talked about our workload program at 60-some thousand hours. It's actually 44,000 hours of examination and 22,000 in supervision.

The exam work is a reduction in the time that the states need to spend on insurance-related work. For example, we go in jointly, and the NCUA examiner may look at investments. The state

doesn't then need to look at investments, too, in that particular institution during that exam. So we have to back that out; however, we need to add back in an additional 21,000 hours of supervision that we rely upon the state to perform right now, but if we were doing all the work, we would need to do it in this setting. So we come to a net insurance hours needed for federally insured state-chartered programs of 152,732 hours.

That then takes us to step 2. Now that we know the total hours it would take to examine and supervise those state-chartered credit unions that we are not already providing, we can calculate how many examiners it would take to do that. The first thing that we need to do is figure out how many hours an examiner can devote in a year to what we term as productive time, examination and supervision work.

We base that on the actual workload program we have established for 2004. The nonproductive time, or what we term the administrative time, includes such items as annual and sick leave, holiday time, training, and so forth. So when we back that out, an examiner spends about 59 percent of their time, at least that's what we are planning for next year, on productive examination or supervision-related work.

There are 2,087 hours in a work year total. If 59 percent of that can be devoted to productive work then a full-time equivalent examiner can spend 1,231 hours doing examination and supervision

work. Knowing that and knowing the hours that we need to conduct this risk-management program related to state-chartered credit unions, we simply divide that and come up with 124.1 additional examiners we would need to employ to staff this program.

However, that's not the final piece of that. Of course, if you add that many examiners you are going to have to add management personnel and other support staff for that program. We go through a calculation here using NCUA's existing staffing patterns and organizational structure, again providing for equity, and come up with a total number of additional staff positions of 158.6 that will be needed at a regional level.

That allows us then to go to step 3. Now that we know the number of additional regional positions that we would need, if we multiply that by the average cost per regional position, and we calculate that, again based on the now-approved NCUA 2004 budget, again providing for equity, we arrive at a total cost of that program of \$19.7 million.

However, there are two final sets of adjustments we need to make to net out some things. We look at the central office in this and the bulk of the central office is sufficiently scalable at this point that there wouldn't be an impact in terms of staffing or costs, with the exception of the Office of Human Resources.

Obviously, if we added what equates to about a 16 percent increase in staffing that would have a direct impact on the Office of Human Resources. Also, consider that some offices like the Office of the Chief Information Officer are already staffed to provide support to state examiners in terms of the computers and the hardware and software and so forth, so again either sufficiently scalable or already staffed to provide support to a larger number than the current NCUA staffing.

So when we add back in the additional OHR costs we need to make one final adjustment. The per FTE costs above are not just paying benefits. They include all the costs, travel, training, equipment, regional office, leased space, and so forth.

So the state examiner training and equipment that we currently provide right now are already accounted for up in step 1 so we would back that out again because we would no longer need to be paying for that. We would be paying for our own staff, training, and equipment. That's how we arrive at the imputed value for the state supervisory authority work of \$18.7 million.

I will now turn it over to Len.

MR. SKILES: I don't know. You may be thinking, Skiles, you said this is a relatively simple process, but after you go through it several times, it does begin to jell.

Really, why we wanted to do this is to show you how thoroughly we looked at the process and how thoroughly the formula

is developed to determine what the overhead transfer rate is. You just reflect on those few simple things that I said earlier; that is, we have determined the insurance related work. That's both federal and state. Then we determine the insurance-related costs and then you determine the value of the work of the state regulators. You proportion it, and then you calculate the overhead transfer rate.

We are recommending a 59.8 percent overhead transfer rate for 2004 to be adjusted annually. Thank you.

MR. DOLLAR: Would you go back over that one more time?

[Laughter]

As I did with the budget, but I will do it much more briefly, if we look back over this past three years, and the period of time for which I as Chair have been responsible for our approach to the overhead transfer rate, and the last two years that I have had this outstanding Board working with me on this issue, because this is one of those issues that have traditionally and historically been very controversial and no matter what approach we choose to take, it has its critics from one side or the other, usually, both there would have been a natural temptation, and I think we perhaps all were tempted by this, to say this is a no-win, let's just stay with what we have been doing, take the hits that come, and move on.

But we have chosen not to do that. Our goal has been since I became Chairman, and I know since Vice Chair Johnson and Board Member Matz have come on Board, for us to try to make this process as equitable as possible and as effective as possible for our agency and for the stakeholders.

I think that we have. If you look back just three years ago, the overhead transfer rate was 66.72 percent the day that I became Chairman. Since that time, we have reduced it to 62 percent after the first year following the Deloitte & Touche study. And now, following the incorporation further of the Deloitte & Touche recommendations, and this examination, and this review, and this extensive process, we now bring the overhead transfer rate down to 59.8 percent.

This represents a 3.55 percent reduction in the overhead transfer rate from last year. That's a 220 basis point decrease. It's a 10.38 percent reduction from the high of 66.72 just two years ago. That was a 692 basis point decrease from the 2000 overhead transfer rate.

Am I under any impression that those who philosophically do not believe that there should be an overhead transfer rate will be satisfied by this? No.

Do I believe that those who fundamentally disagree with the structure of NCUA and our method of allocating what is regulatory and what is insurance will be satisfied with this outcome? No.

Do I believe that we have within the responsibility we have been charged by Congress as both a regulator and an insurer to put the most equitable formula in place that recognizes the value of the state contribution, that recognizes that there is an appropriate role for both regulation and insurance and that the safety and soundness nature of insurance-related work is increasing and will continue to increase and therefore, we have the most equitable formula possible to be able to incorporate that? Yes, I believe that we have.

I think even our critics would have to acknowledge that this is an improvement over our existing survey-driven process. Although Deloitte & Touche itself found that our survey-driven process was consistent with cost accounting methods utilized in the private sector, we still felt that it could be improved further.

Not only do I think it is an improvement, I think it is more equitable, and I think that there are two very important facets of this that should be emphasized.

One is that we are now doing the survey on a flow basis, Dave, as you indicated, rather than a look back which admittedly, and Deloitte and Touche noted, can result in examiners trying to remember in November what they did in February. The flow basis makes this much more timely, which was one of Deloitte & Touche's recommendations.

The second is that this is an annual process. By having this formula, we move from establishing the overhead transfer rate for a three-year basis to an annual basis based upon this formula. I don't know how my two colleagues who will be here three years from now feel about that, but I think that it's a positive step. They may wish that it were back on a three-year cycle next year, but I believe that the opportunity to reflect the changes that take place during the course of a year, particularly as we come out of a recession, not knowing the changes in examination and supervision that may be required, I think that going to an annual [process] is again another element in that increased equity.

So thank you for your work. As everyone who has seen this presentation can see, this was not just taking the easy way out. This was getting as in-depth and doing the type of self-study on the overhead transfer rate that we were talking about a moment ago with our accountability of management within the agency.

But I believe the result, although certainly not perfect and certainly not answering every objection to the overhead transfer rate, is a significant improvement, is more equitable, and now, based upon its annual [review], enables the agency to continue to better reflect the changes in the market.

I thank you for your work. I intend to support your recommendation today.

Mrs. Johnson.

MRS. JOHNSON: Thank you, Mr. Chairman. Thank you, Len, Dave, and Larry, for a tremendous amount of work that has gone into this project over several months. I would call you "whiz kids" because of all of the math and everything that's gone into this. I do not know whether that is really an appropriate title, but it represents an exorbitant amount of work in running and testing those numbers, and I do not know whether the public really has the overall insight as to how much work went into this.

We were very comfortable with our current process of relying on the examiner survey, but we did not rest on our laurels. I think the process that we have gone through here today represents the visionary type of thinking currently here at the agency, and I am very appreciative of that.

In my analysis of the overhead transfer formula, I am satisfied that it does emphasize a fair and equitable distribution of the costs associated with insurance-related work for all federally insured credit unions, and thus, it is an improvement over our current procedure, which does rely primarily on that examiner's survey.

It is accomplished by the inclusion of a number of variables, but primarily it recognizes the distribution of assets in the formula, and then it factors in the imputed value of the work that is performed by the state regulators using both actual and historical cost factors. In other words, this proposed new method

takes into consideration two elements that improve and better ensure an equitable distribution of costs that are expensed to the Share Insurance Fund through the overhead transfer rate.

I would like to pose a few questions and go back over some of the things that have been proposed today. Len, I would direct the questions to you since you were the initial spokesperson.

Does this proposed formula cover all the possible scenarios? That is, what if the amount of a state's work becomes extraordinary in a particular instance, do we take this into account with the formula?

MR. SKILES: Well, you heard Dave mention that I think in this year's budget we had 10.8 percent allocated for state work. That's generally the range that we have been having the last few years.

Now, one of the benefits of this, of course, is if you do this on an annual basis that number could change, and it would just factor very readily into the overhead transfer rate. But suppose, for example, you got into a year and suddenly, for whatever unknown reason, hypothetically, there was extraordinary work in an additional state.

Also, I should mention that this overhead transfer rate still maintains the mutual nature for the insurance fund and everything else, so we've carried that over. So to make it work you have to retain that. But if you had an extraordinary circumstance that you

had to address in any one year, we may have to determine a different way to bill for those services.

MRS. JOHNSON: Next question, the asset distribution is an important element of this formula. Does the formula work, if the asset distribution would change significantly?

MR. SKILES: Well, I actually had Larry run those numbers a number of times, and the formula is good so long as the asset distribution stays 90 percent or below either way; that is, if 90 percent of the federally insured assets were in federal credit unions, then this formula begins to drop off in terms of its credibility.

The same thing would be if all the insured assets were in the state credit union. So the formula in terms of the assumptions that we are using today, and the reasonable assumptions that you would see in the future are going to be okay. But if you did have a situation where it went beyond 90 percent one way or the other then we would have to take another look at the formula.

MRS. JOHNSON: So at that point we'd have to come back in, though.

Then I want to go to a point of clarification. Is \$18.7 million the additional cost of doing insurance-related work in state charters or the total cost associated with insurance-related work?

MR. SKILES: That's the net figure, right, Larry, of additional work? The 18.7 is the additional amount of dollars.

MRS. JOHNSON: It's the additional work?

MR. SKILES: Yes.

MRS. JOHNSON: I think the thing that I am most pleased about with the process that we have gone through is the improved transparency in incorporating it. The formula is out there and, as you said earlier, anyone can take a look and plug those numbers in and arrive at the same conclusion.

It also addresses the equity issue by proportionately allocating the cost between the federal and state charters. We are going to publish the formula, correct?

MR. SKILES: Actually, the tables that Celita was pulling up for Dave and Larry will be published. I think we're about there, aren't we, in terms of getting them ready? We're going to put them on the web. They will be published.

MRS. JOHNSON: Because I know everyone is going to want to plug in. It will be a fun process, I'm sure.

As you were actually proposing the formula, did you, again, review the legal basis of the overhead transfer rate?

MR. SKILES: Well, that wasn't the primary reason we looked at this but certainly in looking at the overhead transfer rate we went back, and again, reviewed the legal basis for the overhead transfer rate. From my working group and everything that we have

done, including the input from OGC staff, we're solidly of the opinion that the overhead transfer rate and the basis for the way we are doing it is legal.

MRS. JOHNSON: Then my last question is in reference to some of the numbers that were in the BAM. You made reference to examiners spending between 71 and 74 percent of their examination and supervision time respective to insurance-related procedures. It goes on to say that based on the method used in 2001 that would have resulted in an overhead transfer rate of 68 to 76 percent. How do you explain the range based on what the examiners are actually doing?

MR. SKILES: That's a good question. We did use those figures in the Board Action Memorandum, and it does require some clarification. I'm glad you asked that because I think [going from] 71 and 74 percent to 68 to 76 percent, so the question is how could it be as low as 68, or as high as 76 percent?

Well, you go down to 68 percent based on how you calculate the administrative time, so that has a tendency to pull it down. Or it can go up to 76 percent because not included in that 71 or 74 percent figure, for example that you got, is the amount of state work that is to be done. So that would tend to push it up to the higher range of 76 percent. Am I correct on that?

MRS. JOHNSON: Ok. Well, that is all the questions I have. It is obvious that you have put a lot of hard work into evaluating

the overhead transfer rate. As the liaison to the state supervisory authorities, I have been particularly interested in pursuing a method of determining a fair and equitable distribution of the costs that are associated with the insurance-related activities and the work that we do, particularly in the state-chartered federally insured credit unions.

I'd like to thank you all individually and the rest of your staff. This has been an ongoing, lengthy project, but it is one that I feel has arrived at a very fair and equitable report. I would like to thank you for your diligent work for this much improved process, and I will certainly be supporting your report.

MR. DOLLAR: Thank you. Ms. Matz.

MS. MATZ: Thank you. I, too, want to thank you for the hard work that you have put into this. When you first told me what you were working on, I thought it was impossible. The fact that you've done it is remarkable, so I do want to congratulate all of you and the team that worked on it.

When I first came to the Board this was one of the issues that I heard about on day one, and I have been hearing about it ever since. At that time, I had no idea what an overhead transfer rate was so I came with an open mind, and I have tried to keep an open mind on it. I think that it's impossible to please everybody, and I've come to that conclusion.

So in my mind the most important criterion is to have something that we all agree is fair and that is transparent. I think that you have achieved those goals, as far as I am concerned.

Particularly, adopting this formula will ensure that there will be no guesswork and no surprises. As Mrs. Johnson said, you can just plug in the numbers and figure out what the result will be. So I support the formula and will support the proposal; however, I do want to point out that there is one federal equity issue that was not factored in. That is that NCUA provides training and computer equipment for state examiners, including exam platform support and 5300 call report program, and that's across the board. We don't separate out those states that allow private insurance.

So in most states, the investment that we make goes entirely toward helping state examiners supervise credit unions with federal insurance. But there are nine states where there is private insurance, and it seems to me that they are receiving an imputed value from NCUA that is not factored into the overhead transfer formula.

Currently, private insurance contributes little to any state supervisory programs, and we pay the tab for the state training, computer equipment, exam platform support and the 5300 programming. I think that this is an issue that we should

consider in the future. We had received some comments about this, but it was after the briefings that had gone on, and it was too late to start plugging in [to the formula]. But I do think it's something that we should take into account in the future when we do this.

But I will support the proposal. I think you've done a great job on this. So thank you very much.

MR. DOLLAR: Are there any further comments or questions? Is there a motion?

MRS. JOHNSON: Mr. Chairman, I move that the Board authorize the use of the refined overhead transfer rate method for calculating the overhead transfer rate annually and establish an overhead transfer rate of 59.8 percent for 2004.

MR. DOLLAR: We have a motion. Is there a second?

MS. MATZ: I second it.

MR. DOLLAR: The motion is seconded. All those in favor indicate by saying "aye."

MRS. MATZ: Aye.

MS. MATZ: Aye.

MR. DOLLAR: Aye. Opposed, nay?

The ayes have it, and the motion carries unanimously.

Thank you very much. We appreciate your extensive briefing. I almost hesitate to use the word "briefing" in a case like that,

but there's some good work there, and we appreciate all of that work that went into it.

The last item on our agenda today is NCUA's Operating Fee Scale for 2004. Mr. Winans returns, as does his Deputy Financial Officer, Michael McNeil. Welcome back, Dennis and Mike. The floor is yours.

MR. WINANS: Good morning. The Board is requested to act on the operating fee scale for federal credit unions for 2004. I think you will find this process a little simpler than what we just went through; however, we do have a series of 25 graphs here, [Laughter] which we'll walk through and Mike is going to do the presentation. Actually, it's only one graph.

MR. MCNEILL: Thank you, Dennis. We made the calculation of the operating fee a concurrent process with the development of the budget. Particularly, once the budget and overhead transfer rate are approved, calculating the operating fee is an easy process. In addition, calculation of the operating fee is based on our cash needs, something we introduced in 1997.

The budget is constructed on an accrual basis. In other words, it contains items for which there are no cash outlays, the most notable of which is depreciation.

Since NCUA is not operated on a profit motive, we feel that the operation should be funded on our cash requirements. This leaves more money available for credit unions and for the members'