National Association
of Federal Credit Unions
3138 10th Street North
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December 5, 2016

The Honorable Rick Metsger, Chairman
The Honorable J. Mark McWatters, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: NCUA's Equity Fund Ratio and 2017 Projections

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association focusing exclusively on federal issues affecting the nation's federally insured credit unions, I am writing to you regarding the National Credit Union Administration Share Insurance Fund's (NCUSIF) equity ratio, and the possibility that the agency will charge a premium in 2017.

First and foremost, NAFCU would like to express that we and our members sincerely appreciate the agency's transparency and public deliberation on the possibility of a 2017 premium. This is the latest example of welcome transparency that rightfully focuses on early and advance communication with industry stakeholders.

However, while NAFCU appreciates the agency's candor, and we recognize that the NCUSIF equity ratio has been declining, our members have expressed concerns with the possibility of a premium for 2017. NAFCU is hopeful that a premium will not be necessary in 2017, and encourages the agency to continue to publically explore all available avenues to negate the need for a premium. If NCUA does ultimately decide to move forward with a premium charge, NAFCU urges the agency to release additional information and advance guidance to provide our members with clarity for planning purposes.

Background

As you are aware, the NCUSIF equity ratio is a general measure of the health of the fund and is calculated as the sum of federally-insured credit unions' (FICU) capital contribution of one percent of their insured shares and the fund's retained earnings, divided by total insured shares. Federal law requires the normal operating level for the NCUSIF to fall between 1.20 percent and 1.50 percent, and the normal operating level for the equity ratio has been set at 1.30 percent since 2007.

During the November 17, 2016 NCUA Board meeting, agency staff delivered a presentation discussing the downward trend of the NCUSIF equity ratio, and projections for 2017. To summarize, growth in insured shares in credit unions combined with a continuing low interest-rate environment is causing a decline in the equity ratio, with current projections indicating the equity ratio to fall to between 1.24 percent and 1.27 percent during 2017. The present low interest-rate environment makes it difficult to generate sufficient retained earnings to bring the equity ratio back to 1.30 percent.

NCUA staff used a variety of approaches for modeling the equity ratio over periods ranging from two to five years. Each of the approaches resulted in a steady decline in the equity ratio over the forecast period. As a result of the projected decline, staff informed the Board that NCUA will likely need to charge a premium for 2017 of three to six basis points in an effort to return the equity ratio to the normal operating level. However, under neither the standard projection nor the severely adverse scenario of the economic stress analysis does the equity ratio fall below the statutory minimum of 1.2 percent in 2017.

Despite the fact that equity ratio has been trending downward, NAFCU believes NCUA can maintain an equity ratio above the statutory minimum so long as the agency continues to prudently manage the NCUSIF. While NAFCU acknowledges that the current economic environment has made it difficult to keep the equity ratio at 1.3 percent, there exists a window bounded by the statutory minimum of 1.2 percent and the normal operating level of 1.3 percent, between which the equity ratio may float. This generally allows the NCUSIF to operate through the business cycle without requiring NCUA to charge a premium to credit unions, except under severe distress. So while it does appear that the equity ratio is on a path which may require a premium in the future, that is far from certain, and NAFCU urges prudence on the part of NCUA until such a scenario becomes more of a likelihood.

Prudently Managed SIF Expenses

There are four key drivers of the equity ratio: investment returns, insurance losses, operating expenses, and insured share growth. Of these drivers, operational improvements at NCUA can positively impact three of these factors.

Investment Returns

Investments currently constitute roughly 95 percent of total NCUSIF assets. While the portfolio is limited to U.S. Treasury Notes up to 10 years in maturity, plus a small amount in an overnight account, the portfolio has nevertheless undergone significant changes in recent years. The duration of the portfolio at the end of 2008 was approximately 1.3 years. Half the portfolio was held in the overnight account and just two percent of investments had a maturity of five years or greater.

Since that time, the agency has increased the duration by utilizing a laddered investment strategy with roughly equal amounts invested across the maturity range up to 10 years. As a result, the duration as of June 2016 was approximately 5 years. The agency has explained such a strategy as a “rate agnostic” approach which will presumably be used regardless of the present or forecasted yield curve.

One benefit of lengthening the portfolio duration has been to increase the yield in recent years over what it would have been under the pre-crisis investment structure. The current era of historically low interest rates has lasted longer than many expected, and while the current yield is just 1.8 percent, earnings over that period would have been far lower had NCUA not extended the portfolio duration.

Because investment yields have been lower than historical measures, NAFCU encourages NCUA to continue managing the portfolio pragmatically, and to redouble efforts to cut expenses and losses elsewhere.

Insurance Losses

In most years, the bulk of any changes in the equity ratio can be attributed to the combination of investment yield and share growth. However, during and immediately after the financial crisis, insurance loss expense most affected the bottom line.

More recently, fraud continues to be a leading cause for credit union failures, which negatively impacts the NCUSIF expenses. During the Board briefing, NCUA staff explained that fraud contributed to 10 of the 12 failures so far in 2016, and accounted for 76.5 percent of the $8.5 million total losses. In 2015, there were 16 failures which cost the fund $14.8 million. NAFCU is troubled by the extent of these preventable losses and encourages the agency to maintain vigilant supervision to reign in fraud so those costs are not passed to all credit unions. NAFCU believes that recently approved plans to improve the Call Report will facilitate better vigilance and supervision to help prevent these frauds.

Operating Expenses

Operating expenses for the NCUSIF are determined by the overall spending by the agency as well as the overhead transfer rate (OTR). The agency estimates the portion of its expenses which are devoted to insurance activities, which results in a ratio called the OTR. This ratio is then applied to the agency's actual spending, and that amount is booked as an expense to the NCUSIF.

In recent years, operating expenses for the NCUSIF have risen dramatically. This reflects both the rise in agency expenses – which have grown by an annual average of roughly 7 percent from 2007 through 2017 (budgeted) – as well as by a rise in the OTR from 54 percent in 2009 to 73 percent in 2016. Although the OTR for 2017 was recently reduced by approximately 5 percent, the continued year-over-year operating budget increases continue to divert significant levels of funding away from the NCUSIF.

Conservative Calculation Premiums

If NCUA elects to charge premiums rather than more conservatively control costs associated with the NCUSIF, NAFCU urges the agency to only charge the minimum premium amount that is absolutely necessary to address the declining equity ratio. The onset of the financial crisis led to a steep rise in insurance loss expenses, which served to not only replenish reserves which were being depleted due to failures, but also to grow the level of reserves corresponding to the increased estimate of future losses. The rapid buildup of reserves during that period necessitated premiums in 2009 and 2010 of over $1.6 billion.

Since 2010 the fund has gradually reduced those reserves, which has resulted in negative charges to the insurance loss expense account in the aggregate sum of $736 million from 2011 through 2015. This served to increase net income and retained earnings for the NCUSIF. As a result, the equity ratio exceeded the normal operating level from 2011 through 2013, prompting a distribution in each of those years. Ordinarily those funds would have been returned to credit unions. However, due to the fact that the industry had an outstanding borrowing from Treasury via the Corporate Stabilization Fund, those funds were required to pay down a portion of that balance instead.

The over-inflation of reserves siphoned money from credit unions at a time when the industry was struggling in the aftermath of the financial crisis. While some recovery has taken place, many credit unions continue to struggle today, as evidenced by the high merger rate among small credit unions. NAFCU urges NCUA to be as judicious as possible when determining whether or not to charge a premium in 2017.

Changes to Prompt Corrective Actions Classifications

During the Board briefing, NCUA staff indicated that a three basis point premium would result in an aggregate decline in ROA for the industry of three basis points, while a six basis point premium would result in a ROA decline of five basis points. Meanwhile, a three basis point premium would mean an additional 110 credit unions would have negative net earnings following the premium, while a six basis point premium would result in an additional 219 credit unions with negative earnings.

Further, staff informed the Board that several credit unions will see reductions in their Prompt Corrective Action (PCA) classifications as a result of declines to their net worth ratios; three credit unions would be downgraded from well capitalized to adequately capitalized.

In NCUA Letter to Credit Unions 10-CU-17, NCUA examiners were "instructed not to downgrade a credit union's component or composite CAMEL ratings because of the effect of the premium." The agency also indicated that it would "be as flexible as the law allows in reviewing and approving an NWRP for every credit union that falls into PCA solely due to the premium." NAFCU encourages the agency to take a similar approach, should it determine to impose another premium on credit unions in 2017.

Risk-Based Premiums

Also during the Board briefing, staff discussed the Federal Deposit Insurance Corporation's (FDIC) use of risk-based premium for its Deposit Insurance Fund. Staff stated that the size of the premium would remain the same, but that its distribution among credit unions would be more tilted toward credit unions considered to be a greater risk to the NCUSIF.

As NCUA examines the ramifications of using a risk-based premium for the NCUSIF, NAFCU reminds the Board that asset size is not determinative of risk. Rather, a credit union's activities, practices and programs are more indicative of risk than just simply evaluating asset size. If the agency continues to study a risk-based premium approach, NAFCU encourages the Board to hold briefings to publicly discuss the permissibility of using risk-based premiums, and what effects such a change would have on the industry.

More Accounting Guidance is Needed

Under Generally Accepted Accounting Principles (GAAP), a credit union should recognize a liability if: 1) it is probable that a liability has been incurred, and 2) the amount of the loss can be reasonably estimated. In response to the agency's indication that at least a 3 basis point premium is probable in 2017, several of NAFCU's members have expressed concern that GAAP requires the credit union to immediately recognize a loss. Based on conversations with agency staff, NAFCU understands NCUA's position is that credit unions need not account for a loss until, and unless, the NCUA Board specifies an exact premium amount in 2017. To remedy this misunderstanding, NAFCU asks that NCUA clearly communicate that credit unions do not have to start accounting for the premium until the agency takes official action to charge an exact premium.

In conclusion, NAFCU appreciates the agency's forthrightness regarding this matter, but we look forward to meeting with NCUA staff to discuss this letter's recommendations. Should you have any questions, please do not hesitate to contact me, or Carrie Hunt, Executive Vice President of Government Affairs and General Counsel at (703) 842-2234 or chunt@nafcu.org.

Sincerely,

NAFCU's Share Insurance, Liquidity and Development Fund Oversight Committee

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