BOARD ACTION MEMORANDUM

TO: NCUA Board **DATE:** September 22, 2009

FROM: Director, Office of Examination and Insurance **SUBJ:** Premium Assessments

ACTION ITEM: Approval of the following:

1. Assess each federally insured credit union a premium sufficient to return the National Credit Union Share Insurance Fund's (NCUSIF) equity to 0.30 percent of June 30, 2009 insured shares as provided under Section 202(c)(2) of the Federal Credit Union Act. The amount of the NCUSIF premium is $727.5 million and equates to 0.1027 percent of federally insured shares for the *reporting period* as defined by Section 741.4(b)(5) of NCUA Rules and Regulations.
2. Assess each federally insured credit union a special premium of 0.0473 percent of June 30, 2009 insured shares to repay a portion of the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) as defined by Section 217(d) of the FCU Act. The amount of the Stabilization Fund repayment is $337.8 million. The total will be split between the payment of accrued interest thru June 30, 2010 and a portion of the Stabilization Fund borrowings, as provided under Section 217(c)(3) of the FCU Act.

ACTION DATE: September 24, 2009

OTHER OFFICES CONSULTED: Office of General Counsel and the Office of the Chief Financial Officer

VIEWS OF OTHER OFFICES CONSULTED: Concur.

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes.

BUDGET IMPACT, IF ANY: NCUSIF receipt of $727.5 million in premium charges. Stabilization Fund recognition of the special assessment income of $337.8 million, repayment of $310 million of the $1 billion in funds borrowed and retention of cash for payment of accrued interest on the borrowed funds.

RESPONSIBLE STAFF MEMBERS: Melinda Love, Director Office of Examination and Insurance; Mary Ann Woodson, Chief Financial Officer

SUMMARY: Staff recommends a total assessment of 0.15 percent of insured shares to fund the following: (1) a premium sufficient to return the NCUSIF's equity to 1.30 percent of June 30, 2009 insured shares; (2) repayment of $310 million of the funds the Stabilization Fund has borrowed from Treasury and; (3) repayment of all accrued interest on June 30, 2010.

Following the June implementation of the Stabilization Fund, all federally insured credit unions were advised to adjust their premium expense estimate to 0.15 percent of insured shares. This assessment will maintain the NCUSIF near the normal operating level (NOL) and begin the repayment of the liabilities associated with the corporate credit union stabilization plan.

Background

The Credit Union Membership Access Act (CUMAA) of 1998 mandated that the NCUA Board set the NOL of the NCUSIF beginning in the year 2000 at a percentage not less than 1.20 percent and not more than 1.50 percent. Since December 1999, the NOL has been set at 1.30 percent. The NCUSIF's actual equity ratio has ranged from a low of 1.25 percent to a high of 1.30 percent over the last decade, with the equity ratio at 1.30 percent from 1995 through 2000. In 2001, insured deposits grew nearly 14 percent, reducing the equity ratio to 1.25 percent.[1] From 2002 through 2006, the equity ratio experienced slow growth and reached 1.30 percent as of December 31, 2006, resulting in the distribution of a $51.5 million dividend.

Since the NCUSIF was capitalized in 1985, only one insurance premium has been assessed. That single premium assessment of $165 million (0.0834 percent of insured shares) took place in 1992. The premium was necessary to address significant NCUSIF losses incurred from the problems in New England area credit unions and in the distressed real estate market. Without the premium, the NCUSIF's equity ratio would have declined to 1.18 percent.

As part of the January 2009 corporate stabilization program action, the Board declared a premium assessment, to be collected later this year, sufficient to restore the NCUSIF equity ratio to 1.30 percent. Given the estimated size of the NCUSIF liability from the action, many credit unions recorded an estimated premium expense of 0.30 percent of insured shares during the first quarter of 2009.

In May 2009, Congress authorized the establishment of the Stabilization Fund. The newly established Stabilization Fund allows for the incremental payment of the liability incurred from the corporate stabilization actions. At that time, the NCUSIF premium expense estimate for 2009 was set at 0.15 percent of insured shares based on an initial review by NCUA staff. The review included analyzing the numerous variables that go into determining the liability for the corporate actions and the various income sources for the Stabilization Fund that will ultimately impact the expense to credit unions. The result was most credit unions reducing their premium expense estimate to the new projected 2009 expense level.

[1] In addition to the high level of growth in insured shares, the NCUSIF's equity ratio declined in 2001 due to the disbursement of a $99 million dividend associated with insured shares as of December 31, 2000, which was paid in 2001. Additionally, a change in the overhead transfer rate increased the operating expenses charged to the fund by $23 million. The methodology employed since 2003 in computing the overhead transfer rate reduces the likelihood of such a large fluctuation in the amount of operating expenses charged to the Fund.

NCUSIF Premium Assessment

Since the beginning of January 2009, there has been an increasing trend in the level of distressed assets in natural person credit unions (NPCUs). This impacts both the recommended premium assessment level and the recommended distribution of the assessment between the NCUSIF and the Stabilization Fund.

The premium calculation is based on the new $250,000 share insurance coverage limit. On May 20, 2009 the President signed the Helping Families Save Their Homes Act of 2009, which extended the temporary share insurance coverage limit from $100,000 to $250,000 through the end of 2013. The legislation also eliminated the provision in the Emergency Economic Stabilization Act of 2008 that prevented the NCUA from considering this temporary increase in share insurance coverage for purposes of computing the NCUSIF's equity ratio and determining assessments.

NCUSIF's Current Equity Ratio

The following table contains the calculation of the NCUSIF's current equity ratio.

Total Insured Shares as of June 30, 2009 (rounded)	713,580,500,000	
1% of Insured Shares - Contributed Capital		7,135,805,000
NCUSIF Retained Earnings as of August 31, 2009 (RE)	2,213,247,196	
Less:		
Estimated accrual for the premium currently recorded as a result of the January 2009 NCUA Board Action	800,000,000	
Adjusted Retained Earnings		1,413,247,196
Total NCUSIF Equity (RE and 1% Contributed Capital)		8,549,052,196
Equity Ratio with fully funded Contributed Capital[2]		1.198%

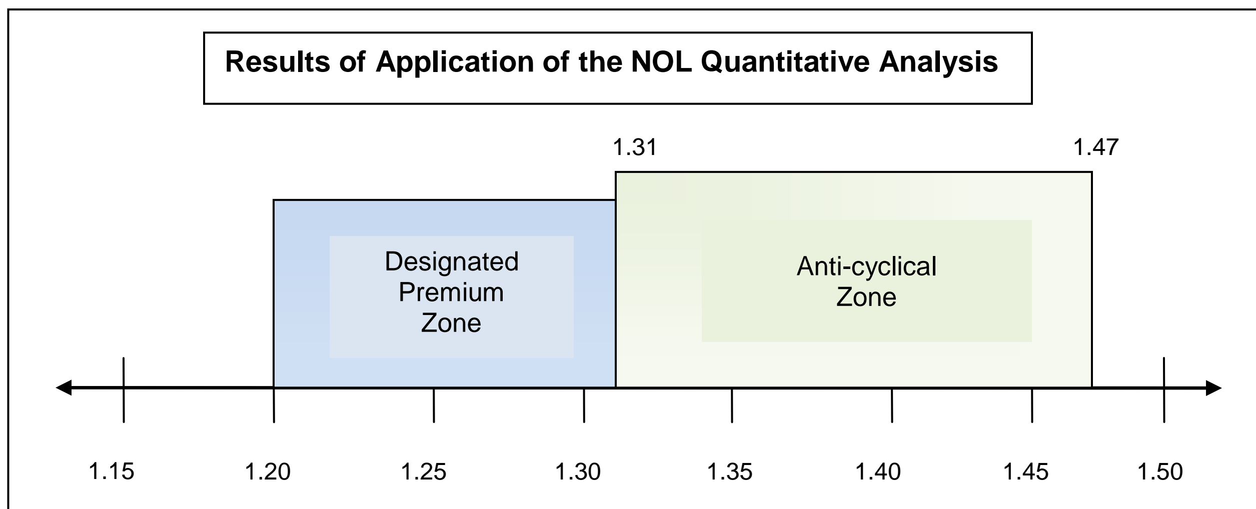
Application of the Policy on Setting the Normal Operating Level (NOL)

The current policy for setting the NOL outlines the stress scenarios to be applied in preparing a quantitative analysis to support setting the level. The stress scenarios include the application of:

[2] The increase in share insurance coverage reduced the equity ratio by 2 basis points. The equity ratio would have been 1.214 percent, based on insured shares of $655 billion at the $100,000 insurance level.

- The highest level of insured share growth experienced in the last 10 years with a minimum of 5 percent;
- The highest level of growth in NCUSIF operating expenses in the last 10 years with a minimum of 5 percent;[3]
- The highest level of insurance losses in the last 10 years measured as a percentage of the NCUSIF's equity, subject to a minimum of $100 million indexed to a measure of concentration risk; and
- A 300 basis point downward shock of interest rates applied to the NCUSIF investment portfolio.

Since implementation of the policy, all of the factors have caused increased stress to the NCUSIF. The difficult 2008 economic and financial environment resulted in the establishment of new extremes in two of the four factors. After the high level of losses experienced in 2008 and the low rate of return on investments were included in the calculation, the amount of equity the NCUSIF would need to withstand the stress scenarios addressed in the policy increased from 1.30 percent to over 1.47 percent (see the diagram below). The top of the designated premium zone increased from 1.24 percent to 1.31 percent, but is limited to 1.30 by the policy.[4]



Staff is not recommending a change in the NOL at this time, but rather a further study of the NOL in early 2010. Additionally, per policy, any increase to the NOL of more than 1 basis point shall be made only after a public announcement of the proposed adjustment and opportunity for comment. In soliciting comments, NCUA would issue a report including data supporting the proposal.

[3] The major anomaly in the growth rate of NCUSIF operating expenses that occurred in 2001 due to the transition in the application of the overhead transfer rate was excluded. See footnote 1.

[4] *Designated Premium Point*. This is the equity ratio needed so the stressed equity ratio equals 1.20 percent. The equity ratio determined by this calculation will be set as the designated premium point. The designated premium point may not be set below 1.22 percent, nor above 1.30 percent.

Stress Testing Results

Stress testing of the NCUSIF provides further support for maintaining the NOL at not less than 1.30 percent and returning the NCUSIF's June 30, 2009 equity ratio to 1.30 percent. Staff updated the December 2008 analysis of the impact of the distressed real estate market and analysis of the potential corporate credit union (CCU) system losses. The analysis also included a new stress test similar to the Supervisory Capital Assessment Program (SCAP) the U.S. federal banking supervisors applied to the largest bank holding companies in the spring of 2009. It is important to note that this testing does not represent what NCUA staff predicts will happen in the future, but rather, these are measures of more adverse stress that serve to provide a point of reference for contingency planning and determining adequate reserve levels.

The following are highlights from each of the four stress tests, which include:

1. Evaluating potential failures and losses due to the distressed real estate market, which includes applying an immediate shock on reserves given a variety of default and loss rates in NPCU real estate portfolios. The analysis revealed rising levels of defaults on all real estate related loans and rising levels of losses associated with the defaults. Additionally, the consensus forecast predicts further increases in the level of defaults. NCUA's 2-year stress scenario resulted in the allocation of $32.5 billion in projected losses amongst NPCUs resulting in the potential failure of 90 NPCUs and a worst case projected loss exposure to the NCUSIF of $1.4 billion.

2. Measuring the risk presented by CCUs consisted of a complete write-off of current NPCU capital investments in CCUs, as well as the impact of an immediate assessment to NPCUs of an estimated Stabilization Fund liability of $7 billion. The analysis resulted in the allocation of $9.3 billion in losses amongst NPCUs and resulted in a projection of 25 NPCU failures presenting a maximum exposure to the NCUSIF of $80 million.

3. Evaluating the impact from both the real estate stresses and the CCU system, which allowed for analysis of the risk layering. As with the 2008 analysis, the layering of both the real estate and CCU risk on individual NPCUs resulted in a pronounced increase in both the number of failures and the level of potential losses to the NCUSIF. Combining the 2-year real estate stress scenario with the CCU stress scenario resulted in a projection of 227 NPCU failures and a maximum exposure to the NCUSIF of $6.4 billion.

4. Performing stress testing based upon the Treasury's Supervisory Capital Assessment Program. This analysis provided a 2-year stress scenario under both an assumed path for the economy (baseline) and a deeper more protracted downturn (more adverse) that included non-real estate loans. This testing provided a measure of a NPCU's capital buffer. The baseline analysis produced an allocation of $32.6 billion in losses resulting in 38 failures with a maximum

exposure to the NCUSIF of $577 million. The more adverse scenario resulted in an allocation of $56.4 billion in losses resulting in 519 NPCU failures at a maximum exposure of $15.5 billion to the NCUSIF.

While none of the scenarios are catastrophic for the credit union system, all indicators point to a rising number of credit union failures through at least 2010. This is further compounded by the expected lower demand for mergers and acquisitions, which may lead to higher resolution cost on individual cases and an increased number of liquidations.

The measurement of the maximum loss exposure calculated in this analysis is consistent with the results achieved through the credit risk analysis completed in the prior stress analysis. The more adverse loss scenarios disclose potential risk to the NCUSIF. However, the entire NCUSIF (contributed capital and retained earnings) covers a very high percentage of any reasonable loss scenarios.

Premium Assessment

The June 30, 2009 NCUSIF equity ratio declined to 1.198 percent when adjusted for a fully funded 1 percent contributed capital and without the benefit of a premium. Staff is fully aware that a share insurance premium in times of economic and financial stress is not desirable. However, the stress analysis points to rising levels of risk and the expectation for more failures in the next year. Additionally, the continued severe problems in the housing sector, financial markets and commercial real estate contribute to staff's expectation of significantly higher losses for the NCUSIF. Staff believes that it is important that the NCUSIF not decline to a level that could undermine public confidence. In staff's view, maintaining the NCUSIF at the NOL of 1.30 percent will achieve this goal.

The amount of premium needed to return the NCUSIF's equity to 0.30 percent is $727.5 million or 0.1027 percent of insured shares.[5] For NPCUs, the premium is $725.3 or 0.083 percent of aggregate assets. Corporate credit unions will pay $2.2 million.

Without receipt of the previously declared premium, the NCUSIF's equity ratio would fall below 1.20 percent, triggering the statutory requirement for preparation of a restoration plan.[6] Depending on the level of incurred losses in 2010, the equity ratio could decline close to or below the 1.0 percent level. If the equity ratio falls below 1.0 percent, credit unions would be statutorily required to immediately replenish the NCUSIF Capitalization Deposit to return the equity ratio to 1.0 percent. Replenishing the NCUSIF now, rather than allowing it to decline using the 8 year repayment schedule, will assist credit unions in avoiding this immediate and anti-cyclical funding requirement.

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[5] The calculation: (*insured shares* * 0.30%) – *retained earnings* = *Premium*
(713,580,500,000 * 0.30%) – 1,413,247,1964 = 727,494,304

[6] Section 204(e) of the FCU as revised by the Helping Families Save Their Homes Act.

While it is difficult to project share growth and the level of losses the NCUSIF will need to expense through the end of the year to fund known and anticipated losses, staff believes the yearend equity ratio will remain near 1.30 percent. Should the equity ratio exceed 1.30 percent, the Fund is prohibited from making the dividend distribution to insured credit unions while the Stabilization Fund has outstanding advances. In lieu of a dividend, the excess equity would be distributed to the Stabilization Fund to pay down any outstanding borrowings.

Stabilization Fund

The Helping Families Save Their Homes Act added §217 to the Federal Credit Union Act to create the Stabilization Fund. The Stabilization Fund can only be used to pay expenses associated with the ongoing problems in the corporate credit union system including payments connected to the conservatorship, liquidation, or threatened conservatorship or liquidation of a corporate credit union. The primary purpose of the Stabilization Fund is to assess over multiple years the cost to insured credit unions associated with the corporate credit union stabilization effort.

To pay for the costs associated with the corporate credit union system, the NCUA Board can borrow up to $6 billion from the Treasury on a revolving basis to make payments from the Stabilization Fund with the ability to increase the funding to $30 billion. All borrowings must be repaid to Treasury with interest. The Board has discretion as to the timing of each payment and the amount of principal included with each repayment, as long as all advances are paid in full within the statutory time limitations. The Board will impose assessments on all federally-insured credit unions as the NCUA determines are necessary to make each repayment.

The Stabilization Fund must repay the Treasury and close down within seven years of taking the first advance. On June 28, 2009, the Stabilization Fund borrowed $1 billion to assume the NCUSIF's Capital Note at U.S. Central Federal Credit Union (U.S. Central). On September 26, 2016, the seventh anniversary of the initial Stabilization Fund advance, the Stabilization Fund will need to fully pay any outstanding liabilities and close. The Board may extend the final repayment date with the prior concurrence of the Secretary of the Treasury.

Stabilization Fund - Repayment Schedule and Assessment

Updated analysis of the corporate credit union securities collateralized by mortgage loans and commercial real estate disclosed a marginal deterioration in anticipated performance. The result was an increase in the total recorded corporate stabilization action liability from $5.98 billion to $6.33 billion. The increase is the result of the changing exposure from the Temporary Corporate Credit Union Share Guarantee Program (TCCUSGP), given the change in expected performance estimates of the corporate system's mortgage backed assets. This portion of the recorded corporate stabilization action liability program will increase from $4.98 billion to $5.33 billion.

While the Stabilization Fund has the $6.33 billion recorded liability, current borrowings from Treasury total $1 billion. The borrowed funds facilitated the transfer of rights and ownership of the U.S. Central Capital Note issued by the NCUSIF in January 2009. By statute, NCUA assesses credit unions to repay outstanding borrowings. Presently, the total is $1 billion plus accrued interest on the borrowed funds. As necessary, NCUA will borrow additional funds to cover realized losses and other resolution actions.

Staff recommends scheduling a repayment of $310 million of the borrowed funds and repayment of all accrued interest as of June 30, 2010. An assessment of 0.0473 percent of insured shares will raise $337.8 and accomplish these goals. Imposing a rather small assessment at this time is consistent with our desire to minimize premiums during difficult times while still beginning the process of liquidating the CCU system liability.

RECOMMENDED ACTION: Approve a total assessment of 0.15 percent of insured shares to fund the following: (1) a NCUSIF premium (0.1027 percent of insured shares) sufficient to return the NCUSIF's equity to 0.30 percent of June 30, 2009 insured shares; (2) repayment of $310 million of the Stabilization Fund's borrowings from Treasury and; (3) repayment of all accrued interest on June 30, 2010.

ATTACHMENT:

1. National Credit Union Share Insurance Fund Stress Testing Results

2. Corporate Credit Union Reserve