National Credit Union Share Insurance Fund Stress Testing Results

In order to ensure the National Credit Union Share Insurance Fund (NCUSIF) is adequately funded, the risk presented by the portfolio of credit unions insured by the NCUSIF must be measured. The testing conducted in preparation of this report provides quantified measures of risk to the NCUSIF and a basis for determining the direction of the risk.

Capital in credit unions is the first line of defense to absorb losses. Capital reassures share account holders, creditors, and other stakeholders that an event such as an unexpected surge in losses or an unanticipated deterioration in earnings will not impair the credit union's ability to provide products and services.

Ninety-six percent of natural person credit unions (NPCUs) have capital levels well in excess of the amounts required to be 'well capitalized' according to Prompt Corrective Action (PCA) regulations. However, losses associated with the current deep recession and financial market turmoil have reduced overall capital levels. Since the September 2008 NCUSIF Stress Analysis, NPCUs' total net worth has declined by $2.6 billion, with write downs of capital investments in corporate credit unions (CCUs) accounting for the majority of the decline. The following chart illustrates the changes in NPCU capital levels.

NPCU Equity and PCA Classification (based only on NWR)		
	9/30/08	**6/30/09**
NPCU Net Worth	$89,972,188,888	$87,339,483,231
NPCU Aggregate Net Worth Ratio	11.17%	10.04%
Critically Undercapitalized Less than 2% (units)	12	21
Significantly Undercapitalized 2% to 4%	15	20
Undercapitalized 4% to 6%	46	81
Adequately Capitalized 6% to 7%	66	175
Well Capitalized Over 7%	7,539	7,379

The second line of defense is the NCUSIF. Losses incurred in the resolution of troubled credit unions, increased reserves for NPCU losses, low levels of income on investments, increased share insurance amounts, and high share growth have resulted in a reduction in the NCUSIF equity ratio, as follows.

NCUSIF Accounts		
	9/30/08	**06/30/09**
Insured Shares (based on insured share statutes at the time)	$600,483,560,348	$713,580,497,293
Contributed Capital at full 1% of statutory insured shares	$6,004,835,603	$7,135,804,973
Retained Earnings – Unadjusted for anticipated premium	$1,697,664,797	$1,532,669,032
Total Equity at full 1% of insured shares contributed capital	$7,702,500,400	$8,668,474,005
Equity Ratio (based on fully funded 1% Contributed Capital)	1.283%	1.215%
Reserve for NPCU losses	$128,621,584	$451,141,006

The completed risk analysis applies a number of stress scenarios as well as estimates the impact on NPCUs and the NCUSIF. Overall, the analysis indicates the NCUSIF is sufficient to handle severe financial stresses on the credit union industry. However, the risk presented to the NCUSIF is increasing due to the exposure to potential losses in the corporate credit union system along with shifting asset concentrations and changes in credit union business models.

Continued stresses related to the residential mortgage market and the impact on both NPCUs and CCUs could cause a material increase in the number of credit unions with inadequate levels of capital and subject to Prompt Corrective Action (PCA). Further increases in the number of troubled credit unions will result in stress to NCUA in resolving problems cases as resources will be strained both in terms of Agency manpower to properly supervise the credit unions and a probable reduction in the number of institutions willing and able to absorb the related assets and liabilities.

SUMMARY OF SCENARIOS AND RESULTS

This report updates the September 2008 analysis of the impact of a further distressed real estate market and analysis of the potential CCU system losses. A new stress test completed for this cycle was similar to the Supervisory Capital Assessment Program (SCAP) the U.S. federal banking supervisors applied to the largest bank holding companies in the spring of 2009. The following are highlights from each of the four stress tests:

1. Evaluating potential failures and losses due to the distressed real estate market which includes applying an immediate shock on reserves given a variety of default and loss rates in NPCU real estate portfolios. The test assumed rising levels of defaults on all real estate related loans and rising levels of losses associated with the defaults for credit unions. Additionally, the consensus forecast predicts further increases in the level of defaults. NCUA's 2-year stress scenario resulted in the allocation of $32.5 billion in projected losses leading to the failure of 90 NPCUs and a worst case projected loss exposure to the NCUSIF of $1.4 billion. The number of failures increased when compared to the results as of September 2008.

2. Measuring the risk presented by CCUs consisted of a complete write-off of current NPCU capital investments in CCUs and the impact of an immediate assessment of an estimated Stabilization Fund liability of $7 billion. The analysis resulted in the allocation of $9.3 billion in losses, leading to a projection of 25 NPCU failures presenting a maximum exposure to the NCUSIF of $80 million. The number of failures decreased when compared to the September 2008 results.

3. Evaluating the impact from both the real estate stresses and the CCU system allowed for analysis of the risk layering. As with the prior analysis, the layering of both the real estate and CCU risk on individual NPCUs resulted in a pronounced increase in both the number of failures and the level of losses to the NCUSIF. Combining the 2-year real estate stress scenario with the CCU stress scenarios resulted in a projection of 227 failures and a maximum exposure to the NCUSIF of $6.4 billion. The dollar loss level increased when compared to the September 2008 results.

4. Performing stress testing based upon the Treasury's Supervisory Capital Assessment Program provided a 2-year stress scenario under both an assumed path for the economy (baseline) and a deeper more protracted downturn (more adverse) that included non-real estate loans. This testing provided a measure of a NPCU's capital buffer. This analysis produced an allocation of $32.6 billion in losses resulting in 38 failures with a maximum exposure to the NCUSIF of $577 million using the baseline assumptions. Using the more adverse assumptions, the result was the allocation of $56.4 billion in losses resulting in 519 failures at a maximum exposure of $15.5 billion to the NCUSIF.

IMPLICATIONS FOR THE NCUSIF

All indicators point to a rising number of credit union failures through 2010. Increased levels of failures at some point are expected to result in increased levels of NCUSIF losses due to the reduction in the number of healthy combination partners able to absorb failed credit union assets and liabilities. Lower demand for mergers and acquisitions will likely lead to higher resolution costs and an increased number of liquidations, which require the NCUSIF to maintain higher levels of liquidity. This scenario also warrants a review of the Asset Management and Assistance Center's (AMAC) available resources to handle potentially significantly higher levels of assets under management by NCUA.

The economic recession that began in December 2007 continued through the second quarter of 2009. High levels of unemployment and severe declines in home prices have contributed to a continued increase in loan delinquencies, and particularly mortgage delinquencies. The supply of homes for sale as measured by the inventory/sales ratio remains high and is expected to rise as increased levels of foreclosed homes are put on the market.

The NCUSIF's equity ratio faces multiple adverse consequences during a recession. Historically, share growth surges during a recession, which dilutes the equity ratio. Share growth exceeded 10% for federally insured credit unions in the last three recessions. Share growth in 2008 was 7.71% and is projected to be near 8% for 2009. The increased level of share insurance also reduces the NCUSIF's equity ratio. Reserves are spent to resolve failed credit unions and the level of reserves for potential losses increases. During this recession, the NCUSIF has earned a near zero return on short-term treasuries. This creates an additional layer of risk for the NCUSIF in the form of reduced investment income.

The measurement of maximum loss exposure calculated in this analysis is consistent with the results achieved through the credit risk analysis completed in the prior stress testing. The extreme loss scenarios disclose potential risk to the NCUSIF. However, the entire NCUSIF (contributed capital and retained earnings) covers a very high percentage of loss scenarios.

While potential losses to the NCUSIF resulting from NPCU failures appear manageable, the number of credit unions with inadequate levels of capital and potentially subject to PCA creates supervision and resolution challenges that would require additional changes in how NCUA supervises and examines federally insured credit unions. The table below puts this into perspective, showing the current number of credit unions subject to PCA and the number of credit unions subject to PCA in certain stress scenarios.

	Current June 09	2-Year Real Estate Stress	Corporate Credit Union Stress	Combined RE and Corporate Stress
Net Worth < 0% (Assumed Failures)	7	90	25	227
Critically Undercapitalized 0% to 2%	14	191	13	308
Significantly Undercapitalized 2% to 4%	20	381	55	644
Undercapitalized 4% to 6%	81	715	371	934

RECOMMENDATIONS

All of the recommendations in the prior stress test report have been implemented, including:

- Reclassifying the Fund's entire investment portfolio as available for sale.
- Increasing the level of non-specific reserves for NPCUs to the midpoint of the acceptable range produced by the application of the NCUSIF reserving methodology.
- Increasing levels of staffing, including problem resolution staff.
- Enhancing evaluation of the CCU investments.
- Enhancing supervision of NPCUs with concentrations of real estate loans in states experiencing the greatest declines in real estate values.

As a result of the analysis and conclusions of this stress testing, there are several new recommendations, as follows:

1. Conduct an exercise to determine if the largest NPCUs have sufficient capital buffers to withstand the impact of an economic environment that is more challenging than is currently anticipated. This process would be similar to the Supervisory Capital Assessment Program conducted by the bank supervisors. The results will supplement the data used in developing NCUA's problem case pipeline.

2. Maintain the NCUSIF at the normal operating level of 1.30% of insured shares. Based on the increased level of share insurance, total retained earnings would need to be maintained at over $2.1 billion to cover almost all levels of projected NCUSIF losses in this stress analysis and preserve confidence in the Fund. A premium of $727.5 million would be needed to improve the equity ratio to 1.30% using June 30, 2009 insured shares.

3. Conduct further study of the NCUSIF's normal operating level (NOL) consistent with the NOL Policy, taking into account the unforeseen level of turmoil in economic conditions.[1]

[1] Any increase to the NOL 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, NCUA will issue a report including data supporting the proposal.

4. Increase the level of field staff with advanced problem resolution training to ensure emerging problems are timely resolved.

5. Increase advanced problem resolution guidance to all field staff including a full analysis of the available administrative remedies for troubled credit unions.

SUMMARY

With an equity ratio of near 1.30 percent, the NCUSIF is sufficient to meet anticipated credit union failures considering almost all stress scenarios run. However, all measurements of risk to the NCUSIF are expected to continue to increase over the short-term as the economic environment continues to be adverse and further consolidation increases concentration risk. While the analysis shows the risk from NPCUs is manageable for the NCUSIF, the stress on existing Agency resources will be substantial.