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National Association of Federally-Insured Credit Unions

December 3, 2019

The Honorable Rodney E. Hood, Chairman
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: National Credit Union Share Insurance Fund Normal Operating Level

Dear Chairman Hood:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to you regarding the National Credit Union Administration's (NCUA) normal operating level (NOL) for the National Credit Union Share Insurance Fund (SIF). NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 118 million consumers with personal and small business financial service products.

One of NAFCU's key priorities is a strong NCUA and a strong SIF. NAFCU is pleased that the SIF has returned $900 million in surplus equity to credit unions over the past two years. While a distribution from the SIF in 2019 will depend on the performance of the fund over the second half of the year, as well as the NCUA Board's discretionary selection of the NOL, conditions for the fund have improved. Insurance losses during the year have been minimal, and agency staff recently announced that it would begin to reverse the shortening of the investment portfolio duration which began in 2017, thus providing the opportunity for greater yield in the future.

Given the improvement in the economic outlook, NAFCU urges a return in the NOL to its historical level of 1.30 percent. Doing so would facilitate the return of even more funds to credit unions and their members, while still providing a strong SIF.

Background

The SIF maintains a stock of equity primarily for the purpose of absorbing future losses related to insured credit union failures without requiring regular premium charges. In 2017, the NCUA merged the Temporary Corporate Credit Union Stabilization Fund (TCCUSF), which had been established to manage the liabilities associated with the failures of several corporate credit unions. With the merger, the SIF absorbed the equity of the TCCUSF ($2.6 billion at the time of the merger), along with obligations associated with the NCUA Guaranteed Notes (NGN) program.

Coinciding with the merger of the funds, the NCUA adjusted its methodology for calculating the NOL. The NOL forms an effective cap on the equity in the SIF. Any equity in the fund at the end of the year in excess of the NOL is returned to insured credit unions in the form of a distribution, so long as there are no outstanding government borrowings. The previous methodology for calculating the NOL involved "an analysis of the stress on the equity ratio based on defined model inputs" over a two-year period.[1] The forecast inputs were determined as the most extreme values during the most recent 10 years for each of three primary drivers: (1) insured share growth; (2) insurance losses; and (3) operating expenses. For a fourth driver – investment yield – the NCUA assumed a 300 basis point downward shock.

In 2017, the NCUA elected to use the variables from the adverse scenario in the Federal Reserve Board's annual stress test supervisory scenarios to estimate a path for the equity ratio over the length of the forecast. Furthermore, the NCUA lengthened the term of the forecast from two years to five. In addition to those structural changes to the methodology, the NCUA built in an additional cushion accounting for the projected decline in the equity ratio through 2019.

This change in methodology played a large role in the resulting increase in the NOL in 2018 and 2019. Whereas the previous methodology consistently resulted in a 1.30 percent NOL, the NOL was calculated as 1.39 percent in 2018 and 1.38 percent in 2019. Although the performance of the SIF, in large part due to the merger with the TCCUSF, returned distributions to insured credit unions of approximately $760 billion in 2018 and $160 billion in 2019, those amounts would have been substantially larger had the NOL not increased. Based on total insured shares at the end of the previous calendar year, NAFCU estimates that an NOL of 1.30 percent in 2019 would have returned an additional $913 million to credit unions.

A summary of the components of the NOL in 2018 and 2019 is shown in the table below:

Component	2018	2019
Statutory minimum	1.20%	1.20%
Plus: Potential decline in insurance fund performance	0.13%	0.13%
Plus: Potential decline in value in claims on corporate estates	0.04%	0.02%
Plus: Projected equity ratio decline in 2018 and 2019	0.02%	0.03%
Equals: NOL	1.39%	1.38%

The NOL in 2020

As the NCUA considers the appropriate level for the NOL in 2020, NAFCU believes that a reduction is warranted. The clearest justification, as shown in the table above, is the allocation for the projected decline in the NOL in 2018 and 2019. The NCUA estimated that trends in the drivers of the equity ratio would result in the decline in the equity ratio through the end of 2019. The agency incorporated an additional layer of protection in order to ensure that the fund's equity would remain at or above the level established for the remaining components (i.e., the statutory minimum, plus the potential decline in SIF performance, plus the potential decline in corporate legacy asset values), once the agency begins to pay down the remaining NGN obligations in 2020 and 2021. However, the anticipated equity decline never came to pass, and those funds, totaling roughly $340 million, can and should be returned to credit unions.

[1] "Share Insurance Fund Equity Ratio and Premium Projections," NCUA Board Briefing (Nov. 17, 2016).

Five-Year Forecast

When the NCUA adjusted its methodology for calculating the NOL, it moved from a two-year forecast period to a five-year horizon. As the agency explained in the final rule formalizing its methodology, "a five-year horizon… was used to cover the cycle of an economic downturn and the life of the NGN program."[2] Given that the remaining NGN program obligations are scheduled to be substantially repaid in 2020, and fully so in 2021, this is an appropriate time for the agency to review its use of a five-year forecast.

The agency's forecast is modeled on the Federal Reserve's stress test scenarios, which are designed for large bank balance sheets. There are currently four banks with assets greater than the combined share of the entire credit union industry, which the SIF insures. Nevertheless, none of those institutions face five-year regulatory stress tests.

Conclusion

NAFCU supports a strong Share Insurance Fund and a normal operating level which provides adequate protection to taxpayers and minimizes the potential for premium charges to credit unions. NAFCU also believes that the SIF should be managed proactively with a goal of identifying and quantifying salient risks. However, those goals must be balanced with the understanding that credit union resources are scarce. Every dollar held in the SIF is a dollar that will not be used to serve credit union members. Consistent with NAFCU's recent testimony on the NCUA's budget, we urge the NCUA Board to consider both the costs and benefits to the industry in setting the NOL.

The NCUA should return to its previous methodology and target a 1.3 percent NOL. Doing so would maintain the same resilient SIF that has successfully backstopped the industry for decades while putting money back in the hands of credit union members. Should you have any questions or concerns, please do not hesitate to contact me at clong@nafcu.org or (703) 842-2276.

Sincerely,

Curtis Long

Curtis Long
Vice President of Research and Chief Economist

cc: The Honorable Todd M. Harper, Board Member
The Honorable J. Mark McWatters, Board Member

[2] 82 FR 46298 (Oct. 4, 2017).