SHARE INSURANCE FUND ANALYSIS & FORECAST

NAFCU RESEARCH DIVISION – August 2017

During NCUA's July 2017 Board meeting, a proposal was announced whereby the NCUA's Temporary Corporate Credit Union Stabilization Fund (TCCUSF) would be closed and its assets and liabilities merged with the Share Insurance Fund (SIF)[1]. NCUA estimates that doing so would increase the equity ratio of the SIF back to the normal operating level (NOL) – currently set at 1.3 percent – and also result in a dividend for federally-insured credit unions (FICUs). Furthermore, it would mean that a premium charge for the SIF would be avoided in 2017. However, there are several downsides to the proposal which credit unions should consider. Most significantly, NCUA proposes to increase the NOL by 9 basis points to 1.39 percent, which could reduce the estimated return to credit unions of the $4.8 billion worth of corporate stabilization assessments paid in prior years.

BACKGROUND

The equity ratio is a general measure of the health for the SIF and is calculated as the sum of FICUs' capital contribution of one percent of insured shares and the fund's retained earnings, divided by total insured shares. The NOL has been set by the agency at 1.3 percent in recent years. If the SIF finishes the year with an equity ratio above the NOL, the excess funds are returned to FICUs. If the equity ratio falls below 1.2 percent, the Board is required to charge a premium to restore the ratio to 1.2 percent at minimum. In effect, 1.2 percent is the statutory floor for the equity ratio, while the NOL functions as a ceiling. The Federal Credit Union Act states that the NOL is to be set by NCUA Board at a level between 1.2 percent and 1.5 percent.

In November 2016 the NCUA Board announced a SIF premium range for 2017 of 3 to 6 basis points. This determination was based on trends within the four primary drivers of the equity ratio: investment yield, insurance losses, insured share growth, and NCUA operating expenses. For three of those four drivers (excluding insurance losses), the recent trends have contributed to the steady downward movement in the equity ratio[2]. NCUA deemed these trends as being likely to persist in the near future, and NCUA's forecasts for the equity ratio indicated that the agency expects the equity ratio to decline further over the next five years. Nevertheless, the NCUA Board elected to maintain the NOL at 1.3 percent.

At the following month's Board meeting, agency staff provided an update on the corporate resolution process. The TCCUSF has a natural end date of 2021 but can be closed at the NCUA Board's discretion. With the $11.2 billion of Treasury borrowings fully repaid in 2016, NCUA began to consider closing the fund early. In doing so, the remaining assets of the TCCUSF would be transferred to the SIF. This would likely boost the equity ratio for the SIF above the NOL, thereby precipitating a dividend to FICUs, and avoiding a potential SIF premium.

[1] The comment period for NCUA's proposal to close the TCCUSF and increase the SIF normal operating level ends September 5. The agency stated that it must come to a decision no later than September 30 in order to close of the fund by December 31. Doing so would allow for a possible dividend to federally-insured credit unions in 2018. Since SIF dividends are determined based on the year-end equity ratio, any delay beyond December 31 would mean that a dividend would not occur until 2019 at the earliest.

[2] The equity ratio ended 2013 at 1.3 percent. Since that time, the year-end equity ratio declined to 1.29 percent in 2014, 1.26 percent in 2015, and 1.24 percent in 2016.

CURRENT STATUS OF THE SIF

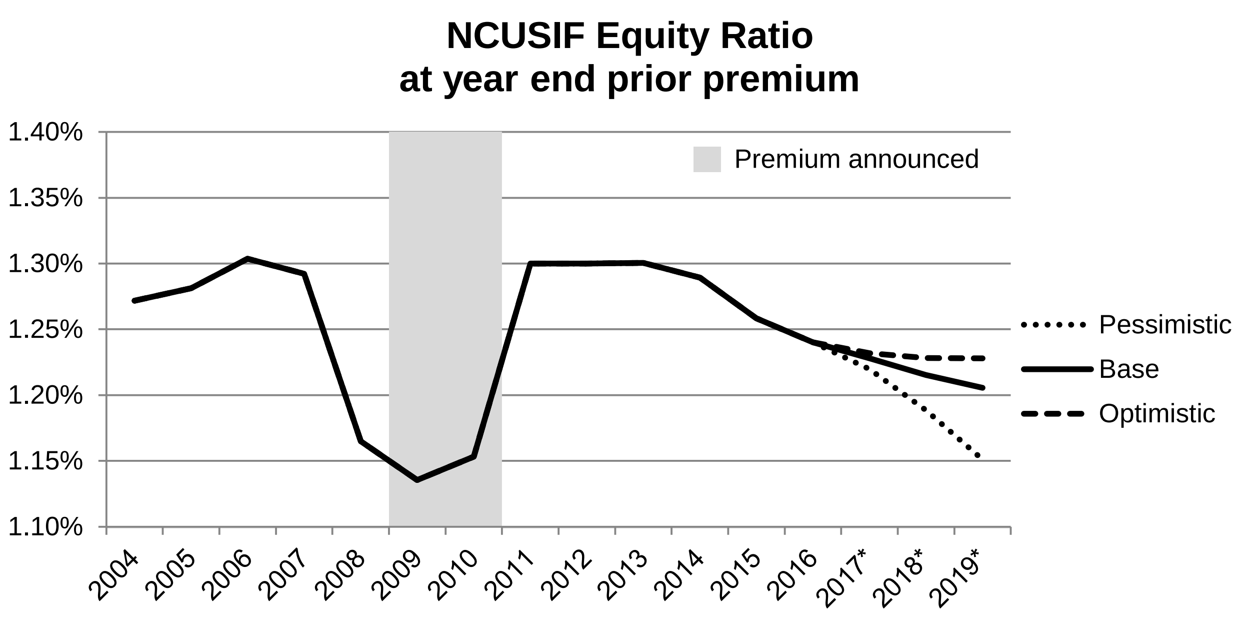
As of June 30, the equity ratio for the SIF was 1.22 percent. This figure is based on estimated insured shares as of that date. After factoring in the mid-year one percent capitalization deposit adjustment to insured shares for credit unions with over $50 million in assets, NCUA estimates that the equity ratio will rise to 1.26 percent.

The biggest change related to the performance of the fund in 2017 has been adjustments in the investment portfolio. In January NCUA realigned the portfolio to invest more heavily in shorter-term securities. The weighted average duration for the portfolio was 5 years in December 2016, but declined to 3.5 years as of June. As a result, the yield on the portfolio also dropped: from 1.8 percent in 2016 to 1.5 percent so far in 2017.

Reserves have also varied from amounts budgeted for the year. Through June, provision for insurance loss expense was negative $1.5 million ($13 million for reserve expenses less $14.5 million for recoveries from failed credit unions), which compares favorably to a budgeted amount of $56 million. Reserves for the year increased from $196.6 million in December to $208.2 million in June, which represents a 5.9 percent increase. Based on NCUA's June 30 estimate, the insured share base for the fund grew 4.1 percent during the first half of the year.

There were two credit union failures through June. Those failures have cost the SIF an estimated $3.8 million. Last year there were 14 failures which cost the fund $8.6 million. As a percentage of total insured shares, CAMEL 4 and 5 rated credit unions made up 0.9 percent as of June 30, which is up slightly from December (0.8 percent). CAMEL 3 credit unions represented 4.4 percent of total insured shares, which is down significantly from December (7.7 percent).

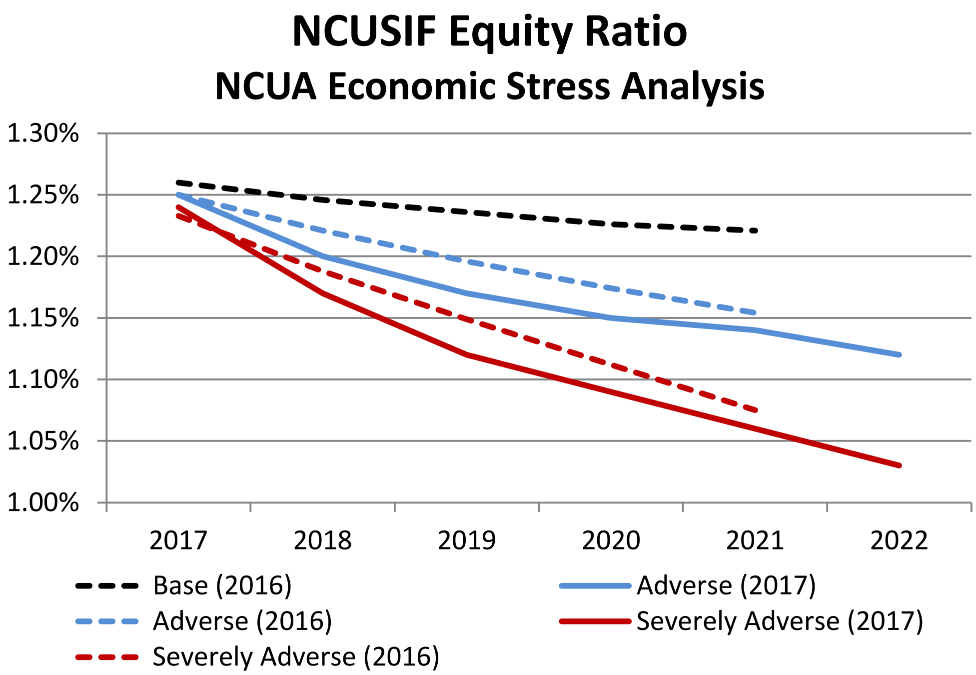
Based on current trends, NAFCU estimates that the SIF will end 2017 with an equity ratio of 1.23 percent (see figure 1), which would be a decline of one basis point from 2016.



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.

NCUA STRESS ANALYSIS & NOL PROPOSAL

At the July 2017 NCUA Board meeting, agency staff updated its forecast for the equity ratio (see chart below). For both the adverse and severely adverse scenarios, NCUA's 2017 forecast turned more pessimistic as compared to 2016. Over the common forecast period (2017 – 2021), NCUA's 2016 adverse scenario forecast showed a 9.6 basis point decline in the equity ratio, while in 2017 the decline grew to 11 basis points. For the severely adverse scenario, the decline in the equity ratio was 15.8 basis points in 2016 and 18 basis points in the updated 2017 forecast. It was noteworthy that in 2016 NCUA's base case forecast estimated that the equity ratio would remain above 1.2 percent through 2021. NCUA has not provided a base case forecast for its economic stress analysis in 2017.



Note: NCUA did not provide a base case for 2017

Source: NCUA Board presentations (Nov 2016 & Jul 2017)

NCUA's rationale for a 1.39 percent NOL is based first of all on the adverse scenario forecast in the above chart. Through 2022, NCUA's forecast shows a 13 basis point decline. In such a scenario, the equity ratio would need to start at a level of 1.33 percent in order to withstand such a decline without resulting in statutorily mandated premium charges on insured credit unions.

A second layer of protection is for exposure to the corporate legacy assets. In the event that the economy declines, the projected cash flows from those assets may also drop. In that event, the SIF may receive a lower return than currently projected. NCUA's base projection is for a $2 billion return to the SIF from the corporate asset management estates (AMEs). Based on the adverse scenario assumptions, that projected return would decline by $400 million, and under the severely adverse scenario the decline would be $1.1 billion. In order to absorb the decline under the adverse scenario, NCUA built in 4 basis points to account for this risk.

The final layer to NCUA's NOL proposal comes from, in essence, advancing NCUA's forecast forward by 2 years. According to NCUA, the reason for doing so is that the majority of the outstanding NGNs will be retired in 2020. Therefore, NCUA wants to account for the anticipated decline in the equity ratio in 2018 and 2019, so that the fund is positioned at that time with the full amount of the aforementioned layers of protection (13 basis points for general trends in the SIF and 4 basis points for volatility in the legacy assets). NCUA's base case in its standard projection shows a 2 basis point decline over the next two years. Therefore, NCUA added that amount to its proposed NOL.

So NCUA's NOL calculation is as follows:

1.20 percent	Statutory level below which NCUA must charge a premium
+ 0.13 percent	Forecasted decline in the equity ratio through 2022 under the adverse scenario*
+ 0.04 percent	Forecasted decline in the receivable from the corporate AMEs under the adverse scenario*
+ 0.02 percent	Forecasted decline in the equity ratio in 2018-19 under the base scenario**
1.39 percent	Proposed NOL

* based on NCUA's economic stress test
** based on NCUA's standard projection

It is important to note that there is no provision in NCUA's proposal for unwinding the increase in the NOL. The NOL is set at the sole discretion of the NCUA Board and it has authority to set it as high as 1.5 percent. In 2010 the Dodd-Frank Act required FDIC to increase its minimum deposit insurance fund ratio to 1.35 percent, and NCUA has cited this in previous discussions of the NOL. Even after the NGN program has ended in 2021, credit unions would have no assurance that the NCUA Board would return the NOL to 1.3 percent at that time.

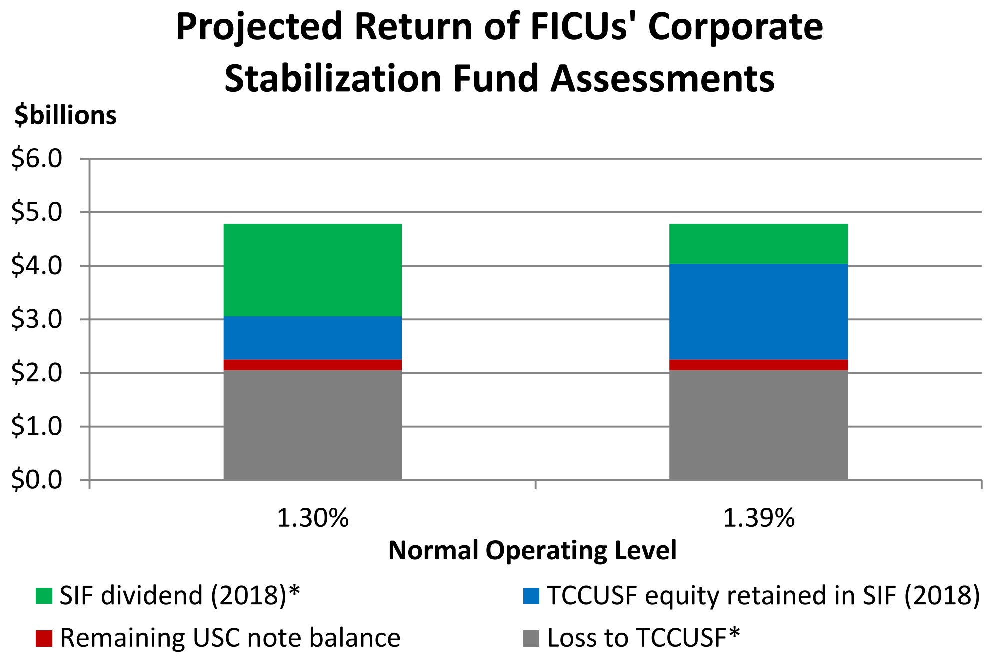
SIF DIVIDEND

If the TCCUSF is closed in 2017, FICUs are likely to receive a dividend from the SIF in 2018, based on the 2017 year-end equity ratio. NCUA staff provided an estimate of the dividend at the July Board meeting. As of March 2017, the TCCUSF's net position was $1.6 billion. Furthermore, legal recoveries in the second quarter increased the fund's position by an estimated $310 million, and NCUA estimates that it will collect $500 to $800 million on the $1 billion U.S. Capital Note in 2017. After considering those adjustments, NCUA's projection for the post-closure equity ratio was 1.45 to 1.47 percent.

The dividend would be the excess equity above the NOL. If the NOL remains at 1.3 percent, the dividend would be 15 to 17 basis points of insured shares[3]. However, if the NOL is raised to 1.39 percent, the dividend would only be 6 to 8 basis points. Thus, an increase in the NOL of the magnitude proposed by NCUA would reduce the estimated dividend that credit unions receive in 2018 by up to 60 percent.

Looking beyond the possible 2018 dividend, a balance remains on the U.S. Central Note which could be collected depending on the performance of the corporate legacy assets. Roughly $2 billion of the $4.8 billion in total corporate assessments is estimated to be a loss to the industry. A breakdown of the refund to credit unions of their corporate stabilization assessments is below (all based on NCUA projections, assuming closure of the TCCUSF in 2017):

[3] This is for the industry as a whole. For an individual credit union, NCUA has proposed two methods for allocating equity distributions related to corporate resolution. Both would be based on the amount of corporate stabilization assessments paid by the individual credit union.



Note: Figures based on NCUA projections. For ranges, midpoints were assumed.

Source: July 2017 NCUA Board presentation

CONCLUSION

The recent decline in the equity ratio for the SIF is the result of several areas of stress. Investment yield has been below 2 percent for a number of years due to the low-interest rate environment. Share growth has begun to accelerate, which has the effect of diluting the equity ratio. NCUA operating expenses ballooned after the financial crisis and continue to grow. If these trends persist – as NCUA anticipates will happen – challenges will continue for the SIF.

The positive performance of the TCCUSF is good news for the industry. A portion of the money paid by credit unions as a result of the crisis will be returned to them, potentially as early as 2018. However, NCUA's proposed increase in the normal operating level for the SIF would have large consequences for the industry. Not only will it have a large say in determining the size of a dividend in 2018, raising the NOL from where it has been historically fixed makes it easier for future NCUA Boards to set the NOL at a similar or even higher level.

Closing the TCCUSF may have other intended consequences. The recent declines in the equity ratio provide a pressure point for NCUA regarding its operating budget. As the prospect of a premium charge in the near future increases, NCUA may be more mindful of budgetary excesses. A return to the normal operating level through extraordinary circumstances may ease that pressure and give NCUA a false sense of security as to the prudence of its management of the fund. Credit unions will have to weigh the benefits of closing the TCCUSF with these potential downsides.

Against this backdrop is the specter of a SIF premium in 2017, which NCUA estimated at 3 to 6 basis points. Many credit unions may favor closing the TCCUSF if only to avoid that premium. But it must be emphasized that such a premium would in all likelihood be at the complete discretion of the NCUA Board. If the equity ratio ends the year above 1.2 percent – which it will, barring catastrophe – NCUA does not need to charge a premium this year. Since 1998, when the requirement to charge a premium if the equity ratio falls below 1.2 percent was established, the agency has never charged a premium when it was not a statutory requirement. Threatening to do so while at the same time proposing to close the TCCUSF and raise the NOL is clearly not favorable to credit unions.