

7535-01-U

**NATIONAL CREDIT UNION ADMINISTRATION**

**Policy for Setting the Normal Operating Level**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Notice.

**SUMMARY:** In May 2021, the NCUA Board (Board) invited comment on the policy to set the National Credit Union Share Insurance Fund (Share Insurance Fund) Normal Operating Level (NOL). The Board requested comment on eight specific factors that impact the calculation of the NOL. This final notice responds to comments on these factors as well as other subjects on which the Board received comment in the notice.

**FOR FURTHER INFORMATION CONTACT:** Russell Moore or Amy Ward, Risk Analysis Officers, National Credit Union Administration, Office of Examination, and Insurance at (703) 518-6383 or (703) 819-1770.

**SUPPLEMENTARY INFORMATION**

**I. Background**

On September 28, 2017, the Board approved the following actions:<sup>1</sup>

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<sup>1</sup> 82 FR 46298 (Oct. 4, 2017).

- Closing the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) and distributing its funds, property, and other assets and liabilities to the Share Insurance Fund, effective October 1, 2017.
- Setting the NOL of the Insurance Fund to 1.39 percent, effective September 28, 2017.<sup>2</sup>
- Adopting the policy for setting the NOL, as outlined below.

### **Policy for Setting the NOL**

The policy for setting the NOL was adopted in 2017 and established a periodic review of the equity needs of the Share Insurance Fund, the results of which are communicated to stakeholders.<sup>3</sup> At least annually, NCUA staff reviews the level at which the NOL is set and reports this information to the Board. Board action is only necessary when a change in the NOL is warranted. The policy establishes that any change to the NOL of more than one basis point shall be made only after a public announcement of the proposed adjustment, with an opportunity for comment.<sup>4</sup> For any such adjustment, the NCUA would issue a report and request for

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<sup>2</sup> The Board last set the NOL at 1.38 percent on December 9, 2019. The Board retained the 1.38 percent NOL at its December 17, 2020, meeting.

<sup>3</sup> As noted, the Board adopted this policy for setting the NOL in 2017. The Board emphasizes that, as a general statement of the NCUA's policy regarding setting the NOL, the Board is not required to follow the notice-and-comment rulemaking process when revising this policy. *See* 5 U.S.C. 553(b)(3)(a). Nevertheless, the Board voluntarily solicited public input on this policy.

<sup>4</sup> One basis point is one hundredth of one percent.

comment that includes data supporting the proposed adjustment. The policy established the following objectives for the Board to satisfy when setting the NOL:

- Retain public confidence in federal share insurance;
- Prevent impairment of the one percent contributed capital deposit;<sup>5</sup> 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.

The current economic landscape and pending resolution of the obligations associated with the corporate credit union asset management estates and NCUA Guaranteed Notes (NGN) Program, discussed later in this document, warrant a re-evaluation of the NCUA's current NOL policy.

## **II. Legal Authority**

Pursuant to the Federal Credit Union Act (Act), the NOL is an equity ratio specified by the Board, which may not be less than 1.20 percent and not more than 1.50 percent.<sup>6</sup> The Board has historically set the NOL as the target equity ratio for the Share Insurance Fund.

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<sup>5</sup> Federally insured credit unions are required to maintain a deposit equal to one percent of their insured shares with the Share Insurance Fund. 12 U.S.C. 1782(c)(1)(A)(i).

<sup>6</sup> 12 U.S.C. 1782(h)(4).

The Share Insurance Fund’s calendar year-end equity ratio is part of the statutory basis to determine whether the NCUA must make a distribution to insured credit unions.<sup>7</sup> 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;
- The Fund’s equity ratio exceeds the [NOL] and
- The Fund’s available assets ratio exceeds 1.0 percent.”<sup>8</sup>

The above provisions of the Act are generally implemented at 12 CFR part 741 of the NCUA’s regulations.

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<sup>7</sup> The equity ratio is also part of the statutory basis for determining whether a premium or Share Insurance Fund restoration plan is necessary. The unprecedented share growth related to the pandemic resulted in an equity ratio of 1.26 percent as of December 31, 2020, and an equity ratio of 1.23 percent as of June 30, 2021.

<sup>8</sup> 12 U.S.C. 1782(c)(3)(A). This section is also subject to 12 U.S.C. 1790e(e).

### **III. Current Normal Operating Level Methodology and Process**

To implement the current approved policy, the NCUA developed a calculation based on scenarios using the following factors:

- The modeled performance of the Share Insurance Fund over a five-year period, assuming a moderate recession.
- The modeled potential decline in value of the Share Insurance Fund's claims on the corporate asset management estates in a moderate recession; and
- The projected equity ratio decline through the end of the following year, assuming no economic downturn.

The stress scenario entails estimating three primary drivers of outcomes: insurance losses, insured share growth, and yield on investments. Additionally, the risk associated with the Share Insurance Fund's claims on, and obligations related to, the asset management estates of the five failed corporate credit unions is a factor in this analysis. The Share Insurance Fund's exposure related to the asset management estates of the five failed corporate credit unions has substantially declined since the last NGN trust matured on June 12, 2021. Though the amount of time needed to fully liquidate all the assets and satisfy all the liabilities of the corporate asset management estates will depend on market factors and ongoing litigation, the risk has significantly declined and will continue to decline and end as the residual assets are liquidated and the estates closed. More information regarding the NGN program and the Corporate System Resolution may be found on the NCUA's public website.

The NCUA's stress analysis is based on the Federal Reserve's adverse economic scenario and applied to the primary drivers. However, the Federal Reserve did not publish an adverse scenario in 2020 or 2021; therefore, the NCUA developed an adverse scenario based on the average of the Federal Reserve's baseline and severely adverse economic scenarios. Historically, this has been a reasonable proxy for a moderate recession. The absence of an adverse scenario published by the Federal Reserve and the pending completion of the corporate resolution program warrant a re-evaluation of the current NOL policy.

#### **IV. Comments on Normal Operating Level and Responses**

The Board sought comment on the policy and approach for setting the NOL of the Share Insurance Fund. Commenters were encouraged to discuss any other relevant issues for the Board to consider. Specifically, the Board was interested in comments addressing the following factors:

- Should a moderate recession be the basis for evaluating the Share Insurance Fund performance during an economic downturn, or should the NCUA change the policy to consider a severe recession?
- What data source(s) should the NCUA use for determining the characteristics of a potential moderate or severe recession—the Federal Reserve scenario, an independent source, or the NCUA's judgment?
- Should the NCUA continue modeling the performance of the Share Insurance Fund over a five-year period? Should the period be longer or shorter?

- How should the NCUA utilize the modeled potential decline in value of the Share Insurance Fund's claims on the corporate asset management estates going forward, until the estates are fully resolved?
- Should the NCUA continue to incorporate in the NOL analysis the projected equity ratio decline through the end of the following year without an economic downturn? Should this period be longer or shorter, or not factored into the analysis at all?
- Given forecasting uncertainties and timing challenges, would it be reasonable for the NCUA to change the requirement to request public comment only if the NOL were to change by a larger amount than just one basis point?
- Should the NOL be re-evaluated in the midst of an economic downturn or should it be left unchanged until the onset of an economic recovery?
- Should the NOL be re-evaluated on qualitative factors based on the COVID-19 pandemic?
- Is there any other information that the Board should consider when setting the NOL?

The Board received 23 comment letters from credit union leagues, trade associations, credit unions, and credit union service organizations.

### **Moderate or Severe Recession**

Most commenters stated a moderate recession is an appropriate basis for evaluating the Share Insurance Fund's performance during an economic downturn. Commenters who did not support using a severe recession cited the few numbers of severe recessions recorded in U.S. history and noted that the low probability of losses stemming from a severe economic event reduces the utility of a severe recession as a basis for modeling. The commenters noted that the

majority of the losses to the Share Insurance Fund have been from fraud, concentration risk, etc., and not from severe economic factors; thus, a model based on a severe recession would not be useful. Commenters expressed that NCUA's own capital planning requirements for credit unions do not require credit unions to build capital to accommodate high impact, low probability events. The Board agrees with the commenters and will retain the moderate recession scenario as the basis for modeling the NOL.

### **Data Sources**

Commenters emphasized the need for NCUA to use an independent source to provide data for NCUA's modeling of a potential moderate or severe recession. The majority of commenters supported continuing to use the Federal Reserve as this independent source, due to its credibility in the industry and its wide use among other banking agencies. Several commenters favored an independent source other than the Federal Reserve or some combination of the Federal Reserve and independent sources. Most commenters recommended the Board not use NCUA judgment as an exclusive means for modeling a moderate and severe recession. Several commenters believed NCUA judgment would be acceptable as a backup means to define a moderate recession when the specific Federal Reserve scenario was not available.

Several commenters did express concern that the Federal Reserve data includes bank losses, which historically have been greater than credit union losses, and the impact this would have on modeling for credit unions. The Board emphasizes the Federal Reserve data used in the modeling process is broad macroeconomic assumptions and is not specific to any one industry. The Board believes the Federal Reserve scenarios are the best choice due to their public



availability and wide acceptance. Other independent sources may not be readily available for public scrutiny or require subscriptions to be able to view. Based on the feedback, the Board believes the NCUA's methodology of using an average of the Federal Reserve's baseline and severely adverse scenarios to approximate a moderate recession is the best alternative.

### **Modeling Period**

While commenters supported the current use of a moderate recession in the modeling process, many commenters recommended the Board shorten its modeling period from the current policy of five years to a shorter period of 18 months to three years. Commenters suggested the current five-year period is no longer applicable because it was put in place in 2017 to account for the remaining maturity of the NGN Program, which was set to mature in 2021. Commenters expressed that a shorter modeling period is also more appropriate because the duration of economic recessions was less than five years. Commenters emphasized the applicability of a shorter period, noting the Federal Reserve baseline and severely adverse recession scenarios are based on 13 quarter terms. Other commenters that supported using a longer period than five years suggested modeling consistent with business and economic cycle trends that typically exceed five years.

The Board disagrees with commenters that state the Share Insurance Fund's performance horizon should be less than five years. As outlined in its July 2017 Notice and discussed at the July 2017 Board meeting, a five-year horizon for modeling the Share Insurance Fund was selected for several reasons. One compelling reason is that the National Bureau of Economic Research—the not-for-profit research organization that establishes the beginning and end of U.S.

business cycles—has calculated that, from 1854 through 2020, the United States has averaged 59 months from the peak of one business cycle to the next. If the modern era (1945 to 2020) is considered, this cycle extends to 75 months.

Though a recession may end, the economy may remain weak during the recovery period. A struggling economy also poses risks to credit unions, and a thorough analysis of the Share Insurance Fund's equity position needs to account for the period of continued economic weakness, which more realistically reflects a recession's effects on the credit union industry. A primary reason the NCUA's projections extend the Federal Reserve's 39-month (13 quarters) scenario to 60 months is that it may take more than 39 months for the effects of the recession and the weak recovery to produce losses. Five years is also consistent with the agency's strategic planning cycle. Therefore, the Board plans to retain a modeling horizon of five years.

### **Potential Decline in Value of the Share Insurance Fund's Claims on the Corporate Asset Management Estates**

Many commenters recommended eliminating the modeled potential decline in value of the Share Insurance Fund's claims on corporate asset management estates since the estates are almost fully resolved and no longer pose a material impact to the modeled results. Commenters felt any remaining impact of the corporate resolution program is likely immaterial and therefore not needed in the analysis.

The Board agrees with the commenters. The last NGN certificate matured in June of 2021. The remaining assets of the corporate asset management estates have not been fully

liquidated yet, but the Board agrees this component in the NOL calculation can be eliminated as the exposure has significantly declined and will be fully resolved within the next modeling period.

### **Decline in the Equity Ratio Through the End of the Following Year Without an Economic Downturn**

The majority of comments on this issue supported eliminating the projected equity ratio decline from the NOL analysis through the end of the following year without an economic downturn. The rationale provided was the near completion of the NGN Program, which negates the need to analyze the projected equity ratio decline through the end of the following year as a backstop to ensure the Share Insurance Fund could stay above 1.2 percent under a moderate recession during the remaining life of the NGNs. One commenter supported retaining the analysis and suggested that the NCUA standardize the period used in the forecast.

The Board agrees with the commenters. This component of the NOL calculation was originally intended to protect against a decline in the equity ratio while the NGNs were outstanding. The NGNs have all matured, and while there are remaining Legacy Assets, the impact of a decline in their value is no longer significant to this analysis.

### **Public Comment Only if the Normal Operating Level Were to Change by a Larger Amount Than One Basis Point**

Fourteen commenters offered comments on NCUA's current policy of notifying and requesting public comment in the event the NOL changes by more than one basis point. Nine of

these commenters favored keeping this requirement in the policy, with most citing the potential impact on credit unions and transparency as the basis for their view. One commenter expressed that even one basis point reflects a large dollar amount and has a material impact on individual credit unions.

The current policy to notify and request comment is necessary to provide transparency involving actions taken regarding the management of the Share Insurance Fund. Commenters believe it is sound public policy to provide stakeholders the opportunity to participate in considerations of even modest adjustments to the NOL and other adjustments that impact the Share Insurance Fund (referring to the Overhead Transfer Rate). One commenter supported continuation of the notice and comment practice but suggested a range of three to five basis points would provide the Board sufficient latitude to adjust the NOL without a full comment period.

Two commenters stated public comment is warranted any time the NOL calculation results in an NOL above 1.3 percent. Individual commenters expressed the following:

- NCUA eliminating the comment requirement for a one basis point change is concerning because it may trigger NCUA to make a series of one basis point increases without the opportunity for public comment.
- Public comment is only necessary if the change prompts a required premium for all credit unions.
- Public comment should be required for all NOL changes, regardless of amount.

Many of the commenters stressed the importance for the Board to consider setting the NOL at a level that achieves a balance between a stable Share Insurance Fund equity position and minimizing financial strain on credit unions. Commenters noted that preserving as much members' equity as possible supports a credit union's mission of providing products and services to their members. Commenters also noted the majority of credit unions are well capitalized and pose little risk to the Share Insurance Fund. Credit unions with higher risk to the Share Insurance Fund are properly identified and working toward resolution, as evidenced by the low number of failures that pose a cost to the Share Insurance Fund.

Many commenters expressed the prolonged history and adequacy of a NOL of 1.3 percent, stating the Board is provided sufficient tools within the Act (premiums and distributions) to manage the Share Insurance Fund's equity within the statutory range of 1.2 percent and 1.5 percent. Many of these commenters cited the more recent NOLs the Board set at 1.39 percent in 2017 and 1.38 percent in 2019 were based on the closure of the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) and the consolidation of the Stabilization Funds' assets and liabilities into the Share Insurance Fund. In the commenters' view, these do not reflect an appropriate NOL going forward.

Other commenters expressed concern over NCUA's budget. These commenters focused on the agency's need to manage expenses to reduce the Share Insurance Funds' obligation to fund a portion of NCUA's operating budget, thus maintaining higher levels of equity in the Share Insurance Fund and minimizing the credit union industry's obligation.

The Board agrees public comment, although not required, could be helpful when considering a change to the NOL policy or methodology. The Board also wishes to clarify two points that may have confused some commenters. Several commenters stated public comment should be requested anytime the NOL results in a premium or potential premium. The NOL does not trigger a premium, but rather establishes the point above which a distribution is required. The actual equity ratio is measured against the NOL to determine if a distribution is required. The Board may only levy premiums when the Share Insurance Fund's actual equity ratio falls below 1.30 percent. Even if the actual equity ratio is below 1.30 percent, the Board weighs other factors, including financial projections, prior to determining whether to assess a premium.

The Board believes the NOL must be set based on a quantitative and qualitative analysis, with the quantitative analysis being the primary driver in setting the NOL and the qualitative factors considered by the Board, as appropriate. The Board agrees with commenters that a request for public comment, although not required, is helpful if the NOL changes. The Board will continue seeking public comment when the NOL changes by more than one basis point.

**Should the NOL be re-evaluated in the midst of an economic downturn or should it be left unchanged until the onset of an economic recovery?**

Ten commenters responded to the issue of whether the NCUA should reevaluate the NOL in an economic downturn or leave it unchanged until the onset of an economic recovery. Three commenters stated the NOL should be continuously evaluated and one stated the NOL should not be changed. The remaining commenters emphasized the need for the process to be

standardized and for NCUA to strike a balance between safeguarding the Share Insurance Fund and avoiding overburdening credit unions and their members.

The Board believes the current process is standardized and based on the risk inherent in the Share Insurance Fund. The recent economic downturn due to the COVID-19 pandemic resulted in unusual share growth and volatility in the financial markets. The Board will continue to apply a standardized approach to calculating the NOL while also using experience and judgment to determine if the NOL should remain unchanged under such circumstances.

**Should the Normal Operating Level be re-evaluated on qualitative factors based on the COVID-19 pandemic?**

Ten commenters responded to the question regarding whether the NOL should be re-evaluated on qualitative factors based on the COVID-19 pandemic. Seven commenters stated the NCUA should not re-evaluate the NOL based on abnormal events with a high level of uncertainty. Several commenters stated they were opposed to the inclusion of qualitative factors as it would reduce transparency. Three commenters stated some support for evaluating factors due to an economic downturn. One commenter stated the NOL should be evaluated holistically, accounting for both data and environmental factors. Another commenter expressed support for a policy that is based on historical record that all U.S. recessions would last only a few months, as has generally been the case since the Great Depression. Finally, one commenter reiterated that the NOL should always be re-evaluated based on qualitative factors, but the policy should be to look beyond the numbers and make decisions based on actual or perceived risk to the Share Insurance Fund and the credit union industry.

The Board agrees the NOL policy should not be constructed to react to single events such as the current pandemic and the methodology should be quantitative and qualitative, with the quantitative analysis being the primary driver in setting the NOL and the qualitative factors considered by the Board, as appropriate. In terms of qualitative factors, the Board reserves the right to consider environmental factors in the decision to change the NOL or retain it at its current level given all available information. Unusual non-quantitative factors affecting the decision regarding the NOL may be disclosed if the impact is material.

**Is there any other information that the Board should consider when setting the NOL?**

Fourteen commenters offered responses regarding additional information the Board should consider when setting the NOL. Nine commenters suggested the Board set the NOL at the pre-2017 level of 1.30 percent. The rationales presented include:

- The risk from the merger of the Stabilization Fund no longer exists,
- The Board cannot assess a premium when the equity ratio is above 1.30 percent, and
- The NCUA should not hold more equity than legally required, except for identifiable losses.

Commenters also voiced opposition to any statutory changes removing the 1.50 percent NOL ceiling or removing the restriction on premiums when the equity ratio is at or above 1.30 percent. Several commenters stated the NCUA should convert all Share Insurance Fund accounting to private generally accepted accounting principles (GAAP) to allow for earlier recognition of the one percent capitalization deposit adjustment. One commenter stated that, if



the NCUA wanted to manage to a NOL higher than 1.30 percent, there would be a couple of options, including but not limited to cutting operating expenses, increasing investment yields, or using its borrowing authority. Finally, one commenter recommended the Board reconsider the current NOL policy objectives. The commenter stated the NOL does not prevent impairment of the contributed capital deposit and setting the NOL has very little to do with public confidence in federal share insurance and the equity ratio declining below 1.20 percent over a five-year period. What matters is identifying and preparing for risks that threaten the Share Insurance Fund's equity ratio.

The Board does not agree with arbitrarily setting the NOL. The NOL represents the level of equity the Share Insurance Fund should have to meet the policy objectives based on a robust modeling of risk.

While commenters provided feedback opposing any statutory changes removing the 1.50 percent ceiling on the equity ratio or the 1.30 percent cap on the Board's ability to charge a premium, the Board has determined these comments are outside the scope of this request. These changes would be a matter for Congress to decide. However, the current statutory restrictions are a constraint on the Board's ability to pursue a counter-cyclical approach to managing the Share Insurance Fund.

Regarding changing the accounting methodology for the Share Insurance Fund, the NCUA offers the following response. GAAP treatment does not directly tie to the NOL policy and is considered beyond the scope of this request. This can be considered separately as appropriate.

With respect to the audit, the NCUA's Office of Inspector General engages an independent auditor to express an opinion on the NCUA's financial statements based on their audit and in accordance with auditing standards. The 2020 audit opinion indicated the Share Insurance Fund's financial statements present fairly, in all material respects, the financial position of the Share Insurance Fund in accordance with U.S. GAAP. Share Insurance Fund footnote disclosure numbers eight and fourteen include detailed financial information about the NGN program and the Asset Management Estate Fiduciary Revenues, Expenses, Assets and Liabilities. These footnote disclosures and the amounts contained within them are fully audited as part of the Share Insurance Fund's financial statement audit.

With regard to the comments stating that if the NCUA wanted to manage to an NOL higher than 1.30 percent there would be a couple of options, including cutting operating expenses, increasing investment yields, or using its borrowing authority, the Board notes that it controls operating expenses to the extent possible consistent with having sufficient resources to achieve the agency's mission. The Board has limited options to increase investment yields, as those are determined by the market and the Share Insurance Fund is limited by law to investing in "any interest-bearing securities of the United States or in any securities guaranteed as to both principal and interest by the United States or in bonds or other obligations which are lawful investments for fiduciary, trust, and public funds of the United States."<sup>9</sup> Finally, borrowing

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<sup>9</sup> 12 U.S.C. 1783(c).

funds on behalf of the Share Insurance Fund would be a liability and would not increase the equity ratio.

Regarding the commenter who offered specific comments on the NOL policy objectives, the Board offers the following responses: The Board believes having a robust methodology to determine what level of equity the Share Insurance Fund would need to prevent impairment of the one percent capitalization deposit, and to prevent it from falling below 1.20 percent over five years in a moderate recession, bolsters public confidence. The Board agrees that it is important to identify and prepare for risks that threaten the Share Insurance Fund. The NOL policy is designed to determine the risk to Share Insurance Fund under a stressed environment, which is when losses generally occur.

### **Final Action**

The Board will retain the current objectives for setting the NOL. When setting the NOL, the Board will seek to satisfy the following objectives:

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

The impact of changes in value of the corporate asset management estates and the decline in the equity ratio through the end of the following year without an economic downturn will be

removed from the NOL calculation. The Board will continue to use a decline in the Share Insurance Fund's equity in a moderate recession to estimate the additional equity needed to prevent the equity ratio from falling below 1.20 percent. Any change to the normal operating level of more than 1 basis point shall be made only after a public announcement of the proposed adjustment and opportunity for comment. In soliciting comment, the NCUA will issue a public report, including data supporting the proposal.

By the National Credit Union Administration Board on December 16, 2021.

**Melane Conyers-Ausbrooks,**  
*Secretary of the Board.*