

Frequently Asked Questions
National Credit Union Share Insurance Fund (Share Insurance Fund)
Normal Operating Level
July 2017

Q1: What is the equity ratio of the Share Insurance Fund and how is it calculated?

The equity ratio is a measure of the Share Insurance Fund's capitalization, as defined in the Federal Credit Union Act.¹ In short, it is calculated by dividing the Share Insurance Fund's net position, less any unrealized gain or loss on investments, by insured shares.

Q2: What is the normal operating level?

The normal operating level is an equity ratio set by the NCUA Board that generally determines when a distribution of surplus equity is made to credit unions from the Share Insurance Fund. Per the Federal Credit Union Act, the NCUA Board may set the normal operating level between 1.20 percent and 1.50 percent. The current normal operating level of 1.30 percent was set by the NCUA Board in 2007, based on the Board-approved methodology in place at the time.

Q3: Why is the normal operating level important?

When the Board established the 1.30 percent normal operating level in 2007, it affirmed that the Share Insurance Fund would maintain a "counter-cyclical posture." A counter-cyclical posture 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. This approach helps ensure the Share Insurance Fund's equity is adequate to withstand adverse economic developments with a lower likelihood of premium assessments or impairment of credit unions' contributed capital deposits during an economic downturn and early phase of a recovery. The NCUA needs to maintain a safe and sound Share Insurance Fund to preserve public confidence in federal share insurance and protect the credit union community and taxpayers.

Q4: Why is the NCUA recommending raising the normal operating level to 1.39 percent now?

With the proposed closing of the Stabilization Fund, the NCUA must ensure the amount of equity held in the Share Insurance Fund is sufficient to cover all the Share Insurance Fund's resulting exposures. These exposures include the performance of the Share Insurance Fund based on the three primary factors that currently affect the equity ratio:

- Growth in insured shares,
- Yield on investments held by the Fund, and
- Insurance losses.

¹ 12 U.S.C. 1782(h)(2)

After the Stabilization Fund is closed, the Share Insurance Fund's exposures will include any potential decline in the expected recovery of its claims on the liquidated corporate credit union's asset management estates. Such a decline would primarily be driven by reduced cash flows from the distressed securities (Legacy Assets) re-securitized into NCUA Guaranteed Notes (NGNs). Therefore, the normal operating level has to reflect this increased risk to the Share Insurance Fund.

Q5: What is the overall approach to determining the proposed new normal operating level?

To evaluate the prudent level of equity the Share Insurance Fund would need to cover all of its exposures if the Stabilization Fund were closed, the NCUA modeled the losses that would be expected under both a moderate recession and a severe recession. For the two recession scenarios, the NCUA modeled the:

- Impact on the equity ratio of the estimated decline in the value of the Share Insurance Fund's expected recovery of its claims on the failed corporate credit unions' asset management estates.
- 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.² The 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.³

Q6: How are the potential losses on Legacy Assets determined?

To determine the amount of equity the Share Insurance Fund would need to hold to cover potential declines in the recovery value of its claims on the corporate credit union asset management estates, the NCUA contracted with BlackRock to incorporate the Adverse and Severely Adverse macroeconomic scenarios into its proprietary models to project cash flows for all of the Legacy Assets. In both the Adverse and Severely Adverse macroeconomic scenarios, the market value of the Legacy Assets declines.

The projected Legacy Asset cash flows were then aggregated by NGN and run through the applicable NGN cash flow waterfall. The 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. This results in an estimate of the change in the net

² 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. Additionally, it aligns with NCUA's strategic planning horizon, which is consistent with government-wide guidelines.

³ [Supervisory Scenarios for Annual Stress Test Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule](#), February 10, 2017.

receivable from asset management estates due to the NCUA, as well as changes in the NCUA's projected recovery on the U.S. Central capital note.

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 recovery value of NCUA's claims – and ultimately the equity ratio – is different, primarily due to how these funds flow through the payout priorities applicable to each asset management estate. Under the Adverse scenario, the NCUA projects a decline in value of its receivables from asset management estates, net of approximately \$400 million. This 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.

Q7: How are the other Share Insurance Fund exposures determined?

The 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. The 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's 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. 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.⁴

Under the Adverse and Severely Adverse scenarios, the equity ratio is projected to drop by 13 and 21 basis points respectively. However, the actual results could vary from these projections based on a variety of factors, including:

- Projected declines in the equity ratio, even under no economic stress.

⁴ 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 conducting 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.

- 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.

Q7: What is the policy behind the NCUA Board’s proposal to increase the normal operating level to 1.39 percent?

The NCUA Board believes the Share Insurance Fund should be able to withstand a moderate recession without the equity ratio falling below 1.20 percent - the Federal Credit Union Act’s minimum equity level for the Share Insurance Fund where the Board must either declare a premium or develop a fund restoration plan. In order for the equity ratio to not fall below 1.20 percent in a moderate recession, the equity ratio would have to be 1.33 percent. In addition, while the Share Insurance Fund is exposed to losses on the corporate system resolution program, it needs another 4 basis points of equity to withstand the impact of a moderate recession the value of the Share Insurance Fund’s claim on the corporate credit union asset management estates. Finally, the equity ratio is projected to decline by 2 basis-points by the end of 2019 - when the remaining NGNs begin to mature in 2020 and exposure to the Legacy Assets can begin to be reduced. This additional 2 basis points helps ensure the 4 basis points of additional equity to account for the potential decline in value of the claims on the asset management estates is maintained in the Share Insurance Fund until the remaining Legacy Assets can begin to be sold.⁵

Therefore, the Board proposes to set the normal operating level at 1.39 percent – the sum of 1.33 plus 0.04 plus 0.02.

Q8: Why not just give credit unions all of the Stabilization Fund’s equity in 2018 and see what, if any, premium charges are necessary in the future?

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 needs 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. If an economic downturn occurs at the same time as a premium is necessary, credit unions would be in the position of paying that premium when they could least afford it. Making this down payment when credit unions and the economy are growing will reduce the likelihood and impact of any larger premium in the future.

⁵ 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).

Q9: What is the projected distribution back to credit unions in 2018, and what will happen to the rest of the projected rebate of prior assessments?

Based on current projections, the distribution back to insured credit unions is estimated to be between \$600 million in \$800 million in 2018. NCUA last announced that the projected rebate of the \$4.8 billion in assessments would be between \$2.6 billion and \$3.0 billion.

In the future, an additional \$800 million to \$1.1 billion may be available for distribution through recovery of the U.S. Central capital note, better than expected performance of the Legacy Assets, and receipt of interest and guarantee fees.

Between \$900 million and \$1.3 billion will be absorbed into the Share Insurance Fund to maintain the equity ratio and account for cash flow discounting methodology differences.⁶

Q10. Why doesn't NCUA set the normal operating level at or near the statutory minimum?

While the Act allows the Board to set the normal operating level between 1.20 percent and 1.50 percent, it also requires the Board to assess a premium or develop a restoration plan if the equity ratio falls below 1.20 percent or is projected to fall below 1.20 percent in six months.⁷

The NCUA Board does not believe it is prudent to set the normal operating level at or near the statutory minimum, thereby making it almost certain any deterioration in the performance of the Share Insurance Fund will require a mandatory premium or fund restoration plan. These premiums could be large and come at unexpected times, potentially when many credit unions could least afford the additional expense. Alternatively, the Board could develop a restoration plan. However, operating under a restoration plan as a normal course of business could erode public confidence.

Managing the Share Insurance Fund with a normal operating level of 1.20 percent also reduces the amount of unexpected losses that the Fund could absorb before impairing the one percent deposit, which would result in an immediate expense to credit unions under accounting rules.

The Board reaffirms its position that the agency maintain a strong Share Insurance Fund for the mutual benefit of the credit union community and taxpayers. It is also important for the NCUA to avoid or minimize any insurance fund premiums, especially during times of economic stress, and keep the money at work in the credit union community. Therefore, establishing the normal operating level at 1.20 percent would not meet the Board's management objectives of maintaining public confidence in the federal share insurance system, avoiding impairment of credit unions' one percent contributed capital deposits, and maintaining a counter-cyclical posture.

⁶ The projected rebate range are shown on an undiscounted basis to align with actual amounts projected.

⁷ 12 U.S.C. 1782(h)(4) and (c)(2)

Q11: Why close the Stabilization Fund now—why not keep it separate until 2021?

As long as NCUA maintains sufficient equity in the Share Insurance Fund to cover the remaining obligations from the Corporate System Resolution Program on top of its ongoing obligations, closing the Stabilization Fund now makes sense. The proposal to close the Stabilization Fund in 2017 is prudent, based on a number of factors. Unlike in 2009, the current exposure presented to the Share Insurance Fund by the corporate credit union Legacy Asset balance and NGNs are both lower than the \$13.2 billion in Share Insurance Fund assets (as of March 31, 2017). Due primarily to the nearly \$4 billion in net legal recoveries, the Stabilization Fund has a positive net position of approximately \$1.9 billion as of May 2017. Additionally, there remain no outstanding U.S. Treasury borrowings. Thus, the Stabilization Fund has served its purpose. Closing the Stabilization Fund in 2017 will most likely result in an equity distribution to insured credit unions in 2018, putting these funds to work in the credit union system prior to its current scheduled closure in 2021.