The NCUA OIG received a request from Callahan & Associates, Inc. (Callahan & Associates) to determine “the legality of the NCUA Board’s approval” to transfer funds from the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to the National Credit Union Share Insurance Fund (Share Insurance Fund) and increasing the Share Insurance Fund’s normal operating level (NOL) from 1.30 percent to 1.39 percent.¹

The OIG determined it is not within the purview of the IG Act to conduct a legal review of the Board’s statutory authority. Consequently, we limited our evaluation to determining the Board’s rationale for setting the NOL at 1.39 percent, effective September 29, 2017.

In conducting our evaluation, we reviewed applicable legislation and NCUA management’s (NCUA) and the Board’s process and rationale for setting the NOL at 1.39 percent. In addition, we compared the NCUA’s rationale for recommending the most recent NOL for the Share Insurance Fund to the FDIC’s rationale when it recommended increasing the Deposit Insurance Fund’s Designated Reserve Ratio effective in 2011.

Legislation and Policy

We summarize pertinent statutory and policy provisions as follows:

- **Equity Ratio:**
  
  o 12 U.S.C. § 1782(h)(2) defines the equity ratio as the ratio of the amount of Share Insurance Fund capitalization, including insured credit unions’ one 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 for losses has been made) to the aggregate amount of the insured shares in all insured credit unions.

Normal Operating Level:

- 12 U.S.C § 1782(h)(4) defines the normal operating level as “…an equity range specified by the Board, which shall be not less than 1.2 percent and not more than 1.5 percent.”
- NCUA pointed out, and we confirmed during our review, that the “Federal Credit Union Act does not prescribe how frequently the NCUA Board must review or set the NOL.” However, on December 13, 2007, the NCUA Board approved a policy for Setting the Operating Level and Monitoring the National Credit Union Share Insurance Fund establishing that:
  - “At least annually, NCUA staff will review the level at which the NOL is set and report this information to the Board. Board action is only necessary when a change in the NOL is determined to be warranted.”
  - “The setting of the NOL will involve both quantitative and qualitative analysis. The results of the quantitative analysis will be the primary driver in setting the NOL, with the qualitative factors considered as appropriate by the Board.”
  - The quantitative analysis involves projecting “…the equity ratio over a two-year horizon subject to defined criteria that will stress the equity ratio.” The four key factors that affect the equity ratio are: (1) Insured Share [growth], (2) [growth in] Operating Expenses; (3) Insurance Losses; and (4) [decline in] Investment Income.”

Closure and Distribution of the Stabilization Fund:

- 12 U.S.C § 1790e(h) provides that “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.”

Historical Actions Associated with the Net Operating Level

We reviewed NCUA and Board actions pertaining to the Share Insurance Fund NOL prior to the Board setting the NOL at 1.39 percent, effective September 29, 2017. We learned:

---

2 The stated purpose of the policy is to provide “…transparency in how the normal operating level and associated dividends will be determined, provides stakeholders with information regarding the assessment of premiums, and ensures rigorous, ongoing analysis of the condition of the fund.”
December 3, 2004, Board Meeting:

- The Board Action Memorandum indicated that:
  
  o “At the October 1999 Board meeting, the NCUA Board *agreed* [emphasis added] that the NOL for each upcoming year would be established annually based upon a recommendation by NCUA staff.”

  o For calendar years 2000 – 2004, the Board approved an NOL of 1.30 percent.\(^3\)

- The Board approved retaining the 1.30 percent NOL for 2005.

December 13, 2007, Open Board Meeting:

- This was the last time the NCUA Board set the NOL - at 1.30 percent, effective January 1, 2008.\(^4\)

- The quantitative analysis NCUA staff conducted in recommending the 1.30 percent NOL incorporated, among other factors, the four primary drivers that impact the equity ratio (as addressed on page 3 above), and projected the equity ratio over a two-year period.\(^5\)

November 17, 2016, Open Board Meeting:

- Discussions during this Board meeting indicated that:

  o Credit unions experienced considerable growth in insured shares in recent years. The NCUA projected that because of the low interest-rate environment, the equity ratio would decline to between 1.24 percent and 1.27 percent during 2017. A premium of three to six basis points would have been necessary to restore the equity ratio to the 1.30 percent NOL.\(^6\)

Table 1 identifies NCUA’s record of the Share Insurance Fund’s equity ratio between 2008 and the second quarter of 2016 and the Board’s actions:

---

3 The Board Action Memorandum indicated: (1) the Share Insurance Fund’s equity ratio for October 2004 was 1.28 percent; (2) the NCUA expected the equity ratio to decline to 1.26 percent as of December 31, 2004 based on the projected total insured share growth for 2004; and (3) by March 2005, the NCUA anticipated the equity ratio would increase to 1.28 percent as a result of the additional one percent deposits due.

4 Discussion during the Board meeting highlighted: “The Fund’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…reducing the equity ratio from 1.30 percent to 1.25 percent. From 2002 through 2006, the equity ratio…reached the 1.30 percent normal operating level as of December 31, 2006[.]”

5 NCUA calculated the NOL as the “…level of equity needed to withstand two years of historical stress[.]”

6 NCUA indicated its projections did not account for extraordinary losses or an unforeseen downturn that might have resulted in the need for an additional or higher premium.
Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity Ratio (Year End)</th>
<th>NCUA Board Action (Premium or Distribution)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>1.26%</td>
<td>No Premium charged</td>
</tr>
<tr>
<td>2009</td>
<td>1.23%</td>
<td>Premium charged</td>
</tr>
<tr>
<td>2010</td>
<td>1.28%</td>
<td>Premium charged</td>
</tr>
<tr>
<td>2011</td>
<td>1.32%</td>
<td>Distribution from the Share Insurance Fund to the Stabilization Fund</td>
</tr>
<tr>
<td>2012</td>
<td>1.31%</td>
<td>Distribution from the Share Insurance Fund to the Stabilization Fund</td>
</tr>
<tr>
<td>2013</td>
<td>1.31%</td>
<td>Distribution from the Share Insurance Fund to the Stabilization Fund</td>
</tr>
<tr>
<td>2014</td>
<td>1.29%</td>
<td>No Premium charged</td>
</tr>
<tr>
<td>2015</td>
<td>1.26%</td>
<td>No Premium charged</td>
</tr>
<tr>
<td>2016</td>
<td>1.24%</td>
<td>No Premium charged</td>
</tr>
</tbody>
</table>

The NCUA proposed a three to six basis points share insurance premium range for credit unions to budget for in 2017. As illustrated in the table above, this proposed premium - if implemented - would have been the first premium imposed since 2010.

September 28, 2017, Open Board Meeting:

- During this meeting, the NCUA recommended the Board close the Stabilization Fund and set the Share Insurance Fund NOL at 1.39% based on the results of the Economic Stress Analysis approach. NCUA’s Office of the Chief Economist modeled changes using the economic scenarios developed by the Federal Reserve.8

- NCUA indicated that in closing the Stabilization Fund, credit unions will avoid a possible Share Insurance Fund premium in 2017 and possibly receive a distribution in 2018,9 “[a]bsent any significant changes in the economy or the Share Insurance Fund’s performance[.]”10

---

7 12 U.S.C. § 1790e provides that “At the end of any calendar year in which the Stabilization Fund has an outstanding advance from the Treasury, the Insurance Fund is prohibited from making the distribution to insured credit unions described in section 1782(c)(3) of this title. In lieu of the distribution described in that section, the Insurance Fund shall make a distribution to the Stabilization Fund of the maximum amount possible that does not reduce the Insurance Fund’s equity ratio below the normal operating level and does not reduce the Insurance Fund’s available assets ratio below 1.0 percent.” During the years presented in Table 1, the NOL was set at 1.30 percent.

8 The Federal Reserve’s Economic Stress Analysis approach models the primary drivers of the Share Insurance Fund’s equity ratio over a complete five-year economic cycle. This approach is based on economic scenarios the Federal Reserve developed to stress test banking entities under its supervision. See 12 U.S.C. § 5365(i).

9 The Board indicated, “Any 2018 distribution will be based on the statutory criteria of the actual year-end equity ratio relative to the 1.39 percent normal operating level.”

10 The Board indicated that previously the NCUA did not project a distribution to credit unions after the Stabilization Fund expired in 2021. A distribution only became possible after NCUA won legal recoveries on behalf of the five failed corporate credit unions of approximately $5.16 billion, which materially decreased the costs to the Stabilization Fund resulting from those failures.
o Discussions between the NCUA and the Board indicated that after closing the
Stabilization Fund, the Share Insurance Fund would bear the remaining risks associated with the corporate resolution program, including the potential for market-value adjustments and write-downs related to the Legacy Assets.

o The Board approved closing the Stabilization Fund, effective October 1, 2017 and raising the Share Insurance Fund’s normal operating level from 1.30 percent to 1.39 percent, effective September 29, 2017, to ensure sufficient equity. The NCUA Board stated that in addition to “[r]etaining public confidence in federal share insurance,” its “objectives in setting the normal operating level” are: “[p]reventing impairment of credit unions’ one percent contributed capital deposit; and [e]nsuring the Share Insurance Fund can withstand a moderate recession without the equity ratio falling below 1.20 percent for a five-year period.”

o To arrive at the recommended 1.39 percent NOL, NCUA modeled losses over five years in a moderate recession (pursuant to the adverse economic scenario developed by the Federal Reserve). Specifically, NCUA indicated to assess Share Insurance Fund performance, they looked at three primary drivers: (1) insurance losses, (2) insured share growth, and (3) yield on investments. Furthermore, NCUA indicated it modeled the Share Insurance Fund’s claims on the asset management estates under these scenarios.

Table 2 identifies the equity components and justifications for the approved NOL under the Adverse scenario:

---

11 The NCUA Board indicated, “Even though the Stabilization Fund is closed, there are remaining obligations of the Corporate System Resolution Program….Changes in the economy or the performance of the legacy assets securing the NCUA Guaranteed Notes program would increase the volatility of the Share Insurance Fund’s equity ratio.”

12 The NCUA Board indicated “The risks to the Share Insurance Fund have evolved and these risks will increase, at least temporarily, with the closure of the Stabilization Fund.”

13 NCUA indicated the Corporate System Resolution Program obligations that remained after closing the Stabilization Fund would create additional risk for the NCUSIF until the end of the NCUA Guaranteed Note (NGN) program in 2021.

14 The Legacy Assets are distressed investment securities held by the Asset Management Estates of failed corporate credit unions.

15 NCUA indicated the Share Insurance Fund needs to be able to withstand a recession without the equity ratio falling below the 1.20 percent statutory minimum over a five-year period.

16 NCUA indicated that because of the risk associated with the remaining obligations of the Corporate System Resolution Program, the agency “evaluated what the normal operating level should be to ensure the Share Insurance Fund holds enough equity to cover the risks posed by these additional obligations, as well as its customary exposures.”
Table 2

<table>
<thead>
<tr>
<th>Justification for the Component Elements of the Share Insurance Fund’s Normal Operating Level, effective September 29, 2017</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory Minimum</td>
<td>1.20%</td>
</tr>
<tr>
<td>Plus: Equity for potential impact on the NCUSIF of a Moderate Recession&lt;sup&gt;17&lt;/sup&gt;</td>
<td>0.13%</td>
</tr>
<tr>
<td>NOL based on the projected impact of a Moderate Recession:</td>
<td>1.33%</td>
</tr>
<tr>
<td>Plus: Impact on the equity ratio of remaining obligations of the Corporate System Resolution Program:</td>
<td></td>
</tr>
<tr>
<td>o Equity for potential declines of the value in claims on the Corporate Estates</td>
<td>0.04%</td>
</tr>
<tr>
<td>o Equity for projected Equity Ratio decline in 2018 and 2019&lt;sup&gt;18&lt;/sup&gt;</td>
<td>0.02%</td>
</tr>
<tr>
<td>NOL incorporating the projected impact of remaining obligations of the Corporate System Resolution Program</td>
<td>1.39%</td>
</tr>
</tbody>
</table>

Ultimately, NCUA indicated it set the NOL to 1.39 percent because:

- “[I]n a moderate recession, the equity ratio would decline by 13 basis points from its customary exposures and another 4 basis points from a reduction in the value of the claims on the corporate estates;” and
- “[T]he equity ratio of the fund is expected to decline by 2 basis points even with no economic stress.”

As part of assessing the NCUA Board’s rationale for setting its NOL at 1.39 percent, we reviewed the rationale behind actions of the FDIC and the FDIC Board as it pertains to its NOL-equivalent Designated Reserve Ratio (DRR). We noted that the FDIC’s DRR remained at 1.25 percent from 2007 thru 2010. The FDIC increased its DRR 75 basis points to 2.00 percent for 2011 where it has remained unchanged through 2018.

In its “Final Rule Setting the Designated Reserve Ratio” for 2011 (December 7, 2010), the FDIC included in part that:

<sup>17</sup> NCUA indicated “Based on the goal of keeping the fund’s equity ratio from falling below 1.20% over the five forecast years, the starting equity ratio would need to be 1.33% to withstand a moderate recession represented by the Adverse scenario.”

<sup>18</sup> NCUA indicated: “A 2-basis point decline in the equity ratio is 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 will help ensure there is sufficient equity to account for the potential decline in value of the claims on the asset management estates and avoid future premiums.”
It is important that the Deposit Insurance Fund not decline to a level that could risk undermining public confidence in federal deposit insurance.

FDIC staff viewed the 2.00 percent DRR as “minimum level needed to withstand a future crisis of the magnitude of past crises.”

The FDIC’s plan “would help reduce the risk of large rate increases during crises, when insured depository institutions can least afford an increase.”

The NCUA Board’s objectives for setting the NOL (as presented on page five) are similar in scope to these sentiments the FDIC presented to the FDIC Board – along with its analysis and various factors - in recommending the increase in its DRR for 2011.19

As previously outlined, NCUA management’s methodology also involved analysis and incorporated various factors in recommending the 1.39 percent NOL. In its analysis, NCUA employed the Federal Reserve’s stress test scenarios simulated over a five-year time period assuming a moderate recession, accounting for the potential declines on the value of asset management estates, and accounting for the NCUA Guaranteed Notes maturing.

We believe the NCUA’s process and basis for recommending the NCUA Board set the NOL at 1.39 percent was reasonable.

The attachment references documents on the NCUA’s public website that NCUA management prepared and presented in recommending to the Board the closure of the Stabilization Fund and setting the Share Insurance Fund normal operating level.

Distribution:
Chairman J. Mark McWatters
Board Member Rick Metsger
Deputy Executive Director John Kutchey
General Counsel Michael McKenna
Chief Financial Officer Rendell Jones
E&I Director Larry Fazio
PACA Director Mary Anne Bradfield

Attachment

cc: Callahan & Associates, Inc.

---

19 As NCUA Board Chairman McWatters indicated in his Statement on Closing the Temporary Corporate Credit Union Stabilization Fund and Setting the National Credit Union Share Insurance Fund’s Normal Operating Level, the FDIC Board’s goal was for the Deposit Insurance Fund to be able to withstand a severe recession (e.g., the “Great Recession of 2007-2009) without impacting the level of premiums charged to banks. Chairman McWatters added that “[t]he NCUA’s approach seeks to ensure the Share Insurance Fund can withstand a moderate recession without needing to assess premiums during the recession or recovery.” The NCUA took a less conservative approach than the FDIC.
ATTACHMENT: OPEN BOARD MEETING DOCUMENTS

Following is information available on the NCUA’s public website specific to the NCUA Board’s decision to close the Stabilization Fund and raise the Share Insurance Fund’s normal operating level:

July 20, 2017 Open Board Meeting

- Board Briefing - *Closing the Stabilization Fund and Setting the Share Insurance Fund Normal Operating Level* ([https://www.ncua.gov/About/Documents/Agenda_Items/AG20170720Item4c.pdf](https://www.ncua.gov/About/Documents/Agenda_Items/AG20170720Item4c.pdf)). This 68 page briefing includes details regarding:
  
  o The status of the Corporate Resolution Program;

  o The equity components comprising the proposed 1.39 percent normal operating level:
    - The 1.20 percent statutory minimum net operating level.
    - The proposed 0.13 percent equity for Share Insurance Fund stress (moderate recession).
    - The proposed 0.04 percent equity for potential declines of value in claims on corporate estates.
    - The proposed 0.02 percent projected equity ratio decline in 2018 and 2019.

  o The estimated 2018 distribution to credit unions based on the excess of the projected equity ratio as of December 31, 2017 over the recommended “Post-Stabilization Fund closure” net operating level.


September 28, 2017 Open Board Meeting

- Board Briefing - *Closing the Stabilization Fund and Setting the Share Insurance Fund Normal Operating Level* ([https://www.ncua.gov/About/Documents/Agenda_Items/AG20170928Item4c.pdf](https://www.ncua.gov/About/Documents/Agenda_Items/AG20170928Item4c.pdf)). This 19 page briefing includes: (1) a summary of the July 2017 proposal to the Board to close the Stabilization Fund in 2017 and set the normal operating level at 1.39 percent; (2) a summary of the comments received to the proposal; and (3) a more brief presentation of the information contained in the July 20, 2017 briefing identified above.

- The narrative of the 19 page briefing ([https://www.ncua.gov/About/Documents/Agenda_Items/AG20170928Item4d.pdf](https://www.ncua.gov/About/Documents/Agenda_Items/AG20170928Item4d.pdf)).