SHARE INSURANCE FUND ANALYSIS & FORECAST

NAFCU RESEARCH DIVISION – March 2018

During NCUA's February 2018 Board meeting, agency staff presented year-end figures for the Share Insurance Fund (SIF). Those figures reflect the merger of the Temporary Corporate Credit Union Stabilization Fund (TCCUSF, or Stabilization Fund) with the SIF, which occurred in October 2017. At the same time, the agency raised the normal operating level (NOL) for the SIF from 1.30 percent to 1.39 percent.[1] Together these actions altered the position of the SIF, as well as the prospects for future payouts to credit unions related to corporate stabilization, as discussed below.

BACKGROUND

The TCCUSF was formed in 2009 to deal with the failure of five corporate credit unions. Had those costs been addressed through the SIF, it would have resulted in sizable premiums to credit unions at a time when many were struggling with the effects of the financial crisis. The formation of the TCCUSF, along with the securitization of the legacy assets of the failed corporates, allowed NCUA to spread these costs over time. The fund ended 2009 with a net position of negative $7.4 billion. Through a combination of assessments, legal recoveries, and improvements in the cash flows provided by the legacy assets, the net position of the TCCUSF improved by roughly $10 billion over the next eight years.

NCUA proposed to merge the TCCUSF with the SIF in July 2017. At the time, the Stabilization Fund had a net (equity) position of positive $1.6 billion, but that amount was expected to grow to over $2 billion by the end of the year. Based on NCUA's forecasts, a merger would increase the equity ratio up to and beyond the NOL, precipitating a distribution to credit unions in the amount of the surplus. On the other hand, a merger would potentially expose the SIF to fluctuations in the value of the corporate legacy assets. If conditions changed such that the expected cash flows from those assets declined, it could prompt a write-down of the receivable from the asset management estates (AMEs) of the failed corporate credit unions, resulting in a loss of equity for the SIF. As a result of a perceived increase in risk to the SIF, NCUA's proposal included an increase to the NOL from its historical level of 1.30 percent, up to 1.39 percent. Under normal conditions, if the equity ratio for the SIF ends the year above the NOL, the amount of equity in excess of the NOL is distributed to credit unions. So the increase in the NOL makes a distribution less likely to occur and, if it does occur, reduces the amount of the distribution.

NAFCU opposed NCUA's plan to close the TCCUSF and increase the NOL by 9 basis points. NAFCU continues to believe that NCUA had the legal authority to distribute refunds to credit unions directly from the TCCUSF. NCUA insisted that the only means to return corporate stabilization refunds to credit unions was through the SIF. While merging the TCCUSF with the SIF did result in a distribution to credit unions, it also meant that a significant portion of the equity from the TCCUSF would be retained in the SIF. NAFCU firmly believes that this money should be returned to credit unions. Furthermore, NAFCU strongly opposed the increase in the NOL. This action effectively increased the share of funds retained in the SIF and, in breaking with the traditional NOL set by prior NCUA Boards, could set a precedent for maintaining an elevated NOL in the future. Finally, NAFCU has concerns that the merger of the funds will reduce transparency related to the general performance of the SIF versus that of the corporate stabilization process.

In September the NCUA approved the merger along with the 1.39 percent NOL, and the TCCUSF was officially closed on October 1. Of the roughly $3 billion of corporate stabilization equity at year-end, the industry will receive a distribution of roughly 7 basis points of insured shares, or $736 million, in 2018.

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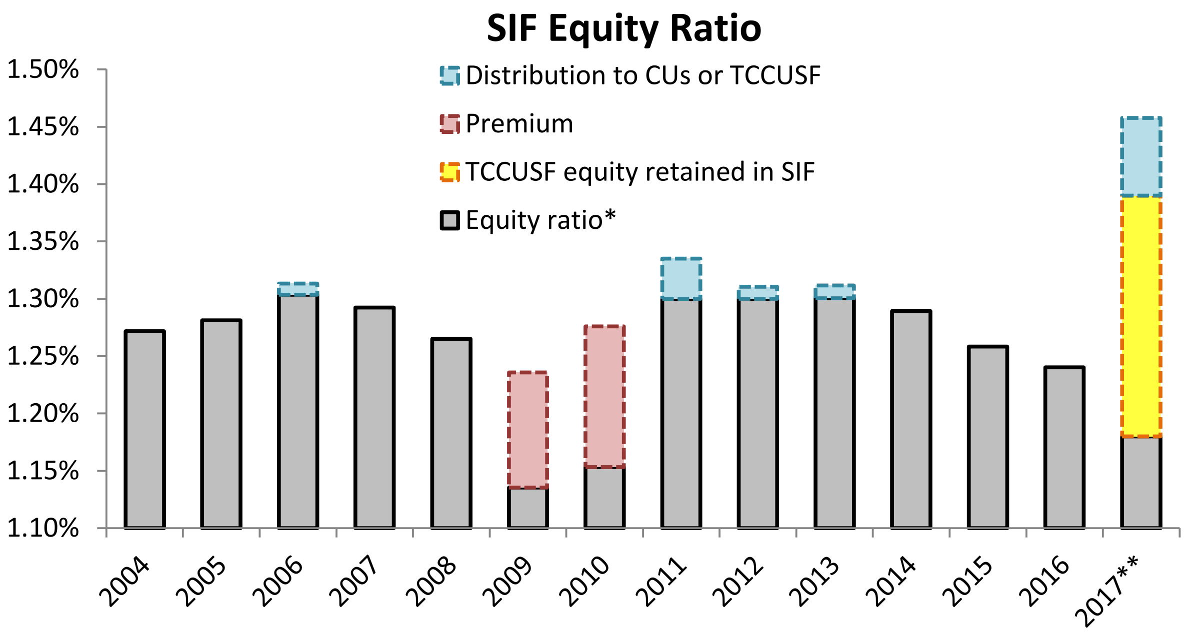
[1] The equity ratio is a measure of health for the SIF. It is calculated as the sum of insured credit unions' 1% capitalization deposit and retained earnings, net of any contingent liabilities for which no provision for losses has been made, divided by total insured shares.

SIF TRENDS

While the SIF received a sizable infusion of equity from the merger of the TCCUSF, it should not obscure from the fact that the equity ratio has been in decline for a number of years. The equity ratio ended 2013 at 1.30 percent (the NOL at the time). However, it has declined every year since then and would have done so again in 2017 had the merger not taken place. The chart below shows the recent trend in the equity ratio.



* After distributions but prior to premium charges, excluding estimated impact of TCCUSF merger in 2017

** 2017 equity ratio excluding impact of TCCUSF merger is based on NCUA estimate

The primary drivers of the equity ratio are: (1) insurance loss expenses; (2) investment yield; (3) operating expenses; and (4) share growth. Each has played a role in the recent slide in the equity ratio. Our analysis below considers recent trends for each of these factors, along with their respective impacts on the performance of the SIF.[2]

Reserves & Insurance Loss Expenses

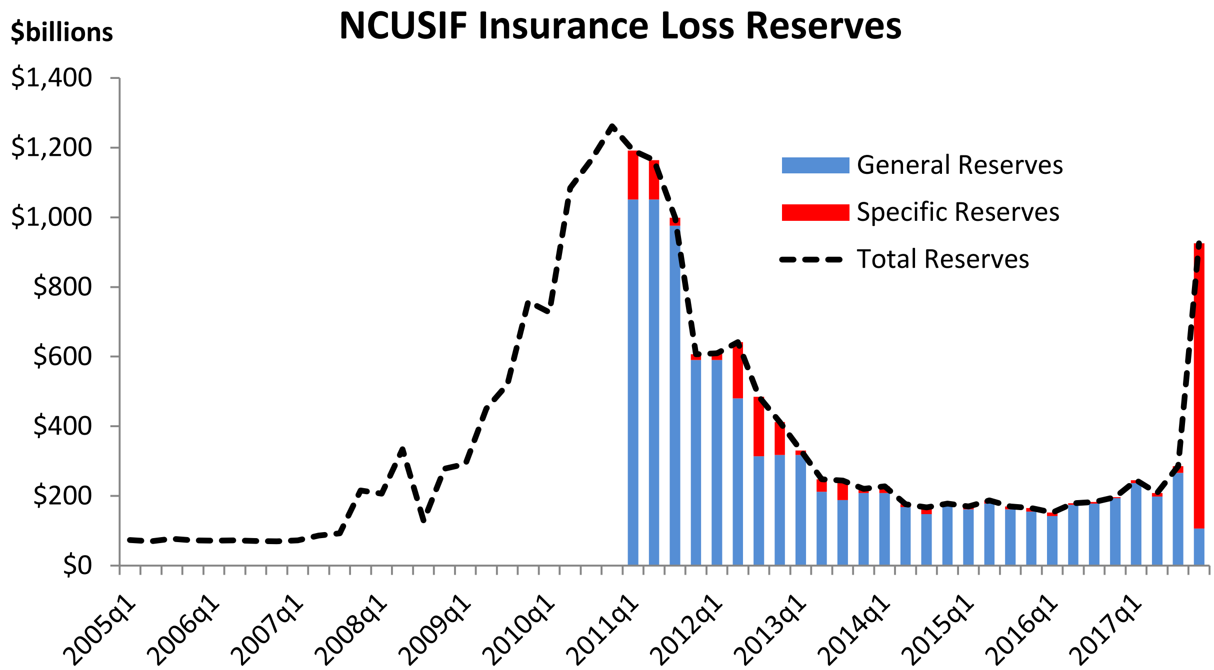
Insurance loss expenses are the most volatile and unpredictable input for the equity ratio. The expense is usually driven by changes in reserves established to absorb losses related to credit union failures. During the financial crisis, insurance loss expenses soared, peaking in 2010 at $736 million (reserves that year were over $1.2 billion). In the following year, NCUA recognized an insurance loss expense of negative $532 million as the agency began a process of unwinding the buildup in reserves. More modest negative values were booked to the expense account in subsequent years as the industry recovered from the crisis. As a result, credit unions were charged premiums in 2009 and 2010, then received distributions in 2011 through 2013[3].

The amount expensed, therefore, is heavily dependent on NCUA's reserving methodology. NCUA uses a two-step process to calculate the SIF's reserve requirements. First, NCUA establishes specific reserves for those credit unions

[2] In discussing the trends and impact of the various drivers on the SIF, NAFCU looks at each in isolation from the closure/merger of the TCCUSF. A fuller review of the merger's impact is below.

[3] By statute, the distributions in those years were made to the TCCUSF since there was an outstanding borrowing from the U.S. Treasury at the time.

which have recently failed or are on the verge of failure. Importantly, before NCUA can establish a specific reserve for a credit union, the failure must be deemed "probable" and the agency must have enough information to make a reasonable estimate of the losses. Then, NCUA establishes general reserves for the remaining population of credit unions for which specific reserves have not already been established. NCUA's general reserve calculation utilizes an econometric model which factors in measures of industry health and financial performance, historical loss data, and other economic measures.



Note: Prior to 2011, NCUA did not report types of reserves in the NCUSIF Financial Highlights

The chart above shows the trend in total insurance loss reserves for the NCUSIF, along with general and specific reserves. (The agency began reporting the latter two items in its monthly NCUSIF financial statements in 2011.) Until the final quarter of 2017, total reserves generally tracked the performance of the overall economy. This is due to the fact that general reserves – which are closely tied to broader economic conditions – typically constitute the bulk of total reserves.

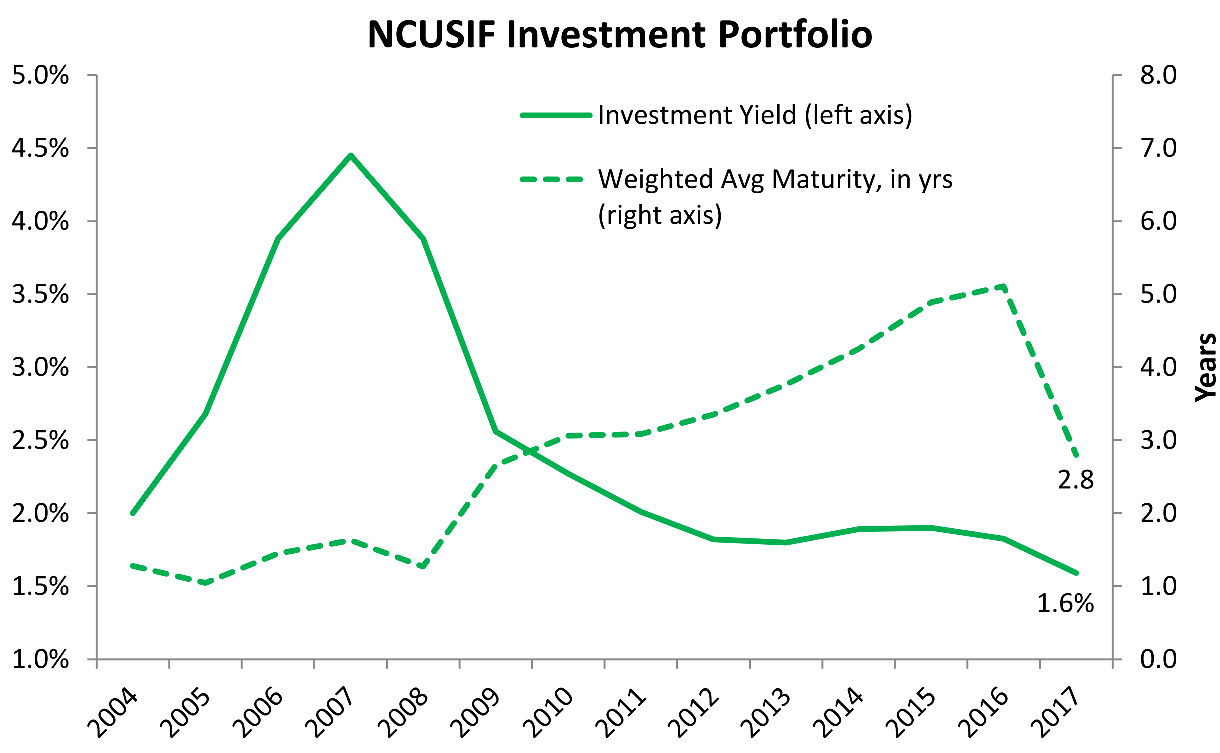
However, the fourth quarter's spike in reserves was driven by increases in specific reserves. In fact, general reserves fell substantially during the quarter. This is likely due to the agency establishing specific reserves for one or more credit unions for the first time during the quarter. This would remove an outlier credit union from the population used to calculate the general reserve. While NCUA has provided few details on the reasons for the increase in specific reserves,[4] recent statements by agency officials suggest that it could be related to the valuation of taxi medallion loans.[5] The increase in reserves during the fourth quarter required recognition of $658 million in insurance loss expenses. This action reduced the equity ratio for the SIF by roughly six basis points.[6]

[4] The agency believes that identifying the credit unions included under specific reserves could harm the reputation of those credit unions and potentially impact losses and recoveries realized during the resolution process.
[5] For example, in December NCUA Board Member Rick Metsger commented that recent prices of New York City medallions sold at auction, along with declining performance of medallion loans, "suggest the Share Insurance Fund's reserves may have to increase in the very near future." (link to NCUA press release)
[6] On the same day that NCUA released the quarterly figures for the SIF, the agency also posted a FAQ on its reserving methodology.

Investment Yield

Cash and investments currently constitute over 96 percent of total SIF assets. While the investment portfolio is limited to U.S. Treasury Notes up to 10 years in maturity, plus some amount held in an overnight account, the portfolio has nevertheless undergone significant changes in recent years. The duration of the portfolio at the end of 2008 was approximately 1.3 years. Half the portfolio was held in the overnight account and just two percent of investments had a maturity of five years or greater. In the following years, the agency gradually increased the weighted average life of the portfolio by investing roughly equal amounts across the 10-year maturity spectrum. As a result, the portfolio duration increased substantially, finally peaking at 5 years in 2016. However, in 2017 NCUA reallocated more of its portfolio to short-term investments, which reduced the duration to 2.8 years.

The chart below shows the trend in both duration and yield for the NCUSIF investment portfolio. By lengthening the duration after 2008, the agency was able to support the yield during an era of historically-low interest rates. The decline in yield during and following the crisis would have been more pronounced had the agency maintained its pre-crisis portfolio structure. However, the recent improvement in market interest rates has not resulted in a stronger yield for the NCUSIF since the agency reduced the duration last year.[7] NCUA explained that this was necessary to meet emerging liquidity needs for the fund. This would generally be associated with the resolution process of failed credit unions, and several large credit unions were placed into conservatorship in 2017.



Operating Expenses

Each year NCUA books operating expenses to the SIF based on a fixed percentage of NCUA's overall operating budget. The methodology for determining this percentage – referred to as the overhead transfer rate (OTR) – was the subject of a rule finalized in November 2017. The new methodology produced an OTR of 61.5 percent for 2018, versus 67.7 percent in 2017. The agency stated that had the new methodology been applied in 2017, the OTR would have been set

[7] NAFCU estimates that the adjustments to the investment portfolio reduced earnings for the SIF by over $40 million in 2017, with an impact to the equity ratio of roughly 0.4 basis points.

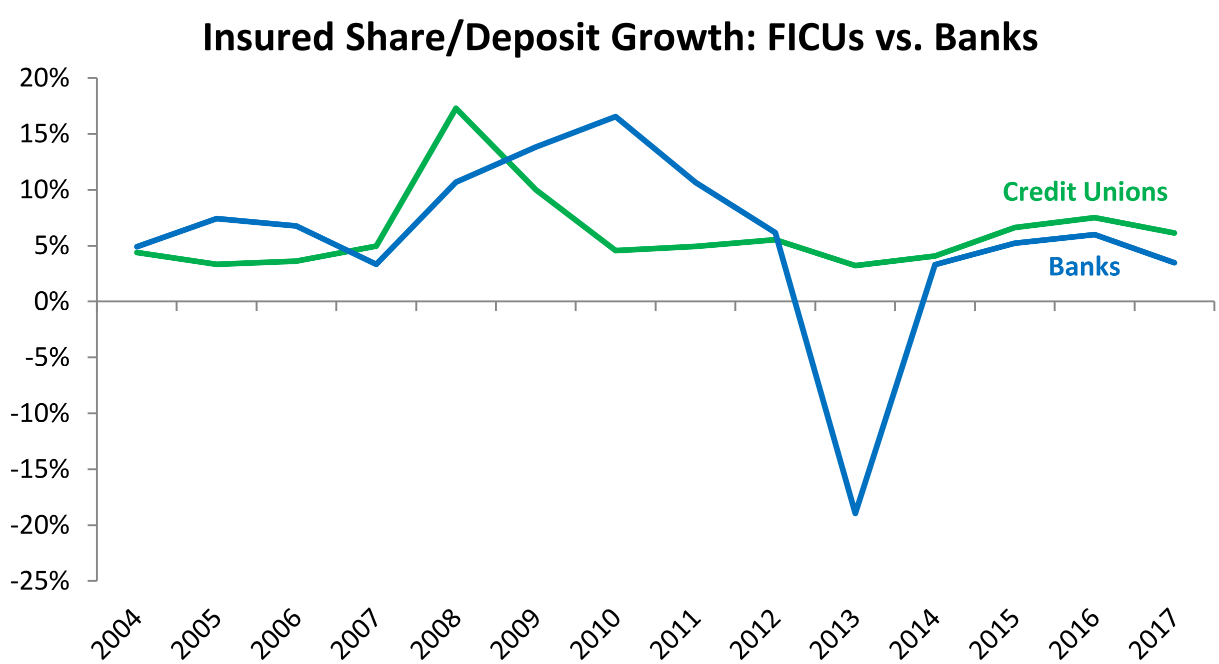
at 60 percent in that year. The decline in the OTR means that a smaller portion of NCUA's operating budget will be allocated to the SIF, with the remaining portion funded by federal credit unions through their operating fee assessment. NCUA will revisit the methodology every three years.

More broadly, operating expenses for the SIF have risen sharply in recent years. From 2008 through 2016, operating expenses increased by over 150 percent. NCUA's overall operating budget swelled during the financial crisis, and this explains most of the increase during that time. In addition, the OTR increased from 52 percent to 73 percent over that span, meaning that a larger share of NCUA's operations was funded through the SIF.

While NCUA's 2018 budget did not achieve the zero or negative growth sought by NAFCU, the agency is slowing its spending increases. The 2018 budgeted amount represents a 2.1 percent increase over the prior year, and the increase slows further to 1.5 percent in the 2019 budget. This combined with the lower trajectory for the OTR due to the change in methodology mean that any rise in operating expenses for the SIF in the near term should be minimal.

Share Growth

Insured shares forms the denominator in the calculation of the equity ratio for the SIF. As long as the equity ratio is above 1 percent, growth in insured shares leads to a decline in the equity ratio.[8] In 2018 insured share growth for the industry was 5.7 percent, which was down from 2016 (7 percent) and slightly below the long-run average.[9]



Note: In 2008 Congress increased insurance coverage limits to $250k for banks and credit unions; from from 2010-2012, FDIC insured entire balance of noninterest-bearing transaction accounts

The chart above shows a comparison between share growth for credit unions and deposit growth for banks. Legislative changes affecting coverage limits skew the figures from some years. Starting in 2014, however, the two growth rates have been very close, with insured share growth for credit unions slightly outpacing bank deposit growth. The latter showed a more pronounced decline in 2017.

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[8] Federally-insured credit unions contribute 1 percent of their insured shares as a capital deposit to the SIF. However, so long as the equity ratio is above this level, each additional share has the effect of diluting the ratio.

[9] Insured share growth over the past 30 years has averaged 6.5 percent

IMPACT OF TCCUSF MERGER

When NCUA elected to close the TCCUSF, its assets and liabilities were transferred to the SIF. At the time of the merger, the TCCUSF had a net position of $2.6 billion. At the end of 2017, NCUA estimated that the net position had improved to $3 billion. This amount, when added to the existing equity in the SIF, raised the equity ratio by an estimated 28 basis points at year end to 1.46 percent. Since this exceeded the normal operating level for the SIF of 1.39 percent, it triggered a distribution to credit unions of roughly 7 basis points of insured shares, or $736 million.

Another facet of the merger is that it prevented the equity ratio from dropping below the 1.2 percent statutory floor established in the Federal Credit Union Act. Due to the sizable increase in reserves during the fourth quarter, NCUA estimates that the equity ratio would have been 1.18 percent at year end had the equity from the TCCUSF not been added to the SIF. The FCU Act outlines a set of options available to NCUA if the equity ratio drops below 1.2 percent. The agency must either charge a premium or establish a restoration plan. If the agency opted for the premium, it would need to charge an amount large enough to reach and maintain a 1.2 percent equity ratio. The maximum amount NCUA could charge would be the amount needed to raise the equity ratio to 1.3 percent. Some parties have stated that the merger saved the industry from a $1.3 billion premium. This is the amount associated with the 1.3 percent equity ratio. It is possible the agency would opt to charge the maximum allowable amount. However, given that the agency would have had the discretion to charge a much smaller amount and that many of the underlying trends for the SIF have turned more favorable, many stakeholders would certainly have argued that a $1.3 billion premium was exorbitant.

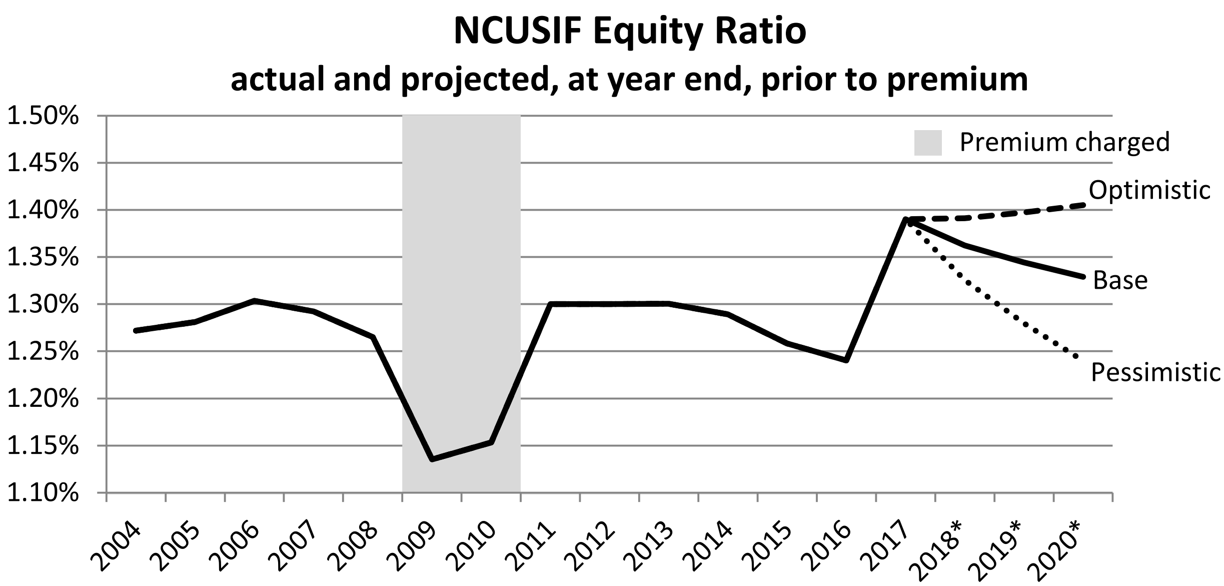
NCUA would also have had the option to establish a restoration plan for returning the equity ratio to 1.2 percent. This alternative would allow the agency up to 8 years to achieve this objective. In the absence of a merger, the agency could reasonably point to the net position of the Stabilization Fund – which is scheduled to expire in 2021 – as providing a backstop for the SIF and allowing the latter to operate with an equity ratio below 1.2 percent for a brief time. As the agency proved last year, closing the TCCUSF can be accomplished in a relatively short time frame, and doing so at a later date still would have provided the necessary equity to clear the statutory threshold. While the equity position of the TCCUSF could have declined in the event of an economic downturn, the fund did not have the same exposures to taxi medallion loans which prompted the sudden plunge in equity for the SIF. Even under the agency's most pessimistic forecast for the TCCUSF, it would still provide enough to fill the gap from where the SIF ended the year (1.18 percent) and the 1.2 percent target.

One aspect of the merger that is beyond dispute is the impact of the increase to the normal operating level. The SIF had traditionally operated with a NOL of 1.3 percent. However, at the same time that the NCUA Board elected to merge the funds, it raised the NOL to 1.39 percent. Of the 9-basis point increase, 6 basis points were directly tied to the merger. NCUA believed it needed this additional equity in the SIF in order to account for potential volatility in the value of the corporate credit union legacy assets. The increase in the NOL altered the calculation of the distribution to credit unions, such that $980 million in funds, which would have been returned to credit unions under a 1.3 percent NOL, will instead be retained in the SIF.

Beyond the dollars involved, NCUA's changes to its methodology for calculating the NOL are concerning. NAFCU will continue to work to ensure a transparent and consistent approach by NCUA, urging the agency to return the NOL to its traditional level as the liabilities associated with the corporate resolution process unwind. But there are no guarantees. Looking ahead to 2021 when the TCCUSF would have expired, the credit union industry will undoubtedly reflect on the costs and benefits of the early closure. It may well be that the increase to the NOL is its enduring legacy.

NAFCU FORECAST

There is some uncertainty regarding the future path of the equity ratio. Primarily, this is due to the range of potential outcomes related to insurance losses stemming from taxi medallion loans. NCUA has released little information regarding its assessment of those loans on the SIF. NAFCU's equity ratio forecast reflects this uncertainty with wide ranges for the three scenarios: optimistic, base, and pessimistic. The optimistic outlook envisions a scenario with moderate share growth, reductions to insurance loss reserves, and further improvements in the value of the corporate legacy assets. The pessimistic scenario includes further insurance losses related to taxi medallion lenders, combined with the impact of an economic downturn. Meanwhile, the base scenario forecast is consistent with the recent gradual downward trend and predicts a decline of 1 to 2 basis points to the equity ratio per year.



Note: The Emergency Economic Stabilization Act of 2008 increased the amount of insurance coverage on all accounts up to $250k. Estimates do not assume full funding of the one percent capitalization deposit at year end.

* NAFCU forecast

CONCLUSION

The closure of the Stabilization Fund changed the dynamics of the Share Insurance Fund. Where the SIF had previously been creeping toward the range where NCUA may have considered charging premiums (NCUA did forecast a 3 to 6 basis point premium for 2017), the addition of the TCCUSF equity means that the SIF should have ample equity to avoid a premium for years to come. But the increase to the normal operating level is a significant change, as well, which should not be overlooked. Whether credit unions receive future distributions related to the corporate resolution process after 2018 will depend in large part on whether, and how quickly, the agency returns the NOL to its traditional level.

As for the secular forces driving the equity ratio, one challenge going forward will be to disentangle their impact from that of the newly-added assets from the TCCUSF. NCUA declined to maintain a distinct equity account related to corporate stabilization, as many commenters had requested. To the extent that they can be measured, recent developments offer hope for further improvement among several drivers, namely the yield curve and share growth. But those factors are overshadowed at the moment by impact of taxi medallion loan performance and valuations. The path of the equity ratio in the near term depends chiefly on how that issue unfolds.