Corporate Credit Union Reserve

Based on NCUA's recently completed analysis of the exposure from the corporate stabilization efforts, the total recorded liability for the stabilization programs increases from $5.98 billion to $6.33 billion. The majority of the liability is associated with the Temporary Corporate Credit Union Share Guarantee Program (TCCUSGP). The analysis of the TCCUSGP liability from prior periods was updated using June 30, 2009 data, resulting in an increase in this portion of the stabilization liability from $4.98 billion to $5.33 billion. The total of the TCCUSGP liability is added to the projected loss on the $1.00 billion Capital Note at U.S. Central Federal Credit Union (U.S. Central) to arrive at the total cost of the corporate stabilization actions taken to date.

<u>Background</u>

The NCUA Board took action on January 28, 2009 to stabilize the corporate credit union system including implementing a temporary guarantee on uninsured shares at corporate credit unions. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* is the applicable accounting standard which requires that financial guarantees are recognized and measured at fair value. Simply stated, the "fair value" should represent what NCUA would have to pay a third party in an arms-length transaction to assume responsibility for the guarantee. Since the type of guarantee provided by NCUA does not contain a market-based premium, NCUA relies upon a valuation probability modeling approach to determine the fair value.

Specific and stable information for the key variables used in the model are not available. Therefore, a forecasting and risk analysis program, or Monte Carlo simulation, is utilized to provide analysis of all of the probable model results. The risk modeling software allows 10,000 trials runs of any set of scenarios. The model produces a distribution of fair value calculation results. NCUA utilizes the 90th percentile fair value as the accounting basis for the estimated liability. A simplified equation for the model is identified below and the key variables are discussed in detail in the next section.

$$\textbf{Fair value of the Share Guarantee} = \textbf{Probability of Default} \times \textbf{Loss given Default} + \textbf{Cost of Capital}$$

Probability of Default: The probability of default is the likelihood that the NCUSIF would have to fulfill the terms of the guarantee. For corporate credit unions that present a very high probability of loss exposure at the most optimistic levels, a 100 probability of default rate was used for those scenarios; otherwise, a range of 1 percent to 25 percent was used for the probability of default, with a most likely probability of 3 to 5 percent. The range was developed by reviewing the history of credit ratings and default rates for financial institutions and bonds.

Loss Given Default: The loss given default is the amount the NCUSIF would have to pay in order to satisfy the claims resulting from the corporate stabilization actions. The NCUSIF's total exposure is the difference between the amount of shares subject to the temporary share guarantee and the value of each participating corporate credit union's assets after the payment of secured creditors and general creditors.

The loss given default has a wide range of possible outcomes. In the worst case, NCUA would simply sell the investments and assets of a corporate credit union at current market values. Alternately, NCUA could borrow funds to pay guaranteed share account holders and hold the investments, reducing the risk to actual credit losses. The losses that would be incurred in holding the investments are difficult to quantify and analysis of the range of results prepared by NCUA staff are used to prepare the possible losses. This analysis includes the PIMCO data.

NCUA utilized the PIMCO valuations, as well as credit ratings for securities not evaluated by PIMCO, along with market price information to evaluate the NCUSIF's exposure for each corporate credit union. For the investments reviewed by PIMCO, the report provides market value information and valuations based upon the projected cash flows of the securities. PIMCO provided information on over 70 percent of the corporate credit union securities. Four values are utilized: (1) the base valuation which PIMCO attributed a 56 percent probability of occurring; (2) a pessimistic value with a 20 percent probability; (3) an optimistic value with a 20 percent probability; and (4) a market value assigned a 4 percent probability.

Cost of Capital: The cost of capital is the return that a third party would expect if they assume the risk of the guarantee and maintain adequate reserves to ensure they were able to fulfill the execution of the guarantee. The amount of capital needed is based upon the estimated exposure to loss. The term of the guarantee and the assumed return on capital impact the determination. NCUA utilized a range of probable rates for the required return on capital based on the cost of corporate debt and normal returns in the financial services industry.

<u>History of the Liability for the TCCUSGP</u>

At the inception of the TCCUSGP in January 2009, a liability of $3.70 billion was established using the investment data corporate credit unions reported in the fall of 2008. In March 2009, after receipt of the analysis of corporate credit union investments conducted by PIMCO and the additional review completed by NCUA staff, the liability was increased to $4.94 billion. In April 2009, a two-year rolling share guarantee was implemented, resulted in a $39.4 million increase in the fair value liability recorded by the NCUSIF, since the term of the guarantee increased from 704 to 729 days. The result was an increase in the TCCUSGP liability to $4.98 billion.

Results of Current Analysis

In August 2009, NCUA engaged PIMCO to provide an updated assessment of fair value and expected loss for specific corporate credit union investments as of June 30, 2009. In addition to the repeat analysis of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO), NCUA obtained analysis of specific commercial mortgage-backed securities (CMBS).

The analysis disclosed the following:

- Only WesCorp presents exposure to the Stabilization Fund using the optimistic valuations with a total exposure of $2.40 billion beyond available capital levels.

- Only WesCorp presents exposure using base valuations with a total exposure beyond available capital levels of $4.14 billion. However, under this scenario, nearly all the U.S. Central Capital Note would be absorbed to cover losses.

In summary, the calculation of the liability fair value for the TCCUSGP is presently calculated at $5.33 billion. With the addition of the $1.00 billion U.S. Central Capital Note, the present total cost of the corporate stabilization program is $6.33 billion. The total will be recorded by the Stabilization Fund, with $1.00 billion currently outstanding in borrowed funds. The statute creating the Stabilization Fund specifies NCUA will assess credit unions based on the level of unpaid borrowed funds, versus the recorded liability.