The Case Against an NCUSIF Premium in 2017

Credit Union National Association
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Executive Summary

NCUA has signaled the possibility that a 3 to 6 basis point National Credit Union Share Insurance Fund premium may be levied in 2017. This is a very surprising announcement given the current and prospective condition of the share insurance fund and NCUA’s past practice. The announcement suggests a change in the long-term fund management strategy by NCUA that CUNA believes is unwarranted.

Although the normal operating level of the equity ratio of the fund is currently 1.3% of insured shares, NCUA’s practice over the past three decades has established a normal operating range of 10 basis points below that level, from 1.2% to 1.3%. Under NCUA’s base case assumptions, the fund will end 2017 with the fund ratio at 1.25%; under its pessimistic assumptions, at 1.24%. In its thirty-year history, the fund has six times ended the year with an equity ratio of 1.25% or lower without charging a premium. Premiums have been reserved for cases when the fund would end the year very close to or below the 1.2% level that triggers a premium requirement.

Therefore, if NCUA follows past practices and policies on managing the share insurance fund, a premium in 2017 is a very remote possibility unless financial conditions take a very rapid and severe turn for the worse.

If NCUA does charge a premium in 2017 despite the fact that the fund’s equity ratio will be in the middle of the normal operating range, that suggests a likely change in future fund management policy, including the likelihood of raising the normal operating level of the fund above 1.3%. The board has the authority to raise it to 1.5%; going further would require legislation.

CUNA believes there is no good reason to tinker with the natural person credit union share insurance fund that has performed so reliably over the entire thirty years of its current form of capitalization, despite turbulent financial markets over that period. Reforms may well be necessary for the FDIC, which suffered two periods of massive volatility in the bank insurance fund ratio. NCUSIF experienced no similar volatility, so FDIC-like reform of the credit union fund is completely unnecessary. Changes to the structure and operation of corporate credit unions since the financial crisis have made them safe and sound partners to natural person credit unions that present negligible risk to the share insurance fund.
Introduction
At the November meeting of the NCUA Board, agency staff presented an analysis of the prospective condition of the National Credit Union Share Insurance Fund (NCUSIF) with the conclusion that credit unions should anticipate a share insurance fund premium of between 3 basis points (bp) and 6 bp of insured shares in 2017.1

To be clear, NCUA did not announce that there will be a NCUSIF premium next year. In NCUA’s summary of the board meeting, Chairman Metsger said: “credit unions next year may need to pay” a premium. [Emphasis added]. Nevertheless, given the current and near term prospective condition of the fund, the fact that the agency is even considering a premium in 2017 is very unusual.

Statutory and Policy Constraints on the NCUSIF Equity Ratio
By law, the NCUSIF equity ratio (the retained earnings of the fund plus credit unions’ 1% deposits divided, by total insured shares) can vary between 1.2% and 1.5%. NCUA is required to charge a premium if the ratio falls below 1.2%, and is prohibited from charging a premium if the ratio exceeds 1.3%. The NCUA Board has historically adopted 1.3% as the normal operating level, which means if the Fund ends a year with a ratio over 1.3%, it pays the excess as a dividend on credit unions’ 1% deposits.2 Therefore, in effect, the normal operating “range” of the fund is from 1.2% (below which a premium is required) to 1.3% (above which a dividend is paid).

Historical Financial Operation of the NCUSIF
It has been slightly over 30 years since the fund was capitalized in its current form, with credit unions contributing 1% of insured shares as capitalization deposits and the fund’s retained earnings making up the balance. Since share insurance deposits are topped off each year at 1% of insured shares, maintaining the Fund in its normal operating range requires net income sufficient to keep the retained earnings of the fund between 0.2% and 0.3% of insured shares. The amount of net income required depends on the growth rate of insured shares. The primary source of fund income is interest earnings on the fund’s total assets: the sum of the 1% deposits and retained earnings. The other available source of income is a premium assessment. The two primary expenses of the fund are operating expenses and insurance losses.

For almost all of its history, interest earnings have been sufficient to cover operating expenses and insurance losses and to keep retained earnings between 0.2% and 0.3% of insured shares. In fact, in the first 20 years of its operation, the fund had to pay a dividend seven times to avoid exceeding the 1.3% normal operating level. In the past 10 years, there were three times the Fund would have

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1 The staff presentation at the meeting can be found [here](#), and NCUA’s summary of the presentation and explanation of the recommended premium range for next hear can be found [here](#).

2 NCUA is temporarily prohibited from paying a NCUSIF dividend to credit unions while the Temporary Corporate Stabilization Fund has an outstanding loan balance from Treasury. Instead, what would have been a dividend must be transferred to the Stabilization Fund, which should increase the size of the eventual refund to credit unions from the Stabilization Fund.
paid a dividend except for the fact the Corporate Stabilization Fund had an outstanding loan from Treasury, which requires that any excess over 1.3% be paid to the Stabilization Fund.

The Fund has needed to impose a share insurance premium only three times since it was established in its current form: an 8 basis point premium was levied in 1991, although it was recorded partially in 1991 and partially in 1992. Following the Great Recession, premiums of 10.3 bp and 12.4 bp were charged in 2009 and 2010.

In summary, during the Fund’s 30-year history, approximately one third of the time it has paid a dividend, and a premium has been required only 10% of the time. It has never ended a year with an equity ratio of less than 1.2%. The lowest yearend ratio has been 1.23%, which occurred on four occasions, and on two of those a premium was required to maintain the 1.2% ratio.

The past practice of NCUA has clearly been to levy an insurance premium only when not doing so would have left the fund with an equity ratio nearly at or below 1.21%.

**Current and Near-Term Future Condition of the Fund**

In light of NCUA’s past successful management of the NCUSIF equity ratio, the prospect of a premium in 2017 is out of character. At the end of September 2016, the Fund’s equity ratio stood at 1.27% of insured shares, up slightly from 1.26% at yearend 2015, but down from 1.29% in 2014. The recent marginal decline in the equity ratio has been caused by healthy growth of insured shares coupled with low earnings resulting from an extended period of very low interest rates. Insurance losses have not been the culprit. In fact, insurance losses have been negative, as excess reserves for losses, expensed during the financial crisis, have been reversed. That process is now about over, removing a positive contributor to net income.

On slide 14 of NCUA’s presentation on the prospects for a premium, the agency provides estimates of the fund ratio for the next few years under a variety of assumptions. The base case assumes interest rates remain flat at the levels of June 2016, and that insurance losses, operating expenses and insured share growth all proceed at average rates experienced over the past several years. The slightly pessimistic “base-minus” case, with lower future fund ratios, assumes lower interest rates, and higher insurance losses, share growth and operating expenses. The slightly optimistic “base-plus” case assumes higher interest rates, and slower growth in insurance losses, operating expenses and insured shares. A summary of NCUA’s projections is found in the following table.

| NCUA PROJECTIONS FOR NCUSIF EQUITY RATIO: |
|-----------------------------|-----------------------------|-----------------------------|
| As of Year End: | BASE-Minus | BASE | BASE-Plus |
| 2016 | 1.26% | 1.27% | 1.27% |
| 2017 | 1.24% | 1.25% | 1.26% |
| 2018 | 1.22% | 1.24% | 1.26% |
| 2019 | 1.20% | 1.22% | 1.25% |
| 2020 | 1.19% | 1.21% | 1.24% |

These projections show that even under the pessimistic base-minus case the equity ratio will not approach the 1.2% premium-triggering level in 2017. Hence our surprise that NCUA has signaled the possibility of a premium next year. In the base case a premium would not be necessary until
sometime in 2021. Further, since the time of these projections, one of the most important drivers of the ratio, the level of interest rates, has risen substantially. The 2-year Treasury yield (assumed to remain at 0.58% in the base case and rise to 2.01% in the base-plus case) has already risen to 1.15%. The 10-year yield (1.47% in the base case and 2.08% in base-plus) now at about 2.5% already exceeds the base-plus assumption. Of course, it will take time for NCUSIF’s portfolio to roll over into the higher rates, but the rise in rates already experienced suggests that projections for the out years may well be higher than the base case projections, rather than in the direction of the base-minus case.

Why the Suggestion of a Possible Premium in 2017?
Considering that in the past, NCUA has never levied a share insurance premium unless the equity ratio would end the year at or below 1.2%, and by its own projections that is unlikely to happen before 2020 or later, why the suggestion that a premium of 3 bp to 6 bp might be imposed in 2017? Doing so would be a sharp departure from the past practice that has successfully maintained the fund between 1.2% and 1.3% for thirty years.

The explanation likely lies in a whitepaper titled *National Credit Union Share Insurance Fund Improvement* published by NCUA in 2013. The paper recommends legislation that would make four changes:

- Remove the current statutory cap of 1.5% on the equity ratio.
- Allow the agency to levy premiums even when the fund ratio exceeds 1.3%.
- Base assessments on the sum of all shares and deposits and liabilities, not just insured shares.
- Allow risk-based premiums.

The white paper suggests NCUSIF needs an equity ratio of “at least 2%,” compared to the current operating range of 1.2% to 1.3%. The rationale provided is twofold: to mimic a move by the FDIC to increase the Bank Insurance Fund (BIF) reserve ratio to over 2% to prevent another insolvency of the BIF, and to be sufficient to cover a loss to the NCUSIF on the order of magnitude of the loss incurred for corporate stabilization, without having to impose significant premiums or resorting to temporary Treasury borrowing.

Both of these rationales are flawed. There is simply no need for a dramatic increase in the equity ratio of the credit union share insurance fund.

**FDIC is Not the Appropriate Model for the NCUSIF**
Following the financial crisis of the last decade, the Dodd-Frank Act revised FDIC’s fund management authority, removing a cap on the Bank Insurance Fund ratio and providing that premium assessments could be based on total assets rather than just deposits. The FDIC board then adopted a target ratio for the BIF of 2%.

The reason for the increase in the BIF ratio is to avoid a reoccurrence of a situation twice experienced over the past 25 years, when the BIF was rendered temporarily insolvent. The first episode was due to large insurance losses stemming from a banking crisis when a large number of
banks failed from the mid-1980s to the early 1990s. The second was the financial crisis and Great Recession of 2007 to 2009. These insolvencies occurred despite substantial increases in deposit insurance premiums during each episode, which placed additional pressure on bank earnings during stressful times. FDIC staff have estimated that a BIF ratio of 2.0% to 2.5% would be sufficient to weather a similar storm in the future, maintaining a positive fund balance and without resorting to extraordinary premiums.

The fact that the commercial banking industry may be subject to periodic crises that imperil the solvency of the BIF does not mean the same holds true for natural person credit unions and the NCUSIF. In fact, over the same period, just the opposite is the case. The graph below shows both the BIF and NCUSIF fund insurance fund ratios since 1988. Over the entire period, including the two instances when the BIF was negative, the NCUSIF ratio NEVER fell below 1.2% of insured shares, much less into negative territory. NCUA did impose premiums during those periods to maintain the NCUSIF fund above 1.2%, but those premiums were substantially less than FDIC had to charge, and even then the BIF balance went negative.

The plain fact is that natural person credit unions are not banks and should not be regulated or supervised as banks; nor should the credit union share insurance fund mimic the bank deposit insurance fund. The primary reason is that credit unions, as cooperatives, have a much smaller appetite for risk than do investor-owned institutions.\(^3\) This is not to say that credit unions do not

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\(^3\) Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn’t Put a Bite on U.S. Taxpayers*, *Journal of Banking and Finance*, 20 (September, 1996), pp. 1305-1327. Kane and Hendershott describe how the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different.
sometimes make mistakes or incur losses from time to time. But loss exposures relative to assets are orders of magnitude lower at credit unions than at banks as the graph above clearly demonstrates. The dramatic solution that FDIC has adopted to deal with the significant problems of the bank insurance fund over the past three decades is just not relevant considering the stable operation of the NCUSIF over the exact same period, operating in the same economy and financial markets.

How Could a Major Loss Arise?
The second reason posited by NCUA for raising the NCUSIF equity ratio to 2% is to be able to withstand a future loss similar in magnitude to that which resulted from the conservatorship of five corporate credit unions during the financial crisis a decade ago. That loss represented about 1.1% of insured deposits. Whereas it is indeed true that a higher equity ratio would be necessary to cover such a large loss without either writing down credit unions’ share insurance deposits or imposing substantial premiums, it is exceedingly difficult to imagine the possible source of such a loss in the future.

For a loss amounting to more than 1% of insured deposits to occur from within the operations of natural person credit unions, there would have to be a complete reversal or negation credit union cooperative structure, operations and supervision. The total natural person credit union insurance losses to NCUSIF during the financial crisis amounted to less than 0.2% of insured shares, and they occurred over a three-year period. Premiums of 10.3 bp in 2009 and 12.4 bp in 2010 were sufficient to keep the fund above 1.2%. This is not ancient history. It is recent, relevant experience showing that large, complex credit unions as exist today performed well during the worst financial crisis in the US since the Great Depression of the 1930s. This is certainly overwhelming evidence that a loss of over 1% of insured shares arising from the operations of natural person credit unions is incredibly unlikely.

The Major Risk to NCUSIF Has Been Removed
Of course, the NCUSIF did suffer a substantial loss in the recent financial crisis. But that loss did not stem from natural person credit unions. Instead, it arose from the conservatorship of four very large corporate credit unions, each with extremely high concentrations of private label mortgage backed securities in their portfolios. Since then, the corporate system has been modified so much as to be almost unrecognizable compared to a decade ago. Indeed, that change was for the most part driven by NCUA’s reaction to the crisis.

The extent of the changes in the corporate system is shown in the table on the following page. Just before the crisis, at the end of 2006, there were 30 corporate credit unions with total assets of $129 billion and total shares of $98 billion. Those shares amounted to 18% of the insured shares in all credit unions, and were 14 times the equity in the share insurance fund. The aggregate capital ratio of the 30 corporates was 2.75%. The largest two corporates held $44 billion and $31 billion in assets, and two more had assets of more than $10 billion. All four of those largest corporates were among the five that were later conserved.

from those faced by a for-profit financial institution, making it less feasible for credit unions to benefit from high-risk strategies.
After the crisis, NCUA imposed a far-reaching new corporate credit union rule governing corporates operations that includes much more stringent investment limitations and higher capital requirements. As a result, today there are 11 corporates will total assets of just $19 billion and total shares of $16.3 billion. Those shares now represent just 1.6% of insured shares in all credit unions, and are in total only slightly larger than the equity of the share insurance fund. The aggregate capital ratio of the eleven corporates is 8.11%. The largest three corporates each has total assets in the $3 to $4 billion range, and another two have assets between $2 and $3 billion.

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<thead>
<tr>
<th>Corporate Credit Unions Then and Now</th>
<th>2006</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Institutions</td>
<td>30</td>
<td>11</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$129 billion</td>
<td>$19 billion</td>
</tr>
<tr>
<td>Total Credit Union Shares and Deposits</td>
<td>$98 billion</td>
<td>$16.3 billion</td>
</tr>
<tr>
<td>Aggregate Capital Ratio</td>
<td>2.8%</td>
<td>8.1%</td>
</tr>
<tr>
<td>Corporate Shares/Natural Person CU Shares</td>
<td>18%</td>
<td>1.6%</td>
</tr>
<tr>
<td>NCUSIF Equity/Total Corporate Shares</td>
<td>7.1%</td>
<td>81%</td>
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<table>
<thead>
<tr>
<th>Largest Four Corporate CU Sizes</th>
<th></th>
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<tbody>
<tr>
<td>First</td>
<td>$44 billion</td>
<td>$3.6 billion</td>
</tr>
<tr>
<td>Second</td>
<td>$31 billion</td>
<td>$3.1 billion</td>
</tr>
<tr>
<td>Third</td>
<td>$11 billion</td>
<td>$3.1 billion</td>
</tr>
<tr>
<td>Fourth</td>
<td>$11 billion</td>
<td>$2.6 billion</td>
</tr>
</tbody>
</table>

The corporate system today is very healthy and much smaller than it was a decade ago, with total assets now only 15% of their 2006 level. And almost all of the potential risk has been regulated out of the system: investment rules are much more restrictive and the average capital ratio is three times higher today than in 2006. A loss on the order of magnitude to the one during the financial crisis would require all the corporates to fail, at loss rates of about 50% of total assets. With their current operations and capital, and the current corporate rule, that’s essentially a zero-probability event.

**NCUA’S Long-Term Plan for NCUSIF is Unnecessary**

NCUA’s plan to revise the fund management of the NCUSIF, following on the heels of a similar plan by FDIC is simply not necessary. Unlike FDIC, the current funding system of the NCUSIF has held up very well over the past three decades, despite a banking crisis and a full scale financial crisis. The cooperative structure militates against excessive risk-taking in credit unions, and the one significant risk to NCUSIF that existed a decade ago has been resolved.

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