7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

Closing the Temporary Corporate Credit Union Stabilization Fund and Setting the Share Insurance Fund Normal Operating Level

AGENCY: National Credit Union Administration (NCUA).

ACTION: Notice and request for comment.

SUMMARY: The NCUA Board (Board) is considering closing the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) in 2017, prior to its scheduled closing date in June 2021. Closing the Stabilization Fund and distributing all assets, property, and funds to the National Credit Union Share Insurance Fund (Share Insurance Fund) will increase the Share Insurance Fund's equity ratio and allow for the return to insured credit unions of any equity above the normal operating level. The return of excess equity would be accomplished through a distribution from the Share Insurance Fund in conformance with the Federal Credit Union Act (the Act). However, given the nature of certain assets and liabilities of the Stabilization Fund, the Share Insurance Fund's assumption of these assets and liabilities will introduce additional risk of volatility to the Share Insurance Fund's equity ratio. Therefore, the Share Insurance Fund would need to hold sufficient equity to cover potential changes in the value of its claims on the failed corporate credit union asset management estates. In addition, the Share Insurance Fund

needs to have enough equity to cover other risks to the equity ratio, such as losses on insured credit unions, under the same macroeconomic conditions that create volatility in the asset management estate values. To ensure the Share Insurance Fund has sufficient equity to absorb these risks, the Board proposes to raise the normal operating level to 1.39 percent.

This notice provides a discussion of the reasons the Board is proposing to close the Stabilization Fund in 2017 and the basis used to determine the normal operating level necessary to account for the additional risk to the Share Insurance Fund. In addition, the notice sets forth a new policy by which the Board would set the normal operating level. The Board solicits comments on each of these proposed actions.

DATES: Comments must be received on or before September 5, 2017 to be assured of consideration.

ADDRESSES: You may submit comments by any of the following methods (**Please send comments by one method only**):

- NCUA Web Site: https://www.ncua.gov/about/pages/board-comments.aspx
- E-mail: Address to boardcomments@ncua.gov. Include "[Your name] – Comments on Stabilization Fund Closure" in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Gerald Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428
- Hand Delivery/Courier: Same as mail address.

Public Inspection: You can view all public comments on NCUA's website at https://www.ncua.gov/about/pages/board-comments.aspx as submitted, except for those we cannot post for technical reasons. NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in NCUA's headquarters at 1775 Duke Street, Alexandria, VA 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6360 or send an e-mail to EIMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Anthony Cappetta, Supervisory Financial Analyst, at 1775 Duke Street, Alexandria, VA 22314, or telephone: (703) 518-1592.

SUPPLEMENTARY INFORMATION:

I. Stabilization Fund Background

Public Law 111-22, *Helping Families Save Their Homes Act of 2009* (Helping Families Act), signed into law by the President on May 20, 2009 created the Temporary Corporate Credit Union Stabilization Fund. Congress provided NCUA with this temporary fund to accrue the losses of the corporate credit union system and assess insured credit unions for such losses over time. This prevented insured credit unions from bearing a significant burden for losses associated with the failure of five corporate credit unions within a short period. Without creation of the Stabilization Fund, these corporate credit union losses would have been borne by the Share Insurance Fund. The magnitude of losses would have exhausted the Share Insurance Fund's retained earnings and significantly impaired credit unions' one percent contributed capital deposit.[1] The deposit impairment, along with premiums that would have been necessary to restore the Share Insurance Fund's equity ratio, would have resulted in a significant, immediate cost to credit unions at a time when their earnings and capital were already under stress due to the Great Recession.[2] In June 2009, the Board formally approved use of the Stabilization Fund for accounting for the costs of the Corporate System Resolution Program.[3] Since then, all of these costs have been accounted for in the financial statements of the Stabilization Fund.

The Act specifies that the Stabilization Fund will terminate 90 days after the seven-year anniversary of its first borrowing from the U.S. Treasury.[4] The first borrowing occurred on June 25, 2009, making the original closing date September 27, 2016. However, the Act provided the

[1] Prior to reassignment of these costs to the Stabilization Fund, the capitalization deposit impairment would have been 89 basis points.
[2] Because the contributed capital deposit is reflected as an asset on the financial statements of insured credit unions, under accounting rules any impairment results in an immediate expense to credit unions.
[3] For more details on the corporate system resolution program, please see the NCUA Corporate System Resolution Costs webpage ((https://www.ncua.gov/regulation-supervision/Pages/corporate-system-resolution.aspx)
[4] 12 U.S.C. 1790e(h)

Board, with the concurrence of the Secretary of the U.S. Treasury, authority to extend the closing date of the Stabilization Fund. In June 2010, the Board voted to extend the life of the Stabilization Fund and on September 24, 2010, NCUA received concurrence from the Secretary of the U.S. Treasury to extend the closing date to June 30, 2021.

In March 2009, the Board conserved U.S. Central Federal Credit Union and Western Corporate Credit Union. In September 2010, the Board conserved three additional corporate credit unions and publicly announced the Corporate System Resolution Program. The Board placed the five corporate credit unions into liquidation in the fourth quarter of 2010. The Board, as Liquidating Agent, administers the assets and liabilities of the five failed corporate credit unions in separate legal entities, referred to as asset management estates.

The Corporate System Resolution Program included providing short-term and long-term funding to resolve a portfolio of residential mortgage-backed securities, commercial mortgage-backed securities, other asset-backed securities, and corporate bonds (collectively referred to as the Legacy Assets) held by the liquidated corporate credit unions. Under the Corporate System Resolution Program, NCUA created a re-securitization program where NCUA issued a series of NCUA Guaranteed Notes (NGNs). The sale of NGNs to investors has provided long-term funding for the Legacy Assets. The NGNs are guaranteed by NCUA in its Agency capacity, backed by the full faith and credit of the United States. While the accounting for obligations associated with the NGNs occurs through the Stabilization Fund, the guaranty is not specific to the Stabilization Fund. All NCUA agency funds for which payments on the NGN guarantees is a permitted use, including the Share Insurance Fund, are potential sources for guaranty obligations prior to any recourse to the U.S. Treasury.

During its life, the Stabilization Fund provides the primary funding necessary for NCUA's guarantees on the NGNs and to complete the resolution of the corporate credit union asset management estates. The majority of this funding has been from two primary sources: borrowings of $5.1 billion (peak outstanding balance) on NCUA's $6 billion line of credit with the U.S. Treasury and $4.8 billion in Stabilization Fund assessments paid by insured credit unions.

In 2010, when NCUA announced the Corporate System Resolution Program, the outstanding principal balance of the Legacy Assets totaled over $40 billion – about four times the size of the Share Insurance Fund. The initial outstanding balance of guaranteed notes backed by the Legacy Assets and sold to investors through the NGN program in 2010 and 2011 totaled approximately $28 billion – almost three times the size of the Share Insurance Fund at that time. As of March 2017, the outstanding principal balance of the Legacy Assets and the outstanding balance of the guaranteed notes back by them have declined to $12.7 billion and $7.5 billion, respectively. Both of these balances are less than the current size of the Share Insurance Fund, which is $13.2 billion in total assets as of March 31, 2017.

The projected range of lifetime Legacy Asset defaults was $13.2 billion to $16.4 billion as of December 2011. As of March 2017, the projected range of lifetime Legacy Asset defaults has declined to $9.9 billion to $10.3 billion. In addition, NCUA's pursuit of legal recoveries in its capacity as Liquidating Agent against various third parties in connection with the Legacy Assets has resulted in net recoveries of approximately $3.8 billion after fees and expenses.[5] Improved projected performance of the Legacy Assets and legal recoveries are the primary reasons the Stabilization Fund's net position has increased from negative $7.5 billion as of December 2010 to a positive $1.6 billion as of March 2017.

It is now possible for the remaining obligations of the Corporate System Resolution Program to be borne by the Share Insurance Fund without inordinate risk, provided additional equity is maintained while the exposure to remaining resolution program obligations exist. As a result, the Board believes the purpose of the Stabilization Fund has been fulfilled.[6] Therefore, the Board proposes to close the Stabilization Fund in 2017. Closing the Stabilization Fund at this time would increase the equity ratio of the Share Insurance Fund and require NCUA to distribute any resulting equity above the normal operating level to insured credit unions.[7] The Board is simultaneously publishing a separate proposal to update § 741.4 of NCUA's Rules and Regulations regarding the method for Share Insurance Fund distributions to insured credit unions.

[5] NCUA does not include potential future legal recoveries in loss projections, as they are inherently inestimable. For a list of legal recoveries to date, see NCUA's Legal Recoveries website (https://www.ncua.gov/regulation-supervision/Pages/corporate-system-resolution/legal-recoveries.aspx).
[6] Worthy of note, if the Stabilization Fund is closed in 2017, it would have been in operation about one year longer than the original seven years provided for in the Act.
[7] The potential return of excess equity would be in the form of a distribution to insured credit unions from the Share Insurance Fund as provided for in the Act. Stakeholders should not confuse this with potential recoveries on depleted member capital. Until senior obligations of each particular estate can be satisfied, there will not be distributions for any recoveries on depleted member capital.

II. Legal Matters

The Act sets forth the purpose, permissible expenditures, borrowing and repayment authorities, assessment authority, investment authority, and procedures for closing the Stabilization Fund.[8] The statute specifically prescribes the conditions for closing the Stabilization Fund and distributing its holdings.[9] The Board has the authority under the Act to close the Stabilization Fund at its discretion at any time when it has no deficit, which then requires that all of its assets and funds be distributed to the Share Insurance Fund.[10] The Stabilization Fund's financial statements have reflected a positive net position since June 30, 2014. Therefore, there are currently no statutory barriers for the Board in regards to closing the Stabilization Fund in 2017. Once the Stabilization Fund is closed, there is no statutory authority that permits NCUA to re-open it for any reason.

The Board is aware of industry opinions that the Act may permit a distribution to insured credit unions directly from the Stabilization Fund. The Board does not believe this is permissible for the following reasons.

NCUA's authority to use Stabilization Fund money arises from the reference to 12 U.S.C. 1783(a) in the legislation that created the Stabilization Fund.[11] Specifically, the legislation provides that "[m]oney in the Stabilization Fund shall be available upon requisition by the Board

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[8] 12 U.S.C. 1790e
[9] 12 U.S.C. 1790e(h)
[10] 12 U.S.C. 1790e(g), (h)
[11] 12 U.S.C. 1790e(b)

. . . for making payments for the purposes described in § 1783(a) of this title."[12] Except with respect to administrative payments, the legislation limits this authority to the context of a "conservatorship, liquidation, or threatened conservatorship or liquidation, of a corporate credit union."[13] Under section 1783(a), permissible uses include payments of insurance under section 1787 of the title, for providing assistance and making expenditures under section 1788 of the title in connection with the liquidation or threatened liquidation of insured credit unions, and for such administrative and other expenses incurred in carrying out the purposes of the subchapter as the Board may determine to be proper.

Here, a distribution, such as an assessment rebate, does not plainly meet any of those criteria, assuming an appropriate nexus to a corporate credit union conservatorship or liquidation could be established in each instance. First, a distribution to insured credit unions from the Stabilization Fund, by its namesake alone, would not be a payment of insurance under section 1787. Further, a distribution could not be in the form of assistance under section 1788, since it would not go to credit unions for the assistance purposes described in section 1788. Finally, a distribution is not an "administrative expense" or "other expense" in the context of the Act.

While the general definition of an expense can be quite broad,[14] section 1782(c)(3) of the Act expressly governs distributions to insured credit unions. Distributions under section 1782(c)(3) are not included as an authority that Congress granted for the Stabilization Fund, particularly

[12] 12 U.S.C. 1790e(b)(1)
[13] *Id.*
[14] Black's Law Dictionary characterizes an expense as "[a]n expenditure of money, time, labor or resources to accomplish a result." Black's Law Dictionary 617 (8th ed. 2004).

since Congress expressly tied Stabilization Fund authority to section 1783(a), to the exclusion of any other section. On the contrary, the Stabilization Fund legislation references section 1782(c)(3) only with respect to distributions flowing *into* the Stabilization Fund, in any circumstances where U.S. Treasury borrowings remain outstanding.[15]

In the only other circumstance where the legislation references a distribution in any manner, it is in reference to the Stabilization Fund's closing.[16] In that circumstance, the Act limits a distribution of all "funds, property or other assets remaining in the Stabilization Fund" to one recipient: The Share Insurance Fund.[17] For these reasons, the Board believes the Stabilization Fund must be closed before a distribution of excess funds to insured credit unions can occur for purposes other than those described in section 1783(a).

III. Closing the Stabilization Fund

A. Accounting and Financial Reporting

The financial statements of the Stabilization Fund and the Share Insurance Fund are presented under standards promulgated by the Federal Accounting Standards Advisory Board (FASAB). These financial statements are presented and audited by calendar year. With the closing of the Stabilization Fund, NCUA intends to prepare final financial statements for the Stabilization Fund

[15] 12 U.S.C. 1790e(e)
[16] 12 U.S.C. 1790e(h)
[17] *Id.* Within 90 days following the seventh anniversary of the initial Stabilization Fund advance, or earlier at the Board's discretion, the Board shall distribute any funds, property, or other assets remaining in the Stabilization Fund to the Insurance Fund and shall close the Stabilization Fund.

as of September 30, 2017. These financial statements would be audited by NCUA's Office of the Inspector General.

Per applicable accounting standards, the assets and liabilities of the Stabilization Fund will be distributed to the Share Insurance Fund at September 30, 2017 values. This transfer will increase the net position of the Share Insurance Fund, resulting in an increase to the equity ratio. As required by applicable accounting standards, certain budgetary accounts will also transfer and be shown in the Statement of Budgetary Resources. NCUA determined the applicable accounting standards in consultation with an independent accounting firm.

The post-closure financial statements and note disclosures for the Share Insurance Fund will continue to provide the same level of detail about the receivables from the corporate asset management estates and the related fiduciary activities. That is, the detailed note disclosures in the Stabilization Fund's financial statements will now be in the note disclosures of the Share Insurance Fund's financial statements. NCUA does not envision any changes to the accounting for the asset management estates. The accounting for each asset management estate has and will remain distinct, which is a requisite in fulfilling the Board's responsibility as Liquidating Agent.

For illustrative purposes, Table 1 depicts the March 31, 2017 Share Insurance Fund balance sheet (unaudited), the March 31, 2017 Stabilization Fund balance sheet (unaudited), and the pro-forma

Share Insurance Fund balance sheet (unaudited) as if the Stabilization Fund were closed on that day.[18]

Table 1: Share Insurance Fund and Stabilization Fund Balance Sheets, Pre- and Post-Closure, as of March 31, 2017 (dollars in millions)

	Share Insurance Fund (Pre-Closure)	**Stabilization Fund (Pre-Closure)**	**Share Insurance Fund (Post-Closure)**
ASSETS			
Fund Balance with Treasury & Investments	$12,766.2	$700.4	$13,466.6
Notes Receivable, Net	8.7	-	8.7
Capitalization Deposits Receivable	316.5	-	316.5
Receivable from Asset Management Estates, Net (NPCU)	51.3	-	51.3
Receivable from Asset Management Estates, Net (CCU)	-	876.3	876.3
Accrued Interest and Other Assets	61.2	2.7	63.9
Total Assets	$13,203.9	$1,579.4	$14,783.3
LIABILITIES AND NET POSITION			
Accounts Payable and Other Liabilities	$26.0	$1.1	$27.1
Borrowings from U.S. Treasury	-	-	-
Insurance and Guarantee Program Liabilities	245.6	-	245.6
Net Position – Contributed Capital Deposits	10,285.8	-	10,258.8
Net Position – Cumulative Results of Operations	2,646.5	1,578.3	4,224.8
Total Liabilities and Net Position	$13,203.9	$1,579.4	$14,783.3
TOTAL NET POSITION	$12,932.3	$1,578.3	**$14,510.6**

Subsequent to March 31, 2017, and prior to the end of the year, there are several items that have been or are expected to be recognized that will ultimately affect the net position of the Share

[18] The impact on the post-closure Share Insurance Fund financial statements will be based on actual results at the time the Stabilization Fund is closed and the presentation may vary somewhat due to the specific application of accounting standards on individual line items.

Insurance Fund. Table 2 includes these additional items and the effect on the projected net position as of December 31, 2017.

Table 2: Breakdown of Projected Net Position Components by December 31, 2017 (dollars in thousands)

Component	Amount (in millions)
March 31, 2017 Pro-Forma Net Position (Post-Closure) – From Table 1 Above	$14,511
Plus: Legal Recoveries that Increase the Value of the Receivable from the AMEs	$310
Plus: Estimated Recovery on U.S. Central Capital Note[19]	$500 - $800[20]
Plus: Share Insurance Fund Net Income 2017q2 – 2017q4[21]	($26)
Plus: Adjustment to 1% Contributed Capital Deposit[22]	$383
Equals: Adjusted Net Position (Post-Closure), as of 12/31/17	**$15,678 - $15,978**

B. Effect on Share Insurance Fund Equity Ratio and Distributions

The Share Insurance Fund equity ratio is defined in the Act as the ratio of the amount of Fund capitalization, including insured credit unions' 1 percent capitalization deposits and the retained earnings balance of the Fund (net of direct liabilities of the fund and contingent liabilities for which no provision has been made) to the aggregate amount of insured shares in all insured credit unions.[23] It serves as a measure of the Share Insurance Fund's overall strength and ability to absorb losses. In general, the Act requires the Board to manage the Share Insurance Fund's equity ratio within a range of 1.20 percent to 1.50 percent.

[19] The estimated recovery includes U.S. Central's portion of the recent legal recoveries.
[20] This estimated range only reflects what is projected to be recognizable by December 31, 2017 under applicable accounting rules, which mainly includes the portion of the U.S. Central capital note for which there is cash available for repayment.
[21] Assuming current yield on investments, insurance losses equal to the five-year average, and operating expenses based on the currently approved NCUA budget.
[22] Based on share growth of 3.71 percent in the first quarter 2017 and the historical share of adjusted contributed capital deposit adjustments collected in October each year.
[23] 12 U.S.C. 1782(h)(2)

The closure of the Stabilization Fund would increase the Share Insurance Fund's net position. This would result in an increase to the Share Insurance Fund's equity ratio. Table 3 shows the estimated equity ratio of the Share Insurance Fund as of December 31, 2017 as if the Stabilization Fund were closed.

Table 3: Projected Share Insurance Fund Equity Ratio as of December 31, 2017 (dollars in thousands)

Component	**Amount (in millions)**
Adjusted Net Position Post Closure - From Table 2 Above	$15,678 - $15,978
Less: Gain(Loss) on Investments[24]	($66)
Equals: Equity Ratio Numerator	$15,744 - $16,044
Equity Ratio Denominator: Projected Insured Shares as of December 31, 2017[25]	$1,089,500
Projected Calendar Yearend 2017 Equity Ratio[26]	**1.45% - 1.47%**

The Share Insurance Fund's calendar yearend equity ratio is part of the statutory basis to determine whether NCUA must make a distribution to insured credit unions.[27] The Act states "the Board shall effect a pro rata distribution to insured credit unions after each calendar year if, as of the end of that calendar year –

- Any loans to the Fund from the Federal Government, and any interest on those loans, have been repaid;

[24] Actual gain(loss) on investments as of March 31, 2017 and could be materially different as of December 31, 2017.
[25] Based on 5.8 percent annual insured share growth, which is the three-year average insured share growth for the industry.
[26] This does not account for extraordinary losses and/or failures in credit unions, abnormally high insured-share growth, or a significant downturn in economic conditions, including declining interest rates.
[27] The equity ratio is also part of the statutory basis for determining whether a premium or Share Insurance Fund restoration plan is necessary.

- The Fund's equity ratio exceeds the normal operating level; and
- The Fund's available assets ratio exceeds 1.0 percent."[28]

As of October 24, 2016, all NCUA borrowings from the Federal Government had been repaid. The Share Insurance Fund's available asset ratio is 1.21 percent as of March 31, 2017, well above the 1.0 percent minimum and is projected to remain above 1.0 percent.[29]

To the extent the equity ratio exceeds the normal operating level as of calendar yearend 2017, a distribution would be paid to insured credit unions in accordance with the Act and § 741.4 of NCUA regulations. The distribution in total would equal the dollar amount of equity in excess of the normal operating level. For additional information on how the pro rata distribution would be made, see the July 2017 Notice of Proposed Rulemaking on this subject.

IV. The Normal Operating Level

Per the Act, the normal operating level is an equity ratio set by the Board and may not be less than 1.20 percent and not more than 1.50 percent.[30] As noted above, if the calendar yearend equity ratio exceeds the normal operating level, NCUA is required to make a pro rata distribution to insured credit unions. The Board has historically set the normal operating level as the target equity ratio for the Share Insurance Fund.

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[28] 12 U.S.C. 1782(c)(3). This section is also subject to 12 U.S.C. 1790e(e).
[29] After closure, NCUA estimates the Share Insurance Fund would hold $4 billion in surplus funds over the 1.0 percent minimum ratio. NCUA currently projects $2.8 billion in guaranty payments on the NGNs after 2017. However, the current estimate for the funding needs net of related cash flows is approximately $1 billion.
[30] 12 U.S.C. 1782(h)(4)

The current normal operating level is 1.30 percent, set by the Board in 2007 based on the Board-approved methodology in place at that time. When establishing the 1.30 percent normal operating level in 2007, the Board affirmed that the Share Insurance Fund would maintain a counter-cyclical posture. In practice, this means the Share Insurance Fund's equity should be built up during periods of economic prosperity and allowed to decline during periods of economic adversity. A counter-cyclical posture allows NCUA to maintain the Share Insurance Fund at a level that is sufficient for it to remain viable even during economic stress conditions without having to charge a premium when credit unions can least afford it.

With the proposed closing of the Stabilization Fund, the Board considered whether the current normal operating level of 1.30 percent would be sufficient to cover all of the Share Insurance Fund's resulting exposures. To determine this, NCUA modeled the losses that would be expected under a moderate and a severe recession.[31] For the two recession scenarios, the agency modeled the:

- Impact on the equity ratio of the estimated decline in the value of the Share Insurance Fund's claims on the liquidated corporate credit unions' asset management estates – which would be driven by a reduction in the value of the Legacy Assets.

[31] In estimating the equity ratio under various economic stress scenarios, NCUA must make estimates and assumptions that affect the model output. Actual results could differ from NCUA's estimates; however, the agency evaluates the reasonableness of such estimates when analyzing the model output. The base scenario for modeling the performance of the Share Insurance Fund is a moderate economic expansion through the projection period with Treasury rates assumed to rise steadily across the maturity spectrum, the unemployment rate remains low and housing prices rise slightly.

- Performance of the Share Insurance Fund based on the three primary factors that currently affect the Share Insurance Fund's equity ratio: insured share growth, yield on investments, and insurance losses.

The Share Insurance Fund was modeled over a five-year period and the Legacy Assets were modeled over their remaining life.[32] NCUA used the applicable variables describing economic developments for the Adverse and Severely Adverse economic scenarios from the Federal Reserve Board's 2017 annual stress test supervisory scenarios.[33] In the Adverse scenario, the U.S. economy experiences a moderate recession, and asset prices decline. This scenario is characterized by weakening economic activity, including higher unemployment, falling short-term interest rates, long-term interest rates that slowly rise, a steadily rising unemployment rate, and sustained declines in housing prices. The Severely Adverse scenario is characterized by a severe global recession that is accompanied by a period of heightened stress in corporate loan markets and commercial real estate markets. In this scenario, the unemployment rate spikes, short-term interest rates fall to near zero, long-term interest rates fall initially then increase slightly, and housing prices decline substantially. Further details on how these scenarios were applied to model the value of the claims on the corporate asset management estates and the performance of the Share Insurance Fund are provided below.

[32] A five-year horizon (beginning at yearend 2017) was used to cover the cycle of an economic downturn and the life of the NGN program.
[33] *Supervisory Scenarios for Annual Stress Test Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule*, February 10, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170203a5.pdf).

A. Determining Equity Needed to Cover Potential Declines in the Value of Claims on the Corporate Credit Union Asset Management Estates

At NCUA's request, BlackRock incorporated the Adverse and Severely Adverse macroeconomic scenarios into its proprietary models to project cash flows for all of the Legacy Assets.[34] In both the Adverse and Severely Adverse macroeconomic scenarios, the value of the Legacy Assets declines.

Credit spreads indicative of Adverse and Severely Adverse market conditions are applied to the forward interest rate curve to arrive at a discount rate to calculate the present value of the Legacy Asset cash flows, as shown in Table 4. For the Adverse scenario, credit spreads similar to the period of the U.S. credit rating downgrade in August 2011 were used. For the Severely Adverse scenario, credit spreads similar to the peak of the Great Recession in 2009 were used.

Table 4: Discounted Legacy Asset Cash Flows (dollars in billions)

	Scenario			**Differences from Base**	
	Base	**Adverse**	**Severely Adverse**	**Adverse**	**Severely Adverse**
Total	$10.3	$8.3	$7.3	($2.0)	($3.0)

The projected Legacy Asset cash flows are aggregated by NGN and run through the applicable NGN waterfall to determine their related projected cash flows. As shown in Table 5, the NGN-

[34] The NGNs remaining after yearend 2017 do not mature until 2020 and 2021. Because these NGNs do not have a call feature (other than a clean-up call provision when the Legacy Asset balances are 10 percent or less or their balances when transferred to the NGNs, which NCUA does not expect to be triggered), they cannot be retired early.

related cash flows include guaranty fees paid to NCUA, guaranty payments made by NCUA to NGN investors for principal and interest shortfalls, guaranty reimbursements made to NCUA for any guaranty payments made, and any residual cash flows left after all of these payments have been made. The present value of the NGN cash flows is determined by the same discounting approach discussed above.

Table 5: Discounted NGN Cash Flows (dollars in billions)

Cash Flow	Scenario			Differences from Base	
	Base	Adverse	Severely Adverse	Adverse	Severely Adverse
Guaranty Fees	$0.1	$0.1	$0.1	$0.0	$0.0
Guaranty Payments	($3.2)	($4.0)	($4.4)	($0.8)	($1.2)
Guaranty Reimbursements	$3.0	$3.3	$3.5	$0.3	$0.5
Residuals	$3.5	$2.1	$1.3	($1.4)	($2.2)
Total	**$3.4**	**$1.5**	**$0.5**	**($1.9)**	**($2.9)**

NCUA then applied the un-securitized projected Legacy Asset cash flows and NGN cash flows to the applicable asset management estates based on the payout priorities in NCUA regulations.[35] This results in an estimate of the change in the net receivable from asset management estates due to NCUA, as well as changes in NCUA's projected recovery on the U.S. Central capital note.[36] For each asset management estate, the impact of the stress scenarios will differ depending on the specific circumstances of the estate. While the decreases in Legacy Asset and NGN cash flows under the Adverse and Severely Adverse scenarios are approximately $2 billion and $3 billion, respectively, the net impact on the value of NCUA's claims – and ultimately the equity ratio – is

[35] Payout priorities are outlined in 12 CFR 709.5.
[36] For more information on the U.S. Central capital note, see NCUA's costs and assessments Q&A (https://www.ncua.gov/Resources/Documents/QA-Corporate-Resolution-Costs-and-Assessments.pdf).

different, primarily due to how these funds flow through the payout priorities applicable to each asset management estate. This is shown in Table 6.

Table 6: Net Receivable to NCUA plus U.S. Central Capital Note Recovery (dollars in billions)

Estate	**Scenario**			**Differences from Base**	
	Base	**Adverse**	**Severely Adverse**	**Adverse**	**Severely Adverse**
U.S. Central[37]	$0.9	$0.9	$0.5	$0.0	($0.4)
WesCorp	$0.9	$0.5	$0.3	($0.4)	($0.6)
Members	$0.2	$0.2	$0.1	$0.0	($0.1)
Southwest	$0.0	$0.0	$0.0	$0.0	$0.0
Constitution	$0.0	$0.0	$0.0	$0.0	$0.0
Total	**$2.0**	**$1.6**	**$0.9**	**($0.4)**	**($1.1)**

Under the Adverse scenario, NCUA projects a decline in value of its receivables from asset management estates, net of approximately $400 million, which would equate to a 4-basis point reduction in the Share Insurance Fund's equity ratio. Under the Severely Adverse scenario, the potential decline in value is approximately $1.1 billion or 11 basis points.[38]

[37] These numbers represent both the $0.1 billion of net receivable due to NCUA and the $0.8 billion expected to be recognized for the U.S. Central capital note. While NCUA believes the full $1 billion capital note will be collected, $0.8 billion represents NCUA's estimate of the recognizable value under accounting rules at yearend 2017.

[38] There are four asset management estates projected to have recoveries for investors in depleted capital instruments of the failed corporates. Depleted capital recoveries would decrease by approximately $1.5 billion and $1.7 billion under the Adverse and Severely Adverse scenarios, respectively. This estimate accounts for any depleted member capital claims the other four asset management estates have against the U.S. Central asset management estate. However, all five estates are currently expected to have outstanding senior creditor obligations, including to the Stabilization Fund (or Share Insurance Fund after closure) via the guaranty provided on the NGNs until 2021. Thus, until senior creditor obligations can be satisfied with certainty – that is repaid or fully funded, including for contingencies – it would be inappropriate for NCUA to make payments to the subordinated depleted capital claimants.

B. Determining Equity Needed to Cover Other Risks to the Equity Ratio of the Share Insurance Fund[39]

NCUA uses the relevant variables from the economic scenarios outlined above to project the values of the three primary drivers of the Share Insurance Fund: insured share growth, insurance losses, and yield on investments. NCUA developed regression equations that relate the historical movements of economic variables to movements in two of the primary drivers of the Share Insurance Fund equity ratio: insurance losses and growth in insured shares. The equations translate the economic conditions in the Adverse and Severely Adverse scenarios into projections of the level of losses and insured share growth. The equations are relatively straightforward and translate economic developments into Share Insurance Fund drivers in a commonsense way using historical data that extends back to the early-to-mid 1990s. For example, the equation for share growth relates annual growth in total shares (inflation-adjusted) from 1991 to 2016 to the unemployment rate, the change in the average annual unemployment rate, the change in the average annual three-month Treasury bill, and the year-to-year growth in real disposable income. In the equation, a rise in unemployment first raises share growth, but continued high unemployment eventually leads to lower growth. Faster income growth tends to lead to faster share growth, and a rising interest rate tends to reduce share growth.

[39] The performance of the Share Insurance Fund described here does not include the losses discussed above related to the claims on the corporate credit union asset management estates. The Share Insurance Fund performance is modeled here based on the current financial position, without factoring in the potential Stabilization Fund closure.

For the insurance loss equation, NCUA projects the portion of shares accounted for by CAMEL 4 and 5 rated federally insured credit unions using data from 1996 to 2016 for the unemployment rate and house price growth.[40] As expected, a higher unemployment rate tends to increase insurance losses, as does falling house prices. Then, the dollar value of losses is projected as a constant percentage of the portion of shares in CAMEL 4 and 5 rated institutions.

To determine the yield on the Share Insurance Fund investment portfolio, interest rate inputs are taken directly from the Adverse and Severely Adverse stress scenarios. These inputs are applied to the Share Insurance Fund's investment portfolio assuming a seven-year ladder.[41] Table 7 outlines the resulting inputs used each year of the projections for the key drivers to forecast the equity ratio under the various stress scenarios.[42]

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[40] See Letter to Credit Unions 07-CU-12 *CAMEL Rating System* for more information on NCUA's CAMEL rating system.

[41] The interest rate inputs used were provided by Macroeconomic Advisers, LLC (April 2017). These inputs were used for two reasons: (1) the Federal Reserve scenarios do not provide the yield on the seven-year Treasury note, which NCUA uses in the stress scenarios. Macroeconomic Advisers uses its proprietary model to extend the Federal Reserve scenarios to a wider array of economic variables, including the full yield curve. (2) Macroeconomic Advisers advances the beginning of the Federal Reserve scenarios to the second quarter of 2017, rather than beginning in the first quarter. This was necessary because, when conducing analysis of the Share Insurance Fund, first quarter data was already known. Macroeconomic Advisers scenarios match the Federal Reserve scenarios for variables provided by the Federal Reserve, but the timing is advanced on quarter into the future relative to the published Federal Reserve scenarios, so that the Adverse and Severely Adverse shocks begin in the second quarter of 2017. Using these scenarios allows NCUA to implement the full effects of the downturn scenarios developed by the Federal Reserve.

[42] These are stress scenarios and do not represent forecasts of likely outcomes. Federal Reserve stress scenarios provide data through the first quarter of 2020. These scenarios are extended through 2021 by Macroeconomic Advisers, LLC using a proprietary model. NCUA assumes that values for the economic variables in 2022 are the same as they were in 2021 (for variables that are rates or growth rates).

Table 7: Projected Inputs for the Primary Drivers of the Equity Ratio[43]

	Base	Adverse	Severely Adverse
Insured Share Growth	2017: 5.10% 2018: 5.30% 2019: 5.50% 2020: 5.60% 2021: 6.00% 2022: 5.70%	2017: 6.60% 2018: 6.30% 2019: 4.20% 2020: 3.70% 2021: 3.90% 2022: 4.67%	2017: 6.92% 2018: 6.20% 2019: 2.34% 2020: 1.66% 2021: 2.48% 2022: 3.90%
Insurance Losses (in millions)	2017: $52.1 2018: $58.1 2019: $52.4 2020: $60.2 2021: $78.1 2022: $76.7	2017: $142.0 2018: $311.2 2019: $257.8 2020: $202.8 2021: $164.2 2022: $188.6	2017: $216.0 2018: $532.0 2019: $425.4 2020: $292.4 2021: $230.4 2022: $269.6
Yield on Investment Portfolio	2017: 1.64% 2018: 1.92% 2019: 2.16% 2020: 2.40% 2021: 2.57% 2022: 2.74%	2017: 1.56% 2018: 1.73% 2019: 1.84% 2020: 1.93% 2021: 2.00% 2022: 2.05%	2017: 1.48% 2018: 1.49% 2019: 1.47% 2020: 1.47% 2021: 1.46% 2022: 1.51%

As shown above, insured share growth rises initially as consumers move funds into safer, federally insured savings instruments – a pattern that is highly correlated to economic downturns. After an initial surge, growth in insured shares slows reflecting worsening economic conditions. Toward the end of the stress scenarios, growth begins to increase reflecting some rebound in the overall economy. Insurance losses peak at the beginning of the economic stress and then decline and stabilize over the following years. Overnight rates drop to 10 basis points for the entire period and the yield on investments drops over the first three years, and then increases as the economy begins to recover.

[43] NCUA used the current budget growth of 4.1 percent in each scenario as the operating expense input.

The results of each stress scenario, expressed as the calendar yearend Share Insurance Fund equity ratio, are included in Table 8 (based on the current equity ratio of 1.26 percent).[44]

Table 8: Projected Equity Ratio under Various Economic Stresses[45]

	2017q1	2017	2018	2019	2020	2021	2022
Baseline	1.26%	1.26%	1.24%	1.24%	1.23%	1.23%	1.23%
Adverse	1.26%	1.25%	1.21%	1.18%	1.16%	1.15%	1.14%
Severely Adverse	1.26%	1.24%	1.18%	1.13%	1.11%	1.09%	1.06%

Neither the Adverse nor the Severely Adverse scenario causes the equity ratio of the Share Insurance Fund to fall below 1.00 percent, the level at which credit union's contributed capital deposit would begin to be impaired.[46] However, by yearend 2019, under both the Adverse and Severely Adverse scenarios, the equity ratio falls below 1.20 percent – the statutory trigger for either assessing premiums or developing a Share Insurance Fund restoration plan. Under the Adverse and Severely Adverse scenarios, for the equity ratio to not fall below 1.20 percent during the full projection timeframe, the equity ratio at yearend 2017 would have to be 1.33 percent and 1.41 percent, respectively.[47] However, the actual results could vary from these projections based on a variety of factors, including:

[44] Using the figures in Table 1 and Table 3 above, the calendar yearend equity ratio of the Share Insurance Fund is projected to be 1.23 percent, if the Stabilization Fund is not closed in 2017.
[45] These scenarios do not account for any substantial increase in NCUA's operating budget or increases in the loss rate of CAMEL 4 and 5 rated credit unions, both of which may increase in times of economic stress.
[46] Credit unions' one percent contributed capital deposits are included in the numerator of the equity ratio and are available to absorb losses of the Share Insurance Fund. However, because the contributed capital deposits are recorded both as equity to the Share Insurance Fund and as assets to credit unions, if NCUA were to use any part of this capital to absorb losses, credit unions would have to write-down (expense) this asset. At the same time, credit unions would be required to deposit additional funds to adjust their contributions back to a full one percent of their insured shares.
[47] Similar results are obtained if the Share Insurance Fund is stressed over two years using the highest observed stress factors during the last ten years.

- Projected declines in the equity ratio, even under no economic stress.
- Extraordinary losses and/or failures in credit unions that are not market related, such as those from fraud or other asset “bubbles”.
- Unusual or abnormally high insured share growth materially different from the historical correlation.
- Economic conditions that involve greater volatility in one or more market indicators as compared to the stress scenarios modeled.

C. Approach for Setting the Normal Operating Level

The Board has the responsibility to be prudent in managing the Share Insurance Fund. In addition to maintaining public confidence in federal share insurance, it is important that NCUA maintain a strong Share Insurance Fund for the mutual benefit of the credit union community and the taxpayers. The Board believes that the Share Insurance Fund should be able to withstand a moderate recession without the equity ratio falling below 1.20 percent. This approach is consistent with the Act’s minimum equity level for the Share Insurance Fund set by Congress. Additionally, it allows NCUA to maintain a counter-cyclical posture, which helps to ensure that credit unions will not need to impair their contributed capital deposit or pay premiums when they can least afford it. The Board does not believe it should set the normal operating level at a point where mandatory premiums or development of a Fund restoration plan would be necessary in a moderate recession.[48]

The Board also considered the amount of equity necessary for the Share Insurance Fund to withstand a severe global recession without having the equity ratio fall below 1.20 percent. While the Severely Adverse stress scenario is more conservative, the Board believes managing to the Adverse scenario provides a good balance between maintaining sufficient equity in the Share Insurance Fund and keeping money at work in the credit union community.

Based on the analyses above, Table 9 shows the calculation of what the equity ratio needs to be to withstand a moderate and a severe recession without falling below 1.20 percent.

[48] The Board believes its authority to establish a Fund restoration plan in lieu of mandatory premiums should only be used for severe, unexpected circumstances. While the Board can develop a restoration plan to restore the Share Insurance Fund to 1.20 percent within eight years (or longer in extraordinary circumstances), this could necessitate one or more relatively large premiums. Further, it could erode public confidence in federal share insurance.

Table 9: Equity Ratio Needed to Withstand an Economic Stress by Risk

	Adverse Stress Scenario	**Severely Adverse Stress Scenario**
Equity for Share Insurance Fund Stress	1.33%[49]	1.41%
Equity for Claims on AMEs (see Table 6)	0.04%	0.11%
Projected Equity Ratio Decline in 2018 and 2019 (based on current performance trends)[50]	0.02%	0.02%
Total	**1.39%**	**1.54%**[51]

To withstand a moderate recession without the equity ratio falling below 1.20 percent, the Share Insurance Fund's equity ratio needs to be high enough to withstand the following:

- A 13 basis point decline in the equity ratio due to the impact on the three primary drivers of the Share Insurance Fund's performance.
- A 4 basis point decline in the value of the Share Insurance Fund's claim on the corporate credit union asset management estates.
- A 2 basis point decline in the equity ratio expected to occur prior to when the remaining NGNs begin to mature in 2020 and remaining exposure to the Legacy Assets can begin to be reduced. This helps ensure the 4 basis points of additional equity to account for the

[49] The 2007 Board-approved policy would also result in a recommended normal operating level above 1.30 percent. To date, the Board has maintained the normal operating level at 1.30 percent, which has allowed NCUA to use the excess equity to help repay outstanding U.S. Treasury borrowings.
[50] The equity ratio has been declining over the last several years and is expected to continue to decline because of the low yield on Share Insurance Fund investments and strong insured share growth. For additional information on the methodology used to project the equity ratio using current trends, refer to the information provided at the November 2016 Open Board Meeting (https://www.ncua.gov/About/Documents/Agenda%20Items/AG20161117Item5a.pdf).
[51] This exceeds the statutory maximum normal operating level of 1.50 percent.

> potential decline in value of the claims on the asset management estates is maintained in the Share Insurance Fund until Legacy Assets can be sold.[52]

Therefore, the Board proposes to set the normal operating level at 1.39 percent. Based on the yearend equity ratio projections of 1.45 percent to 1.47 percent from Table 3, this would result in an estimated initial Share Insurance Fund distribution of 6 to 8 basis points (approximately $600 to $800 million) paid in 2018.[53]

Policy for Setting the Normal Operating Level

The Board retains the authority to reassess and set the normal operating level periodically, in particular when there are changes in the risks to the Share Insurance Fund's equity ratio, such as maturity of the NGNs. Based on the approach discussed above, the Board proposes to replace its current policy for setting the normal operating level with the following.[54]

Periodically, NCUA will review the equity needs of the Share Insurance Fund and provide this analysis to stakeholders. Board action is only necessary when this review determines that a change in the normal operating level is warranted. Any change to the normal operating level of

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[52] The Board must consider retaining this equity now, because as the equity ratio declines, the Board would be unable to replenish the equity through premium assessments as long as the equity ratio remains above 1.30 percent, per the Act. 12 U.S.C. § 1782(c)(2)(B).

[53] The 4 basis points of equity included for covering losses on the Share Insurance Fund's claims against the corporate asset management estates, along with any recognition permitted on the outstanding balance of the $1 billion U.S. Central capital note (an estimated range of 2 to 5 basis points of equity), may be available for a future Share Insurance Fund distribution – provided it is not consumed by an increase in future legacy asset losses from an economic downturn or other losses and factors affecting the equity ratio. Future distributions also depend on any subsequent changes the Board might make to the normal operating level.

[54] The current policy was approved at the December 3, 2007 NCUA Board meeting open to the public.

more than 1 basis point shall be made only after a public announcement of the proposed adjustment and opportunity for comment. In soliciting comment, NCUA will issue a report including data supporting the proposal.

The Board's main objectives in setting the normal operating level are to:

- Retain public confidence in federal share insurance,
- Prevent impairment of the one percent contributed capital deposit, and
- Ensure the Share Insurance Fund can withstand a moderate recession without the equity ratio declining below 1.20 percent over a five-year period.

V. Request for Comment

The Board seeks comments on the proposed closure of the Stabilization Fund in 2017 and the related approach for setting the normal operating level of the Share Insurance Fund. Commenters are also encouraged to discuss any other relevant issues they believe the Board should consider with respect to this matter. In particular, the Board is interested in comments on whether to:

- Close the Stabilization Fund in 2017, close it at some future date, or wait until it is currently scheduled to close in 2021.

- Set the normal operating level based on the Share Insurance Fund's ability to withstand a moderate recession. Or, should the Share Insurance Fund be able to withstand a severe recession.
- Base the approach to setting the normal operating level on preventing the equity ratio from declining below 1.20 percent, or some other higher minimum level.

Commenters are encouraged to provide the specific basis for their comments and, to the extent feasible, documentation to support any recommendations.

By the National Credit Union Administration Board on July __2017.

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Gerard S. Poliquin

Secretary of the Board