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National Association of Federal Credit Unions | [nafcu.org](http://nafcu.org)

August 2, 2016

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

**RE: NCUSIF Equity Ratio**

Dear Chairman Metsger and Board Member McWatters,

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 issues related to the National Credit Union Share Insurance Fund's (NCUSIF) Equity Ratio.

Attached please find a report from NAFCU's Research Division, which forecasts the NCUSIF's Equity Ratio in 2016-2017 under base-level, optimistic and pessimistic economic conditions. As demonstrated in the analysis, NAFCU anticipates that, under all scenarios, the Equity Ratio will remain above 1.2 percent for 2016. With this analysis in mind, NAFCU believes that the NCUA will not need to assess a premium in 2016.

Further, under base-level and optimistic predictions for 2017, the need for an assessment will be well-avoided. Only under economic conditions mirroring the last economic recession, an extremely low-probability event at this point, would the share insurance Equity Ratio fall below the 1.2 percent threshold. Therefore, NAFCU believes the premium range should be maintained at the current range of zero to six basis points for 2017.

As you know, NCUA sets the Normal Operating Level (NOL) for the Equity Ratio each year, which is set at 1.3 percent for 2016. NAFCU is aware that the NOL may be a matter of debate, but NAFCU recommends that the NCUA implement a plan to exercise caution in order to avoid unnecessarily assessing a premium on credit unions. Such a plan would require careful thought and consideration of multiple relevant factors.

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NCUA has previously advocated for removing the statutory 1.5 percent Equity Ratio ceiling (NCUA White Paper on Reforming the NCUSIF, September 2013). The agency justified this position by arguing that such a change would achieve greater parity with the Deposit Insurance Fund (DIF) administered by the Federal Deposit Insurance Corporation (FDIC). However, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) instituted a higher Equity Ratio ceiling for the Deposit Insurance Fund (DIF) that is specifically intended to address the needs of banks. The bank ceiling is inappropriate as applied to credit unions. For example, NCUA has the ability to require credit unions to maintain one percent of their insured shares in the NCUSIF, whereas the FDIC does not. Given current and future forecasts of macroeconomic conditions, NAFCU believes it would be a beneficial use of NCUA's time and resources to focus on fraud prevention, which has been present in ten of eleven credit unions failures this year, rather than amending the ratio's current ceiling.

In addition, NAFCU believes a more robust dialogue could be achieved surrounding the fund. For instance, the Board could conduct an additional Board Briefing in 2016 to address how the Equity Ratio will be affected by taxi medallions, the interest rate environment, insured share growth, and other significant factors.

We hope you find this information helpful. Should you have any questions or would like to discuss these issues further, please do not hesitate to contact me at [chunt@nafcu.org](mailto:chunt@nafcu.org), or (703) 842-2234.

Sincerely,



Carrie R. Hunt  
Executive Vice President and General Counsel

Attachment

# SHARE INSURANCE FUND SCENARIO ANALYSIS

NAFCU RESEARCH DIVISION

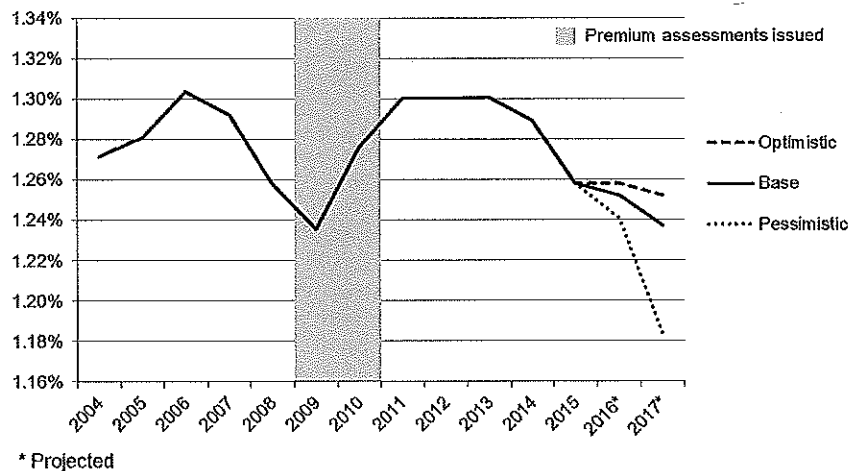
July 2016

During NCUA's July Board meeting, it was noted that no assessments related to the Share Insurance Fund (SIF) are anticipated this year. The SIF's equity ratio is a general measure of the health of the fund and is calculated as the sum of federally-insured credit unions' (FICUs') capital contribution of one percent of their insured shares and the fund's retained earnings, divided by total insured shares. The normal operating level for the equity ratio has been set by the agency at 1.3 percent. If the SIF finishes the year with an equity ratio above that level, the excess funds are returned to FICUs under ordinary circumstances, although currently the SIF is obligated to use such funds to pay down the outstanding borrowing from Treasury associated with the Temporary Corporate Credit Union Stabilization Fund. If the ratio falls below 1.2 percent, the Board is required to assess a premium to restore the ratio to at least that level. The following analysis supports the opinion that a drop in the equity ratio below 1.2 percent is extremely unlikely in 2016, although the downward trend in recent years suggests that this likelihood will grow in future years.

## EQUITY RATIO

There are four primary factors which drive changes in the equity ratio: insured share growth, investment income, insurance loss expenses and operating expenses. Generally speaking, these factors change only slowly over time, so large changes in the equity ratio are rare. An exception from recent experience occurred during the financial crisis when the equity ratio dropped suddenly (fig. 1). Only by assessing over \$1.6 billion in premiums was NCUA able to maintain an equity ratio above 1.2 percent. As economic and industry conditions improved, the equity ratio returned to its normal operating level of 1.3 percent by 2011. However, a number of headwinds have placed downward pressure on the equity ratio in recent years and are likely to continue to do so in the near future.

Figure 1: NCUSIF Equity Ratio



NAFCU's Research Division estimated the impact to the SIF's year-end equity ratio in 2016 and 2017 based on three scenarios: a base case, an optimistic case and a pessimistic case. The three scenarios entail parameters for the various drivers of the equity ratio which are judged to be consistent with economic and industry conditions under these scenarios. The scenario analysis suggests that a slight drop in the equity ratio can be expected under the base case in 2016 to 1.25 percent, with a relatively tight range of expected outcomes of approximately +/- one basis point. Part of the reason for the relatively low degree of uncertainty for the 2016 estimate is that the fund has already reached the midway point in the year. Not only is half the calendar year behind us, but share growth, the chief driver of the equity ratio, tends to be highest during the first half of the year. As a result, it is extremely unlikely that conditions would develop during the remaining part of 2016 which would result in the equity ratio falling below 1.2 percent.

Looking ahead to 2017 does suggest the possibility for an assessment. However, it is only under the pessimistic scenario in which economic and industry conditions would be nearly as bad as they were during the financial crisis that such a situation would arise. Even under such conditions the equity ratio would fall just slightly below the 1.2 percent threshold. As such, NAFCU anticipates that the agency will announce an estimated premium range for 2017 which is similar to its 2016 estimate of zero to six basis points.

Despite the fact that FICUs appear to be in a position to avoid a premium assessment through 2017, the equity ratio has been on a downward path in recent years. While it appears that stresses to the SIF have emerged fairly recently, they were present even during the 2011-2013 period when the equity ratio consistently reached or even exceeded 1.3 percent prior to any distributions on behalf of the Corporate Stabilization Fund. During that time the agency was drawing down reserves which had risen to a peak of \$1.2 billion in 2010. Subsequently, the SIF booked a negative insurance loss expense each year from 2011 through 2015 which buoyed earnings and allowed the fund to perform well despite gathering headwinds.

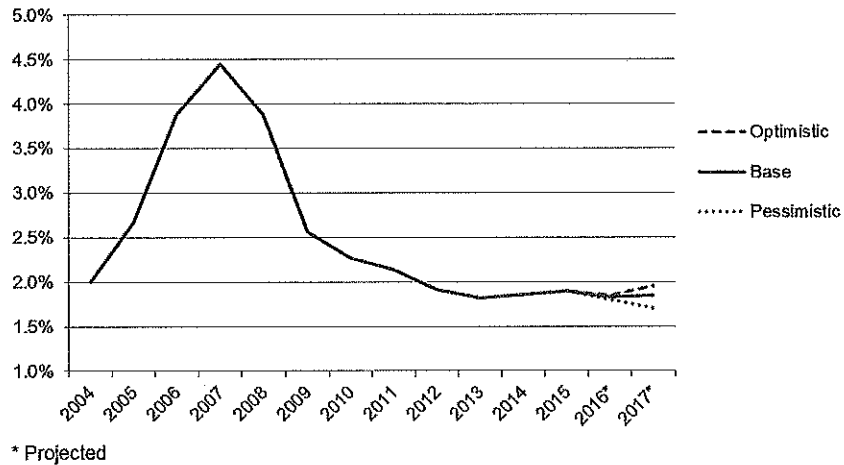
## **INVESTMENT YIELD**

Investments currently constitute roughly 95 percent of total SIF 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.

**Figure 2: NCUSIF Investment Yield**



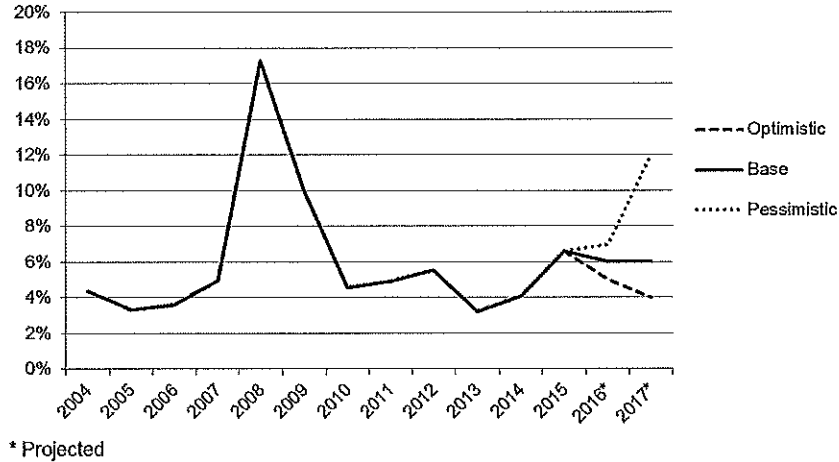
The present structure of the portfolio means that it will be much slower to respond to changes in market interest rates than it would otherwise. In the past, the portfolio yield was far more sensitive to changes in the Treasury yield curve than it is today, which allowed for large swings in yield (fig. 2). This would be a benefit should rates fall further, but in the event that rates increase, the SIF's yield will be less than it could be with a shorter duration. With this in mind, NAFCU assumed a fairly narrow range of potential investment yield scenarios over the next two years.

### SHARE GROWTH

Share growth is a major determinant of changes in the equity ratio. Credit unions contribute one percent of their insured shares to the SIF, which is held as capital by the fund. However, since the fund operates with an equity ratio between 1.2 percent and 1.3 percent, share growth has the effect of diluting the equity ratio.

Forecasting share growth is difficult, and as such, NAFCU's analysis allows for a wide range of possible outcomes (fig. 3). A key determinant of share growth is the performance of financial markets. When returns are low and/or volatility is high, particular in the stock market, households often seek a safe haven for their financial assets. Such a scenario played out during the financial crisis when annual share growth reached 17 percent in 2008. Likewise, share growth accelerated in the second half of 2015 – though not nearly to the same degree – when financial markets were roiled by a number of events, including a rapid rise in the price of oil and China devaluing its currency.

**Figure 3: Insured Share Growth**



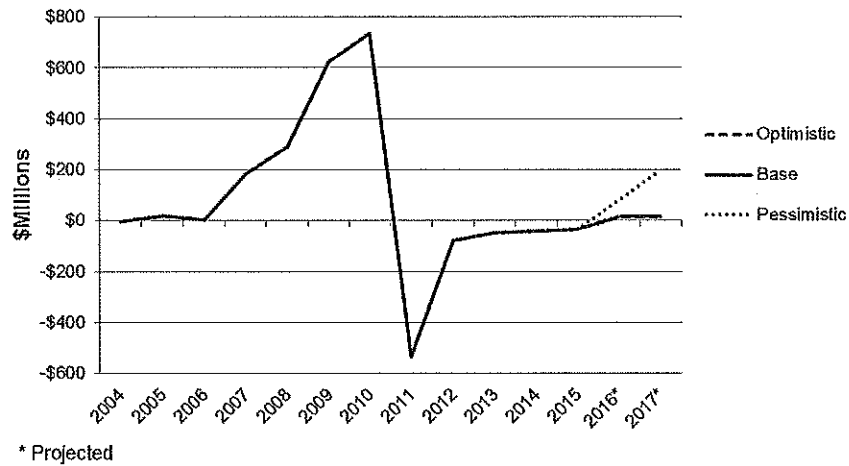
There is a seasonal element to share growth. In a normal year, roughly 75 percent of total annual share growth occurs in the first half of the year. In the first half of 2016, share growth moderated slightly as financial market volatility eased and consumer confidence strengthened. With first-half share growth already behind us, there is a great deal more certainty about the 2016 estimates for share growth and for the equity ratio than there is for 2017.

Of the four factors investigated in this analysis, the two most important are investment yield and share growth. The two can be considered in tandem: in order to achieve a stable equity ratio, higher rates of share growth would generally need to be accompanied by higher investment yields. With the investment portfolio locked into the present low yield due to its increased duration, even a modest rise in share growth from current levels could prove to be problematic. In a non-recession year, average annual share growth has historically been roughly 6 percent, but it was somewhat lower in the years following the financial crisis. Lower share growth has helped to shield the SIF in this low interest rate environment. Going forward, NAFCU's base case assumes a return to the historical norm. That level of share growth combined with the current portfolio yield will not sustain the equity ratio, and further declines similar to what we have seen in the last two years can be expected.

### **INSURANCE LOSS EXPENSES**

In most years, the combination of investment yield and share growth explains the majority of any changes in the equity ratio. However, during and immediately after the financial crisis it was insurance loss expense which most affected the bottom line (fig. 4). NCUA's reserving methodology relies on an econometric model which takes into account industry conditions such as capital levels, delinquencies and CAMEL codes, along with broader trends in the housing market and economy. 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 premium assessments in 2009 and 2010 of over \$1.6 billion.

Figure 4: NCUSIF Insurance Loss Expense



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 has served to increase net income and retained earnings for the SIF, and as a result NCUA was able to pay a distribution to the Corporate Stabilization Fund each year from 2011 through 2013. However, the negative charges to insurance loss expense have gradually tapered, and through June 2016 the insurance loss expense account had a balance of positive \$15.7 million.

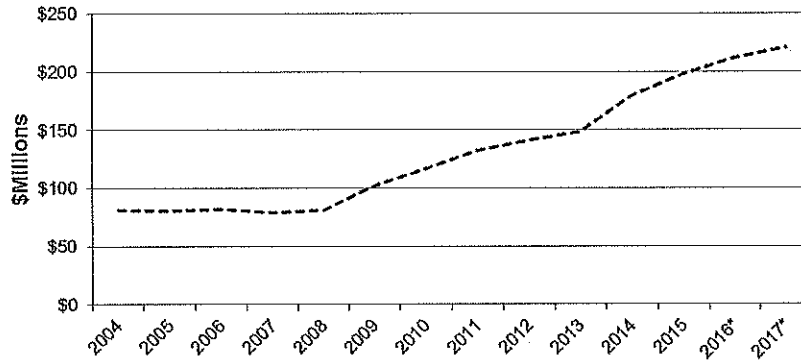
In NAFCU's scenario analysis, the primary question to consider in determining the parameters for insurance loss expense in 2016 and 2017 is the prognosis for the wider economy, including the probability of a recession. In the pessimistic scenario, conditions are nearly as severe as they were in 2007 and 2008 at the onset of the financial crisis. In NAFCU's estimation, this is a fairly low-probability event as the domestic recovery appears to still be on fairly solid footing and the Great Recession was a unique historical event. With that said, it should be noted that weak business investment and slowing growth abroad pose legitimate threats to the economy. Moreover, with rates still near zero, the Federal Reserve would have fewer tools at its disposal to deal with another recession.

## OPERATING EXPENSES

Operating expenses for the SIF 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 SIF.

In recent years, the operating expenses for the SIF have risen dramatically (fig. 5). 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 2016/17.

**Figure 5: NCUSIF Operating Expenses**



\* Projected

Note: NCUA has already budgeted agency operating expenses and the overhead transfer rate for 2016 & 2017. Those figures were used in all three NAFCU scenarios (base/optimistic/pessimistic).

NCUA recently altered its budgeting format to incorporate a two-year budget schedule rather than an annual one. As part of this process, NCUA determined both its overall operating budget and the OTR for both 2016 and 2017. These figures were used in all three scenarios in NAFCU's analysis.

## **CONCLUSION**

The baseline expectation for the SIF over the next two years is for a mild decline in the equity ratio. The present buffer above the 1.2 percent threshold is large enough that a premium assessment is extremely unlikely in 2016, and only the most pessimistic scenario would bring an assessment into play for 2017. As such, NAFCU recommends that NCUA provide assurances to credit unions as early as possible that no assessment is anticipated this year, and that the agency should set an estimated assessment range for 2017 at a level similar to the current year range of zero to six basis points.

However, the shrinking buffer is a cause for concern and given the persistence of this low interest rate environment, the downward pressure on the equity ratio is expected to continue in the near term. NAFCU will continue to monitor the status of the SIF and keep members updated as to the potential for premium assessments in future years.