

# **NCUA's Corporate Stabilization Program, An Update**

CUNA WHITE PAPER  
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## EXECUTIVE SUMMARY

At its December 2016 Board meeting, NCUA presented a detailed briefing on the condition and prospects for the Corporate Resolution Program. Stakeholders are encouraged to read the entire presentation [script](#) and [slides](#). Based on NCUA's presentation and our own analysis, this white paper provides CUNA's view on the outlook for the program.<sup>1</sup>

During the financial crisis, five corporate credit unions became insolvent and were conserved by NCUA. Selling the legacy assets of these corporates at the time would have incurred huge market losses (around \$30 billion), so NCUA and the credit union system sought interim funding from Treasury, and Congress established the Temporary Corporate Stabilization Fund. The obligations of the five corporates were funded by borrowing against the estimated realizable value of the legacy assets in the form of NCUA Guaranteed Notes (NGNs), borrowing from Treasury, and collecting stabilization assessments from all federally insured credit unions. Initial estimates of the total resolution costs using this structure were around \$15 billion, to be funded by roughly \$5 billion in depleted capital from the five corporates and about \$10 billion in stabilization assessments to be paid by credit unions on the basis of their insured shares. An advantage of this structure is that it allowed credit unions to spread the cost of the assessments over several years.

Since then the financial condition of the Stabilization Fund has improved dramatically as the economy and housing markets have recovered and NCUA successfully sued a number of the investment bankers that sold the legacy assets to the corporates. Accounting rules also likely caused some overestimation of losses. The total cost of the resolution is now projected to be between \$5.5 billion and \$7 billion, less than half the original estimates. As the Fund's condition improved, assessments were suspended after 2013, having amounted to \$4.8 billion. With these assessments and \$5.6 billion in depleted capital from the five corporates (a combined \$10.4 billion), credit unions have overpaid the now projected final costs of the resolution by between \$3.4 billion and \$4.9 billion.

That excess will be refunded to credit unions in the form of partial rebates of assessments and partial capital replenishment to members of three of the five corporates. Current projections show that between half and two thirds of the \$4.8 billion of assessments will be rebated through the National Credit Union Share Insurance Fund, and between 15% and 30% of the \$5.6 billion in depleted capital will be replenished.

Although this is much better news than we may have expected at the time of the crisis, the timing of the refunds is uncertain, and much of them will not occur until the last of the NGNs mature in 2021. Capital refunds are unlikely to occur before 2021. Assessment rebates will require merging the Stabilization Fund into the Share Insurance Fund, and could begin as soon as later this year. Refunds will not be fully paid until 2021 or even later depending on the disposition of the remaining legacy assets after the NGNs mature.

There are three important policy decisions that NCUA will need to make concerning the wind-down of the corporate resolution program. CUNA, the leagues and our member credit unions will address

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<sup>1</sup> The slide numbers mentioned in this document refer to [slides](#) presented at the NCUA Board meeting in December 2016.

these issues over the coming months and provide recommendations to NCUA. Credit unions that wish to have their views included in this analysis should send their input to [Refund@cuna.coop](mailto:Refund@cuna.coop).

1. It appears advantageous to merge the two Funds this year and begin the process of assessment rebates in the form of an insurance fund dividend. There are risks and ramifications to this strategy, which we will evaluate.
2. In any event, even if the Funds are not merged this year, the prospect of a considerable capital infusion into the Share Insurance Fund in the next few years from the merger with the Stabilization Fund means that a share insurance premium this year is simply not necessary.
3. As the stabilization program winds down in 2020 and 2021, there will be important decisions on how to be dispose of the remainder of the legacy assets, and NCUA and credit unions will need to conduct a dialog on the best course of action.

## WHAT LED TO THE STABILIZATION PROGRAM?

During the financial crisis of 2007 to 2009, five corporate credit unions became insolvent and were eventually conserved by NCUA. The market value of their assets (largely private label mortgage-backed securities) had fallen, by around \$30 billion. Unrealized losses (other comprehensive income) exceeded their capital. Credit unions found the dwindling accounting capital at the corporates unsettling, and many began the notice process to withdraw membership capital. It was very likely only due to a temporary share guarantee program provided by NCUA that the corporates did not experience major depositor runs. In this situation, NCUA had three options:

- A. Suspend the share guarantee program and allow depositor runs. This would have triggered a direct loss to credit unions with deposits in the corporates of as much as \$25 billion (plus \$5 billion of contributed capital), and follow-on losses to the Share Insurance Fund from credit unions that would have failed as a result.
- B. Allow the five corporates to continue to operate under the corporate share guarantee program indefinitely, or until such time as they either recovered or had to be resolved. The expected losses due to the share guarantee would have to have been carried as a liability of the Share Insurance Fund, which would have required an infusion of capital to that Fund.
- C. Conserve the five corporates, and establish a separate Stabilization Fund to pay for the expected losses.

Option A would have been calamitous for the credit union system. The second and third were similar in that theoretically the same amount of eventual loss exposure was involved. However, the amount of loss that would need to be covered, initially estimated at around \$15 billion, dwarfed the Insurance Fund's \$11 billion equity at the time. Treasury funding was therefore necessary to spread the cost to credit unions over several years. There is a slim chance that three of the corporates might have been able to recover if protected from runs by a deposit guarantee. But Congress would not have granted a Treasury loan if the management of institutions that got into trouble were left in place.

Therefore, Congress established the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) in May 2009. The initial expectation was that the estimated \$15 billion cost<sup>2</sup> of stabilization (losses on the assets held by the five conserved corporates) would be covered by the \$5.6 billion of capital in the five corporates with the remaining approximately \$10 billion to be paid as stabilization assessments by credit unions over the seven-year life of the Fund (later extended to a total of eleven years). With the establishment of the Stabilization Fund, credit unions had access to their shares and deposits in the five conserved corporates at par. The liquidity for this was provided by securitizing the legacy assets into NCUA Guaranteed Notes (NGNs), by borrowing from Treasury under the terms of the Temporary Corporate Stabilization Fund, and by stabilization assessments paid by all insured credit unions.

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<sup>2</sup> The cost estimate was actually a range from \$13.9 billion to \$16.1 billion.

## DEVELOPMENTS SINCE THE CRISIS

Credit unions began paying corporate stabilization assessments in 2009. They paid 4 basis points (bp) of insured shares that year, 13.4 bp in 2010, 25.1 bp in 2011, 9.5 bp in 2012, and 8 bp in 2013, for a total of \$4.8 billion. Combined with the \$5.6 billion of depleted capital from the conserved corporates, that amounted to \$10.4 billion against the original estimate of approximately \$15 billion of total losses, with eight years to go for the Stabilization Fund.

However, there have been no assessments since 2013. This is because since the dark days of 2009, the condition of the stabilization fund has improved dramatically.<sup>3</sup> This occurred for a number of reasons:

- Estimates of future losses made in a time of financial crisis are very likely to overstate actual losses, particularly when conservative accounting principles must be followed. No doubt this occurred, in the same way that credit unions following GAAP overestimated loan losses during the same period.
- The economy improved substantially, unemployment rates fell, and interest rates remained low—bolstering the performance of the mortgages underlying the legacy assets.
- NCUA successfully sued several of the investment bankers that sold the legacy assets to the corporates, recovering a net \$3.2 billion.

As a result, current estimates of the total eventual cost of the corporate resolution are in the range of \$5.5 billion to \$7.0 billion (slide 21). With credit unions having already paid \$10.4 billion toward those costs, they can look forward to a combination of assessment rebates and refunds of capital depletions of between \$3.4 billion and \$4.9 billion. Considering that these estimates are still made under conservative accounting assumptions, and there is the possibility of further legal settlements not included in the estimates, the total surplus is likely to be closer to \$5 billion than \$3 billion. The only events that would darken this outlook would be major downturns in the US macro-economy and/ or the housing market.

## TIMING AND DISTRIBUTION OF REFUNDS

The likely \$4 billion to \$5 billion total surplus in the corporate resolution program will eventually be refunded to credit unions in the form of partial rebates of assessments paid and/or partial recoveries of depleted capital. There are two important issues here: the **amount** of the total refunds depends on the future performance of the remaining legacy assets, any further legal settlements, and the costs of operating the program. The **timing** of the refunds will depend on contractual and legal considerations, and most important, liquidity.

## AMOUNT OF REFUNDS

Consider first assessment rebates. The TCCUSF will not make direct rebates to assessment payers. Instead, the TCCUSF will terminate by being merged into the NSCUSIF. When that happens, the

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<sup>3</sup> A rolling report on how estimates of the total cost of the program have changed over time is regularly updated on NCUA's website [here](#).

balance sheets of the two Funds will be merged, meaning that the surplus in the Stabilization Fund will be added to the equity of the Share Insurance Fund. This will almost certainly cause the Share Insurance Fund ratio to rise above its normal operating level of 1.3%, triggering a share insurance dividend. So, assessment rebates will occur as share insurance dividends, and will be based on the amount of a credit union's insured shares at the time of the rebate. The initial or default expectation was that the funds would be merged after the last NGNs mature in 2021, but it could happen sooner (see below).

Capital replenishment will vary by corporate, and will depend on the performance of the particular legacy assets previously owned by each corporate: each corporate's "asset management estate." To meet the member share<sup>4</sup> and liability obligations of each corporate after the conservatorships, debt funding was required because the legacy assets could not be sold without significant losses. This funding came from securitizing each corporate's legacy assets into NCUA Guaranteed Notes (NGNs), and additional borrowing from the Stabilization Fund, which was funded by borrowing from Treasury and stabilization assessments. Once the NGNs mature and the NGN investors have been paid in full, if the value of the remaining legacy assets exceeds the amount of funding provided by the Stabilization Fund, any excess value will be available for capital replenishment.

Essentially, those credit unions with capital shares in the five corporates had that capital written down, and all federally insured credit unions covered the rest of the expected losses of the Stabilization Fund through assessments in proportion to their insured shares. As each asset management estate is wound down, the first priority will be to repay the NGN investors, followed by repaying any funds provided by the Stabilization Fund (which came from assessments and borrowing from Treasury which has since been repaid by the Fund) and other obligations. In other words, assessment rebates come before capital replenishment. The reason there will be some capital restoration without full assessment rebates is because one of the corporate's asset management estate (WesCorp) will remain in the red. (Slides 26 and 27).

NCUA's latest estimates are that former capital holders of three of the five corporates can expect partial capital replenishment. Replenishment estimates range between 20% and 36% for Members United, 20% to 50% for US Central, and 44% to 63% for Southwest Corporate. There will be no replenishment for WesCorp, and little or no replenishment for Constitution Corporate (Slides 28 and 29). These numbers will change through time depending on the performance of the legacy assets in each estate and possible further legal settlements.<sup>5</sup>

Of the total amount projected to be available for assessment rebates and capital replenishment (\$3.4 billion to \$4.9 billion), under current projections the amount going to assessment rebates would be \$2.5 billion to \$3.2 billion, and capital replenishment would be \$0.9 billion to \$1.7 billion (Slide 21).

The following table summarizes what the final disposition of the stabilization program will be if current projections hold. The "optimistic scenario" refers to the performance of the legacy assets under a strong credit outlook and recovery of the full realizable value of the legacy assets when the NGNs

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<sup>4</sup> Excluding membership capital which was depleted or written down.

<sup>5</sup> Capital replenishment cannot exceed 100% of depleted capital in the event recoveries on the legacy assets are even greater than expected. In that case, any excess would go into the pool funding assessment rebates.

mature. The “pessimistic case” refers to the performance of the legacy assets under a weak credit outlook and sale of the legacy assets at market prices when the NGNs mature (Slide 20).

The table shows that, credit unions have thus far paid a total of \$10.4 billion toward resolution costs: \$5.6 billion in depleted capital in the five corporates and \$4.8 billion in assessments. Current projections for the total cost of the resolution, minus legal settlements are \$5.5 billion in the optimistic case and \$7 billion in the pessimistic case (Slide 21).

In the optimistic case, subtracting the \$5.5 billion cost projection from the \$10.4 billion paid implies total refunds of \$4.9 billion. This \$4.9 total refund would be distributed as \$1.7 billion in capital replenishment and \$3.2 billion in assessment rebates (Slide 21). This means the total refunds of \$4.9 billion would be almost half (47%) of the total amount paid (\$10.4 billion). Further, 30% of depleted capital would be restored, and 67% of assessments would be rebated. Referring to rows 8 to 10 of the table, of the total \$5.5 billion cost of resolution, \$3.9 billion or 71% would be covered by capital depletion and \$1.6 billion or 29% by assessments.

In the pessimistic case, combined refunds would total \$3.4 billion, comprised of \$0.9 billion in capital restoration and \$2.5 billion in assessment rebates (Slide 21). In this case, the total refunds of \$3.4 billion would represent 33% of the \$10.4 billion paid. Further, 16% of depleted capital would be restored and 52% of assessments would be refunded. Of the total \$7 billion cost of resolution, \$4.7 billion or 67% would be covered by capital depletion and \$2.3 billion or 33% by assessments.

In summary, it now appears that two thirds or more of the cost of resolution will be covered by capital depletions rather than assessments. Further, between half and two thirds of assessments will eventually be refunded (or added to the equity of the Share Insurance Fund, causing NCUSIF dividends or lowering future premiums) and between 15% and 30% of depleted capital will be restored. Compared to cost estimates at the time of the crisis, these are very positive results. However, the return of most of these funds to credit unions will be about a decade from the time of original payment. The very low interest rates over the period perhaps lessen the sting of lost revenue.

<b>Summary of Current Projections (\$ bil)</b>		<b>Optimistic Scenario</b>		<b>Pessimistic Scenario</b>	
1=2+3	Total Paid by CUs	\$10.4		\$10.4	
2	Capital Depleted	\$5.6		\$5.6	
3	Assessments	\$4.8		\$4.8	
4	Projected Resolution Costs	\$5.5		\$7.0	
		Amount	% Returned	Amount	% Returned
5=1-4	Total Projected Refunds	\$4.9	47%	\$3.4	33%
6	Projected Capital Replenishment	\$1.7	30%	\$0.9	16%
7	Projected Assessment Rebates	\$3.2	67%	\$2.5	52%
		Amount	% of Total	Amount	% of Total
8=4	Projected Resolution Costs	\$5.5	100%	\$7.0	100%
9=2-6	Net Capital Depletion	\$3.9	71%	\$4.7	67%
10=3-7	Net Assessments	\$1.6	29%	\$2.3	33%

## TIMING OF REFUNDS

When assessment rebates and capital replenishment occur will depend on different factors. Consider first capital replenishment. It can only occur after all obligations of each asset management estate have been paid. In other words, not until after the NGNs mature. The bulk of the NGNs mature in 2020 and 2021, therefore capital replenishment is still three to four years off.

Assessment rebates are a different matter. They can begin as soon as the Stabilization Fund is merged into the Share Insurance Fund. That could happen as soon as later in 2017. However, the full amount of refunds would not be available in the next few years because of accounting rules and the liquidity of the Stabilization Fund.

The current accounting net position of the Stabilization Fund is \$1.5 billion. That is about half of the expected total amount of eventual assessment rebates described above (\$2.5 billion to \$3.2 billion). The bulk of the difference between these accounting and economic values is a \$1 billion written off capital note to US Central, which accounting rules do not allow to be counted until it is actually repaid. That cannot happen until the final NGN holders are paid in 2020 or 2021. A few additional accounting issues that do not allow economic value to be recorded amount to about \$400 million, bringing the total economic value available for assessment rebates to around \$3 billion. The currently expected \$1.4 billion that would go to capital restoration is also not included in the accounting net position (Slide 23).

If the Stabilization Fund were merged into the Share Insurance Fund this year, the equity of the Share Insurance Fund would rise by the \$1.5 billion accounting net position of the

There are three types of valuation of the portfolio of legacy assets:

**UNPAID PRINCIPAL BALANCE.** The total of the unpaid balances of the mortgages securitized in the legacy assets. This is analogous to the par value of a non-amortizing security. The total unpaid principal balance is reduced over time as the underlying mortgages are either paid down, or default. It represents the amount that would be received if all borrowers were to immediately prepay their loans in full.

**NET REALIZABLE VALUE.** The present value of all expected cash flows from the underlying mortgages (future interest and principal payments) using an appropriate discount rate. The future cash flows are estimated based on the expected performance of the underlying mortgages, including estimates of default rates and losses in event of default based on forecasts of driver variables such as macroeconomic performance, employment, interest rates and home prices. Since these net realizable values are estimated, they are often presented in a low-to-high range based on pessimistic and optimistic future values of the driver variables.

**MARKET VALUE.** The amount for which the legacy assets could be sold on the open market.

At any time, the highest of these values is the unpaid principal balance. It represents complete payment of all loans. Next typically comes the net realizable value, which incorporates estimates of defaults. The market value is usually lowest because it builds in an additional discount since a buyer would have to take on the risk of the estimated payments not being realized.

Stabilization Fund, raising the NCUSIF's ratio of equity to insured shares at year-end from a projected 1.25% to upwards of 1.4%. That would trigger a share insurance dividend of 8 or 9 basis points, or almost \$1 billion. In other words, of the \$1.5 billion of the Stabilization Fund's net position, about \$500 million would be used to top off the Insurance Fund at 1.3% of insured shares (of course, also at the same time negating the need for any NCUSIF premium this year) and the remainder would be paid out as a dividend. That would leave roughly \$1.5 billion of additional assessment refunds in 2020 or 2021 as the NGNs mature and the rest of the economic value in the stabilization program is realized.

The attraction of merging the Stabilization and Insurance Funds this year is that it will eliminate the need for an insurance premium and allow the first installment of assessment rebates to occur. However, doing so would not be without risks (Slide 40). The major risk is that a merger would subject the Share Insurance Fund's equity to possible volatility caused by fluctuations in the projected net realizable value of the legacy assets for the remainder of their existence. But, with the passage of time and the very low probability of a significant economic downturn in the coming few years, that risk does not appear to be insurmountable. There will also be liquidity issues to be dealt with (see below), but they would exist with or without a merger of the Funds.

Complicating the payment of assessment rebates are the liquidity requirements of the wind-down of the stabilization program, specifically the maturity of the NGNs. In order to be able to process share withdrawals from the corporates as they were conserved, the Stabilization Fund borrowed from two sources: the US Treasury and NGN investors. Treasury borrowing (now fully repaid) was required because the net realizable value of the legacy assets (the present value of the expected cash flows from the legacy assets) was substantially below the value of the shares and other obligations of the corporates. NGN issuance was approximately equal to the net realizable value of the legacy assets, with Treasury borrowing and assessments making up the difference.

The NGNs were structured to mimic the cash flows of the underlying legacy assets (primarily mortgage-backed securities) but with fixed maximum maturities of ten years. In other words, as the principal balances on the underlying mortgage-backed securities are repaid, the principal of the NGNs is repaid. Although the NGNs have fixed 10-year maturities, many of the underlying securities in the legacy assets have longer amortization schedules. Therefore, in most cases, the NGN investors will not have been fully repaid at the time of an NGN's maturity. In those cases, the NCUA will have to make an "NGN Guarantor Payment," essentially a balloon payment, to cover the remaining balance of the NGN. This is not a payment to cover a loss. It is simply to cash out the NGN investors at maturity before the legacy assets have fully amortized. In fact, the combined net realizable value of the legacy assets at the time of the NGNs' maturity will exceed the total required Guarantor Payments.

NCUA currently estimates that the total NCUA Guarantor Payments that will be required for all NGNs will amount to about \$3.2 billion, and \$2.8 billion of those will occur in 2020 and 2021. They further project that by then the program will have accumulated sufficient cash to pay all but \$1 billion of the Guarantor Payments. Meeting that last \$1 billion of payments will require selling some of the legacy assets, re-securitizing them, or using NCUSIF funds (Slides 33 and 34).

Further, after the NGNs mature in 2020 and 2021, NCUA will face some choices on how to dispose of the remainder of the legacy assets in order to make final assessment rebates and capital replenishments. NCUA's projections are that the difference between the market value and net

realizable value of the legacy assets at the time will be slightly over \$1 billion. (On slide 20, the difference between “monetizing” (selling) the legacy assets and re-securitizing them, which would require waiting for several years for the legacy assets to amortize). It will be vital for credit union stakeholders to be included in the decision-making process then.

Again, as for all of these future projections, actual results will depend on the performance of the legacy assets, prepayment speeds on the underlying mortgages, and possible additional legal settlements. As time passes, it is also possible that the difference between market values and net realizable values will shrink, making outright sale of the legacy assets more attractive.

## **SUMMARY AND CONCLUSIONS**

After a very vexing period in the financial crisis, the condition of the Stabilization Fund has steadily improved. Although it will have been a huge burden on credit unions, the eventual total cost of the resolution will be slightly less than half of the original projections. That is good news. As the program winds down, there are three important considerations:

1. It is possible that assessment rebates in the form of an Insurance Fund dividend can begin this year, with the merger of the Stabilization and Share Insurance Funds. CUNA and its member credit unions will be reviewing this option in detail in the coming weeks, but at first glance it appears to have considerable merit.
2. In any event, even if the funds are not merged this year, the prospect of a considerable capital infusion into the Share Insurance Fund in the next few years from the merger with the Stabilization Fund means that a share insurance premium this year is simply not necessary. The NCUSIF equity ratio is not projected to fall below 1.2% by 2021 under NCUA’s base case projection, and by then the equity boost from the Stabilization Fund will be far in excess of 10 bp of insured shares.
3. As the stabilization program winds down in 2020 and 2021, there will be important decisions on how to be dispose of the remainder of the legacy assets, and NCUA and credit unions will need to conduct a dialog on the best course of action.

CUNA, the leagues and our member credit unions will address these issues over the coming months and provide recommendations to NCUA. Credit unions that wish to have their views included in this analysis should send their input to [Refund@cuna.coop](mailto:Refund@cuna.coop).

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## **CONTACTS IN CUNA’S RESEARCH AND POLICY DEPARTMENT**

[Bill Hampel](#), [Mike Schenk](#), [Perc Pineda](#)

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