National Credit Union Share Insurance Fund Assessment Analysis

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The establishment of a premium assessment is really 4 distinct processes: first an estimate of the fund's equity level at a given point in time, second an estimate of how the equity level will trend over the next 6 to 12 months, third a scenario analysis of the impact of different assessment levels on credit unions, and then finally development of a recommendation on the targeted equity level. Each process has variables associated with making those estimates.

First, let's look at determining the equity level at a given point in time. There are 3 major variables to determining the SIF's equity ratio at a point in time: 1) earnings in the fund; 2) insured share growth; and 3) level of loss reserves. The first two items are fairly transparent to credit unions, while the third is less so.

Mary Ann Woodson reports on the earnings every month, and the financials are available on our website. Earnings are fairly stagnant and not able to contribute significantly to retained earnings at this point.

The insured share growth is shown each quarter through the call reports, and credit unions can find that number by simply ordering an aggregate Financial Performance Report off our website as well. Insured shares are growing at almost 11% annualized after the first quarter of the year. Normally, share growth tapers off as the year goes on, so the first quarter's statistics historically have been higher than the overall rate by the end of the year. However, last year the historical trend did not hold true, and insured shares continued to grow significantly throughout the year. Our estimates this year are assuming that the flight to quality will continue through the year similar to 2009.

The third key piece, the reserves, is the item with the highest number of variables impacting the estimates. I believe it is easier to talk about our reserves by pointing out the similarity to a credit union's Allowance for Loan Losses. We have two basic pieces of our reserves: 1) the general reserve that mirrors a credit unions historical loss reserve and 2) specific reserves that would mirror the reserves of estimated losses on an individual troubled loan.

The general reserve is based on our historical loss levels and the amount of assets in each CAMEL rating category. For each rating category, we have a historically based probability of loss for a credit union with that rating. Then we multiply that probability by our average loss experience if that number of credit unions failed. As you can imagine, the probability for a Code 1 is very small and the probability for a Code 5 is very large. As credit unions migrate to lower ratings, the amount of the dollars in that bucket increases, requiring a higher level of general reserves. So using our ALL analogy, it's like an indirect auto portfolio. You have an inherent

historic loss level for indirect auto loans that are rated A,B,C,D, & E; and as the amount of each portfolio grows, the historic reserve related to that portfolio also grows.

For the specific reserves, once a troubled institution looks to be a loss to the NCUSIF, the regions will provide us analytics estimating the loss level. We then establish a specific reserve for that credit union and remove the assets from the general reserve pool. Those estimates are based on a variety of factors including potential merger partners, asset quality, market factors in the trade area, field of membership, and quality of records. Again, back to the ALL analogy, when a credit union is going to foreclose on a property, they will likely start to carry an ALL reserve specifically for that property based on the loan to value, the property's upkeep, costs to market the home, costs of filings, etc. None of those estimates are fixed quantities early in the process, but many of them can be estimated based on the credit unions' experience.

After we derive an estimate of where the equity ratio will fall for a specific time, we then look forward to develop an estimate of where the ratio may be headed over the next 6-to-12 months. We look at the results of our stress testing, the trending in credit union CAMEL ratings, the general health of the credit union system, changes in the economy, and potential credit union failures. One of our key objectives in looking forward is to keep the fund above the 1% mark so that credit unions will not have to impair their contributed capital deposit in the NCUSIF. The closer we get to the 1.0%, the higher the probability that accounting practitioners, lenders, and other interested parties will look at that asset as being impaired.

Once we determine the estimated equity level, we then look at a variety of scenarios to determine the impact of an assessment on credit unions. Part of that scenario analysis includes looking at the impact on aggregate and individual credit union earnings levels, the migration of credit unions into lower PCA categories due to the assessments, and the impact on aggregate net worth levels.

Finally, using the forward view of the equity ratio and the impact of assessments on credit unions, we then develop recommendations for the Board on whether to bring the ratio back up to our Normal Operating Level of 1.3%, to a level between 1.2 and 1.3%, or to use our new authorities and drop below the 1.2% and restore the fund over an 8-year period. A consistent message from NCUA over the past year has been that we did not want to use our 8-year restoration period prematurely. As long as the trends were still on a downward slope, requiring that our reserves continue to increase to meet full and fair disclosure requirements, we did not want to take the chance of breaking the 1%.

Part of our analytics going forward will be to look at the industry trends, the continued growth in insured shares, the migration of credit unions to lower CAMEL ratings, and the potential for significant losses in specific troubled credit unions.

We are seeing positive signs for the first quarter that may translate into lower general reserve requirements later in the year. The growth of Code 3s and Code 4s seems to have slowed. Aggregate industry earnings are better than expected, delinquency and charge-offs are lower than year-end levels. So that might translate into reductions in the number of 3s and 4s towards the end of the year. But one quarter does not make a trend, and so we really need to see what the

June 30th numbers reveal before we can make a determination of the need for and the amount of a premium assessment.

We should also have more concrete information on the potential for significant losses in some of our larger troubled credit unions towards the end of the summer. There is a potential that our provision for loss expense estimates at the beginning of 2010 will not be sufficient to cover those specific reserves.