**NCUA Board Meeting Transcript Excerpt**
**July 23, 2015**

**2. NCUA Guaranteed Notes Performance Report, and Corporate Stabilization Fund Assessment Determination.**

**Chairman Matz:** The next item is the NCUA Guaranteed Notes Performance Report and Corporate Stabilization Fund Assessment Determination. Staff presenting: Larry Fazio, Director, Office of Examination & Insurance; and Anthony Cappetta, NGN Supervisor. Good morning.

**Larry Fazio:** Good morning, Chairman Matz, Vice Chairman Metsger and Board Member McWatters. Anthony and I are here to provide the Board an update on the corporate system resolution costs and performance of the related legacy assets securitized in the NCUA guaranteed notes.

Let me start off by saying there is no need for an assessment in 2015. In addition, if the latest projections hold true, there will be no need for any additional assessments and an increasing likelihood of a refund to credit unions at some point in the future. I must remind everyone that this is based on point-in-time projections using the best available modeling techniques and assumptions. Actual results can vary materially from projections due to changes in economic conditions and other factors.

We'll now walk through additional information to deconstruct the performance statistics and discuss future considerations related to the period leading to where the NGNs start to mature and we wind down the Stabilization Fund. So if we go to slide two, we have some performance summary statistics here on the legacy assets and the NGNs.

As you can see in the first line, the unpaid principal balance of the legacy assets collateralizing the NGNs has declined to $21 billion as of the end of 2014. This is due to both principal repayments and realized defaults. For context, back in 2010 the unpaid principal balance was over $43 billion. So we've seen a significant amortization down of the size of the position.

On the second line, we can see the legacy assets' net realizable value is now $18 billion as of the end of 2014. This number is calculated based on proprietary modeling conducted by Blackrock. We sometimes refer to it as an intrinsic value. So if you hear net realizable value or intrinsic value those mean the same thing. It represents Blackrock's estimates of the timing and amount of cash flows on the legacy assets discounted at the NGN funding rate.

On the third line, we have for information for stakeholders the market value of the legacy assets, which is at $16.7 billion as of the end of the year. I would also note that neither the net realizable value nor the market value include approximately $930 million in cash and other investments that has accumulated in the NGN trusts that are also available to make principal and interest payments to the NGN investors.

So if we go to the next line, the NGN investor balance, that's the outstanding balance owed to the NGN investors and guaranteed by NCUA, and that has similarly decreased with principal payments. They amortize in concert with the underlying legacy assets. And that's down to $15.2 billion. Thus you can see the NGNs remain very well collateralized.

With the improvements in the economy, both the NRV and the market value of the legacy assets, along with the cash in the trusts, exceed the amount owed to investors by over $2 billion. However, as the legacy assets and cash in the trust are securing the NGNs, they are not accessible until the NGN investors are fully paid off. I will discuss the significance of this in more detail later in the presentation.

Going to the next line, realized legacy asset defaults, those are the actual defaults or realized losses on the legacy assets that are inside the NGN program, and they now total almost $8 billion, $7.9 billion, as of the end of 2014.

The final line gives the latest projections on the total lifetime legacy asset defaults, and it's a range of $10.5 billion to $11.3 billion. And so I would note the significance of the last two line items. We can see from that that as of the end of 2014 over 70 percent of the total projected defaults have already been realized. These are real losses, the majority of which are real losses. They're not accounting projections anymore.

If we turn to the next slide, this slide illustrates how the legacy asset performance translates into cost to credit unions in Stabilization Fund assessments. If you recall from the previous slide, the most recent estimate of total projected legacy asset defaults ranged from $10.5 billion to $11.3 billion in the last line on the previous slide. However, the first line in this slide shows the total projected resolution costs as of the end of the year to range from $7.9 billion to $9.7 billion.

Costs are around $2 billion lower than defaults on the underlying securities because of direct and indirect legal settlements as well as what we call excess spread between the lower NGN funding rate and the underlying yield on the legacy assets, which offset some of the defaults in the costs. I would also remind everyone that we have never built potential legal recoveries into our projections, as they are inherently inestimable.

Thus, in addition to preventing losses to the credit union system on the order of $40 billion when we took the action to stabilize and resolve the situation and protecting the credit union system as we know it, our resolution and funding mechanism through the NGNs provided a beneficial spread and preserved several additional billion dollars in legal upside.

So if you go through the math on this slide, the next line shows the depleted corporate capital, member capital in the corporate credit unions that have failed. It also shows, so if you just do the math, the first line minus the corporate capital is the projected Stabilization Fund cost, and then you deduct the assessments paid to date of $4.8 billion, and that gets you to the net projected remaining assessments of negative $2.5 billion to negative $0.7 billion. The fact that those net projected remaining assessments are negative indicates that there's a potential for a refund and some recovery of member capital depleted in the particular asset management estates for the corporates.

I want to note a couple of things about the improvements in the projections. First of all, total costs and resulting assessments are significantly lower than original estimates due to much better than expected recovery in the housing market, a sustained low interest rate environment and legal recoveries that account for almost a third of the improvement in the net projected assessments.

Total assessments of $4.8 billion were driven by cash and contingent liquidity needs of the Stabilization Fund. There were large obligations of the estates maturing through 2012 that had to be repaid. Even with the assessments, the agency had to borrow from its $6 billion Treasury line, with the outstanding balance peaking at $5.1 billion in 2012.

The purpose of the assessment in 2013 was to restore a bit more of the available line with Treasury, given the potential for unexpected liquidity needs. It was only after the 2013 assessment was collected that we were successful in the JPMorgan legal settlement, the proceeds of which allowed us to further pay down the Treasury borrowing.

So if we turn to slide three, I wanted to give the Board a little bit more insight into how we calculate the range of net remaining assessments. And so you can see here we dimension the range that we come up with for the net remaining assessments basically on two spectrums. One is on the underlying default or credit loss scenarios. I think of that as sort of an optimistic and a pessimistic credit loss scenario. And then a disposition methodology, do we end up holding all the securities to try to fully realize the entire intrinsic value over the next 30 years, or do we monetize them in a more timely and orderly, but still orderly, fashion and have slightly lower recoveries but less risk and less uncertainty?

And so you see that's how we dimension this. You can see that the ends of the ranges are highlighted in the orange boxes. That was the negative $2.5 billion to negative $0.7 billion net projected remaining assessments. Those are sort of the goalposts of the range, and they're a combination in the first sense, in the strong credit scenario, of trying to realize full intrinsic value, but over a very long period of time. That's both optimistic scenarios, and that's the $2.5 billion potential net refund. The $700 million is a more pessimistic credit scenario and a more prompt, orderly liquidation of the securities.

I want to repeat, though, these estimates are, again, based on projections. The assessment range is generated using projected legacy asset cash flows, and actual performance can, again, vary from projections, given changes in the economy and other exogenous factors.

I would also note that the fact that we have a negative projected remaining assessment range does not mean there are any actual funds yet available to refund to credit unions now. Again, as I noted, the underlying legacy assets are not available to NCUA to access, as they are securing the NGNs, which is my segue into the next slide.

The point of slide four is to give you a sense of how we are projecting the NGN payoffs and final maturities to occur. What you see here on the slide above the line is each NGN deal when it's projected to either naturally pay off because of the cash flows of the underlying legacy assets, so the investors would have been paid off by that, or it reaches its hard final maturity. Most of the NGN deals had a 10-year hard final. A few had seven years. And so you see some occurring in 2017 because they had seven years. The rest are in 2020 and 2021 because they had 10-year hard finals.

And so that's what's above the line. The amount above the line, the magnitude above the line represents the projected unpaid principal balance of the underlying legacy assets that we think will be remaining at that point in time. That doesn't mean that's what we'll necessarily realize in terms of cash. It's just what the outstanding principal balance is at that point.

What you see below the line in the blue bars represent guarantee payments. So NCUA will have to make some what we call hard final maturity payments because of the 10-year hard final or 7-year hard final in the one deal's case. The NGN legacy assets wouldn't have fully paid off the NGN investors at that point, but the NGN security reaches its hard final maturity, and we have to put money in to pay off the investors. But that then also frees up the legacy assets for us to access.

I want to note that the first deal, the one on the far left of the slide, the sort of --

**Vice Chairman Metsger:** Pink.

**Larry Fazio:** Yes, it's orange on my printout, but it looks pinkish on the screen there, the 2011-R6 1A, that's expected to pay off naturally. It's not reaching its hard final. It's paying off on its own in December, actually, of this year. So we're actually in the process now of doing the analysis, which I'm going to talk about here in a second of how we're going to handle these assets.

So let's go to the next slide, slide five. I also want to give the Board a sense of how we can think about the different strategies to manage these assets once they're available for us, these legacy assets, once they're available for us to access. So you have two different graphs here. The top chart represents what would happen if we liquidated all of the securities, in an orderly fashion, but liquidated all of the securities as they became accessible to us. That is, once the NGN investors had been paid off and those assets became accessible.

What you can see here is, and I want everyone to keep in mind, NCUA still owes the US Treasury $2.6 billion. That's on both charts it's represented by the dotted green line. So that's the starting point, $2.6 billion, on the far left side of the graph. All available proceeds must first be used to repay the Treasury borrowings and any other senior obligations of the Fund in the estates before any refund could occur. That's just the principle behind this.

So the top graph shows the projections for the timing and amount of proceeds based on selling legacy assets as they become available. So I'd like to point out a couple of things.

First, selling the assets as they become available would allow us to repay Treasury by the end of 2017. So it would take until 2017 to repay Treasury, but that's when that would be projected to occur. The next NGN maturities don't actually happen until 2020 and 2021, which is when the

NGN program would be concluded, and any funds at that point in time from the sale of the legacy assets, which would be represented by the black, the dark black line, could then be refunded to credit unions. So the refund still wouldn't occur until 2020, 2021.

This process on that slide would result in certainty as to the recovery amount, an end to the need to oversee the legacy assets, and the refund would happen faster. However, the projected refund would be lower in that case, which takes us to the next slide, or the next chart below, I'm sorry, this slide but the next chart.

So the bottom graph shows the expected cash flows of the legacy assets from holding them until they naturally pay down. If you notice, in this scenario Treasury is not repaid until 2025, and no refund would be available until after then. Further, it would take until 2038 to realize all the underlying cash flows. So refunds would be spread out over the 13 years following 2025. Uncertainty and risk about realizing the projected values would remain for a long period, though based on current projections the nominal total amount of any refund would be greater.

So, going to slide six, I want to point out a couple of things. First of all, NCUA has a duty to make best efforts to repay Treasury as soon as practical, but Treasury understands we're going to do so in an orderly way. We're not going to necessarily do it in a way that causes inordinate losses on the sale of securities.

The two illustrations on the prior slide were represent sort of the ends of the spectrum of disposition strategy -- sell everything as they become available, hold everything. The reality will be some mix of the two. Staff is performing and will be performing a bond-by-bond analysis as these securities become available for us to manage and access to determine the best strategy for each security.

We'll need to consider such factors as the difference between the market price and what our projected intrinsic or net realizable value is, what the risks involved with holding the security are over the long term, considerations relative to legal remedies, both legal remedies in process as well as potential future legal remedies that may remain at that point, and then a host of other considerations, to develop an optimum monetization strategy for the bonds as they become available. And, again, that only occurs once the NGN investors have been repaid.

So simply to recap, projections currently indicate no significant cash needs for the Stabilization Fund until 2017. The performance of the legacy assets and NGNs continue to improve. Projections do indicate that some legacy assets will be available to manage beginning as soon as December of this year. I would remind everyone again, Treasury borrowings outstanding remain at $2.6 billion and must be repaid before refunds could occur. NCUA always pays its debts.

There are no projected remaining assessments and an increasing probability of a refund to credit unions, although not until at least 2021. And, again, all of the above projections are based on point-in-time estimates that could be materially affected by changes in future economic conditions.

More details are available on the NGN program information and corporate system resolution costs pages on our website, including a question-and-answer document related to what we just discussed. The latest Q&A gives significant clarifications on this.

I'd be happy to answer any questions you have at this time.

**Chairman Matz:** Thanks, Larry. This is great news, and better than we ever dared to hope for in 2009 when we were trying to figure out how we were going to deal with the crisis that was upon us and we were concerned that we might lose 2,000 consumer credit unions if the losses -- $33 billion in losses -- cascaded through the system.

I just want to reiterate that we still have 15 lawsuits pending against the Wall Street firms that helped create this crisis, and we don't know what those recoveries will be. But we have recovered $1.75 billion to date. We are optimistic that we will add to that. So, in addition to the recovering economy, we can expect additional offsets to the costs.

You indicated that some of the NGNs will be maturing, and I'm wondering how you plan to use the cash from those that mature before the Stabilization Fund expires in 2021.

**Larry Fazio:** So, to the extent that we monetize those assets as they become accessible to us, the first priority needs to be to repay Treasury. That's our obligation and in fact the law for the Stabilization Fund, as we can't make a refund until we've repaid any outstanding borrowings to Treasury. So that would be the first priority.

**Chairman Matz:** Okay. Periodically I continue to read articles and statements by critics who claim that the five failed corporates would have survived without NCUA intervention. So I'm just wondering if you could once again respond to that.

**Larry Fazio:** So, the best way to think about that is in addition to the fact that they would've been completely dependent on government assistance even till today from a liquidity and an accounting value of capital standpoint, if you look at the economic projections, even with the improved projections to date, none of the corporates that failed would've been economically viable.

There's maybe two estates right now that'll have a projected small recovery on the depleted capital, but it wouldn't have been enough for that corporate credit union to have been a viable entity, being sufficiently capitalized and certainly relative to the risk of having held these legacy assets to maturity. I would also point out that the corporates would not have benefited from the excess spread that was built into the NGN funding structure, because of our full faith and credit status we got a much more favorable funding rate on that, and that offsets the costs significantly, as well.

**Chairman Matz:** Thank you. I wish we could once and for all dispel that myth and invite anyone who still believes it to come in and get your briefing.

**Larry Fazio:** Sure.

**Chairman Matz:** Board Member McWatters?

**Board Member McWatters:** Thank you. Let's go to slide two, if we could. That box in the lower right-hand corner seems to be the key box in this entire slide deck showing the range of potential refunds from $700 million to $2.5 billion. Now, I think on the next slide you go into some detail trying to unpack that, but I thought it might be helpful to do that just at the table.

So when I look at the $700 million to $2.5 billion refund, it seems to me one underlying assumption is that we continue with a healthy economy. This does not assume recession. It does not assume financial meltdown. It does not assume a housing problem.

**Larry Fazio:** Yes, could we turn to the next slide?

**Board Member McWatters:** Sure.

**Larry Fazio:** So, again, we do dimension it a little bit on a credit loss spectrum.

**Board Member McWatters:** Right.

**Larry Fazio:** But it's not a recession or a severe recession. It's a slightly elevated or slightly pessimistic credit scenario based on the current good economy.

**Board Member McWatters:** Based on the current good economy, so --

**Larry Fazio:** Based on the current good economy. So you're right that it doesn't factor in a severe recession or even a recession.

**Board Member McWatters:** Okay. So people thinking about a refund need to keep this in mind. This is not a guarantee or anything approaching a guarantee.

**Larry Fazio:** That would go back to my grandfather, who has a farmer's old saying, "don't count your chickens until they're hatched." So until we actually have the money in hand --

**Board Member McWatters:** I think we had the same grandfather. I didn't know we were related. Okay, so one underlying assumption is a good economy. Now, the low end of the range, the $700 million, it seems like that's predicated on the orderly disposition of the legacy assets when the NGNs are repaid.

**Larry Fazio:** That's correct.

**Board Member McWatters:** In other words, it's not a hold to maturity strategy but an orderly liquidation, not necessarily a fire sale, let's sell it all today in the market, but orderly liquidation. And the high end, the $2.5 billion, in addition to assuming a good economy, is based upon the Blackrock proprietary NRV, assuming hold to maturity strategy.

**Larry Fazio:** Yes, and baked into that sort of hold-to-maturity strategy is a preferential funding rate, the full faith and credit funding rate, which is not really a market reality.

**Board Member McWatters:** Yes. So one thing that I want people to think about is that the range is somewhat dependent upon what is done with the legacy assets. And there are some people may say sell them, I'd rather take my share of the $700 million. Other people say hold them, I want to take my share of the $2.5 billion, assuming these are the real numbers.

So you and I spoke briefly about a strategy of resecuritizing the legacy assets into marketable securities and then distributing the marketable securities to the stakeholders so someone who wants to exit and take their share of the $700 million can sell the marketable security and someone who says you know, this is a pretty good return, I think I'll just hold on to these marketable securities, take my share of the $2.5 billion, if it turns out to be the case, as, of course, the market could collapse while they're holding it and they get a lot less than that. Do you have any comments on that that would be helpful?

**Larry Fazio:** So, if we go back to slide six, so that's sort of why we have the sell/hold/resecuritize line up there. One way to monetize the assets, how we monetized, raised funds with the NGNs, was to resecuritize the legacy assets. So you could replicate that process again at the end of the life of the NGNs, the current NGNs.

A couple of things that I would point out about that. If we were going to do that, it would only be after we've repaid Treasury.

**Board Member McWatters:** Absolutely.

**Larry Fazio:** So we couldn't tie up the legacy assets in a new set of securities and then not repay Treasury. So we'd have to monetize enough assets to at least repay Treasury. Then what's left over, which would represent the refund part to credit unions, theoretically we could securitize them. There'd be costs associated with that, and we would have to explore and are exploring, actually, as part of our due diligence around all of this process, whether or not we legally could do a distribution in kind instead of a cash refund to credit unions, all the other complications and considerations that have to go into that.

But obviously in terms of the theory, the intuitive appeal is credit unions who want their, sort of, money now can sell that security into the marketplace and take their money and move on, and others who want to ride it out and see if they can get a better value over time could hang on to their piece.

**Board Member McWatters:** Right, it affords choice.

**Larry Fazio:** Yes.

**Board Member McWatters:** The only other question or comment I have is on slide five. And I look at slide five, Larry, and I must admit it's sort of a throwback to taking the SAT, or the LSAT, that when you look at something like that and you remember that when you turn the page in your test booklet and you had 14 seconds to understand this slide, it's still -- that's an excellent work product, but it takes me more than 14 seconds. But I appreciate it very much.

**Larry Fazio:** Okay.

**Chairman Matz:** Vice Chairman?

**Vice Chairman Metsger:** Yes, I'll stay with slide five. I notice at the bottom it says confidential, internal use only. I just wanted to let you know it's no longer confidential. Just looking ahead and following up on what Board Member McWatters said in terms of looking at disposition strategy going forward, I think it's very creative what Mark said about in terms of a way to potentially deal with credit unions who want both ends of the spectrum. That might be something we want to explore.

But it would seem to me that resecuritizing them, should we at that time, and of course none of us will be here for that, just from a policy standpoint wouldn't seem to be the right policy in terms of resecuritizing for us to hold. I mean, we're not an investment bank. So it would either be a cash distribution or, as Mark suggested, some way, if there's value, in which that value can be extended back to the credit unions, rather than for us to hold them would seem, from a policy standpoint, the best way to go.

**Larry Fazio:** Yes, we're not in the business of reinvesting failed credit union assets. I mean, that's not what we're supposed to do from a policy standpoint. Our job is to do an orderly liquidation. And, of course, with the size and scope of the corporate crisis we needed the NGN process to achieve that. But when we get to the point in time where these are available to access, it's a much smaller problem, and we don't need to be managing those for the next 20 or 30 years.

I would point out if we did resecuritize them, back to that point, they wouldn't be guaranteed by NCUA. NCUA wouldn't be involved at all at that point. We would set it up, if we go down that path, we'd set it up as a trust with a trustee security, and we'd be out of it at that point. So you're right, we shouldn't be involved in trying to manage these over the long haul.

**Vice Chairman Metsger:** Well, I just think it's important to clarify so no one gets the misimpression that we're going to continue to hold for them, that it would only be in terms of how best to reconvey whatever assets were remaining to those who have a stake in them in the credit union industry. I have no other questions. Anthony, thanks so much for all your help today. It was really great.

**Chairman Matz:** Thank you very much.